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EIR Economics

CRASH TRIGGER

New Tens of Billions Pile into 'Financial Locust' Funds

by Paul Gallagher

The large number of highly leveraged equity takeovers and buyouts of companies now being staged and planned by hedge funds and private equity funds, are massive bets in a failing economic game, and threaten imminently to trigger an international debt collapse. Though in recent weeks, regulatory institutions of the United States, Britain, and the European Union have pointed to the danger, their public statements have been aimed at lulling their citizens, and their actions have been weakly directed at a previous stage of the crisis—"fighting the last war instead of the coming one."

The danger of an auto sector debt collapse (especially at Ford and GM), which Lyndon LaRouche warned of nearly two years ago, has turned into an ugly reality which—while also ruining the employment of many tens of thousands of skilled wage-earners—this has repeatedly shaken the credit derivatives and related speculative markets during 2005-06. In meetings and statements at the end of September, Federal Reserve and British Financial Services Agency (FSA) officials claimed that they had cleared up the chaos in the credit derivatives markets, but made only the vaguest allusions to the newer, worse threat of highly leveraged takeovers—and highly leveraged defaults.

Betting on a Folding Game

The globally-reported collapse of the $9 billion Amaranth hedge fund, though *not* highly leveraged by standards of big hedge funds either in the time of LTCM's 1998 blowout, or now, nonetheless appeared to put billions of debt at risk or into default. It also caused losses of hundreds of millions of dollars for at least six public and private employee pension funds in the United States. The same order of losses are involved in the slower-motion collapse of the once-$12 billion Vega Partners hedge fund, now reportedly down to a billion or so of capital.

But much bigger market debacles are promised by the ongoing huge borrowings of both hedge funds and private equity funds which are trying to get control of firms in order to loot them of dividends and other payouts, or to take them over outright, to break them up and "unlock their shareholder value." In the process, these completely unregulated and unregistered funds, and many others they trade with, get involved in "equity derivatives" contracts, about which New York Federal Reserve governor Timothy Geithner has been warning for months.

It is the leveraged equity-buyout defaults which result, which were on the warning agenda of the regulators from the Federal Reserve, British Financial Services Agency, and SEC who met in New York on Sept. 27. Hedge and private equity funds are borrowing large multiples of the total earnings of the companies they're trying to take over—as in the case of the Appaloosa, Cerberus, and other funds borrowing $3 billion or more to get control of bankrupt Delphi Automotive. The group of funds which is taking over Harrah's Casinos, paying $15 billion or 65 times Harrah's annual earnings (!) are borrowing $6 billion or more, at least 25 times the target's annual earnings, for the takeover. And the list goes on, including Kerkorian's Tracinda fund's and allies ESL funds group's schemes (shelved at the moment) for taking over General Motors.

This represents taking on huge debts to make bets on a game which is collapsing, LaRouche noted, leaving these "geniuses" to try to "pawn off" the collapsed results.

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(LaRouche proposed a way to spot a hedge fund manager: He's got three balls.) The U.S. and U.K. housing bubbles, the last four years' commodities bubble, and interest rates have all gone rapidly into reverse as the economy goes down, making these highly leveraged takeover speculations explosive for the "players" and for the system. And not only do the regulators know it; the banks doing the lending know it too (even if the lunatic hedge managers do not). They are "hedging" and protecting themselves as well.

The London *Guardian* on Oct. 6 ("Fears of Crash Put Focus on the City's Dark Arts") reported that investment banks are preparing for a big expansion of "debt restructurings." They expect much of the private equity fund debt, and hedge-fund borrowings for takeovers, etc., to go bad and have to be restructured. The banks are hiring lots of restructuring experts for this "debt going south." A Wall Street source reported that these bank preparations for highly leveraged defaults, were in part on advice of the regulators who met in New York on Sept. 27, with the British FSA being particularly worried; New York Fed governor Geithner also confirmed on Oct. 4 that "that subject was discussed" at the New York meeting.

A *Wall Street Journal* report Oct. 5 on "How the Amaranth Failure Was Contained" illustrates the way big bank players will act in leveraged defaults. JP Morgan Chase, when it quickly took over Amaranth's outstanding energy trades, also "took over" the $2 billion collateral for those trades—that is, $2 billion of Amaranth's investors' money. Then, they armtwisted the counterparties in the trades, into tearing up their Amaranth contracts and making new contracts with Morgan Chase; kept some trades, and sold others off. Thus, Amaranth's "collapse" of September became Amaranth's outright liquidation of October. It appears now that the pension fund losses we have reported in this collapse may have gotten larger in the process: San Diego county's, for example, likely being $174 million, and Pennsylvania state employees' being $35-40 million. 3M Corporation's pension fund lost $94 million in Amaranth; Philadelphia and New Jersey employees' funds at least $15 million each. Many pension funds have been pouring 15-20% of their portfolios into hedge funds, desperately seeking high returns.

Rapid Concentration of Locust Funds

A recent Hedge Fund Research, Inc. report notes that even while hedge funds have churned in the last 18 months with 2,600 new funds formed and 1,071 disappearing, total net new investment into these increasingly dangerous funds has rapidly climbed. Net new investment in hedge funds was estimated at $24 billion in first quarter of 2006; $42 billion in the second quarter; and a projected $55 billion in the third quarter. There is also rapid concentration going on: The "billionaires"—300 out of the 9-10,000 hedge funds in the world, which have $1 billion or more each under management—control 90% of all hedge fund capital. This concentration is accelerating as large numbers of smaller hedge funds fail, along with a few large ones. At the same time, private equity firms, engaged increasingly in speculation indistinguishable from that of hedge funds, are on track to raise a record amount of money, and the overwhelming majority of it for leveraged buyouts. They took in $172.2 billion in capital during the first three quarters this year, already surpassing the amount they raised in 2005, and at a pace to break their record set in 2000.

Private equity firms and funds now attract a total investment almost equal to that of the entire publicly-traded stock markets, and a lot of that private equity investment is just debt.

Yet the report found that average hedge fund returns for 2006—notoriously, this average represents *only those hedge funds which have survived*—are 6.9%, which hardly covers the large fees and commissions most of the funds charge for management. One fund manager was quoted in the Oct. 5 *Wall Street Journal,* "It's getting harder to make money" as more and more capital piles into the same speculations, and derivatives bets on those speculations. In response to the growing difficulty, the fund managers are going for much bigger leverage—i.e., they are borrowing much more to speculate with. This is what made LTCM's crack-up an imminent danger to bring down the entire world financial system, eight years ago.

Coming to Their Senses

The Investment Dealers Association of Canada on Oct. 4 released a resolution, which they called a "national call to action," to create and enforce requirements that all hedge funds register, name their managers, disclose all their fees, disclose their investment strategies, and disclose details on how each fund is valued. The association's resolution calls for expanded enforcement teams to be set up by the Royal Canadian Mounted Police; and for the creation of a national Capital Markets Court as a separate division of Canada's federal criminal court system. Insider trading would be a major target of investigations and prosecutions in this court, as they have been in Sen. Arlen Specter's (R-Penna.) hearings in the United States.

The Canadian-based sector of hedge funds is small, and supposedly manages only about $26 billion in capital. Nonetheless, the "call to action" is a potential model for dealing with the hedge fund-equity fund monster.

Former New York Fed President William McDonough, who led the LTCM bail-out operation in 1998, said on Sept. 28 that because the Securities and Exchange Commission is leaving hedge funds largely unregulated, it "invariably demands now that the Federal Reserve interest itself in institutions other than the banks more than it had to in the past." He added: "One would hope that we would not wait for a crisis that is truly a mess, for the Congress and the President to look at the structural issues and decide to put in place a supervisory system that is more appropriate."