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Special Report

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Hedge Funds are not the Enemy

By Rich Kleinbauer

Rich Kleinbauer is Director of RMK Research & Markets, a Switzerland-based research boutique working in collaboration with Arbor Research & Trading. Rich has been active in institutional fixed income, asset allocation and portfolio construction and hedge fund management for over 15 years.

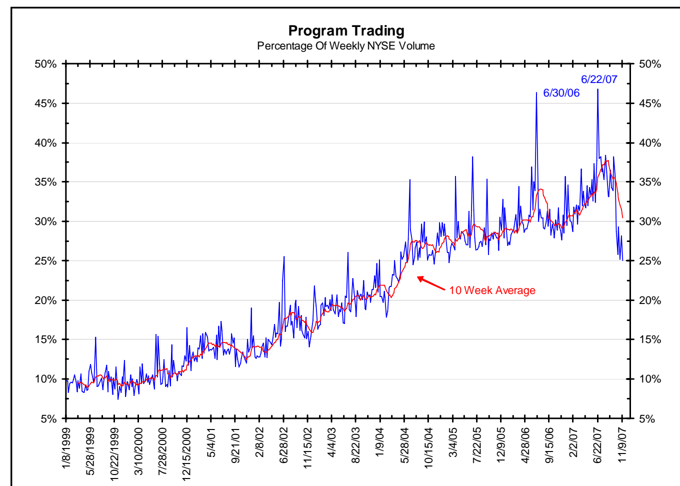
A complex relationship exists between hedge funds and prime brokers. The term "service provider" is a misnomer as prime brokers provide essential services to hedge funds, but they are often also competitors either via prop desks or their own products. While hedge funds generate order flow and cash flow their interactivity with prime brokers is harmonious, if slightly distrustful.

Prime brokers main job is to assist in borrowing securities and provide financing for leveraging. Additionally, they supply trade execution, reporting and risk management. Most importantly perhaps, prime brokers' reputations and client connections assist in the essential function of raising assets, not just for fledgling managers but also fully established managers.

These services have earned prime brokers a healthy fee of about **4% of assets** under management according to a recent industry report. The prime broker business is lucrative as the barriers to entry are high. It is a virtual oligopoly. About 25 brokers actively compete for this business, but the 5 largest (Goldman, Morgan Stanley, Bear, Citi and JP Morgan) dominate. A 2007 Federal Reserve report shows these **5 prime brokers control about 85% of the hedge fund market**

The graph to the right shows program trading as a percentage of all NYSE trading. This is not the stuff of retail clients and its ever-increasing volume illustrates how dominant hedge funds have become in recent years. Even its recent decline can be traced back to hedge funds – this summers' trouble with quant fund strategies.

So, the Federal Reserve is aware of the high concentration of capital access in the hands of a few prime brokers, most of whom have their own products which compete with their customers, but are they doing anything about it? Hedge funds themselves are not overjoyed to pay 4% of assets on top of their management and performance fees and have made efforts to change control of capital access.



Hedge Funds Take Action

A handful of hedge funds have tried to extract themselves from the grip prime brokers have on them by raising capital directly in the markets, but success has been limited. Citadel raised $500 million in a 5-year debt offering last December paying 190bps over the 5-year Treasury. Since then, however, no other fund has raised cash by issuing debt. Fortress, GLG and Och-Ziff issued stock in 2007, but Fortress' share price is down 50% since its first trading day in February. Och-Ziff is down about 20% since its IPO in November.

Part of the reason for this limited success raising permanent capital comes down to the solidity of a hedge fund's asset base. The assets are controlled by the fund's investors. They may choose to sell if investment performance slips. If the asset base shrinks it impairs cash flow generation to pay dividends and interest. Permanent capital is like customers in a restaurant. Get served a bad meal

and it's unlikely you'll return. Similarly, generate negative performance over back-to-back quarters and suddenly investors set down their dinner napkins and start heading for the exits. Drake Management, a $13 billion fixed income specialist shop, despite phenomenal performance as recently as early 2007, is struggling with investor redemptions at the moment after only a couple of poor months.

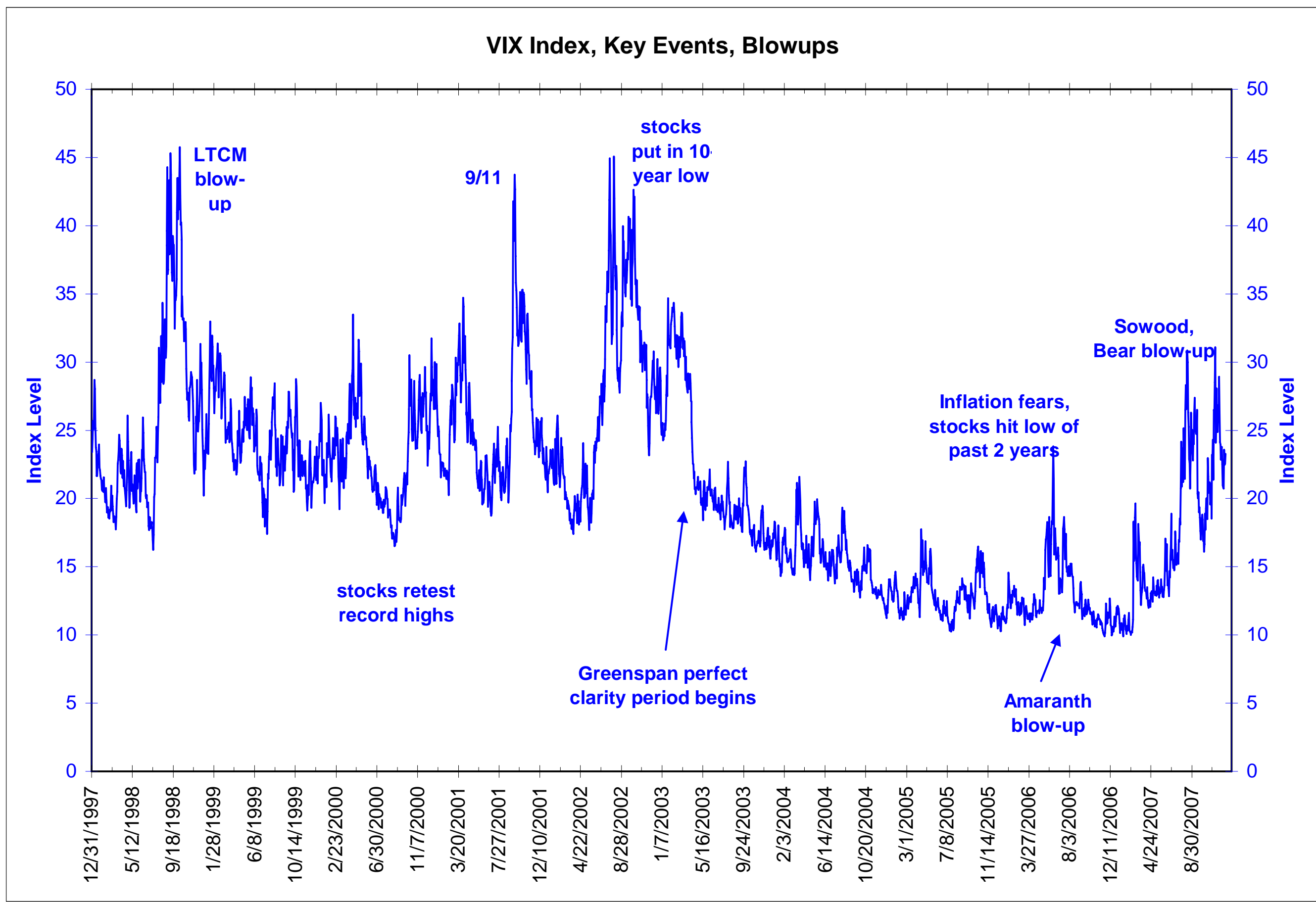
With capital access unmistakably controlled by prime brokers, some hedge funds have taken other measures to protect their businesses from a scenario perhaps best described as "here today, gone tomorrow." They've increased the stickiness of their clients. Provisions hindering an easy or quick exit such as lock-ups, gates, early redemption penalties, and side pockets have found themselves imbedded deep inside hedge fund offering memoranda. These measures seem to have provided a positive benefit for investors. One recent study has shown a performance gain of over 2% per annum for hedge funds with annual withdrawal features compared to those with a more typical quarterly withdrawal. In this sense, less liquidity for investors has proven to offer more.

Hedge Funds as Lenders of Last Resort

When it comes to liquidity, there are two groups of hedge funds – liquidity takers and liquidity makers. A majority of hedge fund strategies, those controlling about 80% of the $2.7 trillion in assets, are liquidity takers. These managers have a view on the relative value of two assets and leverage that view. Trading pairs of securities has various forms. Arbitrage strategies, quantitative black-boxes, long/short equity and event-driven are examples of management methods which convert a small price advantage into a sizeable gain thanks to the leverage in the trade. These liquidity takers seek to amplify price distortions into a decent profit with sufficient, low cost, easy access borrowed capital. They depend on prime brokers for access to stock and capital.

Other hedge fund strategies, mainly global macro together with private equity, are liquidity makers. These managers invest capital and arrange loans based on their assessment of the prospects of a business, a merger, or a rescue of businesses in distress. These managers believe that by providing others with access to capital they can influence the success of a venture or a merger and thereby benefit financially. Liquidity makers invest for control. Citadel's $2.5 billion cash injection into E*Trade is a recent such example. The evolution of hedge funds as lenders of last resort has become prevalent over the past 10 years and now plays a key role in the smooth functioning of capital markets – just compare the unwinding of the LTCM and Amaranth blow-ups: one required FOMC orchestration; the other's assets were bought and sold by competitor hedge funds. Recent blow ups have shown, when given the chance, hedge funds have the capability to constructively work through difficult situations.

The graph on the following page shows stock market volatility in the context of certain historic events. With Greenspan's perfect clarity period of Federal Reserve policy now over, perhaps volatility has again returned in a more permanent fashion to earlier, higher levels. Hedge funds' contribution to overall market volatility has mitigating attributes. Liquidity taker strategies, as seen this summer by certain quant funds, can exacerbate volatility when model relationships fail. Liquidity maker strategies, on the other hand, have become the new lenders of last resort and will tend, therefore, to provide a buffer in periods of extreme market distress.



Conclusion

Prime brokers impose heavy costs to capital, and governments selectively regulate then release. This is friction. Should governments allow market forces to respond to excesses instead of imposing solutions? Yes!

Certain hedge funds strategies are better positioned than banks, brokers and governments to navigate the excesses and errors unintentionally created inside the regulated world of western economies.

If an orderly breakup and dissolution of troubled business by hedge funds provides the more reasoned and rational solution, why interfere? Their motives are purely consistent with all that drives the capitalist system – exploit opportunities for their own benefit. Since regulators are aware that just a handful of prime brokers provide the liquidity to the hedge fund community, perhaps its efforts are better spent breaking up this oligopoly instead of regulating hedge funds directly.

We may never know whether hedge funds could have provided a better solution to the subprime CDO crisis than the government sponsored one now in front of the people.

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