



CALLAN  
INVESTMENTS  
INSTITUTE

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# Hedge Fund Alert

## Looking Around the Corner for More Risk and Opportunity

How do current market activities, regulatory changes and dislocations potentially impact the ability of hedge funds to prosper going forward? The huge changes occurring in the markets are having a significant impact on hedge funds, including short sale restrictions, disclosure requirements and the effective elimination of the investment banking model and its attendant impact on sources of funds to provide leverage and liquidity. Current and potential hedge fund investors should be aware of changes in the market and should monitor investments closely, including asking additional questions of their hedge fund managers and gathering vital market and regulatory information. Fiduciaries should not take a “wait and see” approach, but should pursue key information in order to make prudent decisions.

The investment banking industry, as hedge funds have known it, is a shadow of its former self. One result of this shift is a regulatory-induced deleveraging of institutions that provided sources of capital for hedge funds. With the demise of Bear Stearns and Lehman Brothers we saw the cost of many transactions, such as swaps, increase significantly. The pricing of other services, such as prime brokerage, will also likely increase as the number of providers narrows. As those costs increase, net returns for hedge funds will come under further pressure on the margin. The temporary SEC restriction on short selling of financials, and the possibility for additional longer-term restrictions going forward, has undermined hedge funds’ ability to manage risk. At a minimum, one can reasonably expect the re-introduction of the previously repealed uptick rule for short selling. The future is uncertain, and the capricious political and market environments make the rapidly evolving prime brokerage model an issue to consider.

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### **About Callan Associates**

Founded in 1973, Callan Associates Inc. is one of the largest independently owned investment consulting firms in the country. Headquartered in San Francisco, Calif., the firm provides research, education, decision support and advice to a broad array of institutional investors through five distinct lines of business: Fund Sponsor Consulting, Independent Adviser Group, Institutional Consulting Group, Callan Investments Institute and the Trust Advisory Group. Callan employs more than 170 people and maintains four regional offices located in Denver, Chicago, Atlanta and Florham Park, N.J.

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### **About the Callan Investments Institute**

The Callan Investments Institute, established in 1980, is a source of continuing education for those in the institutional investment community. The Institute conducts conferences and workshops and provides published research, surveys and newsletters. The Institute strives to present the most timely and relevant research and education available so our clients and our associates stay abreast of important trends in the investments industry.

How are hedge funds holding up? It is too difficult to say exactly, at this time. According to industry estimates, September may end up being the worst month on record for hedge fund returns, punctuated by the market crisis and a sharp spike in withdrawals. If so, it would eclipse August 1998, which marked the nadir of the Long-Term Capital Management crisis. Given the turmoil in the markets, especially with counterparty risk, hedge funds understandably do not want to disclose their thoughts, let alone their positions. The perception of redemptions can become a self-fulfilling prophecy, as it begets more redemptions. While the longer-term fundamentals of hedge fund investments may be sound, especially for fresh capital coming in today, too many nervous investors running blindly to a fund's exit will force an unnecessary predicament, much like a run on Jimmy Stewart's bank in "It's a Wonderful Life." While it is too early to predict the long-term net effect on hedge fund investing, investors can respond in the short term by talking to their hedge fund managers and monitoring regulatory changes.

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## **Important Considerations for Hedge Fund Investors**

A fiduciary's job is not to know all the answers, but rather to monitor and ask questions. Following is a list of the types of questions fiduciaries can utilize with their hedge fund managers along with the context of expected answers.

***Q: How have your prime brokerage relationships changed? What are you doing about embedded counterparty risks?***

***A:*** The insolvency of Lehman Brothers (or even Refco several years ago) has been instructive for hedge funds dealing with their prime brokers. Setting up separate accounts that restrict securities lending and other counterparty risks has increased the cost of doing business, but the ability to control underlying assets is more certain.

***Q: How has your strategy been affected by the change in shorting rules and disruptions in securities lending?***

***A:*** Some strategies, such as distressed opportunities, fixed income arbitrage, global macro and managed futures, have not been directly affected, but market neutral equity, convertible arbitrage and merger arbitrage are adversely affected, at least in the short run. While the lifting of the SEC's short selling ban on October 9, 2008 will restore an essential tool to many hedge funds, short-selling restrictions still exist outside the U.S.

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Given the current market conditions, many large investors are revisiting their securities lending agreements. If the pool of securities available for lending is reduced, the cost of borrowing securities may materially increase, thereby hampering hedge fund returns. However, markets for securities lending will naturally stabilize as new participants with lendable securities are attracted by higher rates of return and stronger collateral agreements.

**Q: Given that hedge funds have typically guarded their actual short positions zealously in the past, how might new disclosure requirements of short positions impact their ability to add value?**

**A:** Since the disclosure requirements of Form 13F<sup>1</sup> affect investment managers investing more than \$100 million, the new short disclosure rule will likely impact a large number of hedge funds operating in the U.S. In response, managers may adjust capacity or concentration limits of short-selling strategies so that short positions in individual securities do not need to be reported (i.e., when they are less than 0.25% of the class of securities issued and outstanding by the issuer and the fair market value of the short position is less than \$1 million).

**Q: How secure are your funding sources? How are back-up financing facilities arranged?**

**A:** The cost of borrowing has escalated dramatically in recent weeks, as is evident in the record high spread of LIBOR over the Treasury bill rate. New sources of financing for hedge funds will likely fill a void, as traditional overnight financing from many prime brokers has been impaired or is at least viewed as unreliable. Term financing commitments enable a fund to lock up financing costs for a period of time (e.g., 90 days or more).

**Q: How has your targeted amount of leverage changed for a given strategy?**

**A:** Higher financing costs and tougher margin requirements have undermined the use of leverage in certain strategies (e.g., market neutral equity, convertible arbitrage, fixed income arbitrage, merger arbitrage) that typically needed it. Fortunately, as volatile markets have widened spreads on relative value trades, today's investment opportunities for new capital do not demand the old level of leverage to reach attractive risk-adjusted return targets. The key for capital being deployed is the stability of funding sources.

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<sup>1</sup> Pursuant to Section 13(f) of the Securities Exchange Act of 1934, [www.sec.gov/answers/form13f.htm](http://www.sec.gov/answers/form13f.htm)

**Q: To what degree are the underlying holdings deemed to be illiquid (e.g., percent of assets held as Level 3 assets per FAS 157)? Has the fund's valuation policy for pricing these assets changed given current market conditions?**

**A:** While the effect of FAS 157<sup>2</sup> will be visible next year in hedge fund audits as of calendar year-end 2008, managers should be prepared to discuss how much of their portfolio assets are not readily valued by the observable market quotes or pricing models. Well defined valuation policies should already be in place and valuation duties handled by reasonably independent, competent and experienced professionals.

**Q: Given the liquidity of your underlying portfolio, how is your fund positioned to meet expected redemption requests at year-end or before?**

**A:** Whether overseeing a fund-of-funds (FOF) or hedge fund, managers now greatly appreciate the value of long-term capital commitments. When reacting to unexpectedly bad returns, an investor base that is concentrated with few clients, is short-term performance driven, or is provided with vague or poorly detailed communications will more likely rush the exit at the next available redemption date. Without long-term capital from a diversified base of patient, well-informed investors, let alone lenders, leverage and illiquid holdings have become incompatible bedfellows in this current market.

**Q: Assuming poor hedge fund returns in 2008, how might the manager react in order to recover losses and retain key employees in 2009?**

**A:** For hedge funds facing significant losses (e.g., 20% or more) year-to-date, incentive fees in 2008 may be minimal, if any. Consequently, in 2009 these fees will likely be constrained, as high-water mark clauses preclude new incentive fees to accrue until prior investor losses are recovered. In this setting, key employees of such funds may be tempted to join or form new hedge funds with fresh capital or no overhanging high-water marks. Faced with such defection risk, beleaguered hedge fund managers may be tempted to increase strategy risk by doubling down on existing positions or concentrating their bets. Of course, alternative responses exist. If not already implemented, broader equity distribution or profit sharing plans can help to build stronger vested interests and improve focus among key professionals.

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<sup>2</sup> For more information regarding FAS 157, see [www.aicpa.org/pubs/jofa/nov2007/fair\\_value\\_measurement.htm](http://www.aicpa.org/pubs/jofa/nov2007/fair_value_measurement.htm)

If an investor poses these questions to their hedge fund or FOF manager and does not receive satisfactory answers, it may be time to terminate the relationship and consider better alternatives. Investors should also take note if a manager outperforms its peers at unexpected levels—this could suggest the manager has taken on excessive risk or poorly marked illiquid assets.

Redemption notices typically need to be submitted 45 days or more before the actual redemption date, so any proactive planning must consider long lead times for withdrawing capital. Anticipating notice deadlines then dictates priorities for a decision-making process. Because a redemption notice can significantly impact a hedge fund manager's liquidity needs, the investor's commitment to redeem should be firm. For example, if a "provisional" redemption notice is submitted before a final decision is made by an investor's calendar-driven committee process, withdrawing the notice before the actual redemption date may have unintended consequences. When a highly coveted hedge fund manager has a long-standing queue of other potential investors, that manager facing redemption requests may prefer another new investor or seek to treat any withdrawn redemption request as a fresh contribution subject to new high-water marks and lock-up provisions.

## A Time for Crisis Management

We are in the midst of a market crisis, but a knee-jerk reaction is the wrong response. Now is not the time to make irrational changes to an established investment program. Hedge funds in particular face a changing landscape that challenges their investment models; most can and will adapt, but some cannot. However, Callan views hedge funds as an implementation strategy, not a formal asset allocation strategy. Today investors' questions go beyond how the markets might respond over short-term periods. The future is unpredictable, and it is always important to be vigilant of the changing regulatory environment and potential impacts on a hedge fund's portfolio risk and performance. Significant market dislocations often offer the best times to find good investments. However, there are clearly additional challenges that clients need to consider.

Fiduciaries should probe their managers and the market for information to make informed decisions about whether to make changes, stay the course or rebalance. Investors should institute specific manager changes if they feel uncomfortable with the answers they receive from their managers to questions like those posed above. Taking or delaying action depends on each investor's unique situation and risk tolerance. Market dislocations highlight risks but also create opportunities. Depending on the investor, this crisis may be the catalyst to decrease or increase hedge fund allocations.

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## Author



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Jim joined Callan Associates in 1989. Prior to his career at Callan Associates, Jim worked with the Pacific Stock Exchange (PSE) from 1982 to 1989. Until 1985, Jim worked on the PSE's options trading floor. Thereafter, as manager of the PSE's securities research department, he was responsible for developing and monitoring new stock, bond and option listings.

Jim earned a B.A. in Economics/Environmental Studies from Dartmouth College in 1982. He received his M.B.A. in Finance from Golden Gate University in 1987. His graduate studies focused particularly on publicly traded securities and capital markets.

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