Financial crisis taught the hedge-fund investors valuable lessons

THE financial crisis that began in 2007 and climaxed last year let loose a nasty chain of events that proved detrimental to offshore hedge funds.

The massive drop in liquidity, the bankruptcy of large financial institutions, plummeting share prices and the US Securities and Exchange Commission's temporary ban on short-selling, hit the hedge-fund industry hard.

Panic led to redemptions, forcing some hedge funds to impose gates averting forced liquidations, and others to liquidate positions at fire-sale prices.

Engulfed by fear, prime brokers made it difficult for hedge funds to borrow, and many hedge funds were forced to sell to meet margin calls. Funds that applied excessive leverage found their losses rise exponentially.

So what effect has this near financial meltdown of the global financial system had on the business of the average hedge fund and fund of hedge fund manager?

Hedge funds are sold as investments that are uncorrelated to the markets and that provide downside protection of capital through the implementation of sophisticated investment strategies. Hedge funds are typically small, owner-managed businesses that never grow to the level of long-only funds as hedge-fund strategies tend to deliver diminishing returns as funds become too big, making it difficult for the manager to be nimble, opportunistic and successfully chase alpha.

The industry is driven by the premise of talent and skill.

Investors compensate the hedge-fund manager handsomely by paying on average a 2% management fee on assets and a 20% performance fee on all profits based on a high-water mark principle. In the case of a fund of funds, the charges are even higher.

These attractive fee structures are much higher than the traditional fund management fees, attracting many entrants (good and bad) into the hedge-fund industry.

The high-water mark principle means that funds can charge performance fees only if returns are better than the high-water mark. If returns fall below this threshold, funds have to recoup losses to this level before they can once again be eligible for performance-fee participation.

Funds that faced redemptions and losses in 2007-08 saw the assets they had under management drop, which resulted in lower management fees earned due to a smaller asset base.

The funds that faced big losses did not earn any performance fees, and it could take them a long time to recoup the losses to reach the level of the high-water mark before they can once again earn performance fees.

According to numbers published by the Wall Street Journal in 2008, only 10% of hedge funds were receiving performance fees, which means that 90% of funds fell below their high watermark. This effect of lower earnings led to forced closures for many small hedge funds, reducing the number of players in the sector.

That can be seen as healthy. In the end, the good guys will survive, and the overall quality of the

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industry should improve. The big concern for investors is where funds have closed down and reopened under new names and brands because they could not recoup losses. There are two ways of looking at this.

- This behaviour could be seen as bringing into question the integrity and goodwill of managers driven by short-termism and quick profits, the type of qualities that bring the industry into disrepute. True hedge-fund managers should honour their obligations and commitments to investors, and face up to the consequences.
- Consider a hedge-fund manager who has consistently outperformed over many years and has one disastrous year that puts him back. This manager needs to continue to run operationally, pay the rent, pay staff and so on. Some investors are comfortable with resetting the high-water mark because of the trust they place in the manager, but in the end it is up to investors to decide who to invest with, and make judgment calls.

The one positive outcome of the financial crisis is what it has taught investors. Wise up, understand who and what you are investing in, go through the detail of the contract and mandate, and have clear expectations of delivery by the fund manager.

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