Hedge Funds
Has the Music Stopped?

by Tim Jamieson and Hugh Larratt-Smith

One of the questions that's been batted about for the past two to three years in the asset-based lending community is "Will the unprecedented liquidity in the marketplace dry up? And if it dries up, will it be with a whimper or a bang?"

One of the primary drivers of this liquidity has been the hedge funds. The growth in assets under management by hedge funds has been mind-boggling. According to *Reuters*, hedge funds are estimated to have $2 trillion in capital under management, and Fitch Ratings has estimated that they borrow as much as twice that amount, giving them investable assets of as much as $6 trillion. More than $1.8 trillion of that is deployed in the credit markets, based on an assumption that credit hedge funds are leveraged by between five and six times.

In the old days, hedge funds were an exclusive club of sophisticated investment managers who hedged stock and bond positions, often holding short and long positions simultaneously. Once the preserve of the rich and famous, the entrance fee to this club for investors was typically $5 million to $10 million of investable assets. One of the appealing aspects of investing in the hedge fund world was that it was lightly regulated, so investment decisions could be made rapid-fire in order to pounce on opportunities. Hedge funds tended to invest in highly liquid, easily traded bonds, commercial paper, currencies and stocks.

Over the past decade, hedge funds have morphed into capital pools which are as varied in their investment

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strategies as the custom paint colors available on a new Ferrari. One of the interesting aspects of the hedge fund world is that many hedge funds raised capital with minimal restrictions on how they could invest. Some hedge funds were given a hunting license with few rules, if any. Again, many investors were attracted by the lack of regulation.

Another interesting development in the last decade is the increasing amount of investment in the hedge fund world by banks, pension plans and family wealth management companies. Many institutional investors, who never dreamed of investing in this asset class, now find themselves knee-deep in hedge funds.

Until the beginning of the summer of '07, many investors in hedge funds were enjoying the ride (unless they'd invested in Amaranth). The volatility of the bond, syndicated loan, commercial paper and stock markets in July, August and September changed some investors' perceptions about risk. Although some hedge funds that made bearish bets on the credit indices in June '07 made outsized returns in the following two months, other hedge funds were forced to dump assets at fire sale prices to meet redemption calls. What looked like a ripple effect at the beginning of the summer ended up looking like a tsunami by Labor Day.

For example, Goldman Sach's flagship Global Alpha hedge fund was down 22.7 percent in the month of August, according to *The Wall Street Journal*, the worst month in the fund's 12-year history. So far this year through the end of August, it was down 33.4 percent due to bad bets on everything from the Canadian dollar to the Australian dollar to the Norwegian stock market to the Japanese carry trade. Over the past 12 months, the fund has lost 37 percent of its value.

For the past three tumultuous months, investors have found it difficult, and sometimes impossible, to price many exotic financial instruments hard-hit by subprime turmoil. And the funding turmoil is showing up in some very unexpected places like Northern Rock Bank, the 8th largest bank in England. The surprise with the Northern Rock meltdown in September was its minimal exposure to subprime mortgages. In France, Canada, Germany and Australia, some hedge funds and conduits issuing commercial paper have faced liquidity squeezes in August and September.

One of the magnifying factors in this market freeze-up has been the poor liquidity and lack of transparency of many of the assets that were being dumped. Complex mortgage securitizations, pools of ABL and cashflow LBO loans, and commercial paper issued by conduits became tougher to value or unload quickly to meet margin or redemption pressures.

While there is greater transparency because of the new accounting rules requiring Wall Street firms to distinguish between financial assets that have real market prices versus those based on models or are basically management guesses, the nervousness remains. Given the current market stresses, bigger portions of the Wall Street firms' securities holdings might fall into the category of management guesses, and relying on these estimates might not help restore investor confidence.

Obviously a big area of concern is the category for asset values based on estimates, or Level 3 at the Wall Street houses. These assets made up about ten percent or less of overall financial assets at Goldman, Morgan, Lehman and Bear Stearns at the end of their fiscal second quarters in 2007. Including Merrill Lynch & Co., which doesn't report results until October '07, the firms designated $331 billion as Level 3 assets, or about 6 percent of total assets, according to *The Wall Street Journal* and *Reuters*.

Of the nearly $270 billion in financial assets on Lehman's balance sheet at the end of the fiscal second quarter, for example, about $22 billion, or 8 percent, fell into Level 3. The firm said in its financial filings that values in this category "reflect management's best estimate of what market participants would use in pricing the asset." At Bear Stearns, about $18 billion of the firm's $220 billion in financial assets fall into this category, according to *Reuters*.

One of the problems facing hedge funds is that the market thinks their balance sheets have the same type of Level 3 exposures, but many of them don't face the disclosure requirements as the Wall Street banks. Hence, the nervousness and increasing redemption requests.

Adding to this market pressure is the sheer volume of cashflow deals in the pipeline and the potential for losses on the day the loan gets booked. For example, the banks arranging the financing of KKR's $22 billion purchase of Alliance Boots PLC, a buyout whose debt banks were forced to hold this summer, have sold a portion of the United Kingdom drugstore chain's £750 million ($1.52 billion) mezzanine-debt facility at 95 cents on the dollar, which means they probably will post a loss on the transaction.

Earlier that week, banks sold investors a $1 billion slice of Allison Transmission Inc. loans, part of $4.2 billion in buyout debt for the auto-parts maker that they were unable to sell in July. The $1 billion loan also was sold at a discount, of 96 cents on the dollar.

In the S&L meltdown, one of the investment strategies that brought the S&L industry to its knees was investing long, funding short. Some people who are lenders to hedge funds are now thinking they've seen this movie before.

The recent credit crunch has been exacerbated by the leverage used by hedge funds to magnify returns. With the kind of very aggressive borrowing by hedge funds, it doesn't take too much of a move in the market for alarm bells to begin ringing in the offices of chief credit officers.

That's one of the reasons the leveraged finance marketplace is choking on the pipeline of deals coming to market this fall. The prime brokers at the Wall Street firms and banks who arrange hedge funds' borrowing lines have been drastically cutting back, in light of the meltdown of several prominent hedge funds. Without the borrowing power, hedge funds have sharply curtailed the deals they're willing to commit to. To top this off, the world's top banking authority, the Basel Committee, is considering new capital charges that could make some of the risk-taking behavior behind the current credit crunch much more expensive.

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As noted, many big banks have been caught out in recent months as markets froze for complex instruments like certain asset-backed securities, leaving lenders holding billions of dollars in bridge loans, bonds and other securities that are difficult to value. A lot of these deals are syndicated to hedge funds, who may be borrowing from the same bank that's choking on its own unexpected exposure to a failed syndication.

It is precisely this type of asset (LBO cashflow loans), because of its high coupon, which has proven attractive to a number of hedge funds, many of whom, in an effort to increase their returns, leveraged their bets by borrowing funds from investment banks through the use of repurchase agreements. "Unfortunately, if you live by Wall Street, you can also die by Wall Street", notes Jeff Schwartz, a bankruptcy partner at New York's Hahn and Hessen LLP in New York, who has been involved in a number of hedge fund meltdowns. "In times of market stress, Wall Street firms will mark (and remark) repo collateral very conservatively. In the event of a margin deficit, the hedge fund must immediately come up with additional collateral or their investment will be sold out from under them. The odds of this happening only increase the further you get away from treasuries on the liquidity scale."

The Basel Committee may decide to levy new charges covering risks that arise when markets freeze, thereby making it difficult to value assets, according to *Reuters*, as well as for risks in complex products under stress and securitization warehouse facilities. This regulatory uncertainty is making life more difficult and expensive for hedge funds.

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We are hearing anecdotal stories from credit officers in banks about concern over loans to hedge funds that do ABL and cashflow deals. One aspect of their reasoning can be summed up as: "Why does our institution want to lend money to an ABL or cashflow hedgie doing deals that we wouldn't do ourselves?"

The flip side to the liquidity crunch are the hedge funds who don't rely on leverage to do deals. Jeff Brandlin, from Brandlin & Associates in Los Angeles, comments, "Some of the big hedge funds have kept their powder dry and are looking to invest and lend when the opportunities present themselves. By then, some of the 'hot' money will have left the market and there will be fewer bidders at the table."

Echoing this, Michael Forte, founder and managing member of Cedarwood Associates, LLC, a private investment services firm in the New York City area, comments, "Hedge funds that remain liquid and are able to deploy an experienced middle office onto the battlefield will be able to capitalize on attractive buying opportunities to the extent credit markets continue to soften and funds are forced to sell off portions of their private book to meet senior debt obligations and redemption requests." According to Mr. Forte, "this market is going to require patience, as well as a disciplined credit policy."

Adding to the mix is the uncertainty about how some hedge funds may behave in a restructuring where compromise is required. Much of the documentation governing the right side of a borrower's balance sheet has not been stress-tested.

And a recurring theme in many conversations is concern over the relative youth and low pecking order of

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many hedge fund portfolio managers, as well as a lack of workout experience in a recession. Some hedge funds view portfolio management as a cost, as opposed to an investment, and keep their portfolio management groups understaffed and overworked. Seasoned portfolio managers at conventional ABL shops tell us about going to lender meetings and meeting hedge fund portfolio managers who have never experienced a troubled loan.

Some lenders express concern that hedge funds are not particularly transparent, and do not have to rigorously mark loans to market the way a bank does. Deals that run into trouble can be taken out of the pool of assets at the hedge funds' discretion. This type of leeway can lead to situations where a hedge fund is unwilling to show a borrower "tough love" when it's required, and instead, just shovels more money at a failing company.

Indeed, some may argue that investment professionals are incentivized to do just that. Compensation packages (made up mostly of a year-end bonus which is based on current income) can undermine the long- to mid-range investment management strategy needed to weather a credit crunch. Rather than establishing reserves on an underperforming credit, stopping advances and initiating a turnaround plan, some hedge fund compensation packages encourage fresh advances supported by a revised business plan which primarily increases current interest and transaction fee income for the hedge fund. In addition, the revised underwriting may simply justify the existing book values and the new loan advances increase management fees by increasing assets under management. Also, the lack of middle-office resources in many hedge funds further limits how much time can be spent on underperforming credits and further encourages providing additional liquidity, if it can somehow be rationalized.

Many readers know or will have heard stories about the hedge funds who commit to a $20 million piece of a deal and don't show up at the due diligence meetings, or those who say, "Aw, if the deal doesn't work out, we'll blow the paper out at 96 cents on the dollar and move on." In the meantime, anyone who has tried to sell an impaired loan knows full well how the price can dive to 30, 40 cents on the dollar. Or there can be no bids at all.

But as ever, if things go very bad, the "rolling loan gathers no loss" theory should be put on the back burner– the first bankers to call in their hedge fund loans will do far better than those who wait, even if in so doing, they worsen the panic they fear in the first place. Special provisions in the Bankruptcy Code regarding qualifying financial contracts such as repurchase agreements and swaps make quick action the way to go, notes Jeff Schwartz, who has been involved in a number of hedge fund problems. "Under the Code, there is no such thing as a preference and almost no such thing as a fraudulent conveyance claim involving transfers of collateral to an undersecured counterparty, so the normal rules of engagement don't apply. This is really a situation where the prize goes to the swiftest, so we've had clients literally show up at a fund's office and refuse to leave until they get more collateral. Unlike a bank loan scenario, collective action is neither expected nor rewarded."

Another pinch point has been increased redemption requests from investors in hedge funds. One common rumor circulating in Greenwich, CT is some investments in hedge funds were made by family wealth management companies with scant due diligence, or with too much reliance on the reputation of the hedge fund manager. Some of these family company wealth managers have recently pressed the panic button.

Complicating matters is that some hedge funds transfer assets to offshore affiliates. According to Mr. Forte, many hedge funds manage investments offshore, using entities located in places such as the British Virgin Islands, which offer significant tax benefits to eligible investors when compared to higher tax jurisdictions (i.e., the United States). This could add a layer of complexity to the scaling down or unwinding of a hedge fund.

There is little doubt that hedge funds have played an important role in providing rescue capital to companies that desperately needed to restructure their balance sheet or to buy some time. The key question on many ABL and cashflow lenders minds is how some hedge funds will weather the stress tests that may be ahead, if the economy slows. ▲