Asset Liability Management of a Hedge Fund

Yesterday we looked at how hedge funds resembled banks. In fact they look pretty much like the result of the dismemberment of banks. Now lets look in a bit closer, at the capital structure of a hedge fund. To a corporate treasurer, a hedge fund would look like a very strange animal. The hedge fund manager looks at NAV (net asset value) of his portfolio on the one hand, and investors providing capital on the other. If you don't believe me, ask any hedge fund manager about his assets and liabilities. We rule out credit managers since this would be familiar to them, or should be familiar to them. Even the odd credit hedge fund manager does a double take from time to time. If we ask what the assets and liabilities of a hedge fund are, it should look something like this.

Assets

Current Assets – Assets that can be liquidated quickly

Cash – that's easy
Marketable Securities – the liquid long positions
Accounts receivable – proceeds of sale of assets, premia from written options and CDS
Interest receivable – from fixed income

Non Current Assets – Assets that can't be liquidated quickly

Illiquid investments – private equity, small caps, large positions,
Cash from shorting held with Prime Broker

Liabilities

Current Liabilities – Short term liabilities

Securities borrowed for shorting – and which may need to be covered or recalled
Short term loans – for leverage

Long Term Liabilities – self explanatory

Equity

Share Capital

The typical hedge fund is open ended, i.e. has a variable equity structure. This means that balance sheet leverage can be affected by changes in equity, as much as by the mark to market of the fund's assets and liabilities. The fund manager has some degree of control over the assets and liabilities, hopefully. It is their job to grow the equity in a stable way. But instability can come from the equity base as well, often when the manager is not performing well. Investors can redeem out of a fund causing the equity to shrink and requiring the fund manager to reduce the size of the balance sheet. This is not always easy to do. Even if balance sheet leverage is allowed to change to handle changes in equity, providers of credit to the fund will be watching the stability of capital as well and are likely to similarly restrict funding precisely when a fund needs it. The Share Capital of a hedge fund therefore needs to be appropriately structured taking into account the strategy that the fund manager pursues and the nature of the fund's assets and liabilities. This is the argument for lock ups and long notice periods.

Today there are funds which offer high liquidity and there are those with restricted liquidity. Mostly the liquidity terms are driven by what the fund manager can achieve. Terms that are too restrictive can hamper the growth of the fund. Terms that are too relaxed result in an unstable capital base. More often the terms are driven by the reputation of a manager. The better the reputation, the greater the demand, the better the terms in favour of the manager. Unknown quantities have to

live with providing good liquidity whether their strategy warrants it or not. It is clear, however, that sometimes, restrictive liquidity terms are there for the protection of the investor as much as the business interests of the hedge fund manager.