HENNESSEE GROUP LLC
HEDGE FUND ADVISORY

500 FIFTH AVENUE, 47TH FLOOR
NEW YORK, NEW YORK 10110
212-857-4400

THE COMMITTEE ON BANKING AND FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES, 105TH CONGRESS
JAMES A. LEACH, CHAIRMAN

FULL COMMITTEE HEARING ON HEDGE FUND OPERATIONS

OCTOBER 1, 1998

WRITTEN TESTIMONY OF CHARLES J. GRADANTE

PRESIDENT AND CEO, THE HENNESSEE HEDGE FUND ADVISORY GROUP

WITNESS LIST FOR OCTOBER 1, 1998

PANEL I

ALAN GREENSPAN
CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

WILLIAM J. McDONOUGH
PRESIDENT, FEDERAL RESERVE BANK OF NEW YORK

PANEL II

DONNA TANOUE
CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

BROOKSLEY BORN
CHAIRPERSON, COMMODITY FUTURES TRADING COMMISSION

JULIE WILLIAMS
ACTING COMPTROLLER, OFFICE OF THE COMPTROLLER OF THE CURRENCY

RICHARD LINDSEY
DIRECTOR, DIVISION OF MARKET REGULATION, SECURITIES AND EXCHANGE COMMISSION

PANEL III

CHARLES J. GRADANTE
PRESIDENT AND CEO, THE HENNESSEE HEDGE FUND ADVISORY GROUP

HENNESSEE GROUP LLC
HEDGE FUND ADVISORY

TESTIMONY OF CHARLES J. GRADANTE

PRESIDENT AND CEO, THE HENNESSEE HEDGE FUND ADVISORY GROUP

"Chairman Leach, thank you for inviting me on behalf of the Hennessee Hedge Fund Advisory Group and as a spokesperson for the hedge fund industry. I would like to put my testimony in context of my career experiences, which I believe are pertinent to the issues Congress is addressing at this hearing regarding the hedge fund industry and specifically, Long-Term Capital Management.

I come to this Congressional Committee today with career experiences as a President and CEO of a US national bank during the difficult lending period from 1990 to 1995. I have also policed the trading activities (particularly risk) of proprietary traders at a major investment bank and, as you know, Mr. Chairman, proprietary trading at investment banks is the precursor to hedge fund limited partnerships. Currently, I am President and CEO of the Hennessee Group LLC, which provides investment advice on $890 million of capital invested in hedge funds"

I. INTRODUCTION

As I see it, the fundamental issue related to Long-Term Capital Management LP boils down to supervision and regulation. To what extent should current supervision and regulatory practices be modified, if at all. Clearly, transparency, lending practices and market integrity are all intertwined in the situation at hand and need to be addressed if the Committee is to rule effectively on the fundamental issue of supervision and regulation. In addressing this issue, several questions seem to be of paramount importance, namely:

- Is the fundamental concept of hedging valid?
- Have hedge funds collectively grown so large and their positions so venturous that they are a source rather than a mitigation of systemic risk?
- Do hedge funds present systemic risk to U.S. markets or non-U.S. markets?
- Do hedge funds distort market integrity?
- Are current standards of supervision and transparency adequate to maintain bank safety and soundness?
- Should hedge funds be more regulated?

II. IS THE FUNDAMENTAL CONCEPT OF HEDGING VALID?

Most of the capital at risk in the U.S. and probably worldwide is not hedged, so one must ask the fundamental question: is hedging a valid approach to risk capital?

Although A.W. Jones is credited with starting the first hedge fund back in 1950, the concept of hedging is as American as apple pie and my partner E. Lee Hennessee and I strongly believe that classic hedging strategies are not only something that have evolved over the last 200 years, but are essential to market integrity and liquidity.

The origins of hedging in the United States dates back to the eighteenth century in the agriculture industry. Farmers were the first "hedgers" by selling crops or cattle yet to be harvested at a price for future delivery. In doing so, they locked in a price "today" and were "not exposed" to future market fluctuations. In essence, they "hedged" their market exposure for the period of time it took them to harvest and deliver their product.

The early hedge funds pursued a similar strategy of selling equities short to reduce or eliminate the exposure to future market fluctuations created by being long equities. The hedging strategy centered around equities on the "long side" outperforming up markets while the equities on the "short side" did not create a drag on performance and possibly even added to the portfolio's return since there are always stocks that lose value, even in a bull market. In a market correction, the short portfolio would outperform the long portfolio or at least "hedge" the slide in the long portfolio's value.

Clearly, hedging has been around for a long time, which in and of itself validates its presence in the market place, and we believe it will become more, not less important, as markets increase in size and volatility. In fact, my partner and I believe that someday it will be considered imprudent for an investor not to hedge some element of market risk.

III. HAVE HEDGE FUNDS COLLECTIVELY GROWN SO LARGE AND THEIR POSITIONS SO VENTUROUS THAT THEY ARE A SOURCE RATHER THAN A MITIGATION OF SYSTEMIC RISK?

We have provided the Committee with the *Annual Hennessee Hedge Fund Manager Survey*, performed in January 1998, which contains proprietary research collected from 306 hedge funds (excluding fund of funds and CTA managers) managing $90 billion of limited partner capital (unlevered). Some of the key relevant points uncovered by the research include:

- The hedge fund industry was estimated at $210 billion as of January 1998.
- There were an estimated 3200 hedge fund managers covering 20 distinct and recognizable money management styles.
- The vast majority of hedge fund managers have less than $500 million of capital from limited partners and these managers added 61% to assets under management (new capital plus performance growth); whereas funds with capital above $500 million grew 47% in assets under management.
- Gross market exposure (long positions plus short positions) for the industry was 128% in January 1997 (93% long and 35% short) and was 132% in January 1998 (85% long and 47% short).

Although leverage on partnership capital was applied (i.e., longs plus shorts), the industry as a whole (with the exception of macro managers and levered bond managers) does not use large amounts of margin or leverage (usually well written Reg-T limits).

Looking at our research, several inferences can be made:

- Macro managers and managers like Long-Term Capital are a segment of the industry, however, they do not fairly represent what the majority of hedge funds are trying to accomplish and how they accomplish it. Therefore, when we talk about the hedge fund industry, are we talking about the minority of large firms representing 30% of hedge fund capital and major users of OTC derivatives; or are we talking about the over 3000 hedge funds who manage money with less leverage and are not major users of OTC derivatives.
- Clearly, we need to try to avoid what appears to be unavoidable; that is, gross generalizations about the industry based on media attention and specific observations about major macro hedge fund players who do not represent the industry as a whole.
- On an unlevered basis, the large so-called "macro" managers do not represent a significant percentage of the estimated $30 trillion world market. This is not to say that they cannot move illiquid markets, but they themselves do not constitute a massive financial presence. Instead, similar to someone proficient in "judo," a macro manager can use the market's established inertia to accelerate a market condition that was already developing beneath the surface of that market. With few exceptions, it seems unlikely that a macro manager can create a major market movement without the fundamentals of that market movement already in place; albeit often unrecognized by even the most astute market observers. Which brings me to my final point on size.
- By several key measures of control (13D filings and amount of capital relative to the U.S. bond and equity markets), hedge fund managers are less of a force than mutual funds and institutional money managers. What seems to be apparent is that their relevance to major market moves is more about their "influence" than their size or venturous positions.
- When hedge funds of any kind transact a large position, that position will likely not escape the notice of other professional investors. Not withstanding efforts by hedge funds to conceal their trading strategies, most professionals regard it as naive to think that information never goes beyond the sales or credit desks of hedge fund counterparties. Consequently, hedge funds can indirectly influence the investments of professional money managers that have far greater financial clout in the market place, namely: pension funds, mutual funds and insurance companies. At times, it seems jokingly, that hedge funds should be called "herd funds." Once the financial herd begins to follow it can manifest itself into a stampede.

From where I stand, hedge funds collectively have not grown so large and their positions not so venturous that they are a source rather than a mitigation of systemic risk. If we were to criticize hedge funds for anything, it would be for their **influence**, not their financial presence. However, that would be like criticizing a corporation who is not the largest in its industry, but is the most astute and a trendsetter that is widely copied by its competitors.

IV. DO HEDGE FUNDS PRESENT SYSTEMIC RISK TO U.S. MARKETS OR NON-U.S. MARKETS?

Hedge funds have recognized early rumblings in the market place before they surfaced. An example of this is the ERM crisis of 1992 where hedge funds shorted sterling and Italian lira. Hedge funds by far were not the only players, nor did they create the market conditions that they capitalized on. The inertia was already set in motion. Furthermore, mutual funds, pension funds and insurance companies from all over the G7 were involved. At that time, G7 institutional capital under management was estimated at $10 trillion versus macro managers $12 billion.

It is virtually impossible for me to comment on the potential systemic risk associated with Long-Term Capital, but one thing does seem clear to me and that is that systemic risk, if it did exist, involved the key issue of risk management on the part of Long-Term Capital and its bankers. Although I believe Long-Term Capital is an isolated case, I do place more responsibility on the lenders for any systemic risk present. Either the lenders were mislead (which I do not believe to be the case) or they did not follow basic lending principals of credit risk management.

We may need to tighten margin requirements on certain levered bond arbitrage and adjust other areas, but I believe the present system of control for systemic risk is fundamentally adequate. Lenders have to "know their credit" and if they cannot do so they should not lend. Granted, Long-Term Capital's business model made inappropriate economic assumptions. That happens all the time in business seeking a profit. Without understating the seriousness of mismanagement at Long-Term Capital, it is ultimately the lenders responsibility (not the borrower) to ensure the safety of the banking system.

Hedge funds will not present systemic risk if bankers apply traditional lending principals. In most cases they do. Much has been said about the "star" system of lending in the case of Long-Term Capital. I believe that had a lot to do with the amount of credit extended.

Two questions immediately pop up. Can you adequately measure risk in the case of Long-Term Capital and is leverage bad.

Leverage inherently is not bad. It is the relationship of leverage to the volatility of the trade that is the risk and that can be difficult to measure because historical statistical relationships may not adequately define "one-off" events. Or at least it appears that way; and especially difficult when we have what is termed "a four standard deviation" move in the market. Businessmen do not ordinarily plan for or hedge for a "four standard deviation move" in any business assumption. If they hedged for such a move they probably wouldn't make a profit. However, bankers are supposed to balance that line between "best case" and "worse case" and determine the appropriate lending limit.

If you limit leverage by hedge funds, are you also going to limit leverage at investment banks and commercial banks. Certainly leverage was a catalyst for failure but what ignited the catalyst was a faulty business model at Long-Term Capital. A model you would unlikely find at any investment bank or commercial bank.

Since leverage and statistical risk measurement are linked at the hip, I would like to make a basic but fundamental point about statistical analysis and quantitative modeling. One of the inherent problems in statistical simulations of market relationships is the use of "standard deviation" or related measurements as a risk control tool. The concept of standard deviation was originally developed as a quality control tool for industrial production lines. The concept of sampling a batch of "widgets" and plotting its mean and standard deviation against the desired "standard widget" works well for quality control of "**machine**" oriented production processes. Although we have not developed a better approach, it is all we have to measure expected dispersion or variance between two or more securities. Obviously, Long-Term Capital used more sophisticated mathematical models but it is my belief that quantitative modeling is flawed when "one-off" events take place. Case in point, Russia. I myself have used quantitative modeling to predict "mean time to failure" for component parts on aircraft. The mathematical modeling works because operating parts to an aircraft are more predictable than "**human**" nature, political events, etc. Clearly, lenders need better tools to measure risk versus lending exposure. Although an improvement, I do not believe "Value at Risk" is the answer to the Long-Term Capital problem.

V. DO HEDGE FUNDS DISTORT MARKET INTEGRITY?

Regulations governing market integrity are designed to ensure a level playing field for all professional money managers and individuals alike. It is a gross understatement that hedge funds are not regulated. Regulations, such as, insider trading restrictions, 13D filings, order execution priorities and position limits apply to all market players including hedge funds. Restrictions on the ability to accumulate positions which would enable someone to "corner" or "squeeze" a market also apply to hedge funds.

Transaction and large position reporting requirements not only protect market integrity but also serve to monitor systemic risk.

VI. ARE CURRENT STANDARDS OF SUPERVISION AND TRANSPARENCY ADEQUATE TO MAINTAIN BANK SAFETY AND SOUNDNESS?

It is unclear whether lending institutions can effectively monitor derivative risk. Putting this issue aside, I believe current standards are adequate provided they are utilized by lenders.

Businessmen often put "profit before process." This is the nature of the world we live in. Regardless, lenders must always put "process before profit."

VII. SHOULD HEDGE FUNDS BE MORE REGULATED?

Faulty business models will always rear their heads as long as the forces of capitalism and free markets are intact. Wasn't the systemic collapse of the real estate market in the 1980's a faulty business model? Weren't real estate developers overly aggressive in their economic assumptions and weren't they overly levered. Didn't the financial lenders relax standards especially when it came to the "stars" of the real estate world.

When the systemic risk of that crisis was evaluated, did we conclude that real estate developers needed more regulation or did we conclude that established bank lending practices were adequate but not effectively applied and excess liquidity in the financial system undermined lending credit standards.

Although the real estate crisis in the U.S. and Long-Term Capital are miles apart in the spectrum of lending dynamics, the underlying issues, as I see it, are the same:

- Faulty lending practices coupled with overzealous borrowers who were highly levered and fell prey to a "one-off" economic condition.
- A business model whose economic assumptions were inappropriate for the leverage provided by the lending community.

In conclusion, hedge funds do not need more regulation. Existing regulations and credit standards are adequate if properly implemented.