Systemic Risk in the Hedge Fund Industry: Risks arising from the liability side of hedge fund balance sheets:

Are hedge funds banks? Some people seem to think so. In particular a research report, excerpts of which are available at http://ftalphaville.ft.com/blog/2007/02/07/2365/the-great-unwind-is-coming-warn-dresdner-pair/ , draw comparisons between Citadel and Deutsche Bank's investment banking division. The similarities are remarkable. For a long time there has been a preference for hedge funds set up by proprietary traders as opposed to asset managers. Historically asset managers tend to be seen as long only index benchmark huggers and prop traders as swashbuckling long short risk takers. Its pretty clear that one could take a bank, cut it up into little bits and end up with a collection of hedge funds. Fixed income traders trade relative value and global macro. Structured derivatives desks need to lay off their option risks in everything from fixed income to credit, equities, FX and commodities. Equity sales desks provide flow information. Equity prop desks beef up trading profits to augment fee and interest income. On the commercial lending side, asset liability management requires credit traders. In wholesale credit, asset backed and structured credit desks are active. In distressed debt, the commercial lending activities also cross over. In investment banking, mergers and acquisitions provide event driven opportunities. In trade finance and factoring we have the basis for the asset based lending hedge fund.

Many articles on hedge fund risk consider the risks that hedge funds pose to investors. Tail risk, liquidity risk, concentration risk, excessive leverage, short optionality, are oft cited criticisms of hedge funds. But there is also risk on the liability side of hedge funds' balance sheets. We've made a stab at associating hedge funds with banks. Now lets look at how banks are funded. The deposit taking bank is funded by a large number of depositors each providing small amounts of capital to the bank. The fact that there are many diverse individuals, each with their own liquidity requirements, providing capital, means that a bank can quantitatively model the aggregate liquidity requirements of the collective and thus optimize its asset base to the collective and not the individuals that make it up. It allows banks to borrow short term, through current accounts and short term deposits, and lend long term through mortgages, term loans, and other forms of longer term assets.

If you ran a bank, how comfortable would you be if you had 100 depositors, each providing you with 10 million dollars in deposits? That's 1 billion dollars of capital. Additionally, how comfortable would you be if 70 of these depositors came from the same industry and 80 of them from the same country? This is typically what many hedge funds face. Most of the capital they receive come from a small number of investors. Most of these investors are funds of funds. The representation of investors from New York, London and Geneva is disproportionately high. Most of these investors talk to each other, exchange notes and are very likely to behave as a coalition.

This is not to deny that there are systemic risks arising from the asset side of hedge funds' balance sheets. The risks on the liability side are as great. At the heart of this strange evolution of the typical hedge fund funding base is the evolution of the industry. By their opacity and coyness, hedge funds have traditionally found that investors find them instead of the other way around. The only investors in the business of expending considerable search costs are professional investors. Funds of funds are the largest such aggregators.

Aggregators do more than reduce the granularity of assets. They create correlation. To the extent that hedge funds are influenced by the preferences of their largest clients, large aggregators decrease independence in trading behaviour and hence the returns. If regulators worry about a hedge fund blow up potentially precipitating a system wide problem they should perhaps look at the stability of the system arising from the source of capital.

More later on the asset liability management of the hedge fund.