SUMMARY

"Within five days Lehman had gone bust and it quickly became clear that the world's financial system had problems far beyond a single badly run investment bank and temporarily frozen credit markets. After two decades of expansion and deregulation, and the greatest bull market finance has ever known, many of the world's banks were dangerously undercapitalized. Governments were forced to step in, providing capital, loans and guarantees to banks. In America, the euro zone and Britain the sums involved so far amount to about one sixth of GDP."[1]

After a severe economic drawdown, massive government bailout programs and exceptional stimulus measures, central banks trying to stoke economy by lowering interest rates, executives collecting million-dollar bonuses, irritated investors with less confidence in the financial system, everyone is asking for heavier regulation, enhanced transparency and more effective internal risk management systems.

Without the assistance of governments and central banks, the economic distress would have been extremely worse, but the recession has still been painful and, more importantly it has prompted a sense of outrage at the financial industry. Cases of firms like Lehman Brothers and AIG have pointed out that insolvency issues related to a large player are relevant not only for the individual institutions themselves, but also, and more importantly, for the stability and the integrity of the entire financial and economic system.

Among the others, hedge fund industry was blamed for having played a crucial role in the current financial and economic crisis. Managers were criticized as being selfish and careless about the investors' community. They were also accused of having contributed to the selling pressure in the stock markets, through short-selling transactions and particularly through the massive selling of shares to which they were forced because of deleveraging requirements and surge in redemptions.

Other critics are addressed to the excessive use of leverage, to the fee structure, to the lack of appropriate regulation and transparency about their strategies and investments. Indeed, hedge funds are usually not required to file a registration, nor to disclose data

[1] *Unnatural selection*, Economist.com, September 10th 2009.

about performance, assets under management (AUM) and their financial position. Managers are perceived as having the ability to move markets in order to pursue their objective of enriching themselves and their clients.

As a result, hedge funds have been accused of having magnified the financial crisis due to counterparty concerns, loss of confidence by investors and increased systemic risk. The Madoff episode has provided extensive evidence about the drawbacks of loose regulation and offered support to those claiming a stronger regulation and its enforcement in order to protect investors and the financial system, by closing the gaps and eliminating the weaknesses of the hedge fund industry. Although Madoff was not operating as a hedge fund, he operated through several funds of hedge funds, so there has been a great reputational damage and reduced investor confidence in the hedge fund industry.

Instead, advocates of hedge funds claim that they have been able to obtain historically higher returns, with respect to the conventional investment strategies. According to them, each of these funds is a business and, occasionally, businesses can fail and go bankrupt. Hedge fund failures are part of the financial life, as well as bank or company failures. Of course, these failures do have the potential to create dangerous effects on the financial markets, but investors should always diversify idiosyncratic risk and hold portfolio of hedge funds as opposed to just few hedge funds.

Despite the fact that hedge funds are currently in the spotlight and that they are drawing several critics, surprisingly very little is understood about who they are and what they do. It is indeed not easy to define what a hedge fund is.

The fund is a collective investment scheme, or better a pooled investment vehicle, meaning that investors entrust their money to a fund manager, who then invest in publicly traded securities in an effort to make a positive return.

Hedge funds are also defined as loosely regulated investment vehicles because they are not subject to any formal constraint about use of financial leverage, short selling, types of securities the fund can invest in and investment strategies. In other words, they fall outside many of the rules and regulations governing mutual funds. In addition, hedge funds are generally not required to issue periodic reports about their position. It goes without saying that even though the term “hedge fund” seems to imply market neutral positions and low risk strategies, their actual risk profile is quite different.

Lack of constraints, which in turn means lack of transparency, allows skilled managers to achieve higher returns relative to more regulated investment vehicles. In particular, hedge funds try to profit in all kinds of markets by pursuing leveraging and other speculative investment practices. Scarce transparency is another important characteristic which, as we said earlier, is strictly linked to the loose regulation and implies high difficulty in obtaining reliable information.

Hedge fund managers ask investors to pay two different fees. First, they ask a fixed reward for their managing skills, which consists in a periodical asset-based fee that usually range between 1%-2% of the assets under management. Then they charge a performance-related fee of about 20% of the realized profits. It is common for such fee to be effectively paid only only on new profits, not on profits recovering from previous losses. This mechanism, known as high-water mark, implies that managers do not receive any performance fee if they incur in a loss, until the loss has been made up, that is when AUM level reaches and goes beyond the previous highest level.

The main purpose of the performance fee is to provide incentives to the fund’s managers to generate positive absolute returns as managers have a claim on a share of the profits, whereas the high watermark serves as an incentive to avoid losses. However, the high watermark has a negative side effect as it also incentive managers to close the fund after a large loss, raise new financial resources and re-open a new fund with a new high watermark, so that they will be able to obtain 20% performance fee soon again.

Differently from mutual funds, who can only go long and decide not to invest in a particular company or sector if they don’t like it, hedge funds do more: they can short-sell. Thanks to short positions, hedge funds are able, at least in principle, to achieve consistent returns in bull as well as bear markets. In other words, to them it makes no difference whether the market is going up or down.

Hedge funds usually are highly leveraged. Using leverage affords the levered entity to obtain higher returns, but increases also risk, since it works both on the up-side and down-side, amplifying potential gains as well as potential losses. In other words, leverage undoubtedly has its advantages, but they come at a price. If a hedge fund is too much leveraged and the market moves in the direction opposite of the manager's opinion, it ends up losing too much money.

We cannot say that leverage per se is good or bad, since it should be evaluated together with market exposure, credit risk and illiquidity. Having a leverage of 4:1 instead of 2:1, i.e. assets of $100 funded by equity of $25 or $50, does not automatically imply that there is a higher risk. The leveraged entity could have invested in government bonds while the less leveraged entity could have invested in stocks.

Hedge funds are not liquid products. They usually have lock-up periods, during which investors must commit their money, extending for months or years. Certain hedge funds suspend or defer redemptions as a defensive measure because they want to avoid unprofitable liquidations of their positions. Not only they limit the possibilities to effectively redeem the investment but they can also require redemption notices.

Hedge funds also use gates, thus limiting the amount of withdrawals from the fund during a redemption period and the amounts of money that can be withdrawn on a particular redemption date. It goes without saying that investors, both funds of hedge funds and direct investors, perceive such an investment as a medium/long-term investment.

The first hedge fund was a long-short equity fund and was rightly described as a hedged fund. Nowadays, the term "hedge fund" refers to an extremely heterogeneous asset class, extending from the original low risk, market neutral strategy of Jones, which have low correlation to the overall market movements to include directional, unhedged and highly leveraged strategies.

Intuitively, hedge funds provide diversification strategies. Since they invest in several types of strategies and employ several investment techniques, they show returns that tend to be uncorrelated with stock market indexes and other traditional investments. Hence, they can be used to improved investors' risk-adjusted returns.

After a decade of high growth, the hedge fund industry is now experiencing a tremendous shock. With liquidity squeeze and extreme market conditions on the one hand and global deleveraging on the other hand, hedge funds have tried to withstand placing liquidity restrictions, thus trying to break through the downward spiral of the last two quarters of 2008.

According to the International Financial Services London (IFSL) estimates, the hedge fund AUM have felt slightly more than 30 percent in 2008 to $1,500bn. A research from Morgan Stanley shows that total assets of the industry were down to about $1,330bn at the end of March 2009. Overall, the size of the industry has declined because of a combination of two main factors. Namely, the negative performance and asset outflows due to liquidations of funds and increase in redemptions.

Measuring the performance of the hedge fund industry is far from being an easy task. Hedge fund managers report performance data to databases on a voluntary basis and they tend to stop reporting when performance gets really poor, thus creating a selection bias. As a consequence, they usually exit the database also for reasons other than liquidation. In addition, estimates on performance are affected by the survivorship bias, i.e. the fact that hedge fund industry's returns for a particular year do not take account of hedge funds that closed during that year, which makes the overall results positively skewed.

2008 has been a tremendous year for most asset classes, including hedge funds. The industry posted drawdowns that rank among the worst in its history and suffered heavy losses following extraordinary events in the marketplace. Investors had a reminder that hedge funds are exposed to several risk factors, such as credit risk, liquidity risk and a variety of equity risk factors.

Chart 1: Comparative Index Annual Returns and Standard Deviations (2008)

	CS/Tremont	S&P500	MSCI World	MSCI Emerg. Markets	S&P CSGI	Global Bond
Annual Return	-19.1%	-37.6%	-42.1%	-54.5%	-46.5%	0.8%
Annual St. Dev.	9.8%	20.9%	23.6%	37.4%	42.9%	6.1%

Source: Bloomberg.com, hedgeindex.com and standardandpoors.com

The hedge fund industry finished the year 19 percent down as measured by the Credit Suisse/Tremont Hedge Fund Broad Index. As shown in chart 1, both hedge funds and equity indices fell sharply as volatility increased. Hedge funds suffered the most in September, October and November when they registered some of the worst months in their history.

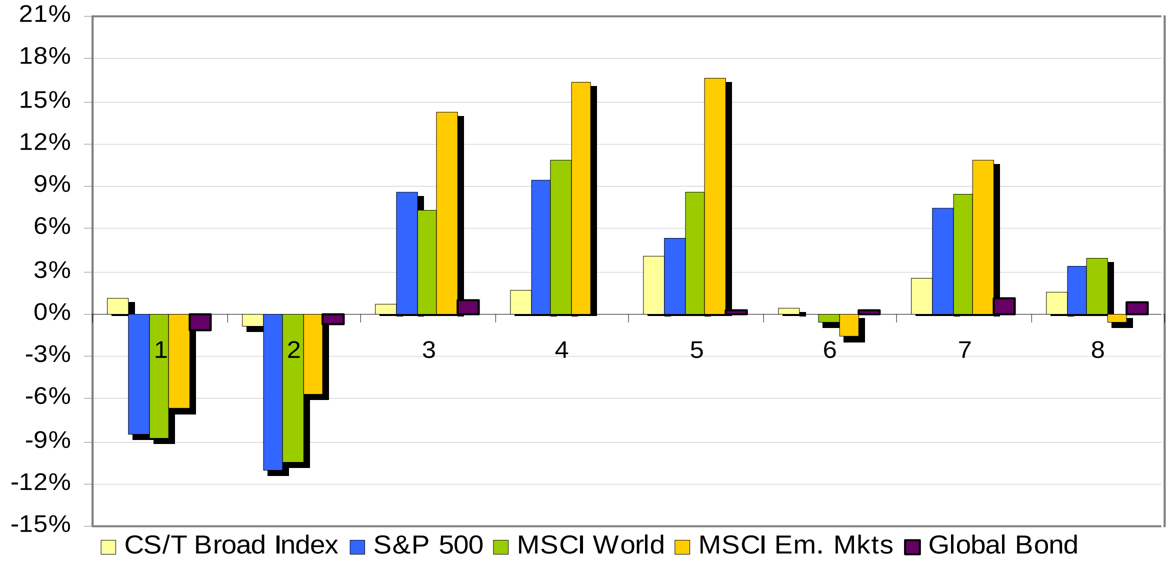
The broad picture of the year is that hedge funds generally beat stock market indices. Put differently, we could say that equity markets experienced an awful year while hedge funds as a group a bad one and they came nowhere near beating bonds or cash.

While financial markets suffered and overall performance for the industry was negative, not all hedge funds and investment strategies lost money during 2008. Some funds were able to generate alpha despite the adverse market conditions. According to the Credit Suisse/ Tremont database, Managed Futures and Dedicated Short Bias, which typically perform well in market downturns, registered double digit positive returns.

2009 has seen major economies worldwide introducing aggressive economic stimulus plans while central banks across the globe have maintained low interest rates and intervened where necessary. The markets were also encouraged by the stress tests conducted on largest banks by the US Government and by other countries. The Libor-OIS spread has narrowed during the first half of the year, signalling that credit markets were becoming healthier and less tight while confidence was increasing. In particular, the spread is decreasing to its historical levels, meaning that financing costs and credit conditions are coming back to normal levels.

After a challenging 2008, hedge funds have started performing better in 2009. They experienced an inversion of the second half of last year and posted the best start to a year in a decade as markets are recovering. Hedge funds, as measured by the CS/Tremont Broad Index, have registered positive returns for both the first and second quarter 2009 and for seven out the first eight months in 2009, as shown in chart 2.

Chart 2: 2009 Comparative Index Monthly Returns (January 2009 – August 2009)



Source: Bloomberg.com and hedgeindex.com

Apparently, hedge funds have been able to avoid large drawdowns in the first two months despite the losses of major equity markets. Then, they maintained a relatively defensive position in the following months when all the broad equity indices were posting large positive returns, thus limiting the negative effects of elevated volatility. Just as like as they fell less than equity markets last year, this year hedge funds are rising to a lower extent.

The first quarter saw hedge funds outperforming traditional equity and bond indices. During the second quarter the investors community regained the risk appetite lost in the last part of 2008 as equity markets rallied. According to Credit Suisse Research, investors approached the levels of risk appetite that characterized the period before the Lehman collapse. However, the VIX volatility index registered large upward swings in June after it decreased in the first part of the year. These market movements created difficulties in the equity space but hedge funds were able to avoid drawdowns and registered positive returns in June as well.

The VIX index continued to decrease and reached 23.09 in July, its lowest level since September 2008, and in the same month equity indices registered good results while hedge funds maintained their defensive position vis-à-vis the markets. Hedge funds continued to perform well but less than equities in August, a month in which there was great concern by economist on whether markets would continue to rally or not.

According to the Credit Suisse/Tremont Broad Index, at the end of August the industry was up almost 11.57 percent since the beginning of 2009, or 17.9 percent on a yearly basis. By looking at annualized returns it is clear that hedge funds succeeded in keeping volatility low despite the large swings of the VIX index in June and July. Interestingly, the industry has performed slightly below the S&P 500 index.

Although 2009 has been favourable to hedge funds as an asset class, things are different at the sub-category level. According to the Credit Suisse/Tremont database, Convertible Arbitrage strategy, which performed negatively in 2008, is up more than 35 percent since the beginning of the year, thus continuing to be the best-performing hedge fund strategy this year followed by the strategies that exploited emerging markets momentum. Other strategies which suffered a hard hit to their reputations over the past years are experiencing a good period as well.

On the other hand, managed futures which was very strong last year is down almost 7 percent. The worst-performing strategy so far this year is dedicated short selling which suffered from the powerful rally in global equity markets and was down on average more than 7 percent in July and 1.7 in August, reaching a -18.68 percent since the beginning of the year.

To sum up, strategies that performed well in 2008 are now performing poorly while the worst performing funds of last year are amongst the best performers in 2009. Credit Suisse/Tremont reports that eight of ten strategies posted positive returns in August and are experiencing a positive performance year to date.

The hedge fund industry has not been immune to financial market dislocations: many hedge funds have wavered, some have even performed well but the majority of them have gone out of business. Overall, investors have lost confidence and risk appetite in the asset class.

While governments worldwide are still busy trying to tackle the severe crisis that crippled financial markets, hedge funds have started to register comforting performance and started to experience a slow down in asset outflows.

However, they now face a new challenge, coming from regulators. It goes without saying that, after the events of the past 18 months, many things will change in the future and the hedge fund industry will not be immune. Managers are currently concerned about the impact that recent events will have on their business and on the environment in which they work.

The general opinion is that we have assisted to years of excessive deregulation and now we are called to regulate the unregulated. As a consequence, both investors and alternative asset managers will face a new environment, characterized by a more sophisticated and robust infrastructure. Structural changes will shape the future of the hedge fund industry and, most importantly, the way in which hedge funds will organize their business and trading activity will be at least as important as how well they perform.

In this chapter I will try to discuss some key issues and analyze some of the likely changes that will characterize the near future of the hedge fund industry.

The recent experience has taught that any single financial institution, bank, insurer or fund may pose systemic risk to global financial markets. As such, an unregulated hedge fund industry has the potential to threaten the markets and magnify the extent of a crisis.

Indeed, hedge funds are very active and leveraged market players, thus have the potential to create a relevant impact on markets. Until now, they have been able to build up massive leveraged positions and to take excessive risks. Moreover, they are no longer a little niche industry for sophisticated investors and in the last three years they did contribute to magnify market movements as a result of deleveraging and investor redemptions.

According to Andrew Donohue, SEC director, hedge funds account for 18 – 22 percent of the total trading on the New York Stock Exchange but the SEC has at its disposal only incomplete and unreliable data, hence cannot exercise a proper oversight.

However, hedge funds bring also some benefits to the markets. Namely, they have an increasingly important role in current capital markets both as a source of capital and as an investment vehicle for institutional and high net worth investors. They also provide liquidity and possibilities of portfolio diversification.

Before the current crisis, the industry has reported several years of growth but needs to adjust and refine now in order to regain strength and stability so to attract again less confident investors and earn the community consensus.

It will not be sufficient anymore to show historical track records or outstanding skills or rely on reputation because investors have learnt the lesson and will be more rigorous in conducting their due diligence and fund selection processes. The current crisis has led to the conclusion that standards and conventions adopted in the past may not be accepted in the future and hedge funds will have to adapt if they want to attract investors and perform well. In particular, hedge fund managers must move quickly towards newly proposed rules in order to check and understand to which extent and how they will affect their business and operating model. Although new rules are not definitive, managers should monitor developments carefully as new rules emerge.

Effective Risk Management, adequate corporate governance, transparency and independency will be critic factors for the comeback of the industry. In addition to that, managers will not earn large fees anymore.

It is clear that the legislative action will strengthen regulation and will likely lead to mandatory oversight and regulatory requirements for the hedge fund industry. The result is that after 20 or 30 years in which the hedge fund industry has been able to obtain a light regulation it is now trying to prevent over-regulation. Although it is still unpredictable whether hedge funds will be required to register with national commissions such as the SEC or subject to the oversight of central banks, they will have to face more stringent rules for sure and reconsider the way they manage their business and disclose the relative risks. Most likely, hedge funds will have to adapt to the best practice standards and demonstrate robust controls and processes.

There should be a balance between regulation and flexibility of the universe of alternative investments, so to obtain the twin goals of higher protection for investors and for financial markets on the one hand and maintain the benefits coming from the hedge fund industry on the other hand.

Although regulations governing the hedge funds vary across different countries, overall they are loosely regulated and they are free to employ various techniques and instruments to execute their investment strategies. In the USA, there is no corporate governance at all, hedge funds are not subject to any agency which has the mandatory power of inspection and control over their activities. They are only subject to various anti-fraud rules.

However, if the activities of hedge funds will be under increased scrutiny, they will need better corporate governance as it represents one of their weakest points right now. Hedge funds will be required to demonstrate that they have a sound governance structure, allowing to clarify how decisions are made as well as control structures that allow to adequately manage several types or risks such as investment, operational and credit ones. Risk Management is becoming increasingly important and is gaining unprecedented attention from hedge fund managers as they feel that it has become an almost non-negotiable prerequisite to attract resources. Indeed, managers agree that this area will undergo significant changes in the near future as investment and operational risks are rising significantly and the marked volatility of financial markets is magnifying the concern of both investors and regulators.

It goes without saying that nowadays it is far more difficult than ever to achieve effective protection against markets turbulence. According to Moody's, deficiencies in operational management and control accounted for a relevant portion of the losses suffered by hedge funds last year. Many conventional approaches have failed and so an effective handling of risk issues has been demonstrated to be imperative.

As we have seen, the new environment for hedge funds will likely be characterized by rising costs due to the more stringent regulation, to the need for more transparency and more robust risk management processes. At the same time, investors are not willing anymore to pay expensive fees. These issues lead to the question of whether the hedge fund industry will be characterized by fewer but bigger funds, thus becoming more consolidated.

Indeed, managers will need a stronger capital base to give investors confidence about the stability of the fund. Moreover, they will be pushed to increase the size of their fund in order to increase revenues.

It goes without saying that in the new hedge fund industry it will be extremely difficult for small funds to attract money and survive. It will be even more difficult for new start-ups to face the barriers to entry represented by the increasing costs.

On the other side, the hedge fund marketplace will become stronger as a result of the ongoing turmoil and funds natural selection process. It is also true that fewer managers and less assets will be able to profit from the opportunities rising in the markets.

After a period in which credit was seemingly available everywhere and to anyone, defaults rates were somewhere near zero and distressed debt investors had no opportunities to invest, corporate defaults recently soared to levels higher than at any point in the recent history, distressed debt began to be available and companies started to go bankrupt.

Today, the world of distressed debt securities and companies involved in bankruptcy or restructuring is without any doubt full of opportunities for hedge funds. However, one should bear in mind that no profits come without risk. Distressed debt is an extremely risky investment area and not all distressed companies are worthy to invest in. In order to enjoy the benefits of what could be one of the greatest distressed cycles in history, investors must pay attention and be diligent in their assets purchase process. Additionally, investors have to consider that such investment strategy is characterized by a time horizon going from 3 to 5 years.