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Hedge Fund ALERT

Industry Pros Brace for Deep Freeze

A swath of industry professionals including hedge fund operators and prime brokers are preparing for a stretch of deep illiquidity.

Consider a note that global-macro firm **Element Capital** sent to investors after the close of trading on March 13, stating that extreme volatility had "begun to impact the liquidity and funding environment:' And that was before the financial market plunged on March 16.

In its letter, Element relayed numerous marketwide steps taken in the previous days to adjust to the new environment.

For example, derivatives clearinghouses have substantially increased margin standards for their contracts, including hikes in the security deposits buyers and sellers must supply in the form of so-called performance bonds. While **CME Group** wasn't named in the letter, the exchange operator hiked collateral requirements for many products, including what amounted to a 61% bump for S&P 500 futures from March 2 to March 17.

The commission merchants that take Element's orders, meanwhile, have departed from a standard practice in which they waited a day before passing along the tighter requirements. Concerned that hedge fund managers won't be able to front the additional cash or securities, they now are asking those firms to meet the new standards on the day they change.

Element said in its letter that it also saw evidence that some relative-value fixed-income books were unwinding amid a steep decline in debt-market liquidity (see article on Page 1). In fact, there is talk that the **Federal Reserve** took the potentially destabilizing effects of those sales into account in pumping liquidity into the market over the past week.

While Element still is aggressively looking for places to deploy capital, the $18 billion firm also is taking steps to avoid a liquidity crunch. Among the maneuvers was a simplification of the shop's portfolio, with a preference for highly liquid holdings.

Element has exited some over-the-counter contracts in favor of exchange- traded positions that can be more easily bought and sold without dealing with bank intermediaries. Because many of their employees are working from home, banks are operating below capacity when it comes to trading over-the- counter contracts. Element is among many others in keeping large amounts of capital in cash or equivalents, and has more money in excess margin collateral.

Prime brokers separately have been increasing daily margin requirements for some hedge funds, particularly those running long-only or long-bias portfolios. "Their performance is really suffering, and there have been margin calls;' one prime- brokerage executive said, adding that all of his clients have met those calls so far.

Michael Katz, founder of vendor-focused advisor **Quadrangle Consulting**, said prime brokers' responses also have included contacting clients with term loans. The purpose is to get a better read on whether those firms' abilities to repay will be affected by worsening returns or incoming redemptions.

Term loans typically are taken out by managers that employ leverage equivalent to at least three times their equity. While standards vary, a firm that loses 15-20% over a month, 25-30% over three months or 35-50% over 12 months might be considered in technical default. In that scenario, the prime broker could call the loan and force the manager to exit its positions.

Usually, a bank would seek to avoid that outcome. But with an unprecedented number of hedge funds potentially about to hit their one-month loss triggers all at once, the prime brokers might seek to reduce their exposures by demanding repayment – causing the declines to become realized.

In addition, hedge fund managers, and equity-focused shops in particular, have been seeking to establish nonbank custodial accounts where they could park unleveraged assets out of the reach of their prime brokers. The idea there is to avoid having assets stranded at banks that encounter liquidity crunches of their own, as occurred in **Lehman Brothers**' 2008 blowup. "Managers are preparing for a worst-case scenario;' one administrator said.

Elsewhere, law firm **Schulte Roth** sent an alert to clients reminding them of their options and obligations should various disasters arise. For example, the firm is advising managers to consider updating marketing materials to reflect material facts that have arisen amid the market stress and guiding them on how to handle illiquid holdings.

Hedge Fund Performance

	Feb. Return (%)	YTD Return (%)
BENCHMARK INDICES		
S&P 500	-8.2	-8.3
Russell 2000	-8.4	-11.4
MSCI EAFE (Europe, Australia, Far East: net)	-9.0	-10.9
Barclays Aggregate Bond	1.8	3.8
Barclay Hedge Fund Index	**-2.7**	**-2.9**
3,000+ funds (unweighted)		
Credit Suisse Hedge Fund Index	**-2.0**	**-1.8**
5,000+ funds (weighted)		
Eurekahedge Hedge Fund Index	**-1.6**	**-1.6**
2,700+ funds (unweighted)		
HedgeAlytix (CogentHedge)	**-2.4**	**-1.9**
600+ funds (unweighted)		
HedgeFund Intelligence	**-1.0**	**-0.6**
7,000+ funds (unweighted)		
Commodities	-0.2	-0.2
Convertible & equity arbitrage	0.1	0.4
Credit	-0.3	0.5
Distressed	0.2	0.1
Event-driven	-1.7	-1.8
Fixed-income	-1.2	-0.5
Global equity	-2.6	-2.1
Latin American debt	-2.0	-1.6
Latin American equity	-2.2	-1.3
Macro	-0.2	0.1
Managed futures	0.1	0.3
Mixed arbitrage	-0.1	0.3
Mortgage-backed securities	0.5	1.5
Multi-strategy	-2.1	-1.7
Technology	-3.5	-3.9
U.S. equity	-3.0	-3.7
HFN Hedge Fund Aggregate Average	**-2.3**	**-2.4**
4,900+ funds (unweighted)		
HFRI Fund Weighted Composite	**-2.0**	**-2.4**
2,000+ funds (weighted)		
Preqin Hedge Fund Analyst	**-2.2**	**-1.6**
2,000+ funds (weighted)		