- Absolute Return - https://hfm.global/absolutereturn -

2008: The year from hell

Posted By *Miles Kruppa* On October 5, 2018 @ 3:43 pm In News | No Comments

---

It's difficult to overstate the impact of the 2008 financial crisis on the hedge fund industry. Wall Street remembers September 15 – the day Lehman Brothers filed for bankruptcy – as the anniversary of the worst market crash in modern history, but most hedge funds would shudder at the mention of November 15, or "redemption day."

Hedge funds posted their worst performance ever in 2008. They failed to protect capital, their raison d'etre, during the worst economic crisis in modern history, and investors were not happy about it. Industry mammoths like Citadel, D. E. Shaw and Fortress Investment Group were forced to suspend redemptions as investors tried to flee.

To top it all off, Bernie Madoff admitted to a $50 billion fraud in his wealth management business, which counted hedge funds and funds of funds as clients. It sparked a second wave of redemptions as investors began questioning the integrity of the more than $2 trillion industry.

2008 ushered in a brave new world in which the trifecta of quantitative easing, record low interest rates and suppressed volatility have made the hedge fund returns of yesteryear almost impossible to find. Hedge funds have also been forced to reevaluate their management of leverage and liquidity, two factors that spelled death for several crisis casualties.

To mark the 10-year since the financial crisis, Absolute Return asked hedge fund managers, allocators and prime brokers to reflect on the events that defined arguably the most challenging year the industry has ever faced.

Mike Hennessy, co-founder of Morgan Creek Capital Management:

It was clear as can be that there was going to be a major credit crisis. Most of the [John] Paulsons, Kyle Basses, John Burbanks of the world and all others knew it, so it was no secret. I remember preparations being made as early as '05 because…the subprime stuff was dirt cheap.

Kenneth Tropin, principal of Graham Capital Management:

We had a credit team mostly in mortgages in '07, and we started selling down the book to reduce it in size as the mortgage market started getting hit. It became obvious to us that the financing quotes we were getting from counterparties were optimistic in the sense that a bond could be marked by counterparties at 90 for financing purposes, but you couldn't sell it at 90. It was a number significantly lower than that.

Judith Posnikoff, managing director at PAAMCO:

I oversaw our quant hedge funds back in 2007 – so August of 2007, those first two weeks were pretty ugly. Then there was a recovery, which tends to happen in those strategies when there is a liquidity event, because it's not indigenous to the market structure – it's just forced selling…It's clear in hindsight that something was going on.

[1]

Judith Posnikoff

Tropin: It was a catalyst for us as an organization to say we need to meet about risk every day – not just when we have an issue, but we have to have our risk committee begin the process of meeting every day because we don't like the way the world looks.

James Litinsky, chief investment officer of JHL Capital Group:

Prior to the crisis, banks were willing to be the counterparty for some of their underlying prime brokerage clients. Morgan Stanley was the
counterparty for their clients, so when their clients had an issue, Morgan Stanley was on the hook. What that meant was to the extent that client was trading with somebody else, that somebody else was exposed to Morgan Stanley.

Joel Press, then managing director at Morgan Stanley Prime Brokerage:

At the time, mortgages were not a big part of the prime brokerage industry. From a securities trading point of view, there were hedge funds that traded asset backed [securities], but not a lot. Asset-backed was really more of a banking and financing thing, not a trading and not a hedge fund thing.

In February, a $2 billion asset-backed securities fund run by Peloton Partners is forced to liquidate after the fund's prime broker, Goldman Sachs, withdraws financing. Lenders seize the fund's assets after a frenzied effort to find buyers proves unfruitful.

Litinsky: What you recognized was there were 100s of billions of losses, of payments, that would need to be made if [credit default swaps were] triggered. The way we described it is the banks were almost like bookies sitting at the fault lines of all of this.

Michael Vranos, chief executive officer of Ellington Management Group:

[2]

Michael Vranos

If you go back to 2008, there was a prevailing theory that early payment defaults were caused by fraud. By looking at roll rates and the rates at which defaults were occurring, we discovered that it was actually loan to value, specifically negative equity, which was driving up defaults. You've got to remember this was a relatively new phenomenon then because homeowner equity had only continued to grow up to that point. Housing prices were going up, so only now in retrospect does it seem somewhat obvious. It wasn't obvious then.

In March, rumors spread that Bear Stearns is on the brink of insolvency, weighed down by billions of dollars in bad mortgages. Hedge funds and other counterparties flee, causing a run on the bank. On March 16, J.P. Morgan announces it will pay $236 million for Bear's assets, which include a sizeable prime brokerage business.

Litinsky: I remember talking to somebody at Bear Stearns who was sitting on the trading floor…the Friday before they went down, and he was saying to me, "We're fine."…And then on Monday they were gone.

Tropin: There were a lot of conversations about, "Do we have any positions there?" We didn't PB there, but we did business with them, so we had to get on top of which traders are giving up trades to or through Bear.

Posnikoff: I wouldn't say that it was that obvious that we were in for a rough ride, because you can have something like that happen and it can be isolated. But I think it was definitely the second big step in the failure of a lot of things.

In April, Citigroup is accused of misleading investors in its Falcon Strategies hedge fund after posting a 40% loss from highly-leveraged fixed income trades. In 2015, Citigroup agrees to a $180 million settlement with the Securities and Exchange Commission, which claims Citigroup failed to notify investors about a severe liquidity crisis the funds experienced after lenders withdrew financing.

Press: People wanted more leverage, and we didn't have it to give.

Tropin: It wasn't even trading accounts that were spooking people at the time. It was also, where is your cash held? You couldn't be at that time 100% comfortable with almost anybody.

Posnikoff: The story that everybody had was this global growth story. It was like oil prices were high, commodity prices were high, you know all of this because of this global growth story. You heard it everywhere, and I remember being worried about that because when you hear one

explanatory story like that, then you want to step back and really reanalyze the data itself to make sure that it's correct.

Taking the stage at the Sohn Investment Conference in May, Greenlight Capital founder David Einhorn says he is short Lehman Brothers. He accuses the bank of lying to investors about losses on its asset-backed securities holdings. "In the real world, illiquid assets carry a discount," Einhorn says. "In the current melee the opposite seems true: Illiquid assets are more valuable because it is easier to convince the accountants that they have not declined in value compared to liquid assets where there is more transparent pricing data."

Litinsky: I remember being at a conference in the summer of '08, I believe it was in Germany, and it was a European financials conference. It was like the twilight zone because they were talking about the American problem…and it seemed very relaxed. I remember looking at their balance sheets and some of the Spanish ones–I was in utter shock that they would be so relaxed, because according to my math they were insolvent.

Tropin: Somewhere around June or July we got really short [equities], and conversely [long] fixed income because, particularly in stress periods, they tend to move in opposite directions. So we would have gotten very long Eurodollars, very long [Treasury] bonds.

By midyear, some of the largest hedge funds face billions of dollars of investor redemptions. Several bar investors from withdrawing their full balances. HBK Capital Management allows only 10% of assets to leave per quarter, sparking certain investors to place outsize redemption requests.

Mike Hennessy

Hennessy: Individually you can understand it, and by and large it was the right thing to do, and you kind of plan for that, but too many of them got over their skis. Too many of them got too illiquid, too levered.

Litinsky: Heading into Lehman we were at, even for us, a very high cash balance.

Vranos: I recall one of our repo portfolio managers coming up to me and saying that Lehman was quite disappointed in us moving our repo from them. They were actually trying to talk us into keeping our repo in there with them. Now think about that – that is counterintuitive to an outsider who would assume they would be looking to reduce their balance sheet. It occurred to me then that Lehman [would rehypothecate] our securities at lower haircuts to other counterparties and [was] possibly using the haircut differential to fund their business. That scared me a little bit.

Jonathan Berger, then chief investment officer of Stone Tower Capital:

Every day was [a] bad day in 2008. The environment just kept getting worse and worse. So when there were the rumors of Lehman, every…night we would have conference calls with our colleagues to make sure we were prepared and ready for the worst

Glenn Dubin, co-founder of Highbridge Capital Management:

I was actually on an offsite with executive committee members of my hedge fund, Highbridge Capital, in Colorado the weekend before Lehman Brothers imploded. Jes Staley, who was the head of asset management at the private bank, was at the offsite with us. Jes was also on the management committee of J.P. Morgan, and he pretty much was on the phone the whole weekend with various people on the management committee, including Jamie Dimon. Our offsite was supposed to last until Sunday, but I remember Jes coming into a meeting that we had midday on Saturday with this ashen look on his face, and [he] said, "We've got to go back."

A summer of financial reshuffling by regulators culminates in Lehman Brothers' formal bankruptcy filing on September 15. In refusing to bail out Lehman, the U.S. Treasury allows one of the world's largest banks to take the fall for the industry's excessive risk-taking in mortgage and derivatives markets. Lehman's prime brokerage unit, once a favorite of hedge funds, freezes assets held in overseas jurisdictions, causing liquidity crunches at several of the bank's clients.

Press: The Lehman prime brokerage agreements were much more complex and provided different ways of looking at what they could get for collateral. Even though you thought you were in one situation, you actually signed an agreement that created a different legal position as a general creditor. That's what made Lehman really complex.

Posnikoff: The counterparty would make a big margin call and people would have to scramble…so we were very very fortunate that we didn't lose any of the underlying hedge funds, but it was a really rough time. And at the same time we were having to check out the counterparties…because they were also having problems – rumors about Morgan Stanley and Goldman. We were really concerned about them because Bear had already gone down, Lehman had gone down, and then the question was: Who was next?

Litinsky: The clients wanted out, which means hedge funds had to get out and the leverage had to come down, so everybody was a forced seller. If you've got cash, it's a great place to be.

Press: You had the worst of all worlds. You had Lehman not giving you your money and your investors saying, "I want my money." How do you fund that? That's why the hedge funds that didn't have gates and… equity hedge funds, especially, that were not in hard-to-value securities–they were the ATMs for the investors. Some of the good guys who didn't do as poorly were the ones who suffered the most in terms of asset withdrawal.

In the days following Lehman's bankruptcy, speculation builds that Morgan Stanley will be the next casualty. Hedge funds rapidly withdraw from the bank's prime brokerage division and place short bets against its stock, prompting chief executive John Mack to accuse short sellers of sinking the share price.

Litinsky: There was a rush out of Morgan Stanley for a period of time, and they were just not letting people out.

Press: After Lehman, the pressure became unbearable. When Lehman failed…I would say everyone who was senior level in the prime brokerage, if they got four hours of sleep a night they got a lot. And some of us slept at the firm because we were just inundated.

Litinsky: We knew that there was going to have to be a collapse of a major financial firm due to the moral hazard concerns…. Our view was if it had gotten to Morgan Stanley, the system was already gone anyway.

Press: I lost relationships with clients. We didn't get money out fast enough. They thought we were not telling them the truth, and from their perspective, I'm not going to tell you they were wrong.

Tropin: If the credit default swap of xyz bank is going to the moon, the stock price is going through the floor, other dealers are saying to us we won't trade with xyz any more–you have to react to that, no matter if your relationship manager at the particular institution is saying it's okay.

Litinsky: The first year or two after the crisis a lot of money went to J.P. Morgan because they were sort of going around the Street pitching, "Oh, we're the safest." But the truth is that if it had gone much beyond Lehman it would have taken down them too–it was taking down everybody.

On September 19, the SEC and U.K. Financial Services Authority ban the short-selling of financial companies. "Under normal market conditions, short selling contributes to price efficiency and adds liquidity to the markets," the Commission writes. "At present, it appears that unbridled short selling is contributing to the recent, sudden price declines in the securities of financial institutions unrelated to true price valuation."

Posnikoff: People forget how widespread those were because it started out that they were just financials, bank stocks etc…and the actual list ended up being huge and the actual list was huge. It included General Motors because of GMAC and all these other names that you couldn't short, and so it was interesting to see how the managers were able to trade their books through a period of time like that and keep hedged and so forth.

Hennessy: That caught us off guard. It caught a lot of people off guard. Even more so, we had equity hedges on, and their definition of financials was extremely broad. It was ridiculous.

Litinsky: When the short ban happened in financials we were not involved at that point. There's some luck to that…Particularly in short-selling you have to take your profits and move on, and also recognize that when you have financial institutions that are so leveraged, the stock is like a call option. We were not of the mindset of riding those to zero.

Fallout from the banking system begins to crash financial markets, and the Dow Jones Industrial Average suffers its worst intraday fall in history. In October, the pain spreads to global stock markets and large hedge funds, most notably Ken Griffin's Citadel, which works to deflect market rumors of its demise.

Kyle Bass (October letter):

"Be wary of 'trusted' individuals telling you everything is fine today and that it is safe to buy equities in general. [Warren] Buffett has enough money to be able to have his holdings drop 50% and still fly in his jets and live in the way to which he has become accustomed. Do you have enough capital to take what you have left, cut it in half, and continue to live the way you have for the past few years? I don't."

Jared Herman, president at HedgeBay Securities, a broker in the secondary market for hedge funds and illiquid assets:

It was insane. We had a four or five lines telephone system and all the lights were on at the same time. It was call to call to call…We had a price for everything that people asked us for. Whether they chose to deal or not was another story, but we certainly had a price.

Litinsky: There was effectively a liquidation of the hedge fund industry to get all the leverage out.

Tropin: There was a big move at one point in the spread between Eurodollars and the Fed Funds rate because of LIBOR getting blown out. We had a pretty big book that was exposed to that, and it was very unknowable as to how that was all going to sort out. It turned out that the portfolio manager who was managing that book ultimately ended up making money by the end of '08, but it was a pretty difficult period in there…That was something nobody had ever seen before.

Herman: The institutional investor side, especially people who had leverage or structure around their investments in funds, were the most pressed to do something because their IOU…was called. They were getting a margin call, effectively, and they had to do something. Those people were all first. Then the people who were a half or a quarter step behind them were all of the fund of funds that promised monthly and quarterly liquidity, but who we discovered later were slightly mismatched because the guys they invested with were terribly mismatched.

Litinsky: The investment banks had unlimited leverage, essentially, so the hedge funds got it too. It started with the banks, and it went down through the system to the biggest risk takers.

Andrew Lahde (October 17 investor letter):

"I will no longer manage money for other people or institutions. I have enough of my own wealth to manage. Some people, who think they have arrived at a reasonable estimate of my net worth, might be surprised that I would call it quits with such a small war chest. That is fine; I am content with my rewards…Steve Balmer, Steven Cohen, and Larry Ellison will all be forgotten. I do not understand the legacy thing. Nearly everyone will be forgotten. Give up on leaving your mark. Throw the Blackberry away and enjoy life."

Dmitry Balyasny (third quarter conference call):

"We definitely don't need 8,000 hedge funds…There is going to be a giant washout of funds that don't bring anything to the table…This year is going to mark the end of stock selection in isolation

as a winning formula for running a hedge fund and managing money."

Litinsky (October 21 investor letter):

"Some might argue that this could not have been foreseen because the short selling ban was really what lit the spark that precipitated a larger unwind. This argument is flawed because the reality is that whenever you have an industry where the principals are widely reported to be making hundreds of millions and even billions you can be sure that they will be targets of some form of populism when the cycle turns."

On November 15, hedge funds are inundated by calls to return investor capital. Near the end of the month, Tudor Investment Corp. becomes one of the most prominent hedge funds to suspend redemptions, saying it must "endeavor to structure the Tudor BVI Portfolio to ensure maximum flexibility and liquidity." Tudor sequesters investments in difficult-to-sell securities that amount to almost 30% of the fund's holdings, mostly in emerging market debt. Weeks later, Citadel announces its flagship funds will suspend redemptions, having declined by roughly half.

Dubin: We had a particularly big allocation to credit markets, and the credit markets were frozen, so we made the difficult decision to block client redemptions at yearend. In hindsight, it turned out to be a great decision because when the markets rallied and the credit markets thawed, not only did we get back all the clients' money from the losses in 2008, but we actually were up north of 40% in the first half of the year.

Tropin: We had maybe…$1 billion in redemptions, and I think we made that much in trading profits and ended the year [slightly lower] in AUM. We were fine as an organization, and ultimately clients gave us a lot of credit for coming through the financial crisis profitably and successfully.

As hedge funds scramble to contain losses, federal officers charge Bernard Madoff with running a $50 billion Ponzi scheme that fleeced investors ranging from the Palm Beach Jewish community to Swiss funds of hedge funds. Prosecutors say Madoff's sons reported the scheme after he confessed "it's all just one big lie," confronted by $7 billion in redemption requests.

Posnikoff: Everybody knew about Madoff in the sense that there was just something weird there. But for the most part, people couldn't put their finger on what it was. We had looked at Madoff on behalf of a client back in the '90s and said no…You have to be able to explain the underlying investment strategy, and if you can't you should never make an investment there.

Hennessy: In talking to my endowment and foundation peers through time…the word got out this guy was a total scam artist. So when it hits in '08, not only was it stunning the scale he had developed by then, but the fact that there were fund of funds in there. Not only that, they did no due diligence, which is one of the things a fund of fund is charged with doing.

Herman: There was so much uncertainty, and the real juicy size claims were all held by the feeders, so the feeders did what they wanted to do. It was a very difficult exercise because it was cents on the dollar. In the very beginning there was relatively little to no trading in the thing.

Posnikoff: I think that did…hurt people's impression of…the quant strategy, because it was sort of touted as a quant option strategy…That was an example where everything failed in terms of what investors and regulators should do.

Press: When you saw the dust settle, I think that's why there weren't a lot of lawsuits in this industry – because there was an integrity to the industry. You might have been disappointed in its performance, but not its overall integrity.

Hennessy: Shit happens, and you expect some casualties, but it was much more widespread. These guys are the cream of the crop, supposedly, and you're paying 2 and 20, they're richer than god, and this is what you get? This is when you need the hedge fund industry to shine, and they completely failed in our opinion.

Article printed from Absolute Return: **https://hfm.global/absolutereturn**

URL to article: **https://hfm.global/absolutereturn/news/the-year-from-hell/**

URLs in this post:

[1] Image: **https://hfm.global/absolutereturn/wp-content/uploads/sites/13/2018/10/Judith-Poskanoff-e1538768451697.jpg**
[2] Image: **https://hfm.global/absolutereturn/wp-content/uploads/sites/13/2018/10/MikeVranos-e1538768534181.jpg**

Copyright © 2015 HFM Week. All rights reserved.