Prevent the perfect storm

Symmetric information and greater investor awareness can help prevent hedge funds infecting each other and the market

Like nocturnal forest creatures, hedge fund managers have not relished the glare of attention brought on by the difficulties of the sub-prime mortgage market. They relish even less the suggestion that anyone should investigate, regulate or license private investment vehicles like hedge funds. The main argument against such measures has been that the sophisticated investors in hedge funds are perfectly able to look out for themselves.

This is a compelling argument. It breaks down only if aspects of typical hedge fund behaviour pose risks to investors; risks that even sophisticated parties could not be expected to divine from a careful reading of a private placement memorandum. These are not the risks of fraud, deliberate concealment or gross mismanagement on the part of hedge fund insiders. Examples of that kind have been few and far between in the hedge fund industry. But there are features of a typical hedge fund structure that could, given the right (or wrong) conditions, result in adverse consequences.

Hedge fund structures

In a typical hedge fund, a limited number of sophisticated institutional or high-net-worth individual investors purchase shares in a limited liability company incorporated in a tax-friendly jurisdiction. An investment manager controls the day-to-day operation of the fund. The manager places restrictions (called gates) on the ability of investors to withdraw their money from the fund. These may include notice periods (60 to 90 days are customary) for the redemption of shares, and restrictions on the number of shares that can be redeemed within specified periods.

The investment manager, subject to the overall supervision of a board of directors, makes the crucial decisions about what and when to buy, when to sell and when to hedge. The manager will also have primary responsibility for valuing the assets held in the fund's portfolio. He will prepare and circulate a per-share net asset value (NAV) calculation to investors, usually on a monthly or quarterly basis. At least once a year, but sometimes no more often, independent accountants will audit the fund's books and records.

For these services, the investment manager typically receives a fee that has two components: a percentage of the value of the fund's portfolio (often 2% a year) intended to cover the administrative and overhead expenses of the fund and the manager; and an incentive fee equal to a specified percentage (often 20%) of the appreciation of the value of the fund's portfolio (in excess of some benchmark such as Libor) over the previous year. This, in the jargon of the business, is the classic two-and-20 fee structure.

No single element of a conventional hedge fund structure is troublesome by itself. But under certain circumstances the components can operate together to produce undesirable results.

Asset liquidity

Depending on the investment objectives of the fund in question, the assets that the investment manager will acquire with the fund's money may range from traditional financial instruments (stocks, bonds, loans), to non-traditional financial products such as derivatives, or even physical assets such as works of fine art, wine collections and antique automobiles. In all cases, the assets will either be liquid (that is, ones for which there is an active re-sale market with easily accessible price quotations) or illiquid (assets that are thinly-traded or idiosyncratic). Illiquid assets, by definition, lack an active secondary market that can provide reliable valuations and a ready avenue for disposal.

Many hedge funds started life with predominately liquid financial assets. This has been true even in the area of emerging markets where Brady bonds and sovereign global bonds were plentiful enough. The spreads on these conventional liquid instruments have narrowed dramatically in recent years, however. This has led some investment managers, in the relentless search for gratifying yields, to walk in ever more exotic pastures. The portfolios of the funds they manage may have begun to see an increasing concentration of illiquid investments. Such investments are hard to value, hard to sell, and nearly impossible to sell quickly other than at a devalued price.

Conflicts of interest

Valuing truly liquid assets is not difficult; that's part of what makes them liquid. Illiquid assets are another matter. Two problems can lie beneath the surface. Accounting standards define the fair value of an illiquid asset as the price that would be paid in an orderly transaction under existing market conditions. The forced sale of an illiquid asset by a hedge fund (a disorderly transaction) to meet an unexpected redemption request, or such a sale in panicky market conditions, may result in a sale price well below the fund's historic valuation of the asset.

Second, the investment manager may have to make a judgment call. He will have a direct interest in ascribing the highest valuation to the illiquid asset. Investment manager annual incentive fees are usually based on the value ascribed to the assets in the fund's portfolio; the fees are not based on the actual profit or loss that the fund may realise when an asset is sold. In contrast to liquid assets (where fluctuations in market prices are simultaneously reflected in the calculation of incentive fees), an investment manager holding an illiquid asset that he suspects has declined in value, may be tempted to retain the asset in the portfolio to put off the day of reckoning. Recent academic research suggests that when a hedge fund investment manager's compensation turns on the value it ascribes to illiquid assets in the portfolio, there is indeed a temptation to value high.

Information flow

Not all hedge fund investors are created equal, at least with respect to information

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flows. A fund's constitutive documents will require the dissemination of information about the fund's portfolio at specified intervals. The manager will, for example, inform all shareholders of the net asset value, probably quarterly or monthly. Rarely, however, will the fund's rules prevent the manager from making such information available to certain investors more frequently. It is not unusual for a large investor to negotiate the terms on which it will take a position in a fund. Those terms may require the manager to give that investor privileged access to information about the composition of the portfolio. By itself, there is nothing illegal or immoral about an asymmetrical approach to information flows to fund investors. Its significance must be seen in light of the fund's redemption policies.

In most hedge funds, redemptions by shareholders are restricted. A shareholder wishing to redeem its shares must give the manager advance notice of that intention. Even then, redemptions can only take place on a limited number of redemption dates throughout the year. If the investor fails to give notice on or before the prescribed notice date, his redemption request may not be satisfied until the next redemption date.

It is here that the access to more recent information about the fund's portfolio and financial condition may give a tactical advantage to certain shareholders. If, based on such information, a shareholder perceives trouble, he may submit a redemption request. It will be satisfied before his fellow shareholders have woken up to the situation and sent their own redemption requests.

When a fund has a large percentage of its portfolio in illiquid assets, there may be dramatic financial consequences for the less favoured shareholders. The inclination of most fund managers is to meet redemption requests out of cash reserves or by the sale of liquid assets. For the reasons discussed above, no fund manager wishes to be forced to sell an illiquid asset into a market that he believes is inhospitable.

But the effect of using the fund's liquid reserves to meet redemption requests inevitably increases the percentage of illiquid assets in the fund's total portfolio. A good analogy is a bucket of seawater: as the water evaporates the saline concentration of what is left in the bucket increases. In this situation, because the manager will have sold the fund's more liquid assets to meet early redemption calls, the remaining investors in the fund are increasingly (and often insensibly) exposed to the risk of an ever more illiquid residual asset pool.

"A problem becomes serious when one aspect of a financial structure exposes, transmits and aggravates another difficulty"

A perfect storm

Under certain circumstances, these features of traditional hedge fund structures can operate to the disadvantage of some investors. A perfect storm might unfold something like this: in the pursuit of yield, the fund manager increasingly invests in illiquid assets. The proper valuation of those assets can be difficult for outside auditors to verify. The fund manager will experience at least a subliminal temptation to ascribe the highest defensible value to unreliable assets. Why? Because to do otherwise would reduce this year's incentive fee. One or more of the large investors that have negotiated deals giving them access to information about the fund on a monthly, weekly or even daily basis, see trouble coming. They put in redemption requests in time to be satisfied on the next scheduled redemption date. The fund manager will pay out these early share redemptions at a per-share net asset value that reflects the valuation which he ascribes to the fund's illiquid assets. To meet those early redemption requests, the fund manager sells liquid assets. If additional redemption requests, which are not balanced out by new subscriptions to the fund, come in over the following months, the investment manager may have no choice but to begin the untimely disposal of its illiquid assets. This may be at prices lower than the assumed valuations used to determine the NAV of the shares redeemed on the prior redemption date.

In a refreshing recognition of the problem, the investment manager of one major hedge fund caught up in the sub-prime liquidity crunch is reported to have written to the fund's shareholders saying that the fund would temporarily suspend redemptions of its shares. In light of the drying up of liquidity for the fund's assets, the manager is reported to have told investors, "there is no way to report net asset values that would be simultaneously fair both to investors redeeming from these funds and to investors remaining in the funds."

This grisly scenario (which is admittedly extreme) would place fund shareholders in competition with each other. Such suspicions can render a fund more fragile and susceptible to skittish shareholder behaviour.

Remedies

The aspects of hedge fund structures that give rise to these concerns would change if enough prospective investors insisted upon changes. For example, the practice of asymmetrical information flows could easily be ended. There is often no bright line between a liquid and an illiquid asset, but managers could still give shareholders an indication of the relative concentration of illiquid assets in a fund's portfolio. Alternatively, an investment manager could rateably sell liquid and illiquid assets to meet very large redemption requests, which would help avoid the evaporating seawater problem. There are signs that some hedge fund managers, perhaps at the behest of their investors, have begun to improve transparency and reduce the danger that shareholders may perceive themselves as being in competition with each other.

Hedge funds are subject to a process that many other investment vehicles and financial products have undergone before them. Politicians, industry groups, regulators, academics and journalists are furiously engaged in diagnostic, prognostic and occasionally post-mortem studies of hedge funds. The alleged secrecy of hedge funds brings to these investigations a fascination traditionally associated with inquiries into groups like the Freemasons.

When analysing any financial structure, however, it is important to remember that in a stressful environment the constituent elements of the structure will not operate statically. A problem becomes a serious problem when one aspect of a financial structure exposes, transmits and aggravates a difficulty elsewhere in the structure. A serious problem becomes a systemic crisis when an exposure in one v ehicle infects investors in all similar vehicles with a Cartesian scepticism. What do they, or what can they, really know about how their own money is being managed?

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