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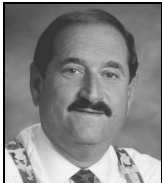
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Investors Force Hedge Fund Changes

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COMMENT



BOOKBINDER

A bit more than a year ago, the great bull market swooned when a clutch of former Wall Street bankers and Nobel Prize winners made a series of terribly leveraged bets that turned horribly wrong.

The near-collapse of Long-Term Capital Management opened a window on the clubby world of hedge funds, and a credit

culture that allowed a small private organization to increase its balance-sheet leverage to a staggering 25:1, holding trading positions (on paper) of \$1 trillion.

After the usual round of recriminations and government hearings, many now consider last year's event, well, a non-event. Oversight by banking regulatory agencies on tightening lending to hedge funds and increasing public disclosure of trading positions is only beginning to wind through Congress.

After a year of studying this issue, a group comprised of four regulatory agencies recommended that derivatives remain unregulated, an opinion that Congress will consider at hearings in January.

Meanwhile, banks and securities firms continue to monitor fund leverage and strategies with active risk management, and Federal Reserve Chairman Alan Greenspan recently encouraged bankers to be extra vigilant. Since many hedge funds are highly active traders, the concern is that commercial banks and brokerages might ease credit standards in order to court even greater trading fees.

Though some funds claim they will move offshore if Congress forces greater disclosure, most have already responded to the demand from investors for greater investment transparency. A careful evaluation of last fall would show that the estimated 4,000 hedge funds have changed course, due to investors demanding better reporting, more timely information and stronger accountability from their managers.

By nature, hedge funds are secretive. Partly, this is to keep their trading positions confidential. Partly, as last year showed, some managers don't want to disclose the amount of leverage they employ.

In truth, most hedge funds do not engage in extreme leverage. And despite their reputation for aggressive speculation, hedge fund performance overall is only modestly above equity indexes on a risk-adjusted basis. Hedge funds are fundamentally a wealth maintenance tool, acting as a hedge against traditional market risk and a way to diversify stock and bond portfolios away from market volatility.

The media's fixation on the troubles of a few star managers has

overshadowed the vast majority of funds which labor in relative obscurity. (The average hedge fund has \$50 million of assets.) The goal of most hedge funds is prosaic: To use investment and risk management strategies to seek positive returns regardless of market direction.

The negative attention surrounding LTCM has done little to squelch investors' appetite for hedge funds – in fact, quite the opposite. Hedge funds have gone mainstream in the last several years, increasing to more than \$350 billion of assets, according to Cerulli Associates Inc., Boston.

This growth has mirrored the U.S. economy and a booming stock market that has created enormous personal wealth. In the U.S. alone, there are now more than 2 million high-net-worth people eligible to invest in hedge funds, nearly double the total a few years ago.

In search of new sources of noninterest income, a number of leading commercial banks and regional banks have begun to offer hedge funds and "fund of funds" through their trust and private banking departments.

Though wealthy people still represent the bulk of investors, institutional investors will increasingly dictate the rules and have a larger voice in the way hedge funds are run. Enticed by strong risk-adjusted returns and a desire to pull some winnings out of the stock market, institutional investors are allocating increased amounts to hedge fund managers, utilizing strategies from convertible arbitrage to distressed investing and financial services sector investing.

Cerulli estimated that nearly 25% of the money invested in hedge funds is now institutional, up from 5% a few years ago. Recently, the \$160 billion CalPERS plan system announced it would invest \$13 billion in hedge funds. CalPERS, a well-known shareholder activist, is likely to force even greater change among the private world of hedge funds, as it has done with other investment advisors.

The fear is that these new conservative investors will somehow slow down free-wheeling funds. But that might not be so bad. Some hedge funds have courted trouble in the past by moving too quickly, abandoning their original investment mandates for new financial products or markets. Institutional investors, as well as private bankers looking to add new products to improve distribution channels for sophisticated investors, will start using their clout to change the operating philosophy of hedge funds, a real positive for a group that has been cloaked in secrecy.

As witnessed, changes in a hedge fund's strategy can result in abnormal performance, and institutional investors will increasingly rely on subadvisers to monitor their managers' strategies and performance. As hedge funds gain greater acceptance, investors will increasingly commit capital to those managers who explain their strategies, leverage and returns.

Fortunately, most hedge funds have already come to this conclusion. Amazing what a few Nobel Prize winners can do when they put their heads together.

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