

A graphical look at hedge fund leverage

Mar 5th, 2009 | Filed under: [Today's Post](#)

Britain's Financial Services Authority (FSA) recently found that hedge fund leverage was nearly extinct (for now). In what is billed by the FT as the "only authoritative data on the opaque industry", the FSA found that the average hedge fund had leverage of 1.15x, down from about 2x a year ago and 1.44x as late as last spring.

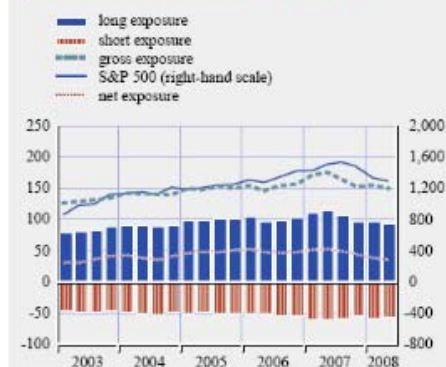


According to the [FT](#), the FSA defined leverage as long positions over NAV, "ignoring short positions."

But what happens when you account for shorts? Regular readers may remember the chart below left from a recent European Central Bank report (see [post](#)). The ECB reported *gross* leverage (longs plus absolute value of shorts) from Hennessee Group and found leverage levels around 1.5x. (To compare to the FSA's estimate, note that longs over NAV was under 1.0 - likely due to the fact that only lower-leveraged long/short equity funds were counted.) This seemed to back up what managers were telling Merrill Lynch in a survey cited by the ECB (right panel) - that a majority of managers were actually using no leverage at all.

Chart 1.31 Exposures of long/short equity hedge funds

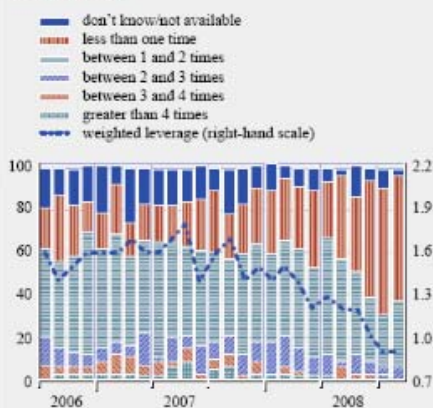
(Q1 2003 – Q2 2008, average of exposures as a percentage of capital under management and S&P 500 index levels)



Source: Hennessee Group.
Note: Based upon analysis of 100 long/short equity hedge fund managers. Gross exposure equals to the sum of absolute long and short equity exposures.

Chart 1.32 Hedge fund leverage

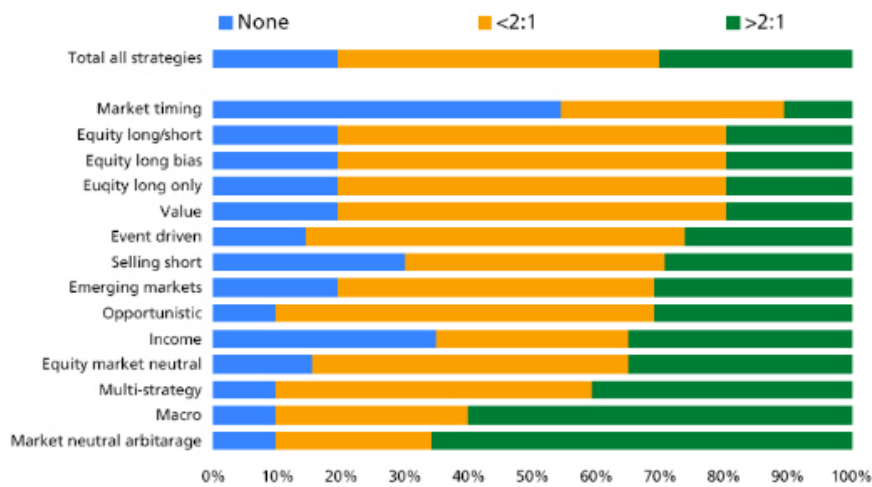
(Sep. 2006 – Oct. 2008, percentage of responses and weighted average leverage)



Sources: Merrill Lynch, *Global Fund Manager Survey*.
Notes: Leverage is defined as a ratio of gross assets to capital. The number of responses varied from 32 to 45.

Data cited by UBS's Alexander Ineichen suggests that managers use a little more leverage, but not much more. In this UBS chart cited by a recent [AllAboutAlpha.com post](#), you can see that managers report slightly higher, but still relatively modest, amounts of leverage:

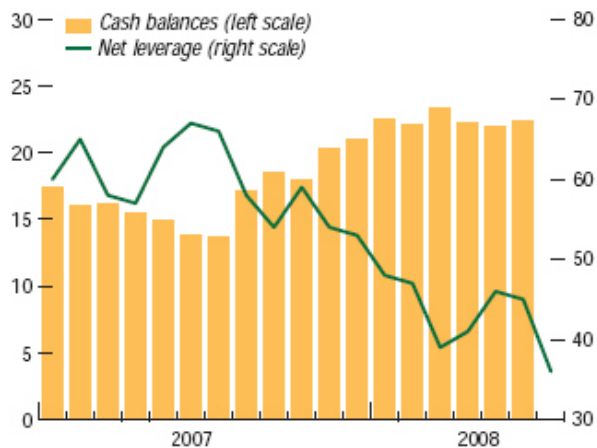
Chart 24: Global hedge fund assets breakdown by leverage (2007)



Source: Lipper, BCG analysis

Note: Leverage corresponds to the ratio of the value of the fund to money received from subscriptions.

The Merrill Lynch data cited above wasn't the only data from a prime broker that showed surprisingly low leverage levels. Kostas Iordanidis, who was until recently head of Unigestion's fund of funds business cited Morgan Stanley data (below) in a recent presentation to the Swiss CFA Society ([full presentation](#)). As you can see, this data roughly lines up with that above.



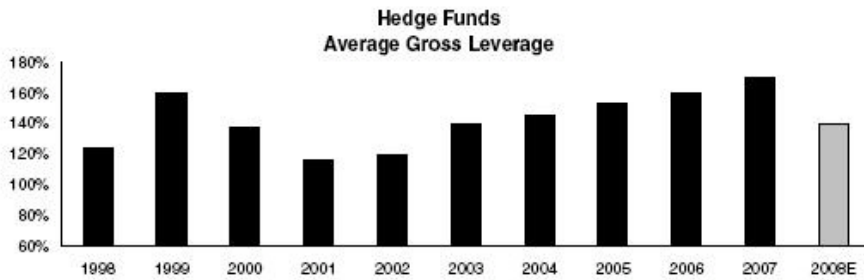
Source: Morgan Stanley Prime Brokerage.

Note: Leverage defined as assets divided by equity capital cash balances as a percent of total assets.

Bernstein Global Wealth Management found basically the same thing (chart cited by the [FT](#) below). The FT reported that nearly two-thirds of hedge fund managers surveyed by Bernstein felt deleveraging was at least half-way done by November 2008.

Exhibit 2

Average hedge fund leverage (gross market exposure as % of AUM) has risen this decade, until falling recently

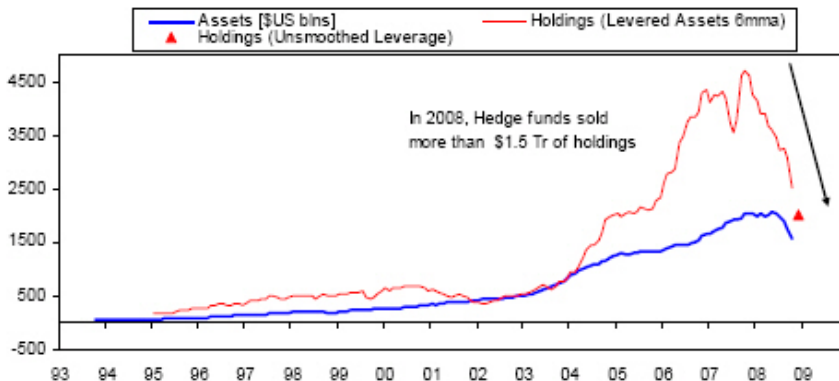


Source: ISFL, IMF World Financial Stability Report, Barnestein estimates

Regular readers may also remember the chart below from a recent paper by the Bank for International Settlements (see [post](#)). The Bank essentially divined the leverage used by hedge funds by examining their performance history. The conclusion: bared any leverage used by equity hedge strategies (thin line: all funds, thick line: funds that specifically said they used leverage).



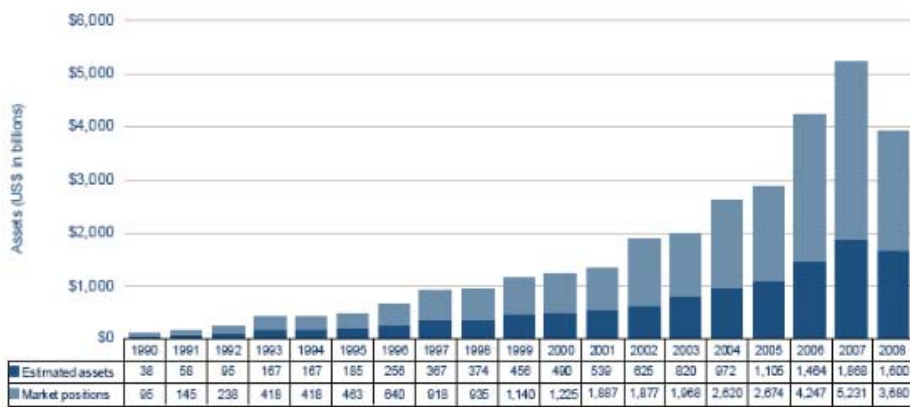
As you can see, "divined" leverage seems to increase markedly around 2004. This seems to match what Bridgewater (now the "**largest U.S. hedge fund**") reported in a recent client note. A chart from that report was contained in the Swiss CFA Society slides by Kostas Iordanidis (link above).



Bridgewater may bristle at being lopped in with those risky and highly leveraged hedge funds. But according to their own data, hedge fund leverage sits at only a little over 1x (after, as it points out, a large amount of recent hedge fund selling).

Still, some sources indicate that leverage remains around 2x. Uber-blogger **Paul Kedrosky** posts the following chart (specific source not cited, but reportedly from

MIT's Andrew Lo):



Sources: through Q3 2008 – HFR Industry report. Q4 2008 projections – based on CS analysis

And data cited by UBS's Ineichen (cited above) also suggest that hedge fund leverage has dropped from nearly 3x to around 2x over the past year (see related [AAA post](#)).

This drop in leverage begs the question *“What’s going to happen if/when that capital flows back into the industry?”* To be sure, some of the delevered assets aren’t coming back. But as Bernstein wrote in conjunction with the survey mentioned above (as [cited](#) by the FT):

“The magnitude and duration of hedge fund deleveraging, the amount of cash on the sidelines, and the potential buying power this represents for a market rally are among today’s key investment controversies.”



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