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Use in case of turbulence

As a year of market ructions continues with the current stock market nosedive, effective cash management is becoming increasingly important, as hedge funds seek safety and look to reassure investors.

Talk about being kicked when you're down. Having stuttered their way to largely flat YTD returns, hedge funds were among the many investors to take a hit when markets began to plummet last Thursday. Stock markets in the US, Europe and Asia recorded their biggest losses for two years – wiping billions of dollars from global value.

Of course, it's not the first time hedge funds have suffered. And many would argue the warning signs were pronounced. But what appears different about May through August 2011 is that more managers are taking more risk off the table and less are willing, or able, to get a handle on the storm. At an Institute for New Economic Thinking conference in April, just months before he was to exit the hedge fund space entirely, George Soros said he found the current environment “much more baffling and much less predictable” than he did at the height of the credit crisis.

Tellingly, Soros's hesitancy was reflected in particularly high cash holdings at his flagship Quantum Endowment Fund. The fund was down a reported 6% for the year to mid-June and, according to reports, Quantum portfolio manager Keith Anderson took cash up to 75%. Soros wasn't the only one; Moore Capital was just one of a number of other firms reported to have taken a similar stance. According to a June Bank of America Merrill Lynch survey, 18% of allocators were overweight cash – the highest percentage for a year.

The bank's July survey makes for better reading – overnight cash holdings for the survey's asset allocators, including hedge funds, were at 4.1%, down from 4.2% the month previous – but levels remain among the highest for months. Safety in cash has rarely been more widely sought. Managers are battening down the hatches.

Cash management has always been of importance to hedge fund managers. The nature and tone of the recent turmoil, however, have given the service – long considered among the more uninspiring elements of the hedge fund risk model – a heightened sense of purpose.

“There're two dimensions to the cash management question,” says Andrew Kennedy, COO of London-based hedge fund SAM Capital. “The first is about trying to make a return for your investors from the cash you're sitting on – in the current environment that's very difficult because anything short term offers virtually negative returns. The other is almost a risk management decision, about being in cash to avoid potential market losses, and that seems to be driving a lot of the cash decisions right now.”

Typically, SAM will sit at 20-50% cash overnight and sometimes as high as 70-75%. Very occasionally, Kennedy adds, the firm will move to 100% cash overnight before starting again the next day. The firm is “definitely on the higher end” of that range at the moment, he says.

Quantifying the average hedge fund's current cash holdings is a tricky business – wide variations along the lines of fund strategy and risk appetite make the task a misnomer to a certain extent. What is clear is that cash levels at hedge funds are unusually high.

Bank of New York (BNY) Mellon Alternative Investment Solutions, which offers cash management services as part of a full or partial prime custody relationship, has seen increased activity since the start of the year. "To be honest, we've seen managers turn to cash period," says Luke Spencer-Wilson, alternative investment services sales at the firm. "A lot more managers will have redeemed some of their bond positions, for example, to cash."

In fact, the BNY Mellon banking group at large has made headlines for seeing an influx of cash. In what was widely considered an unprecedented move, BNY Mellon Corp has begun charging institutional clients a reported 13bps for excessively large deposits compared to June averages. Other banks are expected to follow.

Chicago-based Horizon Cash Management, a third-party specialist with a large hedge fund client base, is another business to profit from the current uncertainty. "Overall, we have seen all types of funds increase their cash reserves," says Horizon president Pauline Modjeski.

"One of the reasons why we see increases at times like these is that funds are either reducing their leverage or sweeping out all excess balances from the prime broker or clearing firm," she adds. "Some funds tend to keep a cushion of excess cash to cover small margin movements. However, we also have seen funds do away with this cushion and keep just the required margin or collateral needed."

European debt concerns, debt ceiling congressional wrangling, and BNY charging clients for depositing cash have all led to increased awareness of cash management, says Lou Lebedin, co-head of prime brokerage in the US at JP Morgan. "Lately we have noted a slow migration moving back into select prime and government/repo fund products, but cash deposits are still the preferred option."

Operating a highly liquid strategy, SAM Capital will frequently move in and out of cash. Whether it's for overnight security or short-term safety, typical measures have been to purchase money market instruments via the firm's prime broker. T-Bills (Treasury Bills) and Govies (Treasury Bonds) top the list. SAM's Ucits fund, for example, currently buys German and Dutch T-Bills when running large cash balances.

"The issue right now, especially in the last couple of weeks, is whether there are solvency issues around these issuers," Kennedy explains. "It's not a million miles away from the kinds of issues that started being raised in Q3 2008."

Comparisons to the credit crisis have gained increasing weight in recent weeks. Thursday's plunge brought not only factual similarities but emotive ones too – the fear is back. For many investors, however, a hedge fund allocation is a way of outsourcing fear and concern into the hands of someone more capable of dealing with it.

"The nature of the fee arrangement creates discomfort when a sizable portion of a hedge fund investment is in cash," admits Donald Kendig, a trustee at the \$1.65bn Santa Barbara County Employees' Retirement System (SBCERS). "I have felt the same discomfort with private equity, yet trustees understand intrinsically that you do not want to rush allocations to private equity opportunities, just to have exposure. The same can be reasoned for hedge funds. It feels more difficult, though, maybe due to the belief engendered by hedge fund managers that there should be risk-adjusted opportunities in up, down and sideways markets."

One way Kendig has seen private equity firms handle the “high fees for cash management discomfort” is by rebating a portion of the flat fees when there are long periods of no investible opportunities. This is something, he says, of which hedge fund managers should take note. “True longevity should result for the firms that best manage fee expectations on top of performance. If it is not for lack of investment options, and a hedge fund manager is actually looking at holding cash as a ‘tactical’ investment strategy, the manager better make it clear to the client why it is prudent.”

With market turmoil and uncertainty showing little sign of abating, managerial cash strategy is a conversation that more and more investors are likely to be having with their hedge funds. How much sympathy they offer is, as always, going to depend largely on performance – but there is likely to be a limit to how long an investor will accept paying accelerated management fees for dormant assets. As the events of this week suggest, picking the right cash management strategy, and articulating it to the investor base, appear more important than ever.