corporate finance
HEDGE FUNDS

Hedge trimming

Executive summary

- In response to critics, the UK hedge fund industry is looking at establishing a new body to implement and promote standards. However, the Hedge Fund Standards Board, as it would be known, will not take on the role of regulator, and treasurers need to think about taking their own action.

GRAHAM BUCK CONSIDERS THE IMPLICATIONS OF THE EQUITY SLUMP AND LIQUIDITY FREEZE FOR HEDGE FUNDS AND FOR TREASURERS.

Hard times threaten many sectors, not least hedge funds. Although 2007 was a year in which most of them were able to outperform more traditional investments, the turbulence that rocked the markets in the second half of the year could spell the end of the good times.

The impact would certainly be felt in London, by far the biggest European centre for hedge fund management. According to *EuroHedge*, UK-based hedge fund managers had a total of $415bn in assets under management at the end of June 2007 (80% of the total $539bn in assets managed or invested in Europe). In recent years, their impressive performance has enabled hedge funds to attract a sizeable influx of capital from institutions such as big pension funds. But delivering strong returns has become much harder in the volatile market conditions that have prevailed since last summer.

THE EQUITY SLUMP This year began badly for those exposed to equities. Early January was marked by sharp falls in many stock markets, making the month the worst since September 1998, when Long Term Capital Management had to be bailed out. Reports from the US reveal that some fund managers are shutting up shop, or letting teams of traders go, following recent losses and the sharp reduction in the amounts that banks are willing to lend them.

Having set the pace for deals in the months preceding the credit crunch, a number of funds have already disappeared. The UK has so far been spared any high-profile casualties to match those of the US, which include Amaranth Advisors in 2006 and the two Bear Stearns-managed hedge funds that imploded in the summer of 2007. Another name that made headlines was Australia's Basis Capital. The fund, which was worth US$1bn at the start of 2007, collapsed under heavy losses in structured credits backed by sub-prime mortgages.

Some industry experts predict that the ranks of smaller hedge funds will be further depleted, and those that have played in the credit market and have less than $10bn under management will be the most likely potential casualties.

There are already signs of tougher times ahead. US pension schemes have recently become reluctant to invest directly in hedge funds, and have shown a growing interest in European funds of hedge funds, despite criticisms of the latter's fees, which come on top of the fees of underlying hedge fund managers.

REPORT PREDICTIONS A downbeat report recently published by the Putnam Lovell subsidiary of US firm Jefferies & Co, *After the Belle Epoque*, suggests that while the majority of hedge funds reported healthy figures for 2007 – as they continued to attract investment from asset managers – one in five is set to wither away by 2012 amid competition from alternatives such as exchange traded funds (ETFs). It predicts that "institutional-grade firms generating strong performance in all market conditions will gain further market share at the expense of lesser competitors". And as both institutional and individual investors expect hedge funds to outperform, demand for some form of customised benchmarking will increase.

But the main beneficiaries will be independent and quoted money management firms, "both traditional and alternative", suggests the report. It predicts that their increasing popularity will give them a 33% share of all assets under management by 2012, compared with the current figure of 24%. Given this trend, commercial banks, investment banks and insurance companies "will find it more lucrative to assemble unaffiliated products and play the role of professional buyers rather than fight a losing battle for market share with independent managers". This will lead to the captive fund management operations of banks and insurers seeking greater autonomy, and spin-offs will become more common, particularly in Europe and Japan, according to the report.

RAISING THE GAME Another recent report agrees that hedge funds will have to do more in future to maintain their position, as delivering the impressive returns of recent years is far tougher in the more difficult market conditions now prevailing. The outsourced

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management group SEI suggests that hedge funds will have to “raise their game” to attract more institutional investors and meet their high expectations and conservative attitudes.

Not all is doom and gloom, though. Given the sharp fall in equities over recent months, the majority of hedge funds have managed a fairly creditable performance, and their strategies have limited the damage. The better managed and more focused funds have been able to attract new money. Turmoil in the credit markets is regarded as positive by some hedge funds as it provides good opportunities for distressed asset investing. After a lull for some years, interest in distressed assets has recovered strongly, with some fund managers reporting that conditions for distressed investing are the most favourable since the recession of the early 1990s.

And the UK hedge fund industry is responding positively to its critics, by pursuing plans for a new body to establish and promote standards. A working group formed last year to review political and investor concerns about the industry has proposed that a Hedge Fund Standards Board set up, financed by participating UK hedge fund managers. The new body would set out best practice guidelines for hedge funds to follow, but would not be a regulator and would not have powers to sanction offenders. A comply-or-explain regime would operate, under which fund managers would either confirm they complied with the standards, or explain why if they did not.

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THE IMPLICATIONS FOR TREASURERS Given that hedge funds have exerted a growing influence on capital raising, what are the implications for treasurers? The most apparent is that since September 2007 most hedge funds have been sellers of credit. In the 18 months preceding the credit crunch, they were setting the pace for deals, so prices for bonds have dropped in recent months, although a small group including BlueBay and ECM have managed to buck the trend. Market capacity has been reduced as hedge funds have a hard time finding leverage. It remains to be seen whether this tougher environment proves permanent or temporary. For instance, the traditional long funds could well be attracted back into the market by more attractive terms, given that there is still liquidity.

The consensus is that the availability of leverage will improve from current levels, but a return to the conditions of the first half of 2007 seems unlikely. It is thought that those six months will represent the peak for some time to come. This, coupled with a lack of bank prop desks, means order books will be smaller than in the past couple of years, says Mark Dodd of Royal Bank of Scotland. But they will also be of higher quality, and while spreads are wider, all-in coupon levels are not different from those of the past couple of years.

"With the current quality of order books, there's no need to be five times oversubscribed to get a transaction done," Dodd says. "Hedge funds were typically 15% to 20% of order books last year, but the figure now is back below 5%."

Dodd thinks the markets will cope with the diminished presence of hedge funds: "We'll become more accustomed to smaller, high-quality order books to price successful transactions."

The credit crunch has also affected the credit default swap (CDS) market, where collateralised debt obligations (CDOs) are now unwinding.

Dodd says: "Everyone had become very CDS-focused when evaluating the pricing of a new issue. The dislocation of CDS and cash bonds has led to liquid secondary bonds being far more of a benchmark to price a new transaction. If the current technical CDS move wider continues, cash bonds will outperform the underlying CDS and, in many cases, lead to new issues being priced through CDS levels. In fact, only around 30% of real money accounts are really active in CDS and the remainder really doesn't use it at all."

TAPPING INTO THE DOLLAR MARKETS The hybrid bond market, which has enabled fund-raising companies to maintain their ratings, has proved particularly useful to corporate treasurers over the past few years. It remains accessible, although is mainly restricted to larger, better-rated corporations.

And increasingly evident since the start of the year is the widening gap between the dollar markets and euro-denominated markets. The credit crunch has made it so difficult for European companies to raise funding at home that increasing numbers are resorting to the dollar markets. European companies that have recently launched so-called yankee bonds include BT and Vodafone, Marks & Spencer, Tesco, BSkyB and Network Rail.

A year ago, hedge fund and prop desk activity made the difference between the two markets much smaller (or at least less apparent), but illiquidity has re-emphasised the difference. In January, US investment-grade issuance was slightly ahead of the same month last year, but in Europe it slumped and exposed its relative lack of depth. According to bankers, as well as being bigger and older, the US market's investor base is largely composed of traditional fund managers and is far less reliant on Europe than hedge funds.

TIME FOR ACTION Is there an action plan to deal with this new environment? There are several actions that treasurers can take.

First, it is probably now a good idea to focus more on investor relationships than on traditional asset managers.

Second, from a general funding perspective, treasurers should bear in mind that while spreads may have increased, the real cost of borrowing remains attractive – particularly in the US due to the recent interest rate cuts.

Third, they should not be overly worried about the size of the order books.

And fourth, they should issue when possible rather than when it becomes a necessity. Issuing when it's a necessity always becomes apparent to the market and pricing for the transaction moves up as a result. This means investor roadshows, which can be highly effective, should be presented as general updates rather than related to any specific deal.

"Do the investor work 'under the radar screen' and then you won't find your spreads being pushed wider while on the road," recommends Dodd. This means getting work with investors completed and obtaining the feedback from it. Then, and only then, is it time to tap the market.

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