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Funds of hedge funds

Borrowing and betting

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Are leveraged funds of hedge funds playing with fire?

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NOT long ago, investment in hedge funds was strictly for rich individuals: you might make a lot, but you had to be able to afford to lose plenty too. These days institutions from university endowments to pension funds that were once wary of hedge funds' swashbuckling reputation are entrusting money to them. The industry has rocketed: it now manages over \$1 trillion, compared with \$50 billion in 1990.

Much of the recent growth is due to the rise of funds of hedge funds, which allow investors to diversify their risks by spreading their money across several funds. According to Morgan Stanley, funds of funds have grown at an annual rate of 50% in the past three years, during which time their share of hedge-fund assets has risen from one-fifth to one-third. Despite the part played in their ascent by traditionally cautious institutional investors, funds of funds might be riskier than they seem.

This is because some funds of funds, like the hedge funds in which they invest, are investing not only their equity—the money placed with them by investors—but also cash borrowed from banks in order to boost returns. Although funds of funds' returns have sagged recently, their managers still expect them to exceed the cost of borrowing. So betting borrowed money ought, in theory, to boost returns, to the benefit of equity investors. "When you can borrow at, say, 2%, make 8% returns with low risk—it is almost a no-brainer," says a banker who lends to funds of funds.

No one can be sure of the figure, but bankers estimate the assets of these leveraged funds of funds to be about \$80 billion, up from next to nothing three years ago. Borrowings range from one to four times equity, or maybe even more. According to Hedge Fund Research, a research firm, more than half of existing funds of funds are allowed to invest borrowed cash. Indeed, some worry that there is now tier upon tier of debt, as individuals borrow to invest in funds of funds, which in turn borrow to put money into hedge funds that are themselves placing leveraged bets. "It is a house of cards," says one London fund-of-funds manager. "Each level of debt amplifies the rest—and that is hard to manage."

To this must be added the usual lack of clarity about what goes on in the hedge-fund world. Funds' disclosures are not required to be audited, and there are no industry standards about what should be published and how. Many investments by hedge funds are hard to value because they are in assets, such as the debt of companies in bankruptcy proceedings, that are not traded and so have no market price.

This makes it all the more important that fund-of-funds managers are vigilant. But with more money flooding into funds of funds than managers can cope with—many are closing their doors

to new investment—there is the risk that managers get complacent, or sloppy. “I’ve had managers come in willing to give us money without asking basic questions about how we manage risk,” says the manager of a \$1 billion hedge fund in London.

Fund-of-funds managers aim to cut through all this complexity, by selecting on their investors' behalf a few of the 6,000 or so hedge funds in existence. To be worth it, their choice has to provide returns in excess of the cost of borrowing, if they are leveraged, and two thick layers of fees (their own, and those of the funds they choose). Both funds of funds and the funds they invest in charge management fees (1% to 3% of assets) and performance fees (for hedge funds, a fifth or more of profits). With interest rates in America set to rise, and hedge funds losing money of late due to choppy markets, this is no easy task.

Some critics are concerned that the fee structure might encourage managers to borrow aggressively. Management fees are often calculated on the basis of all the money managed—debt plus equity—so that more borrowing means more pay. “It is an enormous conflict of interest,” says Nathan Gelber of Stamford Associates, a pension-fund consultancy in London.

Pick 'n' mix

Most worrying of all, however, is that funds of hedge funds might not be as stable as their basic sales pitch implies. In theory, the performance of a pool of hedge funds should be uncorrelated with the market as a whole. The complex investment techniques of hedge funds mean that some investments rise and fall with markets, while others move in the opposite direction; some funds follow “market-neutral” strategies. Pick a portfolio of these funds, and the resulting returns ought not to be too bumpy.

It might not work that way in practice. Increasingly, says James Hedges of LJM Global Investments, a hedge-fund advisory firm in Naples, Florida, hedge funds' strategies are correlated and their bets concentrated, because managers are making similar bets based on similar expectations. According to Hedge Fund Research, almost all broad hedge-fund strategies lost money in April and May. The reason, says Mr Hedges, is that “interest-rate expectations are 100% correlated.” For instance, most hedge-fund managers were caught by surprise by March's robust employment figures, which raised fears that interest rates would rise more quickly than had been previously assumed.

And the sheer amount of money flooding into hedge funds means that there are more dollars concentrated on the same positions. Funds also use similar models, based on similar data, to manage risk. The danger is that a sharp market move, triggered by a terrorist attack, say, or an unexpected change in interest rates, could cause a lot of hedge funds to unwind their positions at the same time. “The entire presumption of funds of funds, particularly those using leverage, is that the individual hedge funds are uncorrelated to each other, and uncorrelated to the market,” says one New York hedge-fund manager. “But what if they aren't?”

Many hedge-fund managers have an eye out for trouble. They watch the amount of money placed with them by leveraged funds of funds, aware that in times of stress banks might call this money in. This could in turn force hedge funds to unwind positions in a hurry. Skittish bankers, after all, prompted the demise in 1998 of Long-Term Capital Management, a hugely leveraged hedge fund studded with Nobel economics laureates, in the wake of Russia's default. With markets becoming more uncertain about oil, interest rates and terrorism, and with many hedge funds all betting the same way, piling debt on top of debt looks like a risky game.