No sure bets

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A dangerous concentration of risk among hedge funds is making market regulators uneasy, says Barry Riley

The sea may be calm but are there rocks beneath the surface? Financial regulators are uneasy. The financial markets are too quiet, with volatility at unusually low levels.

On the one hand, nobody appears to be going bust: banks prosper and corporate bond default rates are remarkably low. But there are uncomfortable signs of distortion, such as the compression of corporate bond yield spreads over government bonds.

Speculation abounds, especially in the twin worlds of investment bank proprietary trading and hedge funds. Some of the underlying pressures burst to the surface in May with a sell-off in some of the more speculative asset classes such as commodities and emerging market equities.

In June the ECB sent out warning signals in its Financial Stability Review. Too many hedge funds were clustered together in the same trades, it said, producing a dangerous concentration of risk. The SEC has also been mounting a campaign against hedge funds.

This campaign is in difficulty. The SEC's 2005 ruling that hedge fund managers located in the US must register and deliver information about their structure and activities was overturned by a US court in June this year as "arbitrary". Registration is now a voluntary matter. Anyway, the hedge fund entities themselves are safely berthed offshore, the leading location being the Cayman Islands.

Hedge funds have previously slipped through the regulatory net because they were mainly bought by rich individuals who were not thought to need protection. These days, however, such funds are widely bought by such institutions as pension funds and college endowments and are also straying into the normal retail space, mainly through funds of funds. There is, therefore, an investor protection issue.

The regulators are worried, too, about stability. The crisis in September at Amaranth Advisors, a US-based hedge fund, has confirmed the substantial size of the risks. Another hedge fund group, the Spanish/US Vega Asset Management, has reported losses.

Amaranth lost $6bn on reckless bets on natural gas futures. But it did not actually go bust, as the notorious New York hedge fund Long Term Capital Management did in 1998. It achieved a firesale of its remaining assets, which was a tribute to the liquidity of today's markets. Amaranth's investors may eventually get a small part of their money back.

Well run hedge funds impose powerful risk controls on themselves. Bets are measured carefully and downside risks are managed with stop losses, paired trades and hedges. Risk scenarios are mapped out and contingency plans laid. Leverage is usually less than in the 1990s. There are
close relationships with the prime brokerage arms of the big investment banks, which keep a
close eye on their clients' risks.

The core problem, though, is that the incentives are skewed. Hedge fund managers typically
cream off 20 per cent of the return achieved over a low benchmark rate. For a big fund in a good
year this can amount to many millions. But they pay for none of the downside.

During the past two or three years hedge fund returns have generally been poor. They were on
average negative in May and June this year. Indices such as those of Credit Suisse/Tremont and
Standard & Poor's suggest that the average hedge fund returned 7 or 8 per cent in the first nine
months of this year. According to Mercer, the global pension consultants, only a quarter of
pension fund clients have been pleased with their returns from funds of hedge funds.

More than half of hedge fund subscriptions typically come from funds of hedge funds. Managers
monitor the individual funds and are quick to withdraw their investors' money at the first sign of
trouble.

Amaranth suffered redemptions earlier in the summer because funds of funds detected changes
in its strategies and risks. According to Hilary Till, an adviser to the French business school
Edhec, Amaranth failed to carry out adequate scenario analyses to assess the risks in natural
gas spread trades. It also took massive over-the-counter positions in illiquid markets. In tough
conditions there is an incentive for hedge fund managers to make bigger, and fewer, bets.

Regulators are perhaps not greatly concerned about instability in commodities. Yet insider
trading in the bond derivatives markets has been an important issue and the M&A boom has
triggered enormous speculation this year. Amaranth was not as dangerous as LTCM but it has
sent out its own risk warning.

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