

# Positive outlook

Andrew Shinn, vice president at SunGard Astec Analytics, says securities lending is primed to benefit from increased investments in hedge funds

## Exclusive

Hedge funds faced a challenging market environment in 2010. In turn, the securities lending industry did not benefit from hedge funds' reduced demand to borrow and sell short.

During the credit crisis, hedge funds were forced to meet investors' redemption requests by selling illiquid assets for less than fair value. As a result, many funds were careful not to fall too far below benchmark returns lest more investors pull their capital. The cumulative effect was a trend toward accumulating cash and refraining from taking the same risks that hedge funds did in the past. According to anecdotal evidence, as hedge funds sat on cash, many prime brokers remained quiet on those days when there was little demand to trade.

It is hard to be critical of hedge funds, however, because banks and corporations also accrued and held on to enormous piles of cash. These organisations avoided making any big decisions because of the uncertainty in the economy and regulatory environment.

The situation may be changing, however. Over the past six months, investors have continued to increase allocations to hedge funds. Investors allocated an additional \$15 billion to hedge funds in November, the highest monthly figure since February 2010. And investors in November allocated the most money to long-short funds, which bodes well for securities lending.

## Pension funds increase leverage in 2010

On the beneficial owner side of the business, one new development that emerged last year was the move away from equities and toward leveraged fixed income portfolios and alternative asset classes. For example, it is atypical for

pension funds to lever their fixed income portfolios. But despite the infusions they have received from their respective state governments to make up for losses in 2008, most are still underfunded and forced to take extraordinary steps to meet expected returns.

Pension funds in California, Wisconsin and Ohio argued that equities were relatively too volatile and that leveraging fixed income portfolios was the optimal choice in order to reduce volatility and boost expected returns. Of course the amount of leverage will be in the order of 1.1:1 or 1.2:1, rather than the 30: or 40:1 leverage ratios that have sunk hedge funds and investment banks in the past dozen years.

On the other hand, if interest rates increase unexpectedly, these levered portfolios could suffer outsized losses. While this remains an area to watch, it demonstrates that pension funds are continuing to make thoughtful investment decisions. This mirrors activity in the securities lending industry as pension funds as a whole remain committed to securities lending. Available assets to lend declined from 2008 through 2009, yet increased 25 per cent in 2010.

## What's next for the regulatory environment

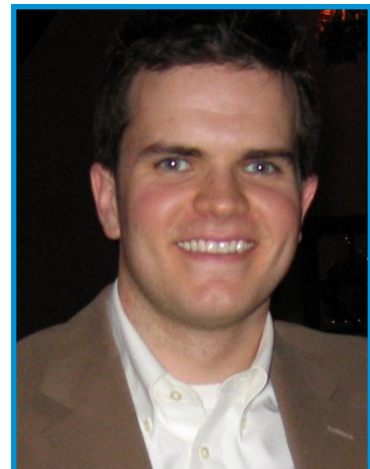
One reason hedge funds hoarded cash was because they were not sure what regulators would do next regarding short selling, for instance. Last February, the SEC decided to institute an alternative uptick rule on a stock-by-stock basis. The rule would take effect when a stock declines in price by at least 10 per cent on a single trading day. Although the SEC continued to push back the implementation date, it is now scheduled to take effect at the end of February

2011. The part that has investors concerned is whether the SEC will allow market makers to be exempt from the rule.

## Insider trading scandal kept in perspective

An unfortunate recent development in the investment management industry has been the insider trading scandal. While the investigation is ongoing, the scandal does not seem to be negatively influencing hedge fund investors too much.

The number of defendants in the case that originated with Galleon increased to 27 in early January. Yet FrontPoint, a fund that was touched by the scandal when one of its managers was charged with insider trading, was able to launch a new \$1 billion fund. This is a positive sign that investors are keeping it in perspective. [SLT](#)



**Andrew Shinn**  
Vice-president, SunGard Astec Analytics  
SunGard