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Hedge Fund Failures

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Hedge Fund Failures

Summary

The growth of hedge funds — private, high-risk, unregulated investment pools for wealthy individuals and institutions — has been a striking development in financial markets. There are now about 8,000 funds with a total of over $1 trillion under management; both figures are roughly 10 times what they were a decade ago. Hedge funds are said to account for 30% of trading volume in U.S. stocks and (at times) even higher proportions in more specialized instruments such as convertible bonds and credit derivatives. Their trades can move markets.

Since hedge fund investment is limited by law to the very wealthy, who are presumed to be capable of understanding the risks and bearing the losses of financial speculation, the traditional view has been that there is no public interest in regulating them. Many still hold this view. However, as their size and presence in the markets has grown, hedge funds have attracted scrutiny from regulators and Congress. Does hedge fund trading now create risk exposure outside the relatively narrow circle of their principals and investors? There are two ways this could happen.

First, the failure of a very large hedge fund, or a number of funds with similar portfolios, could pose risks to banks and other creditors. If hedge funds had to liquidate a large market position quickly, prices could fall sharply, widening the circle of losses. Since markets have limited information about hedge funds, rumors about the solvency of large funds could spread panic when markets were already under stress. The possibility that hedge fund failure might cause other financial dominoes to fall is called systemic risk. The best-known example occurred in 1998, when the Federal Reserve organized a rescue of the Long-Term Capital Management (LTCM) hedge fund, because it judged that default posed an unacceptable risk of disruption to the financial system.

Second, investor protection concerns have emerged as the popularity of hedge fund investment has grown. Hedge funds are open only to "accredited investors," defined as those with over $1 million in assets. In the past, this standard seemed high enough to exclude the small, unsophisticated investors who provide the rationale for government regulation. However, since the $1 million figure includes the value of an individual's residence, rising home prices have lifted many who are not necessarily expert in financial matters over the "accredited" threshold. At the same time, institutional investors like pension funds are placing more of their money in hedge funds, which means that rank-and-file workers, retirees, and others may be unwittingly exposed to hedge fund losses.

This report lists major hedge fund failures since LTCM. Because hedge funds are unregulated and do not file public financial statements, reports of the amount of losses and the reasons for failure are usually second hand and subject to inaccuracies. The list is based on sources CRS considers generally reliable, but there are real limits on the availability of information. For a general discussion of hedge funds, see CRS Report 94-511, *Hedge Funds: Should They Be Regulated?* by Mark Jickling. This report will be updated as events warrant.

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Hedge Fund Failures

Background

In 1998, the Federal Reserve Bank of New York organized a rescue of Long-Term Capital Management (LTCM), a hedge fund that was on the brink of collapse. In exchange for providing about $3 billion to meet the fund's short-term obligations, 14 of LTCM's chief creditors (including several of the best-known Wall Street firms) became the new owners of the hedge fund's portfolio. The Fed's intervention was very unusual. Because investment in hedge funds is by law limited to wealthy individuals and institutions, who are presumed to be capable of understanding the risks and bearing the losses of such investment, regulators do not normally view hedge fund failure as cause for government action. Their strong preference is to let hedge funds default, rather than send a signal to other market participants that they, too, might be rescued from their mistakes.

In the LTCM case, however, the Fed concluded that default might have repercussions beyond the losses that would accrue to the hedge fund's principals and investors.[1] Investors had about $3 billion in LTCM, but the fund had borrowed to accumulate a bond portfolio of about $100 billion, and had assumed derivatives positions with a notional value of about $1 trillion. From the Fed's perspective, a default might have jeopardized the solvency of LTCM's creditors, which included several of the world's largest financial institutions, and its numerous derivatives counterparties. Moreover, if LTCM had been forced to liquidate its positions quickly, prices of bonds and other instruments might have been severely depressed, and other holders would have suffered unexpected losses, even though they had no dealings whatsoever with LTCM. Given that global markets were already under stress at the time — Russia had defaulted on its sovereign debt and Asia was experiencing a second round of financial crises — and investor confidence was low, the Fed chose to intervene rather than risk widespread disruption to the financial system.

The possibility that the failure of a single institution could set off cascading failures throughout the financial system is known as systemic risk. The classic case is a banking crisis, where trouble in one bank can trigger runs on others, including financially sound institutions, if enough cautious depositors decide to withdraw their funds. With LTCM, regulators recognized that hedge funds can also be a source of systemic risk. There are several possible scenarios. First, a single hedge fund could grow large enough to pose a systemic threat if its investments were concentrated in a single market and constituted a significant share of that of that market. In practice,

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[1] For more on the LTCM near-default, and on hedge funds generally, see CRS Report 94-511, *Hedge Funds: Should They Be Regulated?* by Mark Jickling.

this is unlikely to happen, as suggested by the case of the Amaranth hedge fund, which collapsed in September 2006, after losing about $6 billion in natural gas markets, without any discernible impact on the price of gas or other energy commodities. The risk increases, however, if a number of hedge funds make similar investments and incur losses simultaneously, or if other institutions (such as commercial or investment banks) copy hedge fund strategies.[2]

(Hedge funds may also generate systemic risk when they are successful. During the Asian crises of 1997-1998, central bankers and regulators in several countries blamed hedge funds for manipulating currency prices and doing serious harm to the real economies. In addition, some observers believe that hedge fund speculation played a role in high and volatile U.S. energy prices in 2005 and 2006.)

Post-LTCM perceptions of systemic risk are not the only policy concern associated with hedge fund failure. As hedge fund investment has become more popular, new investor protection concerns have emerged. Hedge funds are open only to "accredited investors," defined as those with assets worth over $1 million. In the past, this standard seemed high enough to exclude the small, unsophisticated investors who provide the rationale for government regulation of securities markets. However, since the $1 million figure includes the value of an individual's residence, rising home prices have lifted many who are not necessarily expert in financial matters over the "accredited" threshold. A decade ago, most hedge funds required a minimum investment of $200,000 or more, beyond the reach of most households whose assets were concentrated in their homes. As a result of competition and the growing number of hedge funds, however, there are now funds that will accept amounts as low as $20,000. At the same time, pension funds, foundations, and other institutional investors are placing more and more of their money in hedge funds, which means that rank-and-file workers, retirees, and others may be unwittingly exposed to hedge funds losses. The Securities and Exchange Commission (SEC) has cited this "retailization" of hedge funds as a reason to impose some form of disclosure requirements on the funds or their managers.[3]

Systemic risk and investor protection concerns make hedge fund failure a subject of regulatory and legislative interest. **Table 1** below provides basic information about the most prominent hedge fund failures since the LTCM episode. The list is not comprehensive: many funds fail each year without attracting much notice. Since the list has been generated by searching periodical literature databases (principally ProQuest, Nexis, and Factiva), the cases included have been newsworthy for one reason or another — generally because of their size, the amount of investor losses, the risky or exotic trading strategies employed, or because fraud was involved.

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[2] This was the case with LTCM. The fund was able to borrow extensively and on very favorable terms in part because the lenders wanted information about LTCM's strategy, which was directed by Nobel prizewinners and executed by Wall Street legends.

[3] In testimony before Senate Committee on Banking, Housing, and Urban Affairs on February 5, 2003, in response to a question from Senator Corzine, SEC Chairman Donaldson described the retailization of hedge funds as "a distressing move" that raised the possibility that "less sophisticated investors" might not understand the inherent risks. See also *Implications of the Growth of Hedge Funds*, SEC Staff Study, Sept. 2003, pp. 80-82.

Why Hedge Funds Fail

Although some employ very conservative investment strategies, hedge funds can generally be characterized as high-risk, high-return operations. Pursuit of risk implies a high failure rate: various studies have estimated that from 7% to 10% of hedge funds fail each year.[4] Since estimates of the number of hedge funds range from 7,000 to 9,000, this suggests that several hundred funds cease operations each year.

A recent study[5] distinguishes between three reasons for hedge fund failure:

- *financial issues*, or losses stemming from unfavorable market moves;
- *operational issues*, such as errors in trade processing or mispricing complex, opaque financial instruments; and
- *fraud*, or misbehavior by fund management.

The most common cause is undoubtedly the first. When hedge funds fail to earn the hoped-for returns, they are generally unable to attract new investors and managers find it unprofitable to continue. The normal course is to dissolve the fund, in accordance with the partnership agreement, and return funds to investors. In many cases, investors suffer no loss at all (other than the opportunity cost of their failure to select a more profitable fund), and the end of the hedge fund receives no public notice. Such failures are not captured in the table below.

When financial losses to hedge funds are sudden or severe, investors are likely to suffer major losses, and the event is more likely to be reported in the press. Several such cases are listed below. It is noteworthy, however, that none of the post-LTCM failures has appeared to pose a risk to the financial system. Nor have there been waves of hedge fund failures stemming from major market movements, such as the bear market in stocks of 2000-2002, the subsequent sharp fall in interest rates, or the energy price volatility that followed the invasion of Iraq.

The incidence of failure as a result of operational issues is probably much lower, but is difficult to judge because hedge funds disclose so little information about themselves. Operational concerns have been addressed by regulators, however. In October 2005, the Federal Reserve Bank of New York convened a meeting of 14 major credit derivatives dealers to address back-office problems and to set goals to

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[4] See, e.g., Naohiko Babo and Hiromichi Goko, *Survival Analysis of Hedge Funds*, Bank of Japan Working Paper 06-E-06, March 2006, p. 30, and Nicholas Chan, Mila Getmansky, Shane Haas, and Andrew Lo, *Systemic Risk and Hedge Funds*, prepared for the NBER Conference on the Risks of Financial Institutions, August 2005, p. 51.

[5] Constantin Christory, Stephane Daul, and Jean-Rene Giraud, "Quantification of Hedge Fund Default Risk," *Journal of Alternative Investments*, fall 2006, pp. 71-86.

reduce the backlog of unprocessed trades in that market, where hedge funds play a significant role.[6]

Where fraud is involved in a hedge fund failure, legal and regulatory actions ensure that an unusual amount of information is made public about the fund and the circumstances of the failure.[7] Thus, cases of fraud are likely to be over-represented in any tabulation of failures. While the SEC has noted many times that the lack of disclosure makes hedge fund fraud a *potentially* serious problem,[8] there is no consensus as to whether actual fraud is more common among hedge funds than other types of investment.

Limited information is available about the relative frequency of these three reasons for failure. Christory, Daul, and Giraud categorize 109 cases of hedge fund default between 1994 and 2005, and find that 54% involved fraud, 33% involved financial issues, and 13% involved operational issues.[9] Sometimes the categories may overlap: some cases of fraud begin with financial losses which fund managers fail to disclose.

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[6] "Statement Regarding Developments in the Credit Derivatives Market," Federal Reserve Bank of New York Press Release, Oct. 5, 2005. A year later, the Fed reported that considerable progress had been made: "Statement Regarding Progress in Credit Derivatives Markets," Federal Reserve Bank of New York Press Release, Sept. 27, 2006.

[7] Regulators and prosecutors' version of events is, of course, often disputed.

[8] *Implications of the Growth of Hedge Funds*, SEC Staff Study, Sept. 2003, p. 76.

[9] Christory, Daul, and Giraud, "Quantification of hedge Fund Default Risk," p. 76. The authors define default as "a loss large enough to prevent the manager from pursuing his strategy with his existing investors (resulting in investors exiting the fund at a significant loss)," as opposed to "dissolutions," where funds return all money to investors because of poor performance. Ibid., p. 72.

Table 1. Selected Hedge Fund Failures and Losses Since Long-Term Capital Management

Fund Name (Principal)	Date	Description of Failure or Loss	Sources
Amaranth Advisors LLC (Brian Hunter and Nicholas Maounis)	9/06	Ill-timed speculation in natural gas prices; investors lost about $6.4 billion from the fund's peak value of $9 billion.	*Futures*, 11/06; *Wall Street Journal*, 10/28/06; *The Globe and Mail* (Canada), 9/23/06.
Archeus Capital (Gary K. Kilberg and Peter G. Hirsch)	9/06	Started in 2003 by bond traders from Salomon Brothers, Archeus's assets grew to $3 billion by 2005. By September 2006, assets had shrunk to about $682 million, and the fund announced it would close by the end of 2006.	*New York Times,* 10/31/06; *MarketWatch*, 10/30/06; *New York Times*, 10/05/06.
Latitude Fund (Brummer and Partners)	8/06	Swedish global macro fund closed after losing 27% of its capital in 13 months.	*Daily Telegraph*, 10/28/06; *Powerswings* [http://www.powerswings.com], 9/14/06.
Mother Rock LP (Robert "Bo" Collins)	8/06	Energy fund fell victim to natural gas price volatility — lost $230 million in June and July 2006.	*Futures*, 11/06; *Barron's,* 8/07/06.
International Management Associates LLC (Kirk Wright)	2/06	Founder fled after $150 million in investor assets were discovered missing; arrested in May 2006, Wright faces trial on various counts of mail and securities fraud.	*The Atlanta Journal-Constitution*, 10/26/06, 7/14/06, 2/23/06; *Daily Deal/The Deal*, 7/10/06; *Los Angeles Times*, 3/14/06.

Fund Name (Principal)	Date	Description of Failure or Loss	Sources
Wood River Partners (John H. Whittier)	10/05	Fund was placed in receivership, and the SEC brought civil fraud charges, in October 2005. Wood River had invested 65% of its assets, about $265 million, in a single telecommunications stock, Endwave, whose value plunged in 2005.	*Forbes*, 12/12/05; *Financial Times*, 10/14/05; *Wall Street Journal*, 10/12/05.
Bayou Management (Samuel Israel III and Daniel E. Marino)	9/05	The fund's founder, Israel , and its finance chief, Marino, pleaded guilty to fraud and conspiracy charges in September 2005, admitting to using fake results and accounting to hide trading losses. Investor losses reportedly about $350-$400 million.	*Forbes*, 12/12/05; *Futures*, 11/06, 10/06; *U.S. Fed News*, 9/29/06.
Philadelphia Alternative Asset Management (Paul M. Eustace)	7/05	Fund was shut down by the Commodity Futures Trading Commission (CFTC) amid charges of trading improprieties which involved Man Group, a large UK hedge fund that executed trades for Philadelphia. Assets were $320 at the peak; investor losses estimated at $175 million.	*Washington Post*, 10/19/05; *The Guardian* (UK), 10/10/05; *Barron's*, 7/25/05;*Wall Street Journal,* 7/06/05.
Bailey Coates Asset Management LLP (Jonathan Bailey and Stephen Coates)	6/05	This stock fund incurred losses of nearly 25% in 2005, and ceased operations after promising to return about $500 million to investors. At its peak, the fund held about $1.3 billion.	*Investment News*, 8/22/05; *Financial News*, 7/31/05; *Asian Wall Street Journal*, 6/22/05.

Fund Name (Principal)	Date	Description of Failure or Loss	Sources
Marin Capital	6/05	This bond arbitrage fund had $1.7 billion in capital at its peak. It closed after sharp losses triggered by the downgrading of General Motors to junk bond status. Investor losses were not disclosed; fund promised to return losses to investors.	*Wall Street Journal*, 8/31/05, 6/16/05.
Aman Capital Global (Mayur Ghelani and Rahul Kumar)	4/05	This Singapore fund was closed after losing derivatives trades cost it 18% of its $200 million capital.	*Financial Times*, 4/04/06; *The Edge Singapore*, 6/27/05.
Lyceum Capital (John Muresianu)	2/05	Technology stock fund closed after 28 months of operation, having earned minuscule returns on investors' $112 million capital.	*Wall Street Journal*, 6/16/05, 2/10/05.
Sterling Watters Group (Angelo Haligiannis)	6/04	The fund made "over-under" (long — short) stock investments, and claimed to have had $180 million under management. Haligiannias was arrested and charged with running a Ponzi scheme, but subsequently went into hiding.	*Institutional Investor*, 2/15/06, 8/05
Lancer Offshore Fund (Michael Lauer)	5/03	SEC charged Lauer with fraud and manipulation related to investment in small-cap technology stocks. Investor losses estimated at $500 million.	*Forbes*, 12/26/05; *HedgeWorld News*, 1/06/06; *National Post*, 5/28/03.

Fund Name (Principal)	Date	Description of Failure or Loss	Sources
Eifuku Master Trust (John Koonmen)	1/03	Founded in 2000, Eifuku had $300 million assets at its peak, invested in various Japanese stocks. During 3 weeks in January 2003, the fund lost 98% of its capital.	*Wall Street Journal*, 4/10/03.
Beacon Hill Asset Management (John D. Barry)	11/02	This "market neutral" stock fund was shut down by the SEC, which brought fraud charges based on trading improprieties. Charges against Barry and other principals were settled in 2004. Investor losses estimated at $300 million.	*Derivatives Litigation Reporter*, 11/12/06; *Los Angeles Times*, 10/29/04; *Institutional Investor*, 2/03.
Klesch European Distressed Fund (Gary Klesch)	9/02	Bond "vulture" fund lost money trading WorldCom debt. When closed, the fund (which had aimed to raise $100 million when it was launched in March 2001) had only $15 million in capital.	*Global Finance*, 10/02; *The Times*, 9/10/02; *Reuters*, 9/9/02.
Lipper Convertibles LP (Kenneth Lipper)	2/02	Bond arbitrage fund was liquidated after losing 40% of its value, or about $315 million, in 2001. Fund's capital was reportedly $2.85 billion at its peak, much of it contributed by Hollywood celebrities.	*Business Week*, 12/9/02; *Pensions & Investments*, 8/19/02.
Maricopa Investment Fund (David Mobley)	10/01	Founder was sentenced to 17 years in prison and ordered to repay $76 million to defrauded investors.	*Barron's*, 5/30/05; *Business Week*, 5/26/03; *Derivatives Litigation Reporter*, 6/2/02.

Fund Name (Principal)	Date	Description of Failure or Loss	Sources
Tiger Management (Julian Robertson)	3/00	Once the world's largest hedge fund, with capital of $22 billion, Tiger closed after losses stemming from the tech stock crash.	*Institutional Investor*, 12/1/02; *Wall Street Journal*, 3/30/00.
Quantum Fund (George Soros)	3/00	Fund lost 11% of its capital in five days when the tech-stock bubble burst. By May 2000, losses were 22%. Quantum Fund was subsequently renamed Quantum Endowment Fund and abandoned high-risk strategies.	*Wall Street Journal*, 5/22/00.
Manhattan Investment Fund (Michael Berger)	1/00	In January 2000, the SEC brought charges of fraud against this fund, which sold Internet stocks short during the boom. In 2003, Berger failed to appear for sentencing after pleading guilty to criminal charges, and remains a fugitive. Investor losses estimated at $575 million.	*Newsday*, 9/2/06; *Wall Street Journal*, 1/19/00.

Sources: All sources accessed via Factiva, LexisNexis, or ProQuest databases in October, November, and December 2006.