Learning the lessons from the past

As the hedge fund industry has evolved since 1990 it has had to learn a series of important lessons

By Niki Natarajan

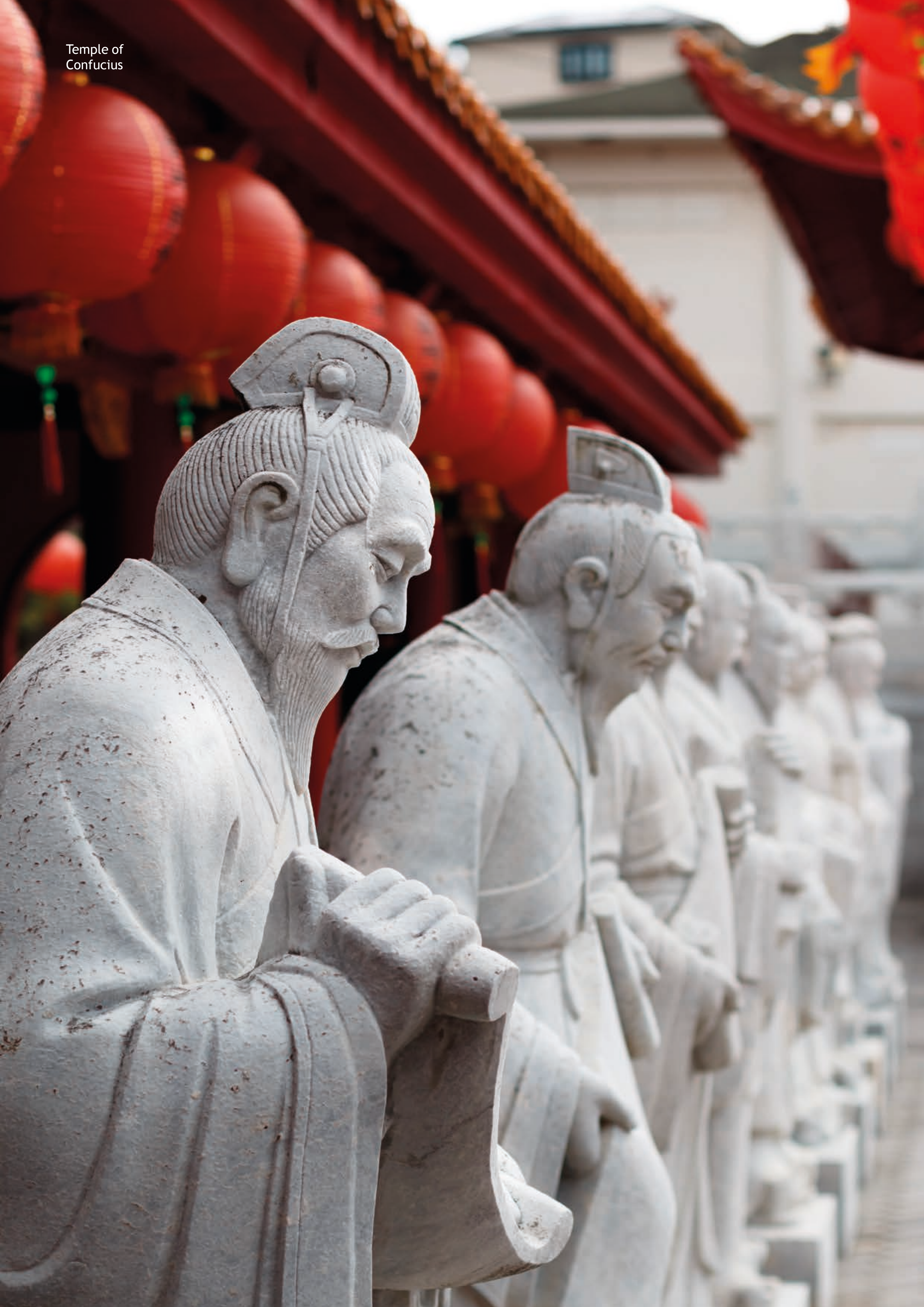
Confucius said, "Study the past, if you would divine the future". If he was right, then what should we study to prepare for the future? Are there lessons the long-only world can teach the hedge fund industry as it enters a new 'retail' era with liquid alternatives? What feedback can the hedge fund industry use from 'failures' such as Long Term Capital Management, Bear Stearns, Bernard Madoff and Amaranth Advisors, among others, as it moves forward?

Regulators are working overtime trying to interpret their solutions to many of the 'lessons' that the various credit crunches, liquidity mismatches and counterparty risks, to name but a few, have taught us, to make banking and investing more 'safe' for investors.

But might their zeal to avoid the past be creating problems in the future? Is the availability heuristic—a behavioural bias that relies on using only the most readily available information to make decisions about the future—driving decisions without considering that there might be data further back in the archives?

What are the top 10 lessons from the last 25 years, and has the industry learned them?

Temple of
Confucius



Lesson 1
Liquidity — available in theory, but is it there in practice?

Selling is often harder than buying. In the past, liquidity mismatching in portfolios was too often overlooked — that was, until the aftermath of it drying up. Today, the mantra is liquidity, liquidity, liquidity, and yet precious returns can of course be lost if that liquidity is not really required.

As underlying strategies are applied to more liquid onshore structures, often via the use of derivatives, an important question to ask is: 'In the event of needing it, will it be available?'

Roger Lowenstein, author of *When Genius Failed*, and of an essay in *The New York Times* September 2008 entitled: *Long Term Capital: It's a Short-Term Memory*, has pointed out that it may not be. "The belief that one can get safely out of a 'liquid' market is one of the great fallacies of investing," he wrote.

Few thought that after the crisis involving Long Term Capital Management (LTCM) in 1998, liquidity could dry up again so fast. And yet it has done time and again, resulting for instance in the near-collapse of Bear Stearns in 2008. The investment bank, which was eventually bought by JP Morgan, got caught out in a supposedly liquid market in sub-prime mortgage investments and the notice of bankruptcy of its two funds investing in these strategies may have been a catalyst for the financial crisis. Ensuring the strategy's liquidity requirements and liquidity of the wrapper are carefully matched is what is essential, in particular as the industry heads into a new era of 'liquid alternatives'.

Lesson 2
Derivatives — friend or foe?

One operative word linking LTCM and Bear Stearns is derivatives. Derivatives enable users to find new ways to re-package old structures, such as debt and mortgages, to provide 'solutions' to challenges that clients present.

When looking closely at how a sudden loss of liquidity hit both LTCM and Bear Stearns, it is important to highlight that the issue was less the assets they traded, but their reliance on off-balance sheet derivatives as a way to trade them.

Today there are two industry shifts that are likely to see the increased use of derivatives. The first is the UCITS revolution that allows hedge fund strategies to fit into a liquid wrapper — where, in many cases, derivatives are being used to achieve this. And the second is the regulators' recent and ongoing moves to deleverage the system.

New regulations such as Basel III are forcing banks to be more parsimonious with their exposures both on and off balance sheet — and hence be more selective as to which hedge funds they finance. Hedge funds that cannot get financing through the traditional channels may have to look at new synthetic financing via derivatives to structure their trades.

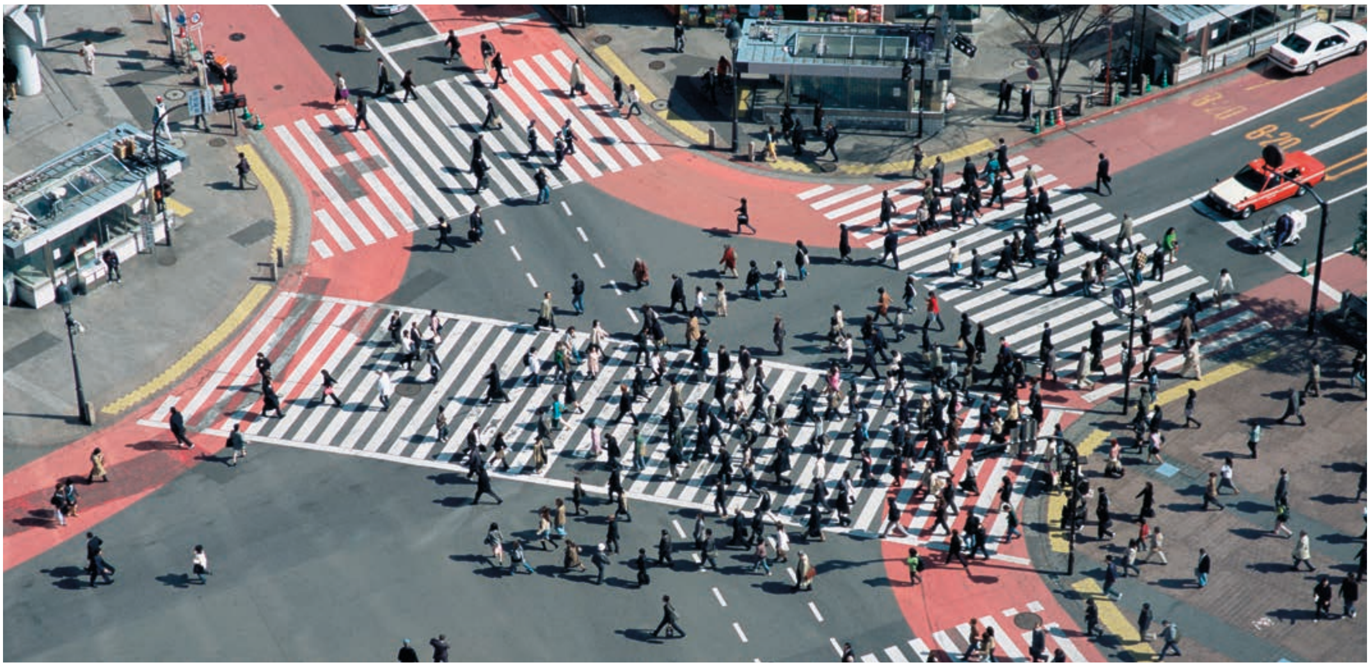
The lesson of previous crises is that derivatives of course cannot really remove risk, but rather allow for the transformation of where risk resides. Investors need to pay attention to where the risk really is.

Lesson 3
Leverage — Hedge funds may have to get by with less

Leverage was one of the factors allowing hedge funds to post outsized returns in the past. Regulation and low interest rates have now conspired to reduce leverage and credit to support such trading strategies of the past.

Bubbles occur when credit is easy to obtain — so regulators globally are now on a mission to make sure that banks and hedge funds are more constrained in terms of their borrowing. In the short term, the new regulations they have been pushing through are likely to stymie returns from some hedge fund strategies. But in the long term it is more than likely that savvy hedge funds will find alternative sources of funding, such as through so-called shadow banking or synthetic financing.

Again investors need to ask: Will the next set of financing innovations potentially bring with them a new set of unintended consequences?



Lesson 4
Transparency — now you have it, but do you understand it?

Thanks to a number of factors including the institutionalisation of the industry and even the Madoff affair, the hedge fund industry has recognised the importance of transparency. For many investors today, third party managed account platforms are no longer a luxury item but an essential business tool.

Few now buy hedge funds without knowing that they get plenty of transparency on what is in the portfolio, but answering questions like: ‘what information do you want?’; ‘how often do you need it?’; ‘what format would you like it in?’; and ’how do you intend to use it?’ is a different story.

One of the greatest liabilities an investor has today is having the transparency but not doing anything with it — or not really knowing what to do with it.

Lesson 5
Diversification — how correlated are you still?

In the early 1990s, more investors moved from balanced to specialist investing, and in doing so they ‘diversified’ into Japan, emerging markets, US and other ‘exotic’ markets — mainly or all through equities. So when the global stock markets crashed in 1997 in the aftermath of the Asian crisis, many discovered they were not so diversified after all.

A similar thing happened during the financial crisis. Many investors that thought they were diversified because of their hedge fund holdings only to discover too late that those holdings had become highly correlated during panic selling of all stocks in the stressed market.

Whether it is avoiding an over-concentration in stocks from banks and financial institutions, as many investors had going into the financial crisis, or not being simply in one hedge fund into which all the ‘alternatives’ allocation was investing in, genuine diversification across asset classes and across providers continues to be one of the most important investment lessons to remember.

The crisis highlighted that diversification alone cannot save a portfolio. Low correlation between assets held is key to capital preservation.

Lesson 6
Key allocator risk — don’t forget consultant risk

Hedge funds have always known about the importance of diversifying their client base. Indeed there are more than one or two managers who will remember their single largest investor pulling their allocation, resulting in their fund’s closure.

Few, however, will have made this connection with consultants. This is a lesson that any hedge fund manager that has been removed from a consultant's buy list can attest to.

When a consultant takes a hedge fund off its buy list, rapid inflows can turn to rapid outflows almost overnight. As the hedge fund industry becomes reliant on the consulting community for institutional inflows, increasingly consultant risk is a lesson in waiting.

Lesson 7
Ongoing due diligence — never skimp on it

From an investor point of view, due diligence is like the right fuel for a car, essential to get right all the time. Without it, or with the wrong kind, the car won't run.

In the hedge fund space, where alpha is mercurial and profitable traders thrive on loopholes, a park-and-play attitude to investing can land investors in hot water. A number of funds of funds and one consultant found this out the hard way in the case of Amaranth Advisors: Rocaton Investment Advisors, an investment consultant, ended up paying $2.75 million to San Diego County Employees' Retirement Association for recommending Amaranth.

Diversification across hedge funds helped those FoHFs with exposure on a performance basis, but not necessarily on a reputational basis. As more and more allocators buy hedge funds directly, and in many cases put lots of eggs in one basket, ongoing due diligence is going to be key to avoid investment-related mishaps.

Lesson 8
Risk management — is it more than just risk reporting?

"The market can stay irrational longer than you can stay solvent" — as said John Maynard Keynes. Risk management is about knowing when to cut positions (or add to them), it is not about avoiding risk.

Investors need to know that the risk management function inside a hedge fund is second to none, and to know the information is right, and that often means having experience of the markets the hedge fund is trading. How a manager stops positions and cuts losses, who is ultimately responsible for risk oversight, and how many counterparties a hedge fund has are all facets of the risk management role. Risk management is far more complicated than simply risk reporting.

Amaranth was an example of a natural gas trade that grew bigger than the regulators knew, because of the 'Enron loophole'. Despite the NYMEX exchange forcing Amaranth to reduce its positions in natural gas, further trades were executed elsewhere such as on the Intercontinental Exchange.

The reason Amaranth is held up as an example for so many of this lesson is that it was not a fraud but an investment related risk — one that rigorous, active and knowledgeable risk management both internal and external could have helped investors avoid.

Lesson 9
Regulated wrappers won't stop frauds

In the new age of liquid alternatives, a potentially new type of investor might start to access hedge funds. It is very easy for the novice investor to be lulled into a false sense of security when they see the words 'onshore' and 'regulated'. But it is important to remember that a UCITS wrapper will not stop frauds.

Manager selection, due diligence, risk management and diversification are arguably even more important for the underlying portfolios when they are wrapped in a new onshore structure such as UCITS because old track records do not count and new managers are able to enter the market.

Lesson 10 Counterparty risk — can history repeat itself?

When Rick Sopher of LCF Rothschild first agreed to host a discussion on counterparty risk it was a topic he felt passionate about — as he could foresee problems that few seemed to be taking seriously.

When the agenda was set six months previously, few even knew that the word ‘re-hypothecation’ even existed, let alone what it could mean to them. But by the time Sopher took to the stage at the British Museum to discuss it on 23rd September 2008, Lehman Brothers had collapsed and there was standing room only in the session.

At the time many hedge funds had only one prime broker, custodian and administrator, and much less thought was given generally by managers and investors to the quality of counterparties than the rest of the business. After Lehman all of this changed of course — and some investors will only invest in a fund now if it has more than one counterparty and, depending on the size of the fund and its complexity, multiple counterparties may be required.

Few believe that this issue could raise its head again as multiple counterparties has often become a non-negotiable element of doing business. The impact of Basel III on limiting bank balance sheets, however, means that smaller hedge funds or those that are not active traders are finding themselves being turned away by counterparties. Some hedge funds are finding they have no choice but to consolidate their activity with a single counterparty to avoid hefty charges. ●

Final thought: Learning the importance of an industry body

Every hedge fund and every allocator will have learned something on their journey. Making sure the lessons, these or others, are firmly engrained as they step towards a new and in many cases more liquid and retail future will stand them in good stead to become the ‘go to’ tool for investors as they manage their assets more optimally.

One last thought — courtesy of Ian Morley, founding chairman of AIMA 25 years ago, who reminds us how standing together with AIMA makes the industry more solid than going solo. “You would not readily think of trade unions and hedge funds as natural soul mates. Yet several years ago I watched a trade union speaker make a point. He asked a member of the audience to break a pencil. They did so easily. He then asked them to try and break twenty pencils all at once. They couldn’t.

“A group is stronger than any individual. A group that speaks with a single voice to represent the collective interest will be heard in the corridors of power in a way that no single person can achieve alone. The trade unions have known this for over 100 years; the hedge fund world for 25 years, when AIMA was formed to be the only global trade association that allows them to lobby as a collective forcing people to listen. As they chant at the Kop in Liverpool: ‘You will never walk alone’.”