

Interview with Arabia Business

Hedges cut down to size

by Soren Billing and Tamara Walid on Thursday, 20 November 2008

This year's Christmas parties in Mayfair, London's hedge fund district, may see fewer corks popping and more job hunting taking place. Yet, as Soren Billing reports, the industry is putting on a brave face.

Hedge funds, once touted as a diversification tool for the very wealthy, have been unable to escape the turmoil in financial markets. They lost \$100bn of assets in October as investors, squeezed by higher borrowing costs and tumbling markets, pulled out, according to research from Singapore-based hedge fund research company EurekaHedge.

Citigroup predicts hedge funds' assets will fall to \$1 trillion by the middle of next year, a decline of almost 50 percent from their peak in June.

This humbling of the industry has helped the investors in terms of getting transparency and getting the managers to work with you.

"We're predicting anywhere between a 15 to 30 percent contraction in the industry. Part of that has to do with deleveraging and part of it has to do with managers meeting redemptions," says Bill Bonde, senior vice president and co-head of hedge funds at ING Alternative Investment Management in New York.

Today, there are around 8000 hedge fund managers around the world, but the top 100 funds hold about 70 percent, or \$1.4 trillion, of total assets.

"Owing to redemptions in the industry, we're going to see a lot of smaller hedge funds closing down," Bonde says.

Hedge fund managers who are far below their high water mark may also struggle. Funds that apply a high water mark to investors' money only pay the fund manager a performance fee when the value of the fund is higher than its previous greatest value. The manager must bring it back above the previous high before receiving a performance fee again.

"Managers who are deep below their high water mark may close their doors. Those that don't won't be paid a performance fee, so that will actually be good for investors," Bonde says.

Some have argued that the situation could be more serious than that, calling the current economic downturn "the death of the hedge fund".

Investors may be less willing to pay fund managers' sky high fees - sometimes up to 20 percent of the fund's profit - in the future, if they are unable to preserve capital when times get tough.

People had, after all, been discussing the credit crisis for months before markets began to tumble, giving fund managers plenty of time to shift their positions, critics say.

"I don't think people could have predicted how quickly and how dramatic [the market] moved," Bonde says. He believes two events in particular served as catalysts for the current crisis, and that neither of them could have been foreseen: the US government's bailout of mortgage giants Fannie Mae and Freddie Mac, in which shareholders were all but wiped out, and the Federal Reserve's decision to let Lehman Brothers fall.

"A lot of investors had preferred financial convertible stock in Fannie and Freddie; municipalities, mom and pops, etc. So there was a bit of a line drawn in the sand there," Bonde says.

"I think one of the things about the Lehman collapse is that there was a lack of understanding at the regulatory level and at the government level of the interconnectedness of the existing financial institutions," says Paul Tiranno, vice president and head of Operational Due Diligence at ING Alternative Investment Management in New York. "When Lehman was allowed to default, I think it started the panic that we're still feeling now."

A shakeout in the industry may be bad news for the world's 8000 hedge fund managers, but when the market stabilizes, the firms that remain may find themselves in a stronger position than they were in before the crisis.

"The surviving funds are going to have far more talented people on them," Tiranno says. "I think this humbling of the hedge fund industry has certainly helped the investors in terms of getting transparency and getting the managers to work with you. We may also see a longer calculation period of performance fees, as opposed to just a one-year calculation period."

Hedge fund managers who end up leaving the industry for good could, in the long run, be a boon for the wider economy.

"Many of those people are going to end up back in the real economy. So you're going to have an inflow of people with a solid understanding of finance and industrial principles," Tiranno says. "You're going to see an upgrade of the level of understanding of the way the financial markets work throughout the real economy as a result of the [hedge fund] lay offs we have seen in the last few months."

Hedge funds have been slow to gain traction with Gulf investors, partly due to their practice of being highly leveraged and of frequently short selling stocks - that is, selling borrowed shares in the hope that their value will decline. Islam prohibits the sale of anything a person does not already own.

Short selling is banned in all Gulf markets except for on the Nasdaq Dubai (formerly the Dubai International Financial Exchange), but some funds say they are able to short the market by using equity swaps.

Kamal Fayad, managing director of Evolvence Capital's Middle East and North Africa-focused hedge fund, says a lack of hedging instruments remains a problem.

"There are no regulated futures on a lot of these markets. Today it's very hard to in any way hedge yourself in most of the GCC and MENA region. There is no index that you can easily short," Fayad, who has around \$50m in assets under management, says.

Lack of transparency makes the market more challenging but also more interesting, he adds. "If you have a perfect market, which is well arbitrated, we are bored and we don't

make money," he laughs.

The fund is currently "slightly below" \$50m due to redemptions by clients needing to deleverage. "But we have a lot of soft commitments for the beginning of next year," Fayad says.

Others aren't doing so well. "If I look at the performance of the competition, we are almost the last man standing," he says.

Still, hedge fund managers seem to be banking on the fact that there will be plenty of demand from Gulf investors in the future.

Earlier this month, Brevan Howard Asset Management, Europe's largest single-manager hedge fund company with around \$26bn under management, listed its BH Macro and BH Global funds on the Nasdaq Dubai.

Last week, Pharos Financial Advisors, a specialist emerging markets fund manager with a focus on Russia, was granted a license by the Dubai Financial Services Authority (DFSA) to operate as an authorized firm within the Dubai International Financial Centre (DIFC).

"The hedge fund industry... is going in reverse so there are fewer funds being created," says Pharos Financial Group chief executive Peter Halloran.

"But we're an existing fund and we see it as an opportunity, as we saw Russia a decade ago as an opportunity. Once it gets going again it'll be a fantastic opportunity to make money."