

Hedge Funds De-Leverage and Cut Risk as Subprime Crisis Unfolds

There is significant investor interest in how hedge funds are reacting during the subprime crisis. The collective actions by hedge funds can have a considerable impact on the markets now that the industry commands almost \$2 trillion in net assets. Equally important, investors desire to understand what hedge funds are doing to preserve capital. The prevailing view is that hedge funds are de-levering either voluntarily in reaction to increased asset volatility and reduced liquidity, or involuntarily as prime brokers cut their lending. But useful public information on leverage and risk-taking for the broad universe of hedge funds is hard to come by.

In Exhibits 1A and 1B we attempt to shed light on current trends by showing gross and net asset exposure for a universe of approximately 225 larger, institutional quality hedge funds whose investment styles are reflective of the overall hedge fund industry.

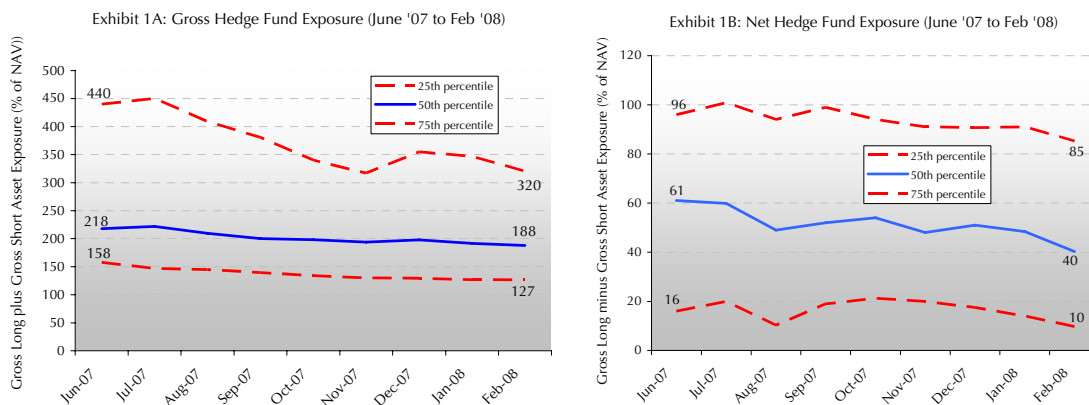


Exhibit 1A tracks hedge fund 25th, 50th and 75th percentile *gross* asset exposures over the nine months ending February 29, 2008. Gross asset exposure represents a hedge fund's total asset holdings, including derivatives, as a percent of net asset value. For example, at June 30, 2007, the median or 50th percentile hedge fund had a gross asset exposure of 218%, meaning that the hedge fund held \$2.18 in asset exposure for every \$1.00 of investor capital. That level of gross asset exposure declined over the subsequent eight months to 188%. Since leverage is properly defined as gross exposure that exceeds the 100% representing investor net asset value, there has been a 25% drop in leverage (118%-88%/118%) since the credit crisis began. More dramatic is the de-levering among hedge funds that generally use higher levels of leverage. Gross exposure for the 25th percentile hedge fund fell from 440% to 320%, or a 35% drop in leverage (340%-220%/340%). Hedge funds that use less leverage, represented by the 75th percentile, had gross exposure fall from 158% to 127%, which actually represents an even larger 53% percentage decline (58%-27%/58%).

Exhibit 1B tracks hedge fund *net* asset exposure, equal to gross long asset exposure minus gross short asset exposure. Net asset exposure is one measure of a hedge fund's sensitivity to the market volatility, though it does not tell you which market(s), i.e. stocks, credit, or currencies. A net asset exposure of 0% would be called "market neutral." Net asset exposures in Exhibit 1B show the same declining trends as gross asset exposures do in Exhibit 1A. The median or 50th percentile net exposure dropped from 61% at June 30, 2007 to 40% at February 29, 2008. 25th and 75th percentile values also dropped, reflecting an industry trend to take less market risk (beta) as the credit crisis has unfolded.

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April 21, 2008