

This is an original article written by Philip Loh on 02/09/2007.

Are hedge funds worth their salt?

In a 1970s backdrop...

The annual fees of a typical hedge fund can be more than twice those of a conventional long only-equity fund. Hedge fund managers claim that their above market average performance, or α , and risk diversification from traditional asset classes are well worth the astronomical charges.

Let consider some arguments against the hedge fund industry. It was economist Eugene Fama who first proposed the efficient market hypothesis. A University of Chicago finance professor, Fama maintains that securities prices reflect the collective wisdom of all participants in a market. As proof, he claims that people who actively pick stocks rarely beat the market over the long haul. The same argument may be universally applied to active investment strategies used in other asset classes.

Even Bill Miller, the star money manager with Legg Mason, after beating the S&P 500 for 15 years running, lost his winning streak in 2006.

Besides, hedge funds can and do go bust, despite having the best risk management models. Recent casualties include two funds run by Bear Stearns, which had invested heavily with high gearing ratios, in the US subprime mortgage market. Just days ago, investors in the two funds realised that they are getting almost nothing back after Bear Stearns came clean with the actual “mark to market” losses. Earlier this year, there was also the US\$6 billion bust of the US-based Amaranth Hedge Fund which speculates in natural gas futures.

So are excess returns over market, or α , a realistic proposition in today’s economic environment?

To answer this question, we must first understand the environment we are operating in. I believe we are heading towards economic conditions similar to those in the 1970s.

To explain why we are heading towards a 1970s backdrop and its impact on the hedge fund industry, I will start with the basic assumption that the returns of all asset classes should mimic the growth rate of nominal GDP in the long run, though the use of financial leverage may distort the exact correlation in the short run.

Over the past 20 years, the three primary asset categories – stocks, bonds and properties – have grown faster than nominal GDP due to the use of credit or debt. This leveraged enhancement of asset appreciation above nominal GDP has been made possible only because of China, which had created a low inflation environment during this period. The one-off inflation compression resulting from the opening up of China had allowed the global economy to grow at a brisk pace without triggering inflation. As a result, borrowing cost took a nosedive.

Normally, inflation would rise after the economy has gone on a growth trajectory for some years. Central banks will then have to raise interest rates to curb the built-up

inflationary pressure. This will in turn lead to a lower level of business confidence and risk appetite, which will push financial leverage and inflation to a more manageable level.

However, in both 1995 and 2000, the global economy did not overheat when it was supposed to. On the contrary, China's growing manufacturing capacity enabled it to absorb a substantial portion of global inflationary pressures. Companies boosted their profits by making their products in China and selling them at the same price in their home bases like the US and Europe. Japan became a victim of deflation for much longer than expected. It was so bad that the Japanese economy went through multiple resuscitation attempts over the past 15 years before it started showing signs of recovery.

It took the bursting of the technological bubble to lead the world into a recession in 2001, which was pretty brief with the help of the infamous MEW (Mortgage Equity Withdrawal), resulting from the biggest housing bubble of our generation, created largely by the US Federal Reserve cutting overnight interest to 1%. The drastic interest rate cut was in part to stimulate the weakening economy but also out of the fear of falling into a deflationary trapping just like Japan. It was at that time that Ben Bernanke, the current Federal Reserve chief, made his famous speech of dropping dollars from a helicopter to fight deflation.

Today, in sharp contrast to the last 15 years, China is beginning to contribute to global inflation. Just look at the elevated commodities and energy prices. With higher inflation, we are entering a period where asset appreciation would be at best equal to or lesser than the long-term growth rate of nominal GDP.

Table 1: Summary of a 1970s Backdrop

More challenging environment for hedge funds to justify fees:

Low inflation environment	Lower borrowing cost	Higher Leverage	Returns on assets higher than nominal GDP	Hedge fund fees lower in proportion to total returns
High inflation environment	Higher borrowing cost	Lower Leverage	Returns on assets equal or lower than nominal GDP	Hedge fund fees higher in proportion to total returns

With a strong run up in the equity market, the majority of hedge funds had actually underperformed long only-equity funds in 2006. Many hedge fund managers are thus under tremendous pressure now to boost returns to justify their fees.

But what is complicating the matter now is that just like sprinters may take steroids to help them win a race, hedge funds may use a legal equivalent in the financial world known as "leverage" to achieve better returns.

Let's examine a scenario of how a leveraged hedge fund strategy can yield α returns on Singapore stocks in general. Assume the past one year returns for the STI is 25 per cent and a hedge fund with an assumed capital of S\$1 uses the "yen carry trade"

strategy to invest in Singapore equities. Assume further that the hedge fund borrowed S\$3 in yen.

The gross returns will be 100 per cent ($25 \text{ per cent} \times 4$) + 40 per cent (estimated exchange gain over the period) – 10 per cent (interest on yen borrowing) = 130 per cent. Deducting the hedge fund performance fee will give a net yield of about 100 per cent.

Did the fund manager actually generate α of 75 per cent or did he give the returns a “steroid boost” by loading up on leverage and risk?

I have read about many large hedge funds using double-digit leverage ratios. The two Bear Stearns funds mentioned earlier in the article were leveraging about 17 times.

To illustrate the double-edged nature of leverage, let’s consider a hedge fund with a leverage ratio of 8. In this case, all you need is just a 12 per cent drop in the underlying asset value and the entire capital will be wiped out. Of course, to be fair, many hedge funds hold short positions, and these positions can benefit from a market meltdown. However, given the strong stock market performance in recent months, it is definitely more tempting to chase after the winning longs.

Now, some of you may ask: why didn’t we see hedge funds having problems when stock markets took a dive in May last year? The answer is simple. A temporary drop of several percentage points in asset value can be papered over in the short run by extensions of further credit by brokerage houses and banks. Many banks that had lent money may have had no clue then as to the true value of the collateral until the hedge fund managers threw the towel in themselves.

I venture to suggest that probably a sustained 25 per cent drop in the stock markets could potentially trigger off a leverage liquidation crisis.

So it’s one thing to be willing to pay hefty hedge fund fees for outstanding asset picking performance. It’s another thing to pay a hedge fund to help you take more risk, when it ends up with a mediocre performance that is “juiced up” by leveraging.

The upcoming macroeconomic changes will likely separate the best of breed hedge funds from the mediocre ones. On one hand, the re-expansion of risk premiums, moderating global nominal GDP, and the ending of the disinflation era, can create unparallel opportunities for many hedge fund managers. On the other, they can bankrupt many others who are leaning too much on the wrong side of the fence.

As the tide goes out, we may indeed find many hedge fund managers swimming naked. The sight might not be a pretty one.