

It's An Ill Wind...

This is a time of great volatility, with the markets akin to a brooding, storm-battered Atlantic. Fear not, says **MIKE BAGHDADY – batten down the hatches and chart your course carefully**

THE MAY STOCK market could have used the *Jaws* slogan: 'Just when you thought it was safe to go back in the water...'

After the tumultuous volatility of 2008 and 2009 it seemed as though the market had settled, but that theory was thrown out by the 6 May flash crash, when a stock like Procter & Gamble could sink 35% in a couple of minutes.

Even factoring in the uncertainties surrounding the economic recovery and Europe's debt woes, it's hard to imagine anything that could slash a company's value so much in one day. In three trading days the Dow made a 1,000-point round-trip, ending 77 points shy of where it began.

The consequent volatility seems to be inspiring fear not just for individual investors but within hedge funds too. As we ended 2008, it appeared that the hedge fund industry could do no right and many predicted its demise. The industry faced its version of a bank run with its first liquidity squeeze in 18 years.

Fast forward a year, and according to the latest Hedge Fund Research (HFR) industry report, the hedge fund industry's assets as of March 2010 were just 2% shy of its October 2007 peak, ending the quarter with \$1.67 trillion in assets, a result of both inflows coming back to the industry and credible performance over the five quarters following the troubles of 2008.

In 2009, the top 25 hedge fund managers

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earned a collective \$25bn, more than they did in the years of plenty, before the crash. But hedge funds will likely finish the first half of 2010 with virtually zero returns, giving up gains made earlier in the year.

Why? Risk appetite has diminished across the globe as more economies have faltered, a fact that hedge funds – with their heavy market exposures – seemed ill-prepared for. The hedge funds are not living up to their mandate to make money in all markets, even risk-averse ones.

New York-based hedge fund Conquest Capital's macro fund runs a risk index published by Bloomberg that gave a strong indication of rising risk aversion back in May, when the flash crash occurred. Risk-seeking had been the rule since December 2008.

According to Hedge Fund Research, there were some hedge funds that performed strongly in 2009: those that invested to profit from credit improvement and the increasing flow of deal transactions, a trend that continued into 2010. HFR noted that bigger funds showed slightly higher average returns. Bigger funds also benefitted from investors' risk aversion: they're viewed as more established, and safer.

One standout performer was long-short fund Senvest Partners, with assets of \$250m and a 20% gain through May 31. Senvest invested in tech stocks like SanDisk and Radware, as well as mortgage insurers, such as Genworth Financial.

“We've done pretty well taking the other side of the fear trade,” said its portfolio manager Richard Mashaal. “The trick is not to get too greedy.”

Some greed is good, but determination to push the boundaries and take calculated risks is still at the core of well-performing hedge funds. Sebastian Mallaby's new book *More Money Than God* shows that the history of hedge funds is a history of men who were able to spot market opportunities



others missed, and who were prepared to gamble a fortune on their convictions.

It's worth remembering that stand-alone hedge funds didn't cause the most recent financial meltdown. More important, even though the most successful hedge fund managers make Wall Street CEOs look like impoverished salary men, their funds are generally small enough to fail. 2008 was a time of carnage in the hedge fund world, but taxpayers didn't foot their bill.

The hedge fund model will survive the crises sure to follow the May flash crash and thrive in their aftermath. It will continue evolving and adapting itself to investors' needs, despite the fears that abound in the markets and the reluctance to take risks that this fear brings with it.

As traders, we can't fear whether stocks and shares are up from one day to the next – managing risk in a volatile market makes a trader, and volatility in any direction brings with it opportunity. **H**

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