

THE GREAT UNWIND

Revisiting the leverage question.

BY PETER KLEIN

WHEN markets start to turn negative, financial leverage can create an environment of continued selling pressure. Lenders require more collateral from borrowers, which often forces them to sell financial assets at already deflated prices. This selling pressure can cause prices to continue to drop, which results in more demands for collateral and even more selling and price declines. A vicious cycle is created which can result in a period of sustained drawdowns. Many financial market commentators refer to this as “The Great Unwind.”

Two thousand eight appears to have provided a classic example of this type of cycle. Starting early in the year, declines in many financial markets which would be considered large by typical standards were followed by even greater declines as the cycle accelerated. The events at Bear Stearns, Lehman and then AIG exacerbated the selling pressure and caused these declines to continue. As the year closed, major equity markets were down between 30% and 50% around the world. Many other markets, such as real estate and commodities have also faced large declines.

Last year presents an interesting opportunity to test the conclusions of a study on leverage I completed in late 2007 and which was published in the Spring 2008 issue of *Canadian Investment Review*. This study—which bore the deliberately misleading title “The L Word”—sought to demystify the use of financial leverage in traditional as well as hedge fund investing. It also analyzed whether leverage is synonymous with financial risk.

The conclusions from the “The L Word” were three-fold. First, leverage is defined in a variety of ways, thus it is important to know how leverage is measured and used when making comparisons across strategies employed by hedge fund and traditional asset managers. Second, one needs to take into account the underlying risk of what is being levered before drawing any conclusions

on the amount of risk in a given financial strategy.

Third, the empirical record supports the view that a high degree of leverage does not necessarily lead to higher financial risk. Among the five financial strategies for which data was analyzed, the historic risk of those which use the least leverage, such as long-only traditional equity investing, was higher than for other financial strategies employing very high amounts of leverage, such as convertible bond arbitrage.

LEVERAGE 2008

Would these conclusions still be valid after the events of 2008? Were the financial strategies employing the highest leverage the worst-hit by The Great Unwind? The table below shows the returns in 2008 for the various strategies considered in my previous study when ranked in decreasing order of leverage. The data for the hedge fund strategies is from the CS/Tremont database and is the compounded monthly return from January 2008 to December 2008 for the sub-indices indicated.

Strategy	Leverage	2008 Return
Convertible Bond Arbitrage	High	-32%
Equity Long/Short	Medium	-20%
Equity Market Neutral	Medium	-40%
CTA/Futures	Low	+18%
Equity Long-Only	None	-30% to -50%

At the top of the list is convertible bond arbitrage—a strategy which employs the highest leverage by most measures. This sub-index posted a loss of just over 30% in 2008—the largest annual loss in its history. Much of this stemmed from the restriction on short selling financial shares that was mandated in various countries during the early fall of last year. This move drastically restricted the ability of many Convertible Bond Arbitrage managers to hedge their positions.

Peter Klein is principal, KCS Fund Strategies Inc. and a professor at Simon Fraser University.

WERE THE FINANCIAL STRATEGIES EMPLOYING THE HIGHEST LEVERAGE THE WORST-HIT BY THE GREAT UNWIND?

This in turn necessitated waves of liquidations of their underlying positions at fire-sale prices. Some may be tempted to categorize this ban on short-selling as a “once in a lifetime” exogenous event that should not be allowed to taint the data on typical returns for this strategy. Such exceedingly unusual events (such as Long-Term Capital Management in 1998 and the Ford/GM downgrades in 2004) appear to be increasingly commonplace over the past decade and should not be ignored when measuring risk.

Next on the list—with middling use of leverage—are the equity long/short and equity market neutral strategies. The returns for equity long/short were negative 20%—which also represents a record loss for this sector but is significantly smaller than for the convertible bond arbitrage managers. Lest one think this is a result of the lower leverage, however, it is important to consider the average loss in the equity market neutral hedge fund sector. Despite leverage similar to that employed by equity long/short managers the average loss was a shocking 40%—which was as large as the losses in many equity markets. Much of this was due to large writedowns arising directly or indirectly from the Madoff scandal. Losses were also due to other investors who sold their relatively liquid equity market neutral funds in order to cover collateral calls on leverage employed in other sectors, such as private equity and real estate.

The strategies with the lowest, most conservative use of leverage analyzed in “The L Word” were CTA/Futures and traditional equity long-only investing. These strategies were also identified as having the highest risk based on the variability of their historic returns. In 2008 this conclusion appears to have been confirmed: CTA/futures managers earned +18% on average for the year, whereas the major equity indices declined anywhere from 30% to 50%. Although one clearly would have preferred to hold the former, these large absolute deviations from zero can only be viewed as consistent with the historic volatility of these two strategies.

THE CANADIAN EXPERIENCE

A quick review of the Canadian hedge fund market shows similar results. The Scotia Capital Canadian Hedge Fund Indices, which provide the most comprehensive overview of the Canadian hedge fund industry, suffered double-digit losses for the year. It is important to keep in mind, however, that the Scotia Hedge Fund Index outperformed the S&P/TSX Composite Index by double digits as well. Convertible bond arbitrage funds suffered possibly their largest declines in September, October and November, finishing the year quite negative. Similarly, equity long/short funds were among the hardest-hit; some of the largest and most well known funds were down in excess of 40% for the year. Many global macro and managed futures funds were positive, consistent with the CS/Tremont indices. Having said this, there were some pleasant results in equity long/short and equity market neutral strategies in Canada with many funds either modestly positive or only slightly negative for the year. The wide variability of returns of Canadian managers is similar to that seen among the individual common stocks that form major stock market indices. This wide variability supports the view that, as with stocks, one needs to adopt a portfolio approach.

In conclusion, the events of 2008 appear to be consistent with the conclusions of “The L Word.” Financial strategies employing the most leverage were not the worst-hit by “The Great Unwind.” As compared to major equity markets, many hedge fund strategies that employed far higher leverage had smaller losses during 2008. ■