THE WALL STREET JOURNAL.
WSJ.com
SEPTEMBER 30, 2008

Market Drop Pressures Hedge Fund Managers

A Worry for the Market: Hedge Funds
May Be Forced to Sell Even More Stock;
Weaker Firms May Go by the Wayside

By JENNY STRASBURG

Monday's market drop could force hedge-fund managers, already pressured by losses, to sell more holdings, spurring further market declines.

The rout couldn't have come at a much worse time for the $2 trillion industry, which is experiencing its worst performance in nearly two decades and has endured significant withdrawals this year and expects more.

"This is going to be a big hit," says Todd Goldman, principal with Rothstein Kass, an audit and tax firm with many hedge-fund clients.

In recent weeks, the credit crisis has reshaped Wall Street and consolidated commercial banks.

Now, it stands ready to decimate hundreds of players in the hedge-fund industry at a time when the markets need their money more than ever.

Even before Monday's plunge, Mr. Goldman and other industry insiders were expecting between 10% and 20% of the hedge-fund industry's assets to be withdrawn by year end.

That could mean some $400 billion yanked from managers' hands, though some money likely would quickly get transferred from losing managers to stronger ones.

Regardless, even though the growth in hedge funds in recent years is expected to resume, a short-term pullback would hurt the markets by accelerating the selloff of stocks and other fund holdings before their values bounce back.

Year-End Decisions

A big chunk of hedge funds' investors have until Tuesday to decide how much money they would like to pull from the funds at year end. Instead of calm in these last days before the quarter's close, investors got panic.

That boosts the chances that hedge-fund closures will pick up sharply in the coming months, experts say, as down-on-their-luck managers continue to lose value in their holdings, and clients bail.

"There's going to be a death spiral for a number of these funds, and I don't think we've even begun to see the unwinding," said Mark Lehmann, president of JMP Securities in San Francisco, a boutique equity-research and brokerage firm.

He said many stocks favored by hedge funds, and where they found havens earlier this year, have been hammered lately.

Some fell by double digits Monday. They include Apple Inc., which fell 18%;U.S. Steel Corp. which dropped 17%; and ConocoPhillips, which gave back 9.1%.

Apple and ConocoPhillips were among hedge funds' 10 most-held names at the end of June, according to Goldman Sachs Group Inc.

Pain Felt All Around

The pain in the markets has afflicted hedge funds of all styles and sizes, including some managers who have been among the industry's biggest stars, such as Kenneth Griffin's Citadel Investment Group and Dinakar Singh's TPG-Axon Capital Management.

Both are losing money this year, and they're far from alone.

In fact, some of the biggest hedge funds have been among the harder-hit.

Still, big funds with years of stellar performance behind them have built up good will among investors as well as investor confidence in their ability to bounce back -- even at a time when rule changes and bank failures have stymied their investment strategies.

Many of the larger, more-diversified funds are expected to survive, even if they slim down for a while.

A Shrinking Pool

But some industry insiders predict that as many as one-fifth of the approximately 10,000 hedge funds that were in business at the start of 2008, as estimated by Hedge Fund Research Inc., will be out of business before long.

"We would not be surprised to see the current population of roughly ten thousand hedge funds shrink twenty percent within the next 12- to 24-month period," principals of Cook Pine Capital, a Greenwich, Conn., firm that invests wealthy clients' money in hedge funds, predicted in a recent report.

Cook Pine's wealthy clients have stayed put during the volatile markets, said Scott Baker, a principal of the firm.

Hedge-fund returns have declined almost 10% this year so far through last week, on average, according to performance data tracked by Chicago-based Hedge Fund Research.

While that handily beats the broader market, it still takes a toll on hedge funds, whose managers are paid handsomely on the premise that they can make money no matter what the market does.

Write to Jenny Strasburg at jenny.strasburg@wsj.com