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Famed for its deal-making prowess — and its bulging Rolodexes — Blackstone has quietly built one of the biggest hedge fund operations in the world. Here's how.

Chilling Times for Hedge Funds

By Robert Sloan

The 2005 bankruptcy of brokerage firm Refco, filed amid an alleged accounting scandal and potential fraud, has ensnared many investors, including, most prominently, veteran hedge fund manager Jim Rogers. Their securities — rather than having resided in segregated accounts at the firm's flagship regulated futures unit, Refco LLC, as creditors claim they should have been — were housed in and controlled by unregulated Refco Capital Markets, and then frozen.

In the wake of the Refco bankruptcy, investors and managers must ask themselves how their assets are being held and whether they can be frozen, or, worse, sold out from under them. Limited partners, general partners — indeed everyone in the hedge fund business — should be worried, because the foundation on which the industry is built may have major structural flaws.

Hedge funds are investment vehicles that are leveraged through short sales, debit financing, derivatives or structured products. The cost of financing is determined in an over-the-counter market where the relationship between credit providers and hedge funds is a brittle one, often bundled with commissions, initial public offerings and capital introductions. Most managers do not have the tools, personnel or infrastructure to handle complex value-at-risk calculations, let alone take action on them.

Prime brokers provide the operational support, reporting and technology infrastructure needed to run a fund. Managers who focus too much on that part of the business may miss the fact that prime brokers are financing more than \$1 trillion in net asset value for hedge funds.

Refco is a frightening reminder that less than eight full years after the collapse of Long-Term Capital Management, we are still coming back to the very basic issue of possession and control: Who holds the underlying assets, and when can they be bought or sold?

At its heart the case of LTCM was about excessive leverage. The Ph.D. Nobel laureates helping to run that firm were able to convince their prime brokers, some of whom also served as their placement agents, not to take "haircuts," the amount by which lenders typically reduce the value of securities put up by traders as collateral. As a

result, LTCM was able to borrow a full dollar for every dollar of securities pledged to finance its trading strategies, leveraging the firm to the point of collapse. The case of Refco is in some ways more terrifying.

Several years ago some well-informed hedge fund managers demanded that they be able to use the cash generated from shorting stocks to finance their long positions. Most prime brokers acceded to their wishes. Embedded in these financing arrangements, which are typically ISDA or enhanced prime brokerage agreements, is language that creates significant credit risk.

Traditional prime brokerage debit financing is conducted in a Regulation T margin account; enhanced prime brokerage and ISDA agreements are handled in a securities account. The former is a customer-segregated account, protected from the risks of counterparty bankruptcy; the latter is not. As happened with Refco, a prime broker is permitted to use the assets in a securities account without restriction. Moreover, under the current legal framework, fiscal prudence is punished: A manager who uses less leverage has more actual securities exposed to a failure by its prime brokerage or derivatives counterparties.

Many fund managers still use a single prime broker; if they do have a second one, they diversify only piecemeal. Too many managers believe prime brokerage is an on-demand service like a checking account — it isn't. Prime brokers can still change their funding terms overnight. The collateral haircuts are priced to win business, and managers are too reliant on a strategy of relationships and commission dollars to deal with serious counterparty-risk issues. The margin lockup agreements through which managers believe they have obtained portfolio protection may be little more than paper promises.

For Wall Street the prime brokerage business is incredibly valuable because it gives dealers an option on a huge source of liquidity — hedge funds' collateral. We have a situation where banks are making huge sums of money in proprietary trading while having the right to terminate or continue financing the hedge fund business. A severe credit crunch looms on the industry's horizon in the form of a collateral squeeze. As customers of Refco learned the hard way, the hedge fund–prime broker relationship is symbiotic up to the point of termination. Then it is unilateral.

Robert Sloan is founder and managing partner of S3 Partners, a New York-based company that provides treasury and liability-management products and services to hedge funds.

Managers could face a major credit crunch if they're not careful, thanks to the prime brokerage agreements they fought so hard to get.