BCM
Newsletter

BALTIMORE CAPITAL MANAGEMENT

575 S CHARLES STREET
SUITE 506
BALTIMORE, MARYLAND 21201
PHONE: 410-727-4480
FAX: 410-783-7917
EMAIL: AGRAHAM@BALTIMORECAPITAL.COM
WWW.BALTIMORECAPITAL.COM

THE WORLD OF HEDGE FUNDS

January 1, 2009
Issue: 50

In past newsletters we highlighted a few problems we thought existed with fund of funds and private equity funds. Over the past year, several structural problems have been revealed within the hedge fund industry that we think negatively impacted markets around the world. Issues that have come to light include funds' perverse fee structure, aggressive use of leverage, contractual clauses, and investor redemptions.

The hedge fund industry has enjoyed two decades of extraordinary growth. From 1990 to 2007, the industry grew fifty fold peaking at roughly $2 trillion in assets and over 7,000 funds. As of 2009, hedge fund assets stand at roughly $1.5 trillion. Likewise, the number of funds expected to fall by nearly half.

A standard hedge fund compensation structure includes a 2% management fee combined with a 20% performance fee based on appreciation above a high water mark. A high water mark makes it so that a manager only receives performance fees on the value of the fund that exceeds the highest net asset value previously achieved. For example, if a fund declines 30% from 100 to 70, and in the second year then appreciates 100% from 70 to 140, the investor only pays the 20% performance fee on the 40% appreciation above the high water mark of 100.
Many within the hedge fund industry argue that this is appropriate because it aligns the manager with investors as they only receive the 20% performance fee when the fund is profitable.

However, a precipitous decline in performance prevents managers from being accountable in that they often close the fund, saddling the investor with heavy losses. Managers did not anticipate a large decline, 30% for example, and consequently realized achieving the necessary 43% return to regain their high water mark was unlikely. As a result, these managers chose to close their fund and return the remaining capital to investors.

Hedge fund participants became discouraged by large losses from funds they falsely assumed would be safe havens in times of duress because the funds were "hedged", these investors received an even bigger shock when managers invoked the gate clauses within their investment agreements. For many funds, if the manager believes that selling assets to meet redemptions would have a negative effect on the remaining investors' holdings they could prevent withdrawals by claiming it would unfairly hurt those who remain invested. As more funds "put up the gates," investors began redeeming investments from whatever funds would allow them, fueling the "crisis of liquidity" often cited by the media.
In an effort to maintain stability in their funds, many managers raised cash positions anticipating future redemptions which propagated the selling pressure. Merrill Lynch estimated that between July and August, hedge funds increased their cash positions from $156 billion to a record $184 billion, 11% of assets. As redemptions intensified throughout the fourth quarter, cash positions certainly increased and pushed stock markets around the world to their lows of the year in mid November.

To say the past year was challenging would be an understatement. However, we believe the relentless selling by hedge funds is a temporary phenomenon. We do not believe this selling activity represents rational investment decisions but in times of great uncertainty many irrational transactions occur. As we enter 2009 we believe market participants will choose to evaluate investments based more on their fundamentals than on the ability to quickly exchange the investment for cash should they change their minds.