Hedge Funds and the Credit Crisis

Bachelor Thesis in Quantitative Finance

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Executive Summary

I Context

The hedge fund industry is arguably the most dynamic sector of the financial world today. Significant pressure is placed on hedge funds, as they live on the premise that the investments they manage should provide high returns and protect capital, irrespective of the broad markets.

Decisions made by hedge funds as to where to allocate capital are extremely influential in the movements of financial markets and the global economy. Hedge funds attempt to exploit complicated niches in all corners of the financial system and buy or sell assets that are perceived to be out of equilibrium in often unbalanced world financial markets.

The last two decades have given considerable confidence to hedge fund investors. Hedge funds have historically fulfilled expectations and provided an alternative investment with flexible money making techniques which led to a rapid growth in the industry.

2007 and 2008 proved to be highly stressful and controversial years for hedge funds, resulting in a severe humbling of the investment strategies that had previously performed so successfully.

II Purpose of the Thesis

The purpose of this thesis is to analyze the performances of different hedge fund strategies during the financial crisis of 2007-2008, as they could not keep up with their promise to perform well in any market environment. The author will also further pursue research of the managed futures hedge fund strategy by gaining firsthand experience of its execution in a hedge fund trading situation during the studied crisis period. Tools, including MatLab, Excel and Bloomberg, will assess data and provide performance outcomes to form the basis of discussions.

A further intention of the author is to discuss hedge funds' impact on financial stability in order to draw a conclusion as to whether they are a positive market participant and create economic value in global markets. Additionally, recent discussions about future regulation will be presented.

III Results

Consistently profitable returns are expected from all hedge funds, but the performance analysis of the different hedge fund strategies has shown that hedge funds did not perform well during the financial crisis, though they still fared better than the considered benchmarks, S&P 500 and MSCI World.
The managed futures strategy proved to be the clear leader in investment performance during the crisis, resulting in a 17% return. This strategy took advantage of the significant downward momentum in the market, as managed futures had short trading positions while the market was capitulating during the crisis.
The author researched the implementation of a self-designed, numerically driven managed futures strategy. The outcome of this implementation proved successful as well, providing a 12% return.
Macro hedge funds were the only other category to achieve positive performance, with a mere 4% return. The remainder of the strategies all posted losses, but they did all successfully outperform the benchmarks, as the S&P 500 and MSCI World Index were down 40% and 43%, respectively.

Since hedge funds provide liquidity to global markets, develop complex risk management tools, serve as an anticipator of economic imbalances and attempt to correct these by arbitraging away noticeable inefficiencies, the author came to the conclusion that hedge funds are a positive market participant and contribute to financial stability.