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This commentary is an extract from an article entitled "Hedge Funds and Financial Crises" that was published in the first issue of the Riksbank's journal "Economic Review" for this year. In addition to the role played by the hedge funds in the financial crisis of 2008, the article describes the difference between hedge funds and mutual funds. The article also discusses the impact of hedge funds on financial crises in a historical perspective.

Hedge funds and the financial crisis of 2008

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A discussion of the role played by hedge funds in developments on the financial markets, and to what extent they are affected by the effects of the crisis, is a recurring feature of every financial crisis. Generally speaking, hedge funds have coped well in periods of financial turbulence. Unlike previous financial crises, however, the current turbulence has had a major impact on the hedge funds. The downturn has affected most types of asset and most markets and this has reduced the positive effects of the diversification in the hedge funds' portfolios. Moreover, several countries have prohibited the shortselling of shares, which has had a negative effect on the funds' arbitrage strategies. This Economic Commentary discusses how the hedge fund market has been affected so far by the current financial crisis.

"Hedge fund" is a collective term for different types of investment fund. A common feature of these funds is that they have absolute earnings targets, that is they set targets for earnings irrespective of developments on, for example, the stock exchange. Hedge funds are primarily intended for institutional investors and financially-strong private individuals. Many hedge funds protect their investments against losses (so-called hedging) although this does not apply to all funds. Instead, hedge funds use a wide range of investment strategies that are more dynamic compared to the strategies used by traditional funds. This is possible because hedge funds are governed by a more liberal regulatory framework that permits both long and short positions and the use of derivatives.[1] Hedge funds can also choose to have a high level of leverage, which can provide a higher return on the capital invested.

Over the last ten years, the hedge fund market has grown dramatically. In 1996, the approximately 2 000 hedge funds around the world managed a total of approximately USD 135 billion. By the end of 2007, 10 000 hedge funds managed USD 2 000 billion (see Figure 1). The Swedish hedge fund market is still developing. The first Swedish hedge fund began operating in 1996 and the market in Sweden has grown since then. By the end of 2007, there were around 70 hedge funds and these managed almost 5 per cent of the total fund capital in Sweden.[2]

Hedge funds in the current financial crisis

Since the emergence and growth of hedge funds, there has been a recurring discussion of the role they play in financial crises. Even though the course of events in the crises of the 1990s and 2000s was very different, the criticism of the hedge funds has tended to be the same. The criticism has mainly been that a highly leveraged hedge fund or group of hedge funds could have a strong impact on prices on the financial markets by launching speculative attacks on certain companies, sectors or currencies. This effect may be reinforced if the speculation of the hedge funds generates herd behaviour among investors. The hedge funds have also been accused of manipulating asset prices and contributing to the development of financial bubbles.[3]

[1] In Sweden, hedge funds are regulated by the Swedish Investment Funds Act (2004:46) and Finansinspektionen's regulations on investment funds (FFFS 2004:2). See Finansinspektionen (2007).
[2] See The Swedish Investment Fund Association (www.fondbolagen.se).
[3] A financial bubble arises when the price that market players pay for a financial asset, for example shares or properties, exceeds the value that the asset has in terms of the income that it can realistically be expected to generate.

Hedge funds have generally coped well in times of financial crisis. The discussion about hedge funds and financial crises has nevertheless arisen once again during the current period of turbulence on the financial markets. The question is: What has the role of the hedge funds been in the current crisis so far? To simplify somewhat, we can say that the hedge funds have been affected more by the present financial crisis than they have affected it. The main argument for this is that hedge funds have experienced more problems in handling this crisis than previous financial crises.

Broad decline for hedge funds

Figure 2 shows the cumulative returns on the hedge fund market and stock market during the present financial crisis. Between October 2007 and June 2008, the hedge funds had a more stable and thus better development than share prices. Thereafter, both the hedge fund index and the share index declined, although the fall was greater for the share index.

The negative development of the hedge funds during the latter part of 2008 cannot be related to a particular investment strategy. In this respect the current course of events on the hedge fund market differs from the situation during the Asian crisis when it was mainly funds that focused on developing markets that suffered. According to the Barclay's database on hedge funds, as many as 89 per cent of the hedge funds had a negative return in September 2008.

Figure 3 shows the market return for six different investment strategies during the period May-October 2008. In May, there was a positive return for all of the strategies. Thereafter, a negative trend began which subsequently accelerated in September and October. The strategies that performed best were the market-neutral strategy and the short bias strategy.[4] The strategies that performed worst during the period were the convertible arbitrage and fixed income arbitrage strategies.[5] The return for the long/short equity strategy was also poor, which indicates that the hedge funds that use this strategy owned a lot of shares during the period despite the falling prices on the stock market.

Changes to the regulations

A unique feature of the current crisis is the decision to prohibit shortselling taken by the authorities in several countries (including the USA and the UK) and implemented in September 2008.[6] The decision to prohibit shortselling (primarily of shares in financial companies) suddenly changed the regulations governing the market and affected different investment strategies to different degrees. There was a major negative impact on some strategies. This applies mainly to strategies in which shortselling is a natural component of the strategy or where there is a high level of exposure to the financial sector. The ban affected hedge funds more than mutual funds because hedge funds use shortselling to a greater extent.

A ban on shortselling in a falling market makes it more difficult to use strategies that reinforce negative market movements. This was also the aim of the ban. However, the ban on shortselling also made it more difficult in the autumn of 2008 to protect long positions through short positions and to use certain arbitrage strategies.

Figure 3 clearly shows the effect of the ban on shortselling on the return for the short bias strategy. The strategy had a good return in the summer of 2008. The return then fell in September, when shortselling was prohibited, and began to increase again in October. Although the short bias strategy exploits falling asset values, it is not particularly opportunistic as it means that the hedge fund always has a predominance of short positions in its portfolio, irrespective of market conditions.

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[4] An equity market neutral strategy aims to avoid market risks by adopting long and short positions. The fund's total position then becomes neutral in the sense that the general market movements do not tangibly affect the fund's result. The removal of the systemic risk does not mean that the fund is entirely risk free. The non-systemic risk remains. A short bias strategy is an investment strategy that gains from falling asset values.

[5] The convertible arbitrage and fixed income arbitrage strategies exploit errors in the pricing of convertible debt instruments and interest rate instruments to generate earnings.

[6] Shortselling entails selling a borrowed share and then buying it back at a (hopefully) lower price.

Broad decline in asset values

Under normal circumstances, hedge funds receive premiums for assuming credit risk, duration risk and liquidity risk. These risk premiums normally constitute a large part of the hedge funds' profits. In the current financial crisis, however, higher risk taking has not led to higher profits for the hedge funds but rather the opposite. The downturn in the autumn of 2008 that hit many different types of asset and many markets at once meant that all these various premium profits disappeared at the same time. The increased risk premiums could simply not compensate for the losses made by the hedge funds.

Many hedge funds generated considerable profits in the period 2001 to 2003 by diversifying their portfolios to include property or commodities. In the current financial crisis, however, investors have been more unwilling to take risks and have reduced the degree of leverage in their portfolios by selling assets. This has pushed down the prices of almost all types of asset, including commodities and property, which has weakened the positive effects of diversification in the hedge funds' portfolios.

It appears that the hedge funds have found it difficult to predict the current downturn in asset values. Unlike, for example, the IT bubble in 2000, it is not this time a question of the correction of prices on a single market due to historically high values for a certain type of asset. Many funds were therefore taken by surprise by the dramatic fall in share prices.

The current crisis is also characterised by an extreme volatility in the prices of both shares and commodities. This has made it more difficult to predict future movements in asset values. For example, many hedge funds that had invested in a negative stock market trend and high commodity prices experienced problems in July 2008 when the trend suddenly reversed with a considerable increase in share prices and a considerable fall in commodity prices.[7]

In addition, unlike previous crises, the present financial crisis is rooted in a bank crisis. The banks' problems have had a direct impact on the hedge funds in the form of more restrictive lending, higher borrowing costs and assets tied up in connection with bankruptcies (e.g. the Lehman Brothers bankruptcy). The funds have therefore been forced to sell off assets in a falling market and this has had a negative effect on their earnings.

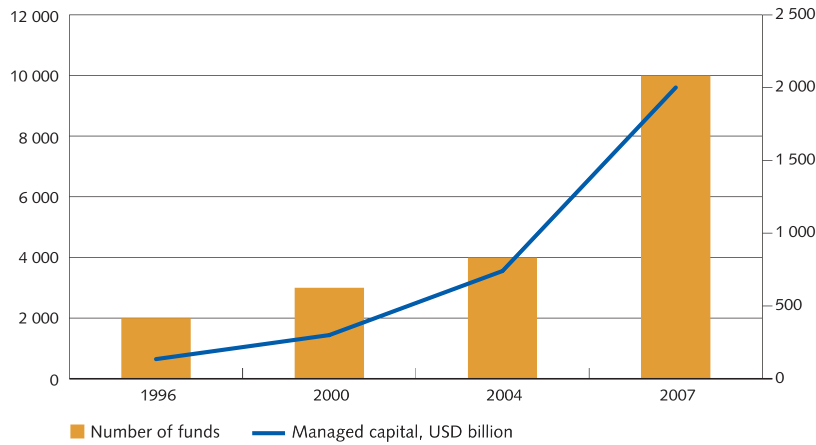
Conclusion

Hedge funds have generally coped well with financial crises. They have, however, been seriously hit by the current turbulence on the financial markets. The factors during the present financial crisis that have undermined the earnings of the hedge funds are a ban on shortselling, a wide-ranging downturn in asset values on many markets, a substantial decline in the willingness to take risks on the part of banks and investors and extreme volatility in the prices of shares and commodities.

[7] See ECB (2008).

Figures

Figure 1. The hedge fund market 1996–2007

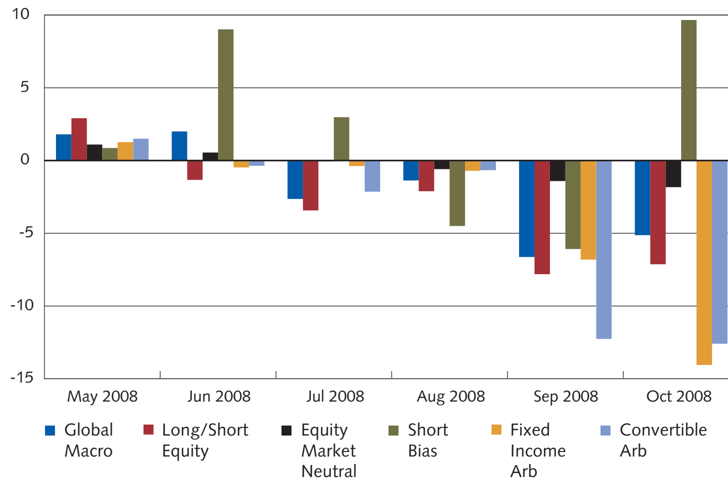


Sources: Strömqvist (2008) and ECB (2007)

Figure 2. Cumulative return during the financial crisis 2008 (Index December 06=100)

Sources: Credit Suisse Tremont and MSCI Barra

Figure 3. Return for selected investment strategies



Sources: Credit Suisse Tremont

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