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Brokerages Tighten Hedge Fund Financing

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Brokerage firms are reducing financing and other services to hundreds of hedge funds, in a move that could accelerate the shakeout among these heavy-hitting investors.

Under financial pressure, securities firms are dividing their hedge-fund clients into lists of those they consider best able to weather the financial turmoil and those they're less sure of. The result is that more funds may have to merge, find other financing at higher cost or close.

The squeeze, described by a range of brokerage-firm and hedge-fund officials, takes different forms. For instance, they say firms have reduced financing for the flagship fund run by John Meriwether, a founder of Long-Term Capital Management, the fund whose near-collapse caused a brief market crisis in 1998. The move has forced Mr. Meriwether's Relative Value Opportunity fund -- down 42% in 2008 -- to reduce its borrowing to finance trades, putting pressure on returns. Mr. Meriwether, whose firm is called JWM Partners LLC, declined to comment.

Banks also have pressed Kenneth Griffin's Citadel Investment Group, whose biggest funds lost 54% last year, to sell some securities and reduce its borrowing to finance trades. Goldman Sachs Group Inc. increased financing costs last year when a big trade went sour for another large fund, Glenview Capital Management. J.P. Morgan Chase & Co. has tightened financing terms for some funds.

Being on banks' less-favored lists doesn't necessarily mean a death knell for hedge funds -- private investment partnerships that cater to institutions and the rich and have wide discretion in their strategies. Plenty of such funds could continue, especially smaller ones that don't rely heavily on Wall Street. Funds also could get off the lists if their returns rebound or they get cash infusions from investors. But since many hedge funds make heavy use of borrowed money, or leverage, reduced financing can crimp performance.

Funds on Wall Street banks' A-lists receive, besides financing, perks such as stock research, trading data and introductions to executives of companies in which they might invest. Among funds on the A-lists are such stalwarts as Moore Capital Management, Tudor Investment Corp. and SAC Capital Advisors.

The B-List

But Wall Street banks have put 200 or more other funds on what might be called B-lists: funds seen as either too risky -- because they could fold -- or not profitable enough to the banks.

The moves reflect a sharp reversal. For years, banks competed hotly to draw hedge funds to their "prime brokerages," which handle securities trading and lend clients money. Now prime brokers are in retrenchment as their parent banks reel from losses and take care not to take undue risk in lending out their cash.

Hedge funds' short-term trading has made them a major force in financial markets, influencing prices of assets from stocks to oil, but their clout is slipping as some post big losses. Their assets have fallen to about $1.4 trillion from $2

trillion in mid-2008, according to the firm Hedge Fund Research. Hedge funds closed at a record pace last year, with around 1,300 liquidating, the firm says.

The shakeout could lead to continued instability in the financial markets in the near term as troubled funds sell assets. Longer term, fewer hedge funds could mean lower financial-market volatility, since the funds tend to be such rapid traders.

Wall Street banks' fund lists aren't uniform. Goldman has a "tail list," meaning funds at the tail end of its ranking of clients by size and profitability to Goldman. J.P. Morgan has a "platinum" list of preferred fund clients, who get a "high touch" menu of premium services. Others are offered a "low touch" list of services.

At Credit Suisse Group, a list of 400 favored funds its prime-brokerage unit wants to do business with is called the "CS400." Those Credit Suisse considers expendable, ranked by their prospects and how much revenue they bring to the firm, are on its "conversation" list. Credit Suisse's prime-brokerage head, Philip Vasan, said the firm has turned down potential clients and is "reserving capacity for long-term clients."

The banks are making a calculation that funds with heavy investor withdrawals and poor 2008 returns have a lower chance of survival. That's partly because of the way hedge funds collect fees. They normally take 20% of investment profits. But a fund that is down, say, 40% from its peak can't start collecting this slice of profits again until it reaches its high-water mark, which would mean recording at least a 66% gain -- a tall order in today's markets.

Harbinger Capital's biggest funds were up more than 40% last year before tumbling to 2008 losses of 23% to 27%. The drops mean they'll have to more than double before their manager, Philip Falcone, can start collecting performance fees again. He is working on starting a new distressed-debt fund that wouldn't face this hurdle. Mr. Falcone declined to comment.

Bad Bet on VW

Glenview Capital is among fund firms on which Goldman tightened financing terms last year, even though Glenview's manager, Lawrence Robbins, has been a Goldman client for years. Glenview had bet against shares of Volkswagen AG and was hammered when the shares -- under accumulation by rival Porsche -- suddenly shot up in October. Higher requirements Goldman set for margin loans forced Glenview to close out positions at a loss, according to investors and others familiar with the matter, and Glenview's biggest fund lost 49% in 2008. Glenview now has roughly $4 billion in assets under management, versus about $9 billion at the start of 2008.

Citadel, long a prized brokerage client because of its big trading volume, was directed by lenders to post more collateral more than once in 2008 as the market turned against it, say people familiar with the matter. The banks' moves -- made even though Citadel has some secure longer-term financing -- caused Citadel to sell some securities and to reduce its use of leverage. Citadel declined to comment.

Losing 'Touch'

In Dallas, fund manager Colby Harlow says he landed on J.P. Morgan's less-favored "low touch" list even though his small $150 million hedge fund broke even in 2008 -- a far better performance than most hedge funds and the markets in general.

Mr. Harlow became a client of J.P. Morgan last spring after it took over Bear Stearns Cos., where he had done business. He says J.P. Morgan recently told him it would stop paying interest on cash balances in his account and has started charging him a fee to borrow certain stocks for trades he used to be able to do without an extra charge. Mr. Harlow said the new costs haven't been onerous to him but the message is clear: Smaller firms are getting less attention.

A J.P. Morgan executive, declining to talk about individual clients, said the bank is focused on profitability: "We look at the wallet opportunity. How much can they really pay in terms of commissions?"

Some funds find that brokerage firms are adding monthly "custody fees" or "administration fees" and ceasing to accept certain assets as collateral on loans. At Goldman, which has imposed some such changes, executives say they are committed to the prime-brokerage business but have ratcheted down risk. People familiar with Goldman expect it to trim its roster of about 1,500 hedge-fund clients by a fifth or more, leaving others with such unattractive service they'll probably go elsewhere.

Investors, too, are ranking funds, and culling them at a faster pace. "We typically have 50 to 75 managers on our radar screen," said Scott Baker of Cook Pine Capital LLC in Greenwich, Conn., which invests in hedge funds on behalf of clients. "Over the past few months, we've reduced that list by probably 25%."

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