Hedge Funds Villains? Regulators Please Take Note.

Hedge funds have had all sorts of bad press. In the past week, just speaking to members of the general public, investors, even hedge fund managers, I was shocked at the level of resentment directed at the industry and in the case of hedge fund managers, even some degree of penitence. How strange.

In 2008, up until the middle of the year, hedge funds hadn’t lost much money. The HFRI Index was down 1.36%, the HFRI Fund of Funds Index was down 2.43%, equity long short was down 3.78%, equity market neutral was up 2.49%, fixed income arbitrageurs were down 2.40%, macro had a good first half up 6.53%, event driven managers were down 2.65% and distressed debt was down 2.81%; even convertible arbitrageurs were down a paltry 6.46%. Emerging market managers were down more heavily, in Asia down 14.50%. Maybe it was the difficulty in shorting in those markets.

From July 2008 it was all downhill. And it began with the failure not of a hedge fund, but of an investment bank. Lehman was too important to fail, but in a dogmatic salute to the free market, it was allowed to. Now we talk about nationalizing banks, everyone being Keynesians, arbitrary, unilateral bailouts, and other innovative plans that involve the temporary suspension of capitalism. In the ensuing carnage, someone decided to ban shortselling. How did the hedge fund industry do? For the full year, he HFRI Index was down 18%, the HFRI Fund of Funds Index was down 21%, equity long short was down 27%, equity market neutral was down 6%, fixed income arbitrageurs were down 18%, event driven managers were down 21% and distressed debt was down 24%; convertible arbitrageurs managed to lose 31%. Only macro managers made a modest gain of 4.78%.

Part of the carnage was down to Lehman’s demise and the resulting disorderly unwinding of contracts with their counterparties and their counterparties’ counterparties. Part of it was a shorting ban that encouraged an industry which in aggregate ran net long and therefore had to delever both longs and shorts. Part of it was a ‘run on the bank’ situation leading investors to redeem from funds in fear of one another’s tendencies to redeem in fear of one another’s tendencies to… you get the idea.

A direct consequence was a general deleveraging in the banking industry, forced deleveraging from the disappearance of Lehman, a large scale and widely connected counterparty. Now the woes in the housing market, the mortgage market, the mortgaged backed market and the CDO structured credit market had been going for almost a year already. Lehman just tipped it over. The whole banking system. Then the whole peripheral banking system or ‘shadow banking’ system. Hedge funds are serviced by prime brokers who are mostly the large investment banks. Prime brokers provide leverage and collateral management to hedge funds. As the banking system fails, and as the prime brokers threatened to fail or failed in the case of Lehman, credit lines are pulled from hedge funds. The result is that hedge funds are forced to reduce their leverage. When everyone is headed for the door, its not the fire that kills you, it’s the stampede.

One area where regulation has not focused sufficiently on is the dearth of independent investment decision making as characterized most glaringly by the fund of funds industry. In the years leading to 2007 one theme was clear and that was that big funds of funds were getting bigger and smaller ones were falling away. This put more and more money in the hands of fewer and fewer decision makers. Size forced large funds of funds into larger hedge funds so that larger hedge funds got larger and smaller ones got smaller and fell away. In addition, the number of hedge funds that were common to the large fund of funds’ portfolios increased, exacerbating the potential for contagion. A problem in a single hedge fund now had the potential to cause a problem in a fund of funds creating a problem for that fund of fund’s underlying hedge funds and thus other funds of funds with similar holdings. For a fund of fund, there was now a correlation or dependence that came from their underlying hedge funds being exposed to the same investors; the same investors who met for lunch at Relais de L’Entrecote in Geneva, or Nobu in London, or Smith and Wollensky in New York, had the same starter, main course and dessert and talked about the same hedge fund managers over grappa.

Regulators have a lot to think about. But its not what they think, or where they are looking. Please look again.