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Hedge-fund problems highlight need for diversification

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The U.S. subprime market has dominated headlines in the last six months. Countywide Financial, a gigantic home lender, has had well-publicized problems.

Bear Stearns, a prominent Wall Street firm, had to bail out its own credit-based hedge fund.

Sowood Capital, another large, leveraged hedge fund invested in subprime debt, blew up after its losses exceeded 50 percent.

However, during the second week of August, quantitative hedge funds (firms that rely on data-based models driven by computers) employing long/short equity strategies suffered heavy portfolio losses, while hedge funds using other strategies didn't.

As losses mounted, funds reduced risk in their portfolios by selling shares and raising cash, only to see the markets rebound as they sat on that cash.

According to The Wall Street Journal of Aug. 10, "After the close of trading, Renaissance Technologies Corp., a hedge-fund company with one of the best records in recent years, told investors that a key fund lost 8.7 percent so far in August and is down 7.4 percent in 2007. Another big fund company, Highbridge Capital Management, told investors its Highbridge Statistical Opportunities Fund was 16 percent down for the year."

Hedge funds have become dominant market players. It's interesting to note how the trading behavior of a class of hedge funds has affected the performance of other classes of hedge-fund strategies.

The MIT Sloan School of Management studied the August four-day financial storm that caused so much pain to hedge funds and their investors. It's developed an interesting hypothesis about the rapid unwinding of quantitative equity long/short portfolios.

The Sloan researchers concluded other broad factors contributed to the losses in this rapid unwind and will continue to affect investment performance both positively and negatively. Investors – particularly trustees and fiduciaries – in hedge funds should pay attention to these factors.

These factors include:

- They believe that a sudden liquidation of a large multistrategy hedge fund or proprietary trading desk – which are not made public – was part of the problem. Speculation that "margin calls from a deteriorating credit portfolio, a decision to cut risk in light of current market conditions or discrete change in business lines was a partial case of collapse," the report says.
- There has been a tremendous growth of long/short and market-neutral hedge-fund strategies.
- Advances in technology, increased competition and decline in market volatility has made it tougher sledding for quantitative (computer-driven) strategies. If everyone is using the same factors, it's hard to develop an edge over competition, let alone passive strategies.
- Leverage has increased dramatically as hedge funds reach for higher returns. Investors and advisors can be swayed by great returns generated by leverage without understanding the higher risks.
- Illiquid credit strategies have led to panic in nearly all markets and strategies. Hedge funds have invested in subprime mortgage, below-investment-grade corporate debt, bank loans and other receivables, such as credit cards, car loans and medical receivables.

Some have leveraged these illiquid investments that exacerbated losses as buyers left the market.

It's easy to get lazy (or arrogant) about investments when times are good. Investors and fiduciaries must understand diversification basics with all investment products, especially in the unregulated hedge-fund arena.

Just as with traditional strategies (stocks, bonds; growth, value; small, large; domestic, international), hedge-fund diversification is crucial. Know your hedge-fund characteristics, strategy, approach, expertise and especially leverage.

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