TheNational

# Credit crisis circles financial sharks

Sara Hamdan

Last Updated: November 30. 2008 11:27PM UAE / November 30. 2008 7:27PM GMT

For the past 20 years or more, hedge funds have been the sharks of the financial world, fast-moving, largely invisible and deadly for anyone who gets on the wrong side of one. The current crisis would seem tailor-made for them, as stock markets gyrate and assets halve in value. The trouble is, many of the funds are in no fit state to take advantage of the situation.

A good number have gone out of business. With hedge fund numbers dropping for the fifth month in a row, the US$1.7 trillion (Dh6.24 trillion) industry is struggling though its worst period in eight years as declines in stocks and commodity prices around the world have led to steady investment losses.

Hedge funds are private, largely unregulated pools of capital whose managers buy or sell any assets, bet on falling as well as rising prices and participate substantially in profits from money invested. They typically charge fees of 2 per cent of assets and 20 per cent of investment profits.

They rode the boom better than anybody else, avoiding scrutiny from regulators and earning colossal fortunes for their staff. But the squeeze has been sudden and brutal. With the effective end of the investment banking model that provided prime brokerage to hedge funds – allowing them to borrow cheaply to buy shares or other assets – they found themselves having to repay those debts. As assets fell in value, they were able to raise less money than they thought to repay their loans, so they had to sell more assets. It became a vicious cycle. In effect, many hedge funds were not hedged at all.

To make matters worse, many customers decided that they wanted their money back. About $62.7 billion was withdrawn from funds in October, according to Singapore-based Eurekahedge, while analysts from Citigroup said that assets were expected to fall to about $1 trillion by the middle of next year.

While hedge funds have held up better than actively managed mutual funds or index-based investments, losses this year are almost certain to be the biggest on record. US global equity mutual funds fell by an average of 39 per cent in the first 10 months of the year, according to data compiled by Bloomberg. The Standard & Poor’s 500 Index was down 34 per cent. The hedge fund industry’s only unprofitable year was 2002, when the HFRI index shed 1.45 per cent and the S&P 500 tumbled 23 per cent. So is this the end for hedge funds?

“I don’t think the hedge fund model is broken,” said Jaeson Dubrovay, head of the $19bn hedge fund group NEPC. “We just need to loosen the credit spigots to get the system working again. However, we don’t anticipate that they will be loosened in any way like they were before.”

Some hedge funds have been unable to cope. About 350 closed down in the first half of this year according to Hedge Fund Research. Many of those still in existence are joining the long queue of fund managers eager to tap liquidity and court regional investors in the Gulf.

Pharos Financial Advisors, part of the Pharos Financial Group, a specialist emerging-markets fund, was granted a licence by the Dubai Financial Services Authority two weeks ago to operate as an authorised firm within the Dubai International Financial Centre.

“Our move to the DIFC was an easy, strategic decision given our expectation that the need for quality asset management in the GCC will grow substantially over the next decade,” said Peter Halloran, the firm’s chief executive. “Already, we have seen tremendous appetite from GCC investors for our Russian-focused investment opportunities.”

Founded in 1997 by Mr Halloran with seed capital from Soros Fund Management and CS First Boston, Pharos runs three funds focusing on Russia and CIS countries, including the Pharos Russia Fund, the Pharos Small Cap Fund and the Pharos Gas Investment Fund.

Mr Halloran said Pharos’s plans for navigating through this difficult period have included shrinking the firm’s balance sheet, not borrowing funds and changing investment strategies in accordance with increased market volatility.

“It’s more difficult to raise funds now, that’s the environment we’re in,” said Mr Halloran. “The pool has shrunken dramatically, [but this] makes our market share a lot larger because we have a lot of competition going out of business and discrediting themselves with poor performance.”

Mr Halloran believes this is the right time to forge ahead with plans to enter the GCC market.

“Given the slowdown in the market, we hold a long-term view [for the region] which is positive. We’d like to invest in these markets directly and launch a MENA fund down the line.”

Though generally optimistic on prospects in the region, Mr Halloran is waiting for global markets to settle down to see results.

“Market volatility is causing hedge funds to implode,” he said. “Credit markets haven’t stabilised so there continues to be pressure [for the industry].”

The money world is entering a period of deleveraging, which also complicates matters for hedge funds, which have tended to rely heavily on leveraging strategies.

“Full deleveraging will probably last a year; it started a year ago for the smart ones and six months ago for every other institution,” said Mr Halloran. “We still have another leg of deleveraging to go.”

Hedge funds fell an average of 5.4 per cent last month, according to the HFRI Fund Weighted Composite Index compiled by Hedge Fund Research, showcasing the longest losing streak since HFRI started the index in 1990.

“These are difficult times to try raising funds, but institutional investors are always looking for opportunities in emerging markets and there will be great ones in the BRIC [Brazil, Russia, India and China] countries in 2009,” said Nick Savastano of Invesco Asset Management Limited when asked about why a Russian-focused hedge fund firm should set up shop in the Gulf when the global industry is facing such difficulties.

BH Global and BH Macro, two London Stock Exchange (LSE)-listed closed-ended feeder funds managed by Brevan Howard, listed on Nasdaq Dubai this month in the hope of broadening the firm’s investor base.

“We chose Dubai because we can operate in the Gulf time zone and tap the rising population of potential investors; also, the regulatory environment is quite similar to that in London so we haven’t had to enter in a completely different set of conditions and regimes,” said Lord Turnbull, the chairman of BH Global.

The US dollar-denominated share classes for both companies have been listed on Nasdaq Dubai in addition to listings on the Bermuda Stock Exchange and the LSE.

No additional capital raising is being undertaken and no new securities are being issued by either company in connection with the listing on Nasdaq Dubai.

Ian Plenderleith, the chairman of BH Macro, added that despite the “terrific upheaval” in the global financial world, there’s still a need for active, skilled investment-management services, particularly for the hedge fund industry.

“The shake-out shows that it’s a demanding business; that’s why we’re in the Gulf, to offer opportunities to a wider audience,” said Mr Plenderleith.

He added that with Nasdaq Dubai's strategic position between western Europe and East Asia, and the exchange's close links to investors in its own region and around the world, additional investor interest is anticipated.

Calls for the regulation of the highly leveraged world of hedge funds are coming into play as hedge fund managers are braced for next redemption day, later this week, although Mr Halloran believes regulation of prime brokers needs to be part of the mix in order to have more effective game rules.

"Regulations need to go not to hedge funds, but to prime brokers who give out the money and see the book of the hedge fund," he said. "You already have access to everything you want to know for hedge funds."

The trouble is, most of it is bad news.

---