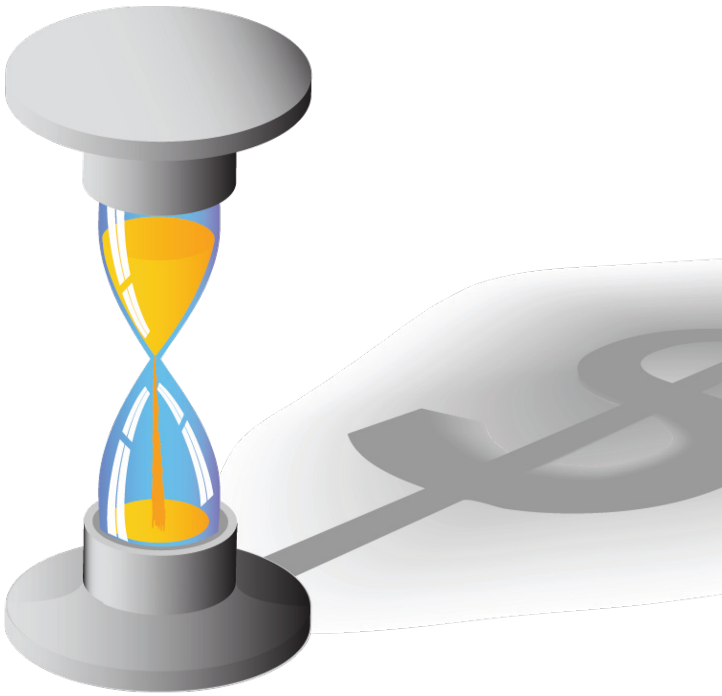
The Hedge Fund Industry Has It Learned Its Lesson?

••Will the lessons learned as a result of the financial crisis make the hedge fund industry stronger? A panel of senior industry practitioners examined mistakes and looked to the future during a New York Chapter panel discussion.



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BY PAUL DEVINE

THE HEDGE FUND industry is a little poorer but much wiser since the financial crisis of 2007–09. Hedge funds have learned from the global market collapse, although some of those lessons should have been learned before and they are the type that could all too easily be forgotten as the hedge fund industry prospers once again. This was the general view expressed by three hedge fund professionals of long experience who addressed RMA's New York Chapter in February.

The panel was drawn from three different stakeholder populations to provide an across-the-board perspective on lessons learned, the current state of the industry, and its prospects for the future. The panelists were:

- *Patrick McKenna,* managing director and global head of Credit Risk Management for Institutional and Emerging Markets and Private Wealth Management at Deutsche Bank.
- *Jamie Raboy,* senior managing director and chief risk officer, Marathon Asset Management, a two-decade-old fund focused on high-yield distressed corporate debt and structured assets.
- *Craig Goldsmith* of Grosvenor Capital Management, which was founded in 1971 and provides absolute-return investing services to a largely institutional client base.

Recent strong results in certain markets have made some hedge fund professionals believe that everything is fine again, said McKenna, although he noted that risk managers recognize that there was a real crisis and that some serious issues remain. But his fear is that, in the next cycle, the industry will forget the lessons that were learned and relearned. "A lot of us have lived through a number of boom-and-bust cycles," McKenna said. "You have to question when we as an industry, and the market generally, are going to wake up to some of the same lessons that appear time and time again."

McKenna identified some key lessons of the recent crisis for hedge funds:

- Maintain diversification of portfolios.
- Obtain good pricing information.
- Conduct stress testing.
- Maintain response speed so that effective action can be taken once a crisis has been identified and the risks involved in exposure to a particular borrower have been identified and quantified.

Agreeing with McKenna's identification of the key lessons, the other panelists added a couple of their own.

Goldsmith remarked that the old lesson about the importance of liquidity was played out once again. "One of the mechanisms that's improved the structure and eliminated some co-investor risk is the investor-level gate," Goldsmith said, a reference to restrictions on the amount of money that an investor can take out of the fund in any given quarter, thereby tamping down potentially crippling withdrawals in a declining market.

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Raboy said a hedge fund should adhere to a consistent method or stick to its core competency. "If you get it wrong, if your sector or your investment strategy has a bad year, most of your investors will be forgiving if you stuck with what you're good at, your core competency," he said. But some funds, he added, "suffered a little bit from style drift" in 2007 and 2008, "trying to be all things to all people."

Problems with Relying on Models

Even some of the newer lessons were not learned for the first time. McKenna said that hedge funds have learned not to rely on models as a result of their harsh experience in 2008. On the other hand, he noted, "one of the things that came to mind looking at the recent financial crisis and lessons learned is . . . what happened with the statistical arbitrage crisis in August 2007." Funds engaged in statistical arbitrage at that time "seemed to be using very similar models," he said.

During the first week of that August, however, market changes that had been modeled as once-in-10,000-year events occurred on three consecutive days. "What we saw with the statistical arbitrage crisis was dependence on models—the belief that the models could calculate to a fine point what the real risk numbers were in the portfolios," McKenna said. "In fact, what we saw is that the models broke down consistently."

Raboy echoed that observation, noting that all organizations got "a little bit complacent" during the strong markets of the middle years of the last decade. He said the complacency arose from the notion of "one-numberitis"—institutions wanting one number to identify their risk. The most obvious candidate was value-at-risk. "While value-at-risk has certain strengths, it also has certain weaknesses, for example, VaR doesn't work very well for a distressed credit asset," he said.

The limitations of modeling and the urge to rely on a single number brought Raboy to his second point: humility. "As investors and risk managers, we have to admit what we can't model," he said. "If you look at 2008 in retrospect, we saw parts of the system stressed that had never been stressed before and couldn't be put into a model. How do you model the rehypothecation market? You can't. But it broke, and it affected the way we all do business."

Transparency, and Intelligent Transparency

More subtle points emerged during the discussion. McKenna returned to the issue of transparency, citing some borrowers who weren't transparent about their actions or strategy. This lack of transparency led, in part, to decisions to "lower our tiering and increase the margin requests."

Raboy noted a "tremendous change in the demand from investors. They're demanding more transparency, more liquidity. There's been a huge increase in focus on the infrastructure of the firm, in the institutional quality of our firm."

Goldsmith distinguished between technical transparency and intelligent transparency. "If someone gives me a hundred CUSIPs [Committee on Uniform Security Identification Procedures] of mortgage bonds, that's all good and would meet the definition of technical transparency. But what I'm really looking for is, what kind of percent is subprime, what's Alt-A, what's the carry, what's the weighted average life, the vintage profile? You need the help of the manager to dissect it in a way that's important to you."

Looking at the Numbers and Reading Minds

McKenna developed the theme of transparency further by talking about the importance of client contact. He said that his bank "has always . . . been very proactive in dialing around to our clients on a quarterly basis in good times. We just talk normally about what's happening in the portfolio, getting an understanding of what's going on."

Raboy reinforced that notion by stressing the importance of listening not only to clients but to colleagues. He spends "a lot of time on the desk talking to the traders. I don't sit in an office. I sit next to the chief investment officer on our desk with the rest of the portfolio managers."

Insight is potentially more important than data. "Numbers will lie to you," Raboy said, "but stress will show on traders' faces and in the things they talk about, or in the positions you hear them talking about. Those won't lie. Talk to them about what's on their book, what they want to make, what they expect to lose, and why they think the position worked. That's the real truth."

Dynamic Margining: Common Sense or Undependability

Despite consensus on many of the lessons learned, the panelists also revealed areas of disagreement. McKenna said Deutsche Bank learned "to place much more of an emphasis on dynamic margining schemes versus static."

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>
> *Patrick McKenna, Deutsche Bank*

Raboy, on the other hand, regarded dynamic margining as little more than a euphemism for the fickle nature of bank lending. "Don't have a business model that is dependent on 'The Street' for leverage or financing. It will go away when you need it most. That's one of the lessons we learned in 1998 and again in 2002, and it obviously got repeated in 2008."

Strike While the Cultural Iron Is Hot

The panelists stressed the importance of a strong risk management culture. "In a crisis, everyone knows the value of a strong risk management culture," said McKenna, "but during the boom times, risk managers need to maintain that culture." Raboy, meanwhile, urged risk managers to develop and reinforce that culture now. "Strike while the iron is hot, while the need for risk management is fresh in everyone's mind."

The Rosy Present and the Cloudy Future

There was similar agreement that the hedge fund industry has largely recovered from the crisis, is wiser for the experience, and has a potentially bright future. Goldsmith noted that "we're seeing inflows; it's generally positive. It's not bubble-year positive, but it indicates industry stability." Raboy agreed, adding, "In some regards, 2009 let some investors and companies off the hook. It was too good a year. It allowed institutions—hedge funds or banks or even corporate issuers—to put off hard decisions. The day of reckoning is still coming."

Raboy described a looming "wall of maturities." The corporate leveraged loan market grew from roughly $1.7 trillion in 2003 to $3.7 trillion in 2008, he said. "A lot of that comes due in 2012, 2013, and 2014," he said. "We've delayed the day of reckoning, but we still have a very large wall of leverage and debt that has to be addressed, and we're going to continue to de-lever the systems."

On the other hand, McKenna noted that a recovery from the uncertain times of 2008, both in terms of performance and redemptions, carries with it the possibility that lessons will have to be relearned in the future. "Lenders are seeing pressure now in this competitive landscape, to renegotiate ISDA terms,[1] to lower the net-asset-value triggers," he said.

Some of that danger of falling back into old, bad habits might be offset by changes in the regulatory environment. Raboy is hopeful a CDS clearinghouse will be created that will increase pricing transparency, margining transparency, and liquidity among those who buy and sell credit default swaps. He also noted that a regulatory adoption of the Volcker Rule[2] "probably would be a net positive, as there would be fewer competitors in the space." Part of the problem with the leveraged-loan market from 2006 through the early part of 2008 is that "we were competing with proprietary desks that had effectively unlimited capital and incredibly inexpensive financing rates," Raboy said. "It made it very hard for us to do our business."

From a regulatory oversight perspective, McKenna said he expects pressure on increased transparency, regulation, and short selling. "We believe there will be reasonable solutions. We don't think that there's any interest in totally regulating hedge funds to the point where they go out of business."

In the view of the three panelists, then, the hedge fund industry has largely recovered from the market crisis it faced in 2008 and has renewed its emphasis on credit fundamentals. And they believe the industry can prosper in the future if it has relearned old lessons, learned new lessons, and commits to a strong risk management culture. ❖

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Notes

1. The International Swaps and Derivatives Association provides a standard agreement that, along with transaction-specific terms negotiated between the parties, defines the terms of interest rate swaps, currency swaps, and many other kinds of derivatives transactions.

2. The Volcker Rule (named for Paul Volcker, former chairman of the Federal Reserve) is a proposal that would prohibit banks that take retail deposits from engaging in proprietary trading that is not directly related to the market making and trading they do for their customers. These banks would also be prohibited from owning or sponsoring hedge funds or private equity funds.