

LGC&D Wealth Management, LLC

Educated Investor Feature Articles: 2008, Vol.20

September 12, 2008

Hedge Funds: Don't Bank on It

[#3 of a 3-part series]

Overview: Banks have been gravitating towards hedge funds as a means of new business for affluent clients. However, the early indications are that such a move may not have been in the best interest of banks or their clients. The following details some of the problems banks have experienced with the hedge fund world.

A May 31, 2008 article in the *Wall Street Journal (WSJ)* summed up the combination of hedge funds and banks:

“Getting into the hedge-fund business seemed like a no-brainer for big banks just a few years ago. Clients were hankering to invest in such funds, most banks had deep experience lending and trading with them, money was pouring into the industry and growth seemed assured.

“But on the heels of a run of recent embarrassments for banks that operate their own hedge funds, or buy stakes in funds, the foray is raising questions.”¹

One of those questions involve whether such a combination is a good idea for banks. In the past year, bank-led hedge funds have been in the headlines for the wrong reasons, with some losing billions of investor dollars and others closing. Let's take a look at some of the banks who have seen their new forays stumble.

Bear Stearns (now part of JP Morgan)

This is the tale of a hedge fund that started in housing and ended in handcuffs. In 2003, Bear Stearns introduced its High-Grade Structured Credit Strategies Fund. The fund showed steady success from its inception, posting returns of 1.0 percent to 1.5 percent per month.² In 2006, Bear Stearns introduced a sister fund — the High-Grade Structured Credit Strategies Enhanced Leverage Fund. At the end of 2006, these funds held a combined estimated \$1.5 billion.³

Unfortunately for investors, the funds' fortunes turned south in a hurry. The funds were heavily invested in the subprime mortgage market, and the turmoil that rocked this market in the summer of 2007 also hammered these funds. In July 2007, investors were told the original fund was down 91 percent at the end of June, and the enhanced leverage fund had no investor capital left.⁴

The tale of woe doesn't end there. In June 2008, the funds' managers — Ralph Cioffi and Matthew Tannin — were charged with securities, wire and mail fraud for allegedly misleading investors about the hedge funds' trouble. According to the *WSJ*, Tannin sent an e-mail to Cioffi, stating his worry that the funds' securities were “toast.” After discussing the situation between themselves and talking to a superior, the managers held a conference call with investors, telling them they were “quite comfortable” with the funds' holdings.⁵

Goldman Sachs

For those who follow the world of investment academia, Mark Carhart may be a recognizable name. Among his studies is his landmark study “On Persistence in Mutual Fund Performance,” which demonstrated that “common factors in stock returns and persistent differences in mutual fund expenses and transaction costs explain almost all of the predictability in mutual fund returns.”⁶

Not long after, Carhart left the academic world to join Goldman Sachs, where he runs the company’s flagship hedge fund, Global Alpha. The hedge fund was started in 1995 with \$10 million and was successful from the very beginning, generating returns of 140 percent in its first full year.⁷

Such returns continued after Carhart joined the management team, as the fund grew to \$10 billion. Carhart’s success led to him being one of Goldman Sachs most highly compensated employees, pulling in an estimated \$15 million to \$20 million per year. Another name in the world of academia, Russ Wermers, remarked that “he wouldn’t have predicted the ‘unpretentious, down-to-earth’ Mr. Carhart would become ‘a master of the universe.’”⁸

That universe turned on him in 2007. In the first eight months, Global Alpha suffered a 33 percent decline due to bad bets on everything from the Australian dollar, the Norwegian stock market and Japanese government bonds. In August 2007 alone, the fund dropped 22.7 percent.⁹

Citigroup

Citigroup has seen several of its hedge funds run into recent trouble.

When Citigroup purchased the Old Lane Partners hedge fund, it may have had its eyes set on more than an investment vehicle. The purchase was a way for the investment bank to lure its founder, Vikram Pandit, to the firm. Citigroup paid about \$800 million for the hedge fund in July 2007, including \$165 million to Pandit, who rose to the bank’s chief executive position in December 2007.¹⁰

Pandit certainly lasted longer than Old Lane. Only 11 months after purchasing the fund, Citigroup closed Old Lane, which had suffered through average returns and a loss of talent, which in turn led to significant investor withdrawals. In April 2008, nearly all outside investors withdrew their money from the fund, removing \$3 billion and leaving the fund with less than \$2 billion, all from Citigroup and Old Lane founders and employees.¹¹

The closing was the latest in a series of bad hedge fund bets by Citigroup. In fall 2007, Citigroup added a new fund to its Falcon Strategies group — Falcon Plus Strategies. This fund had twice the leverage of the other funds in the group and quickly saw its assets plummet. In three months, the fund dropped 52 percent of its value. The Falcon Strategies group as a whole dropped 30 percent in 2007, and Citigroup provided the funds with a \$500 million line of credit in February 2008.¹²

Citigroup also ran into problems with CSO Partners, a fund specializing in corporate debt. The fund posted an 11 percent loss in 2007, prompting investors to seek redemptions on about 30 percent of the fund’s \$500 million in assets. In response, Citigroup put \$100 million into the fund in January 2008 and suspended fund redemptions the following month.¹³

Summary

The marriage of hedge funds and investment banks seemed to be one built on a solid foundation. Banks having significant experience in dealing with hedge funds appeared to understand their culture. In addition, banks could provide hedge funds with tremendous resources for their strategies. In turn, hedge funds could give banks an investing allure for high net worth clients.

However, the relationship is looking more like one built on quicksand. The risky nature of hedge funds can provide banks with a black eye, and the deep pockets of banks make them a target for lawsuits when those risks show up. Investors would be wise to understand that even with the comfort of a large institution backing them, hedge funds are an investment to be avoided.

¹ Gregory Zuckerman and Jenny Strasburg, **Banks Fumble at Operating Hedge Funds**. *Wall Street Journal*, May 31, 2008.

² Gretchen Morgenson, **Bear Stearns Says Battered Hedge Funds Are Worth Little**. *New York Times*, July 18, 2007.

³ Ibid.

⁴ Ibid.

⁵ Kate Kelly, **Prosecutors in Bear Case Focus in on E-mail**. *Wall Street Journal*, June 19, 2008.

⁶ Mark Carhart, **On Persistence in Mutual Fund Performance**. *Journal of Finance*, March 1997.

⁷ Henny Sender, **Credit Crunch: Market's Ride: Goldman Hedge Fund Had Worst Month in August**. *Wall Street Journal*, September 14, 2007.

⁸ Randall Smith, **Goldman Gurus Strike It Rich With Hedge Fund**. *Wall Street Journal*, April 20, 2006.

⁹ Henny Sender.

¹⁰ Eric Dash, **All Told, the Price Tag for Citigroup's New Chief Is \$216 Million**. *New York Times*, March 14, 2008.

¹¹ David Enrich and Jenny Strasburg, **Citigroup to Close Hedge Fund**. *Wall Street Journal*, June 12, 2008.

¹² David Enrich and Tom Lauricella, **Citigroup Aids Internal Funds in Credit Crisis**. *Wall Street Journal*, February 23, 2008.

¹³ David Enrich, **Citigroup Fund Bars Exit by Investors After Bad Bet**. *Wall Street Journal*, February 15, 2008.

This material is derived from sources believed to be reliable, but its accuracy and the opinions based thereon are not guaranteed. The content of this publication is for general information only and is not intended to serve as specific financial, accounting or tax advice. To be distributed only by a Registered Investment Advisor firm. Copyright © 2008, Buckingham Family of Financial Services.
. To unsubscribe, please reply to this email with the subject line "unsubscribe."