Australian Financial Review: Hedge funds' time has come again

By Jonathan Shapiro
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For those that believe that hedge funds won't be able to make a buck in a world where yield hunters and easy money has bid up the price of everything, think again.

The changing forces in the banking sector, deleveraging and a shake-up in corporate governance at the world's biggest companies means it's prime time for many hedge funds.

That's the message from panellists at the Bloomberg Hedge Fund Summit, held in New York earlier this week.

Perhaps the most interesting recent trend in the hedge fund space is increased corporate activism. Hedge fund activism may sound familiar, but what is changing is that these funds are getting greater traction, and now they're targeting the world's biggest companies that had largely been immune from the pestering of hot money.

No company is too large for hedge fund activism. Technology giant Apple, with a $US400 billion market capitalisation, was the target of David Einhorn's $10 billion Greenlight Capital, while Pershing Square's Bill Ackman has poured billions into Proctor & Gamble in the hope that he can cajole the underperforming consumer brands giant to match its peers returns.

Activists are also venturing into the corporate governance minefield of Japan, as Daniel Loeb presented a plan to break up Sony.In the sights of activists

There are several reasons why large companies are in the sights of activists. One is that these hedge funds have been given more capital from investors and can take meaningful positions in large multinationals to enact change.

Large companies also tend to resemble quasi-bureaucracies, have a sleepy shareholder base and are therefore primed for a value creating shake-up.

Another is that corporate governance failings and poor oversight has meant that boards can no longer afford to shrug off the requests of hedge funds that publicly articulate their plans to unlock value.

Clifton Robbins, of **Blue Harbour** Capital, a fund that takes a private equity approach to public investing, says the heavy lifting was done by institutions during the past decade that have pushed for change on corporate bonds.

Today 85 per cent of companies on the S&P500 have un-staggered boards, which means each and every director can be replaced at any year.

Mr Robbins says this is no fleeting trend. It's a paradigm shift which means for better or worse, hedge funds will have a greater say in the direction of companies.

But is it really worth all that hassle and fees to give your money to an activist?Switch in focus

The rising tide of the sharemarket rally has lifted all boats and institutional investors are said to have switched their focus from looking for conservative risk averse hedge funds to ones that can outperform the surging sharemarket.

The strong run in credit, which appears to be coming to an end, has also meant that all the low-hanging fruit in credit markets has already been picked.

But there are still some mammoth opportunities being thrown up as a result of a shake-up in global banking.

A large dearth of capital exists in the European banking system. Distressed debt and credit hedge funds have waited patiently for the continent's largest lenders to face up to the reality that they will need to shrink their bloated balance sheets.

BlueMountain Capital's Jes Staley said if US bank Citigroup had the scale of a European bank relative to its home economy, it would have assets of more than $US50 trillion. Until now, Europe's banks have been reluctant to sell assets, instead pulling back from foreign markets. Last week, Australian banking data showed that for the first time Asian banks had lent more money than Europeans.

Distressed debt appears to be arriving. The banks are slowly offering up assets as they attempt to shrink and bolster their capital bases.

"This is El-Dorado," says Victor Khosla, founder of SVP Global, a $1.7 billion distressed debt fund that believes the trillions of dollars of European bank asset fire-sales will keep his fund well fed for years.

In the US, too, there will be opportunities according to Bruce Richards, chief executive officer of Marathon Asset Management. Unlike Europe, most of US corporate lending is done in the capital markets. But the explosion of high yield bonds and leveraged loan issuance, which has averaged about $US500 billion a year combined means that there is a larger universe of companies that will fail.Ample distressed debt

This will provide ample distressed debt opportunities for Marathon and the half dozen credit funds that continue to prosper in the space.

The spurt in corporate bond issuance and the pressure of Europe's banks to move assets off their balance sheets are manifestation of the same theme. Regulators are no longer comfortable with the banks engaging in the act of borrowing short and lending long. To ensure they don't fail they will need to match their funding and be more liquid.

But if the banks are becoming more liquid than other parts the financial system, such as the capital markets, are by default becoming less liquid.

Trillions of dollars have flown into mutual funds and exchange traded funds. The danger is these funds promise investors access to their capital invested in securities that may not be saleable at the marked price.

In equities there are also doubts about how liquid the market may be times of stress. Tim Garry, of hedge fund Passport, says 50 per cent of trading volume is accounted for by high frequency traders, 30 per cent by exchange traded funds and 30 per cent more traditional investors.

The next market crisis, or opportunity for some, could come when investors all scramble for the exit at the same time.

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