THE LONG VIEW

JOEL PRESS
reflects on leverage and its recent impact on the prime brokerage industry

"THOSE MANAGERS WHO ARE LESS LITERATE IN ETFs ARE NOT AT A DISADVANTAGE, BUT THOSE WHO ARE WELL VERSED HAVE A DIFFERENT PIECE OF AMMUNITION AT THEIR DISPOSAL – AND IT'S A VERY LIQUID PIECE OF AMMUNITION"

The prime brokerage industry has undertaken a dramatic transformation since 2008, and one of the main reasons for this is leverage. The hedge fund community has less desire for leverage and that's not changing for a while; maybe never. And with leverage reduced, so too is the profit margin for the prime brokerage industry.

So, how is the story of leverage unfolding? As of the start of the 2012, we have had a market that people didn't anticipate – managers are revising their portfolios, as their longs are now making money. But it's different depending on whether you're looking at equity or structured products. Currently, there is a deep desire for more structured credit, for more bank debt; those instruments that have a potential for a less volatile rate of return but provide a consistent rate of return over a defined period of time. No one, however, is really using leverage for those instruments. Not using leverage for this type of trading is very different to what we saw in 2008.

In an effort to adapt, prime brokers are re-evaluating their business offerings: what they charge, how they charge and for what kinds of services. Will there be an unbundling of services and, therefore, an increase in cost to the hedge fund industry? An example of that would be capital raising – a service to raise money for a hedge fund at a significant fee for that service. Very different than the service the prime brokerage community has been providing for free as capital introductions.

Costs are also up at the hedge fund level as many firms are using what is called a tri-party arrangement, where execution is through the prime and then securities are moved to what should potentially be a safer haven, such as a trust company. This is an increasingly important part of risk profiling and a direct result of the Lehman failure and now also the MF Global failure. Every time there's a blip in the market, the issue gets more press coverage and more hedge funds evaluate their operations.

The concept of shorting and use of stock-borrow is changing because the shorting of individual stocks is down and the use of Exchange Traded Funds (ETFs) has changed how people view shorting. When you have less stock-borrow in the system, and an increased use of indices, via the likes of ETFs, the prime brokerage business is not nearly as profitable.

The next generation of hedge fund managers, of young entrepreneurs, have advanced through the ranks working with ETFs – and feel more comfortable with them. Those managers who are less literate in ETFs are not at a disadvantage per se, but those who are well versed have a different piece of ammunition at their disposal – and it's a very liquid piece of ammunition. Using ETFs to create short exposure does not require borrowing as does shorting of specific stocks – again, less profitability to the prime broker.

Another key influence affecting leverage is the investor factor. Investors are now dictating what they consider acceptable risk and, as a result, how they think about leverage has changed dramatically. In fact, many investors won't invest if they feel the leverage used to create alpha is inappropriate. Investors have been enquiring about leverage for 40 years. Now, they are saying 'I don't want a leverage strategy; I want my alpha to be unlevered'.

Is the changing face of leverage altering how prime brokers operate long term? It's difficult to predict where the industry will end up, but it could well be the case. No one, for example, could have predicted when ETFs arrived they would become as big a part of the industry and as popular a trading tool.

What is clear is that leverage is not the force it once was, and prime brokers – historically linked to its use – will have to find ways to lessen their reliance on its power. ■

JOEL PRESS is the founder of Press Management

THE WEEK IN QUOTES

"AUA IS VANITY, REVENUE IS SANITY"

Administrators whose primary focus is on building assets are barking up the wrong tree, one provider tells *HFMWeek*

"A LOT OF INVESTORS ARE OFF SEARCHING FOR THE HOLY GRAIL IN THAT RESPECT – AND IT DOESN'T EXIST"

The investor community's "obsession" with liquidity, particularly regarding credit strategies, mystifies Tom Joy, CIO at the UK-based Church Commissioners

"DEFENDANTS BREACHED THEIR FIDUCIARY DUTIES BY CONDUCTING A GROSSLY NEGLIGENT DUE DILIGENCE ANALYSIS"

Hugh Culverhouse, seeking class-action status for investors who lost money in John Paulson's hedge fund after the US firm's reported $468m losses in Sino-Forest Corp last year