

# ■ Financial Evolution and Stability – The Case of Hedge Funds

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Hedge funds are a prime example of financial evolution. Not many years ago they were still marginal players. Today they are among the most important institutions on the financial markets. Hedge funds represent no more than perhaps two per cent of all financial assets. But they leverage their capital base and trade frequently. It is estimated that they generate 30–50 per cent of the turnover on many markets and possibly account for the same proportion of all active risk taking. Hedge funds are also very active in seeking out new markets and new financial instruments.

Below is my view on the evolution of hedge funds over time and also some comments on the recent market turmoil in August 2007.

## Evolution of Hedge Funds

### ALPHA HUNTERS

Hedge funds started as alpha hunters and still like to think of themselves as such. This is understandable, since alpha can be described as the ultimate return stream.

Alpha, defined as excess return over a benchmark, is skill based. Strictly defined, alpha is a zero sum game. All positive alphas have negative mirror images somewhere else. By nature alpha tends to have a low correlation with various benchmarks of risky assets, making them ideal for improving the performance of traditional investment portfolios. Higher return combined with lower risk does wonders for risk-adjusted returns.

However, alpha is short in supply. It is unclear what happens to the total pool of alpha in financial markets over time. As new markets and new instruments evolve, new alpha opportunities arise which expand the alpha pool. However, it is doubtful that the pool of alpha increases much

over time in large and mature markets such as those for equities and bonds.

If hedge funds tear more alpha out of those markets, it implies, by definition, that other players increase their stock of negative alpha. The bulk of that money is institutional, and most institutions have seen stronger governance and better performance measurements over time. In combination with the growing use of indexing and “closet indexing”, this indicates there is unlikely to be a trend of worsening performance amongst other players than hedge funds.

It is highly unlikely that negative alpha among non hedge funds has increased at the same rapid pace as assets under management among hedge funds. The conclusion is that alpha as a percentage of hedge fund assets has decreased as those assets have increased; in other words the average excess return from hedge funds has decreased over time.

It should be stressed that whereas the average hedge fund has produced less alpha over time, some individual hedge funds continue to deliver solid alpha returns year after year.

#### SUPPLIERS OF DIVERSIFIED BETA

Although the alpha part of hedge fund returns has decreased other parts have increased.

Hedge funds are now large suppliers of diversified risk premiums, or beta.

Many hedge funds are on average long equities, credit products, illiquid instruments, carry, term premium etc. while being short volatility. These strategies involve risk, for which investors should be compensated, i.e. earn more than the risk free return without having to display skill. It could be added that profitable timing of beta is a quite different matter and should be defined as alpha.

While the average hedge fund is exposed only to a few of the risks mentioned above, hedge funds as a group on average have systematic exposure to these and other similar risks. Thus, a fairly large proportion of the return on hedge fund indices is not skill based but compensation for various types of risks.

Does this part of a hedge fund's return lack value? Not necessarily. Many of these risk premiums (betas) are “exotic” and not present in a typical financial portfolio. They help diversify these portfolios, thereby increasing their risk-adjusted return. Furthermore, the process of extracting exotic betas often helps improve market pricing and liquidity, just like the hunt for alpha.

However, the growing use among hedge funds of diversified betas could also have some drawbacks. These include higher correlation between different betas and by extension hedge funds, compressed risk premiums encouraging higher leverage and more crowded trades leading to the occasional violent shakeout of weak positions.

From the hedge fund industry's perspective another point should be mentioned. The right price for something that is replicable by a laptop is not 2 and 20. Replication strategies will over time exert downward pressure on fees for hedge funds that rely on betas for performance, and probably even more so in the case of funds-of-hedge funds. Alpha, in contrast, is not replicable and under no downward price pressure. In fact, the price of alpha may well rise over time.

#### SHADOW BANKS?

In recent years the distinction between hedge funds and other organisational forms for financial activities has become increasingly blurred. There has, for example, been widespread discussion as to whether the distinction between private equity and activist hedge funds is disappearing; same business model, different clothing.

Perhaps this should not surprise us. Hedge funds are conceptually extremely flexible organisations. Indeed, hedge funds can be described as all possible investments and vehicles minus the subset of traditional, constrained, investment funds and vehicles.

Or, as industry observer Hunt Taylor put it more colourfully: *The 2 and 20 will continue to attract the best, the brightest and every other financial starlet with a headshot and a dream. Given that the constraints on what they can do are almost nonexistent, I expect hedge funds to seek out any and all return streams, no holds barred. We will see hedge funds in businesses we didn't know were businesses.*

In the recent credit crisis we have seen some hedge funds in effect acting as banks. They have been lending long and borrowing short, expecting the market to go on funding their leveraged risk positions. Banks can do this – they have a lender of last resort should confidence and liquidity dry up. Hedge funds, conduits, SIVs (Structured Investment Vehicles) and the like cannot do this, unless they have secured funding elsewhere. This has become particularly evident lately.

When non-bank vehicles act as banks, they can do so without regulation, capital adequacy ratios and backstop liquidity. In the process they take the liquidity of the markets as given, a free public good. Also, many banks have been running SIVs off their balance sheets in what looks like a

regulatory arbitrage; the capital charge for contingent liabilities is much lower than it would be if the risk were carried on the balance sheet.

What is known as the shadow banking system, regardless of organizational form, is likely to come under the scrutiny of regulators looking for ways to improve the current working of the financial system.

## Hedge Funds and the Recent Turmoil

The first thing that should be noted about the recent turmoil is that hedge funds have not been at the centre of it. Some hedge funds have certainly lost money and even failed, but others have done well and the assets of distressed hedge funds have in many cases been picked up by stronger rivals.

Rather, the problems have centred on asset classes like subprime mortgages and commercial paper, mostly outside hedge funds. Tight bank funding has also been part of the story.

Just the same, hedge funds have not been immune to spillover effects. August was a very bad month for hedge funds. In an unusual pattern most, if not all, sub indices of hedge fund returns were negative.

The main reason was strong contagion effects between different hedge fund strategies, in turn driven by risk reduction and de-leveraging across the board. The risk reduction was partly a normal response to higher volatility and uncertainty, partly a way of cutting losses on positions turning sour but also partly because of funding becoming more expensive and less readily available.

When the hedge fund community cuts risk, it does so by buying back short positions (which hedge funds have sold because they think these financial instruments are expensive on a relative or absolute basis) and by selling out their long positions (which they think are cheap).

Overpriced instruments become even more expensive in this process and vice versa. To the extent that other hedge funds have similar models or qualitative judgments of value, this creates further losses for other hedge funds that often respond by cutting back their positions, thus reinforcing the effect. Especially in market segments where hedge funds account for a large part of the turnover and are major suppliers of liquidity ("crowded trades"), the situation can become explosive and somewhat irrational.

During the recent turmoil this could be seen most clearly in statistical equity arbitrage, with one major player being quoted as complaining bitterly that the market showed relative moves of more than twenty standard deviations per day for three days in a row.

The situation was aggravated by lower liquidity and higher transaction costs, a state of affairs that should be seen as the norm in stressed situations. September and October were much better months for hedge funds, which were making money again despite volatile markets. Positions and leverage have been reduced, which reflects greater uncertainty.

Hedge funds may not be immune to intensifying turmoil and more extreme fluctuations, but they are better prepared and will probably not be at the eye of the storm. They could even prove to be a stabilizing force in an environment in which banks and lenders are increasingly constrained by shrinking capital bases as an effect of credit losses. A risk scenario for hedge funds would be one in which investors withdraw their capital on a large scale, an eventuality that would certainly have some strange effects on market pricing as a result of forced de-leveraging.