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HEDGE FUNDS: BANGS AND WHIMPERS?

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HEDGE FUNDS: BANGS AND WHIMPERS?

This is the way the world ends
Not with a bang but a whimper.

T.S. Eliot, "The Hollow Men"

As the financial press has widely reported, investors have recently poured billions of dollars, pounds, euros, and yen into hedge funds-just how many billions worldwide no one quite knows, although most estimates put the total equity value of all 6,000 or so hedge funds at about $400 billion, with new money coming in at a rate in excess of $8 billion each quarter. As we wrote in our annual hedge fund report this spring, "although it is never easy to determine how much money is too much, we do know that—as surely as night follows day—whenever investment managers of any sort . . . are flooded with money by eager investors, the consequence is a degradation in returns. The talent pool becomes increasingly diluted and opportunities in less liquid situations and on the short side become more crowded and less profitable." Demand in the area has reached such startling heights that many unseasoned managers have raised hundreds of millions of dollars, while long ignored funds-of-funds are now hot commodities. Such unbridled enthusiasm seldom ends without disappointment—although predicting just how, when, and where is another matter entirely.

It is important to note that hedge funds do not constitute an asset class, but are simply unregistered, high-fee, limited partnerships, open only to accredited investors. They pursue a wide variety of unrelated strategies, some extremely conservative, some very risky, which means that "to generalize is to be an idiot" (William Blake, not a hedge fund investor). Nevertheless, one must categorize to some degree in order to compare like with more-or-less like, and we do so by dividing the universe into 20 or so sub-categories, many of which are currently awash in a tidal wave of demand. In some cases (e.g., convertible arbitrage) the infusion of money has created a bubble that is likely to burst when the economic winds shift; in most cases, however, investors may not suffer dramatic losses but may well realize results short of their exalted expectations and simply quit the game in disgust (e.g., merger arbitrage). Only in very few areas does the supply/demand balance still look healthy and underlying conditions appear attractive (e.g., distressed securities).[1]

[1] We refer to this general area as Marketable Alternatives. Our 2001 reports, *Hedge Funds (Long/short equity managers), U.S. Distressed Company Investing, Market-Neutral and Diversified Arbitrage Investing*, and *U.S. Short Selling* discuss these approaches separately and in greater detail.

Convertible Arbitrage

Convertible arbitrage exhibits many symptoms of a bubble. After a difficult 1998, convertible arbitrage managers have enjoyed clear sailing, posting median returns of 11.4% in 1999 and 16.7% in 2000. Stock market volatility and unprecedented new issuance[2] have resulted in strong absolute and relative performance. As a result, investors have flocked into these funds, stimulating increased demand for more products, to which investment banks and the corporations they advise (both in the United States and Europe) have happily responded, since other sectors of the capital markets have been largely closed. By some estimates, arbitrageurs now hold a staggering 75% of convertible bonds outstanding and new issues are often tailored specifically to arbitrageurs' requirements (e.g., zero-coupon convertibles). The bad news is that convertible bond prices tend to collapse every three to four years either due to a drop in stock market volatility or to a widening of credit spreads. When this happens, leveraged convertible arbitrageurs face margin calls and are forced to liquidate positions at fire-sale prices. In the past, they have found buyers among high-yield bond managers, who are often willing to buy "busted" convertibles if the price is right. Today, however, there is a noticeable scarcity of such buyers, and the few that remain would be overwhelmed by a full-scale de-leveraging of convertible bond arbitrage positions.

The managers themselves argue that "this time it's different" because conditions are more stable than in the past. In the 1980s, highly leveraged Wall Street proprietary desks were the primary players in convertible arbitrage and were always susceptible to wholesale liquidation when these firms' risk managers, faced with losses that were impairing their balance sheets, simply ordered the desks to shut down, creating severe short-term imbalances. Now that most of the proprietary trading desks have been dismantled, today's hedge fund managers claim greater stability and staying power, and many have diversified their portfolios by holding higher quality U.S. and non-U.S. issues. Some have even gone so far as to swap out of their credit risk exposure in a growing swap market. Most importantly, leverage is lower today, at three to five times equity, than was the case in 1994, when leverage ranged from five to ten times equity—however it is unclear whether this is attributable to falling equity prices (which reduces hedge ratios), or to more conservative risk management by arbitrage managers.

As is the case in all arbitrage strategies, convertible arbitrage managers vary greatly in their use of leverage, their appetite for credit risk, and their hedging discipline. The greater the leverage, the lower the credit quality, and the less disciplined the hedging, the more likely a manager will be wiped out in a down market. In today's environment, managers that focus on lower premium convertibles, maintain

[2] Through June 30, 2001, $54 billion of U.S. convertible bonds were issued, almost as much in six months as last year's 12-month record of $60 billion. More than 45% of 2001 issuance has consisted of zero-coupon convertibles.

high hedge ratios, but leverage aggressively appear particularly vulnerable to a "run on the bank." Those that focus on high premium issues, maintain lower hedge ratio however use less leverage should be better equipped to weather the next inevitable storm. Regardless of which firm(s) their money is with, however, investors in this space should be concerned. The worst will drown; the best may only tread water.

Merger Arbitrage

In recent years, a constant flow of multi-billion dollar deals overwhelmed dedicated merger arbitrage capital; as a result, spreads remained wide even in high quality deals and merger arbitrage managers reaped handsome profits. Inevitably, those handsome profits attracted investors, who poured money into merger arbitrage funds just as deal flow dried up. After posting median returns of 15.8% in 1999 and 16.3% in 2000, merger funds are now struggling to meet expectations (median return of 5% to 6% through July 2001). To make matters worse, regulators have thrown up roadblocks in the path of several prominent deals. A surprisingly obstructionist European Union stopped the GE acquisition of Honeywell (although rumors persist that GE got cold feet and backed away too easily), while in the United States, a recalcitrant Federal Trade Commission dragged its feet approving the Pepsi/Quaker deal, and the Federal Aviation Administration effectively prevented the merger of USAirways and United.

Flush with capital, but operating now in a low-volume, narrow-spread environment, arbitrageurs are faced with few alternatives and a significant dilemma. They can either raise cash or increase leverage in an attempt to generate meaningful returns. Most are holding 25% to 30% cash and praying fervently for a resumption of merger activity before investors tire of paying high fees for money-market returns. Those who attempt to boost returns by aggressively leveraging their positions run the risk of blowing up—and losing investors the fast way.

In general, merger arbitrage resembles a crowded dance floor whose size has been substantially reduced just as more dancers have shown up. Although it is true that the opportunity set could increase virtually overnight with the announcement of a few blockbuster deals, funds whose mandates include other strategies are now dramatically underweight this area.

Distressed

In sharp contrast to merger arbitrage, the supply of distressed opportunities continues to increase as high-yield default rates have settled in the range of 7% to 9% compared to a rate of 1% to 2% in recent years. This dramatic increase in defaults, however, overstates the current opportunity for distressed funds as many managers avoid the telecommunications and technology sectors (tricky asset plays) that

represent a high percentage of recent bankruptcies. Large attractive bankruptcies remain scarce, especially with several (Finova, Regal) nearing completion. Despite this pause in the action, the longer-term outlook looks promising, especially relative to other opportunities.

Multi-strategy hedge fund managers agree. With the recent scarcity of mergers these funds have begun to ease back into distressed securities, bringing supply and demand into better balance. This was especially apparent in the first quarter of 2001 with an unexpected rally in distressed and high-yield prices. Longer-term, the outlook for distressed investing is positive because opportunities will be plentiful and pricing will eventually stabilize. Although the quality of distressed opportunities is likely to be lower than that of the distressed cycle of the early 1990s (since the recovery rate of many technology and telecommunications companies may be near zero), after a decade of easy credit, the supply of distressed bonds should overwhelm the demand from the hedge fund and private equity communities.

Long/Short Equity Investors

The most popular area of the hedge fund world is undoubtedly long/short equity managers, the appeal of which has been heavily sold to individual investors by prime brokers who provide both trading and fund raising for fledgling hedge fund managers. Meanwhile many institutional money managers (Wellington, MFS, IDS, Lazard, etc.), faced with a continuous exodus of portfolio managers, have started hedge funds to retain talent. While the dramatic inflow of funds has inflated a bubble in convertible arbitrage and led to overcrowding in merger arbitrage, the effect on long/short equity managers is more difficult to gauge. The rapid addition of more players does not necessarily point to impending disaster, only perhaps a more competitive arena and correspondingly lower returns. For example, event-driven value stocks—long a favorite hunting ground for hedge fund managers—have attracted substantially greater attention than in the past, resulting in fewer mispricings and therefore diminished opportunities to earn outsized returns.

On the other hand, equity market volatility will probably increase as a result of increased short selling attributable to the greater number of long/short hedge funds and of Regulation Fair Disclosure (Reg. FD), which requires public companies to replace their former practice of whispering information to Wall Street with sudden bombs dropped in public forums. In short selling, losing positions grow in size, requiring portfolio managers to trade actively in order to manage their risk exposure. This activity generates greater market volatility, particularly when short-term rallies force hedge funds to run for cover, as occurred on January 3 and April 18, when two surprise Federal Reserve cuts resulted in the Nasdaq rallying an astounding 17%. By mandating that companies ensure all investors equal access to all pertinent information at the same time, Reg. FD effectively ensures that substantive changes in investors' expectations

will be transmitted to the markets with greater immediacy, which also creates greater short-term volatility. For trading-intensive hedge funds, volatility creates opportunity.

Most highly leveraged, aggressive growth funds have already been vaporized by the Nasdaq meltdown. As a result, the hedge fund universe is in many ways healthier today than in recent years, since the highly speculative players have been decimated. However, if the back of the great bull market of the 1990s has been broken, investors should lower their expectations for future hedge fund returns since managers will find it far more difficult to generate good returns in a flat or declining market than they did when the wind was at their backs. Some hedge funds will, as usual, assume risks that result in their blowing up with headline-grabbing bangs; many, however, will deliver mediocre returns, disappoint their investors, and gradually expire with a whimper. In short, while a limited number of attractive opportunities remain open, investors will currently find far more chaff than wheat.

What To Do?

From our report on hedge funds earlier this year:

"Faced with an enormous and growing menu of hedge funds, investors should carefully identify each fund's source of value added, and determine as objectively as possible the probability of earning a reasonable return, adjusted for risk and net of all expenses and fees. In other words, *investors should neither pay more simply for the right to incur higher risk than in their conventional equity portfolios, nor invest on the basis of unsubstantiated hope that a given manager will generate sufficient value added to overcome the imposing hurdle of high fees*. Possible sources of value added include:

- the inefficiencies of the arena in which the fund operates (e.g., small-cap stocks, volatile sectors with thin research coverage, complicated financial restructurings like spin-offs or liquidations);
- a willingness to hold intensively researched, concentrated portfolios and/or become actively involved with company management;
- meaningful levels of short selling either to hedge long positions or for outright gain; and
- the opportunistic use of leverage."

To this we would now add:

- Many investors, disillusioned with other asset classes, seem to be viewing hedge funds as the best alternative in a world of bad choices and are impatient to deploy their capital. However, they should avoid the temptation to lower standards to fill a target allocation to the area and should wait patiently for truly compelling opportunities.

- Carefully monitor existing managers for asset bloating. Is the strategy capable of producing returns with the current level of assets? Has the firm adequately increased staff to handle the burden of asset growth?
- Adjust expectations to current market conditions. Almost all strategies assume some level of market directional risk. Most strategies fare better in bull rather than bear market environments since it is far harder to generate profits on the short rather than on the long side.
- Remember that cash is always an alternative. Because of current conditions, the construction of a coherent hedge fund program may now take a year or more, in contrast to the few months required several years ago. Cash in hand is better than investing in haste.