Do Hedge Funds hedge? Explain and assess the strategies Hedge Funds adopt in order to fulfil their objectives. Illustrate your analysis with reference to one of: (ii) the role of Hedge Funds in the financial crisis from 2007.

Jack Pluck

Introduction

Hedging is the process in which some studies refer to as risk management. The reason is that hedging allows organisations like hedge funds to diversify their portfolios in order to reduce risk. If hedging is done properly organisations or investors can try and provide themselves with their own type of insurance. However, due to all investments being carried out on speculations some risk will always remain. This research will describe the main characteristics of hedging and how it can be implemented for different strategies and the techniques used to achieve these strategies. In determining how hedge funds operate and how they try and achieve profits, I will explore the effects the hedge fund industry had on the financial crisis of 2007. Going on to explain how hedge funds played a vital role in the crisis and why some were still able to make unprecedented returns even when the economy was failing. By exploring these effects I will be able to determine the distinction between hedge funds and their impact on the financial crisis, and possible ways the effects could have been reduced.

Hedging

According to Stulz (2007:177), 'Hedge funds are unregulated pools of money managed by an investment advisor, the hedge fund manager, who has a great deal of flexibility'. Hedge funds only take capital from wealthy investors who meet specific

requirements and have an understanding of investments; this is typically because the investments they conduct are expensive and complicated. Hedge funds aim to make high returns from risky investments, which is made possible by the fact they are unregulated and do not have to register with the securities and exchange commission. Some firms try to reduce the amount of risk associated with their investments so that they have better chances of achieving high returns. One technique of doing this is hedging. Acharya and Richardson (2009:233) described hedging as another explanation for risk management.

The principle behind hedging is to try and decrease the amount of risk that results from an investment in a financial security by investing in another at the same time that has the opposite outcome. This is done through a long and short method, whereby an investor will long (buy) a financial instrument they believe will increase in price and short (sell) an instrument that will decrease in price. The best hedge will reduce all risk with potential deviation in prices however; the potential returns are restricted by the cost of the hedge. Other options apart from hedging are arbitrage opportunities or speculative investments. Arbitrage opportunities are situations in which the hedge fund would profit from changes in the price of the same financial instrument in different locations. This investment is considered the least risky and as mentioned by Stulz (2007:180) 'Most hedge funds attempt to find trades that are almost arbitrage opportunities'.

The difference between firms that choose to hedge and those that look for arbitrage opportunities is that hedging requires firms to long or short the instrument in the hope of cancelling risk. In comparison to arbitrage opportunities as discussed by Shleifer and Vishny (1997) who state that 'although such positions offer attractive average

returns, the volatility also exposes arbitrageurs to risk of losses and the need to liquidate the portfolio under pressure from the investors in the fund'. This suggests that arbitrage opportunities are not the least risky as Stulz (2007) suggested, and hedging could reduce the volatile arbitrage opportunities.

On the other hand, firms that are more risky will just long or short on their speculations without hedging them, they either short a position and wait until the price drops enough to collect the returns or long a position they think will increase. This is a lot more risky but the rewards can be far greater than hedging as it is essentially betting. It is hard to distinguish the difference between speculations and hedging empirically, because hedging is just two investments of speculation. It is only apparent that the change in prices reduce the risk when compared with each other that you are able to see why hedging is more secure.

Different hedge funds place varying degrees of emphasis on how much risk they want to try and eradicate, this is because the more a firm tries to reduce risk the more cost it bares and the lower the returns. For example, a hedge fund could essentially just take a long position and see if it pays off, but by doing this they are essentially putting themselves in the position of possibly not making any returns if they are wrong. This is what has opened up the question as to whether hedge funds do actually hedge. Since they aim to make the highest possible returns like all other financial organisations the idea that they would reduce the magnitude of returns by hedging, is contradictory. However, Titman and Tiu (2010:123) do provide the argument that 'better-informed hedge funds choose to have less exposure to factor risk'. The idea of investing without some form of insurance would provide returns solely based on the gambling of the outcomes.

Strategies

As described by Garbaravicius and Dierick (2005:8) hedge funds use any 'combination of leverage, derivatives, long and short positions in securities or any other assets in a wide range of markets'. If a hedge fund wanted to invest 60% of capital in long positions and 50% in short, then the gross exposure for the hedge fund would be 110%. This would provide 10% leverage and as stated by Barbarino (2009) 'the greater the leverage, the less asset price volatility the manager will be able to endure'. By hedge funds being able to acknowledge their leverage, the firms who use hedging can control this more effectively and it allows them to stabilise their returns. Hedging is therefore the management of the firms' exposure.

Hedge funds use these techniques in achieving their strategy when investing, according to Garbaravicius and Dierick (2005:8) 'the first hedge funds were predominantly engaged in market neutral or "hedged" trading, trying to insulate their positions against market-wide gyrations'. Supporting Kroijer (2010) who had set up his hedge fund to follow this strategy from 2002 - 2008. However, Garbaravicius and Dierick (2005:8) suggest that due to the fact hedge funds are unrestricted, this type of investing is not the sole strategy. They suggest that the different types of investment styles can be grouped into 4 categories of strategies. They consist of 'Directional, market neutral, event driven and FOHFs (funds of hedge funds)', with all, aiming to accomplish the highest possible returns.

Hedge funds invest in any or all-financial instruments; bonds, stocks, options, futures etc. and they take different positions depending on what they believe the outcome will be of the instruments. The strategy of the firm is the determinant in what they are

looking for within these financial instruments. For example, the firms who want to be market neutral are much more likely to use hedging to manage their risk. This is because they do not want their results to correlate with economic events and therefore by hedging they are fundamentally protecting their investments from economic volatility. The hedge funds that have the directional strategy invest in all of the financial instruments and they bet on the potential direction of the prices. They use the speculative approach and often use leverage to try and make the highest returns, as leverage allows them to use more capital than they technically have. These hedge funds are the most risky but also have the highest returns if they place the right investments. However, Agarwal and Naik (2000) found that 'in general, the non-directional strategies display more significant loadings on Trading Strategy factors compared to their directional counterparts'. Suggesting the directional strategy provided lower returns and therefore could be viewed as a weaker strategy.

The events driven hedge funds look for derivatives that they know will be affected by economic events, which means they are reducing the speculation aspect of the investment. It is not as secure as a arbitrage opportunity but if firms are able to see a specific event, e.g. UK interest rates being announced to increase then they might choose to short the UK mortgage backed securities as they will assume less people are going to want a mortgage now that repayments will be higher. The events driven hedge funds can use the hedging technique to try and stabilise their investments, it is unlikely they will simply invest solely on a direction of the instrument. These firms have a much higher probability of betting against the market. This means, they can benefit from events that can potentially be disastrous for the economy. If a hedge fund or an investor knows that something will affect the economy in a negative way then they can short the market and end up profiting when the effect starts to initiate.

2007 crisis

As mentioned earlier, hedge funds can use a speculative approach to investing instead of just looking for arbitrage opportunities. If hedge funds knew about the potential decline of the economy from the toxic assets that were created then they could have used this in their favour. Hedge funds are not moral in their strategies; the purpose is to make money that is why the 2007 crisis would have been a great time for profits for the more knowledgeable firms. A lot of firms did go bankrupt during the crisis due to a reduction in the liquidity of the financial assets, but some also profited. The knowledge that could have preceded some large hedge funds in that they knew the assets were going to cause a crisis meant they did not even have to hedge. Hedge funds would have been able to short stocks and futures that they knew were going to decrease. This not only applies to the hedge funds, but all investors that would have been able to see the crisis coming.

The way in which investors would have been able to see this would have been because of their experience with different types of stocks. Hedge funds invest in complicated investment packages and therefore many of them incorporated asset-backed mortgages, specifically subprime mortgages that was said to have been the cause of the crisis. If hedge funds were trading these securities and new the true potential of what they meant then their investment strategies would have been a lot different. As Lo (2008) suggests, hedge funds were the fastest ones to secure their assets by selling off liquid stocks and removing all equity. Doing this allowed hedge funds to remove themselves from the possibility of being highly affected by the crisis. However, if we analyse hedge fund strategies we know that some are market neutral and therefore this would suggest that those firms would be the least effected by the crisis. This was not the case however, this is because the extent in which liquidity was

removed from financial assets within the market meant that the whole industry was effected. It no longer mattered whether firms used hedging to secure themselves because there were not enough positions to go long and short. It seemed that all the long positions made no sense and since everything financial was declining, most financial organisations started to short everything to try and make some money. This would have been the most logical approach as the market was no longer stable.

On the other hand, David et al (2011:45) found from their analysis that ‘hedge funds arbitrage ability is limited by their fast-moving capital’. ‘These financial constraints forced hedge funds to run for the exits after the initial losses’. ‘This behaviour may have amplified the initial negative shocks to asset prices and it certainly did not stabilize markets’. This provides a foundation for the idea as to why hedge funds chose to remove liquidity within the markets as stated by Lo (2008).

The principle of this research is to understand the role of hedge funds during the financial crisis; therefore, if we were to consider the strategies of the hedge funds before the crisis our understanding would be better. Hedge funds would have been using more leverage and would have been hedging their investments to insure they made their returns like usual. If the crisis was approaching then certain securities would have started to change, the returns for the hedge funds would have changed without the hedge funds investing in anything different. This is what is likely to have started the realisation that the economy may have been going into a crisis. If hedge funds and other financial institutions would have kept their confidence and would have carried on investing the same way they had been then the outcome might have been different.

For example, had the hedge funds not withdrawn liquidity from the market and therefore reduced the amount of money within the economy, reduced the amount of money banks had to lend then maybe the effect would not have been as long. There is no way to say this for sure since this is just speculation, but since most investments are based on speculation and all investors were likely to have had the same perspective then it seems obvious that this was the end result. The toxic assets were likely to cause firms to lose money because the basis behind selling mortgages to people behind them did not make sense in the first place. However, firms should have absorbed this loss rather than try to withdraw from the markets. Crotty (2008:53) states that 'financial institutions will be less willing to take the additional risks associated with new loans, and interest rates on bonds will rise as forced sales lower bond prices'. 'The rising cost of capital to shaky financial institutions means that whatever loans they are willing to make will have high interest rates attached'.

Hedging could not have saved hedge funds from the negative outcomes of the crisis, but it is the likely reason as to why so many withdrew themselves when they saw the financial instruments prices deviating too far from their expected outcome. This is because they had speculated on the outcome of the securities including the mortgages to increase and therefore they hedged against this with ones that would decrease. So when they also started to decrease by more than the original short there would have been no risk management technique left other than to try and secure the assets that did not include the toxic mortgages.

Conclusion

Throughout my research I have found that the hedge funds do use the hedging technique to offset the riskiness of their investments. They choose to invest in securities which they believe will have the highest payoff and they are always looking for different ways to accomplish this. Each hedge fund has its own unique strategy of which securities they are going to invest in, the most common technique for hedging is the long and short method. There is always some element of risk associated with hedging because all investments are made on speculations. Some investors prefer hedge funds that try and take a market neutral approach, as they do not want to partake in opportunities that could potentially end up like the 2007 crisis. However, other strategies like the events driven approach can provide far greater returns if the hedge fund is able to determine the correct points in which to buy or sell the financial instrument. There are a variety of instruments hedge funds choose to invest in, but due to the lack of restrictions within most of the shadow banking industry, hedge funds are able to invest in very complex and risky instruments. Other investment organisations like mutual funds are far more regulated and are not able to invest in some of the derivatives that hedge funds can. Derivatives include some of the specified instruments within this research such as options and futures etc. The reason these are the most invested in is because they are very liquid and the ease at which they can withdraw equity if needed is far greater. We see that the hedge fund industry had an effect on the magnitude of the financial crisis of 2007; this is because they were the main source of the reduction in liquidity. Hedge funds were not the cause of the crisis due to the fact they do not create financial instruments to invest in, they are investment organisations and therefore the result was down to brokerage firms who compiled toxic securities.

References

Acharya, V.V. and Richardson, M.P. (2009) '*Restoring financial stability: How to repair a failed system'*. United Kingdom: Wiley, John & Sons.

Agarwal, V. and Naik, N.Y. (2000) *'Performance evaluation of hedge funds with option-based and buy-and-hold strategies'*, SSRN Electronic Journal, .

Barbarino, F. (2009) 'Leverage, Hedge Funds and Risk', *NEPC*, .

Crotty, J. (2008) *'Structural causes of the global financial crisis: A critical assessment of the "new financial architecture'*, Cambridge Journal of Economics, .

David et al. (2011) '*Hedge fund stock trading in the financial crisis of 2007-2009',* Fisher College of Working papers, .

Garbaravicius, T. and Dierick, F. (2005) '*Hedge Funds and Their Implications for Financial Stability'*. Germany: European Central Bank.

Kroijer, L. (2010) '*Money Mavericks: Confessions of a Hedge-Fund Manager'*. Great Britain: Pearson Education Limited.

Lo, A.W. (2008) '*Hedge funds, systemic risk, and the financial crisis of 2007-2008',* Written testimony for the house oversight committee hearing on hedge funds.

Shleifer, A. and Vishny, R.W. (1997) *'The Limits of Arbitrage',* The Journal of Finance, 52(1), pp. 35–55.

Stulz, R.M. (2007*) 'Hedge funds: Past, present, and future',* Journal of Economic Perspectives, 21(2).

Titman, S. and Tiu, C. (2010) *'Do the best hedge funds hedge?'*, Society for Financial Studies, 24(1), pp. 123–168.