

# Older and wiser

Why did last year's collapse of brokerage Refco cause so little damage to the secretive and loosely regulated hedge fund industry? Kevin Voigt looks at how hedge funds have grown up.

**E**ven by the standards of Wall Street scandals, the flameout late last year of commodities and futures trading firm Refco hit the headlines in spectacular fashion. In early October, its then-CEO, Phillip R. Bennett, was brought before the Refco board to answer for US\$430 million in debt he hid from the company. Days later, the brokerage declared bankruptcy – only two months after listing on the New York Stock Exchange.

As one of the largest independent futures trading companies, many immediately wondered if the Refco scandal was part of a house of cards, that its collapse would trigger a contraction of liquidity and further crashes through the industry. It's probably too early to tell, but considering the spectacular speed of Refco's fall and the months that have since passed without similar stumbles, smart money says hedge funds are going to withstand this – at least for now.

The Refco scandal confirmed many peoples' concerns about hedge funds, which are often domiciled in offshore tax havens and act in a highly secretive manner, but Refco didn't reverberate through financial markets as many feared. Refco, as a futures trader, dealt deeply in the hedge fund industry, but wasn't a hedge fund itself – it was a broker. While the firm's swift demise indicated trouble within the company, it didn't reveal any chronic flaws within the industry as a whole. This contrasts with the demise of several large hedge funds during the 1997-98 Asian Financial Crisis.

"Refco proved to be a case of out-and-out fraud by their top executive," says Simon Powell, principal for Peak Capital Ltd. in Hong Kong. And although US\$430 million worth of problems at Refco is nothing to sneeze at, the impact was not nearly as big within its industry as Enron or WorldCom.



## A maturing industry

First developed in 1949, hedge fund strategies came into the limelight in the 1990s, making names for star hedge fund managers such as George Soros and Julian Robertson, and helping to stoke interest in investment in emerging markets in Asia and Eastern Europe. More aggressively managed than government bonds and mutual funds, hedge funds take ambitious positions on future changes in currencies, stock prices and commodities. Unlike long-term investments in a company, which only make money on the upside, hedge funds use complex derivative instruments to make money when the market goes down as well.

The relatively flat performance of equities markets between 2001 and 2004 added to the interest in hedge funds. "It's a non-benchmarked asset – you're given total control of your money," says Powell. "The driver in investing in hedge funds is the total return, rather than outperforming an index."

There are valid reasons for hedge funds' secrecy. "They look for mis-pricings in the market, and take long or short positions based on their findings," says Philippa Hucke, a financial advisor in Hong Kong. "If you decide to short the dollar because you believe the dollar is going to go down, you don't want your competitors to know."

Some companies have bet everything on forecasting changes in

the market – and nearly lost everything. That's the devil's bargain in the hedge fund gamble: the bigger the stake, the bigger the rewards or losses. "When there are huge momentum plays without cover, that's where you get huge volatility and huge collapses," says Hucke. "That's where a lot of scandals occur."

The 1997-98 financial crisis was a reality check for the early exuberance of star fund managers, particularly after the 1998 demise of the wildly misnamed hedge fund manager Long-Term Capital Management (LTCM), a US\$100 billion fund that collapsed during the Russian debt crisis. The lessons learned from LTCM and others is another reason why Refco's failure didn't shake up the industry; since the late 1990s, institutional investors and hedge fund managers have created better risk management controls, according to Jonathan Hall, division director for Macquarie Bank in Australia. "The hedge fund industry really went through its crisis point in 1998," he says. "I think they learned a lot through that experience."

"In the early days, you had people like Robertson and Soros taking an opportunity and pushing it out to the max – big bets for big returns," adds Powell of Peak Capital. "Now it's become much more about controlling risk."

The players who stayed at the table after the LCTM collapse learned a valuable lesson; have a big pot, and don't bet it all. It's a lesson managers in more conservative equities investing could have taught these big stakes players a long time ago.

## Blurring of the lines

Indeed, as hedge funds mature, the very term itself appears to be used more and more liberally. Many funds are starting to look like traditional long-view investors. "There are always going to be some hedge funds that are elaborately dressed up long funds, and long funds with hedging in place," says Hall of Macquarie Bank. "A long-term trend will be the blurring of the line between the two."

For individual investors, it's nearly impossible to understand and evaluate good hedge funds from bad – other than, of course, in their overall performance. But as Refco shows, star players can quickly fall. It's difficult for consumers to weigh the



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## Did you know

► Today there are an estimated 8,000 hedge funds around the world. The volume of assets under ownership has risen from US\$120 billion in 1990 to over US\$1 trillion today.

pros and cons of any firm's individual strategy: The complex financial wizardry is not for the faint of heart. But there's one thing investors will learn quickly about hedge funds – their fees are higher: usually one or two percent of the total assets invested, plus as high as 20 percent of all profits. Huckle says she'll pay for high performance. But the pay structure does cause fund managers to take an exceedingly short view; their slice of profits are based on year-to-year performance. If a fund has a bad year, rather than stick with the strategy, fund managers often close the ailing fund and start anew with a new baseline, Huckle says. "Roughly 55 percent of hedge funds don't last five years," she notes.

Some analysts foresee a rocky decade ahead for hedge funds. The unknowns still abound: Regulators could take an added interest in these investment groups if the Refco investigation reveals creative accounting practices worth

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scrutinising at other firms. Another LCTM-style collapse, no matter how unlikely, would send shock waves around the financial services industry.

Although many hedge funds forecast double-digit returns for the next 10 years, Dr. Terence Moll, a senior partner at Consilium Capital in the United States, offers less optimism in an industry report: "The golden days of the industry are past, for three main reasons: disappointing equity returns, the erosion of opportunities and overcrowding."

As the Refco saga continues, the brokerage house that in large part was built through hedge fund trading is, in the short-term, being saved by a hedge

fund. After a 21-hour marathon auction that pitted five companies against each other, Refco's employees now work under the Man Group, one of the biggest hedge-fund companies in the world. As regulators sift through the wreckage of Refco, its former CEO sits at home with an electronic monitor on his ankle, after putting up a US\$55 million bond. While hedge funds still have a somewhat glamorous image, the industry does seem to be entering a more mature phase. Refco may have been a mid-life crisis, but its side effects were swiftly dealt with. As the Roman senator Cato once remarked: "Old age isn't so bad when you consider the alternatives." **A+**