

Hedge Funds Look To Profit From Securities Lending

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Although hedge funds are most commonly thought of as borrowers in the securities lending market, some funds are starting to earn real revenues by lending out fully-paid stocks and bonds to other hedge funds. By lending wisely, these funds can add 25 to 100 basis points to their entire portfolio returns, producing enough funds to subsidize an operations department, add staff members or invest in new risk-management technology.

The world of securities lending tends to be hidden from the view of most hedge funds. In practice, pension plans, mutual funds and other long asset holders seek to lend stocks and bonds to prime brokers, which in turn lend them to hedge funds to facilitate shorting. Some assets are oversupplied and are rarely lent while others are in constant demand and produce high borrowing fees. When hedge funds short and must borrow stock, they get it via their prime broker, which often borrows it from a pension plan or mutual fund. Likewise, hedge funds that enter the market as lenders must use the resources of their prime broker or other self-clearing broker-dealers to get assets to another hedge fund.

Vodia Group recently completed a study examining one asset class—U.S. equities—and how hedge funds compare to other asset lenders. We found that hedge funds lend out only 2% of their available

U.S. equity assets, compared to 15% for mutual funds and 14% for U.S. public pension plans.

Hedge funds have a structural advantage in the lending market. When pension plans and mutual funds lend, they must go through their custodian or lending agent to reach a prime broker. A hedge fund

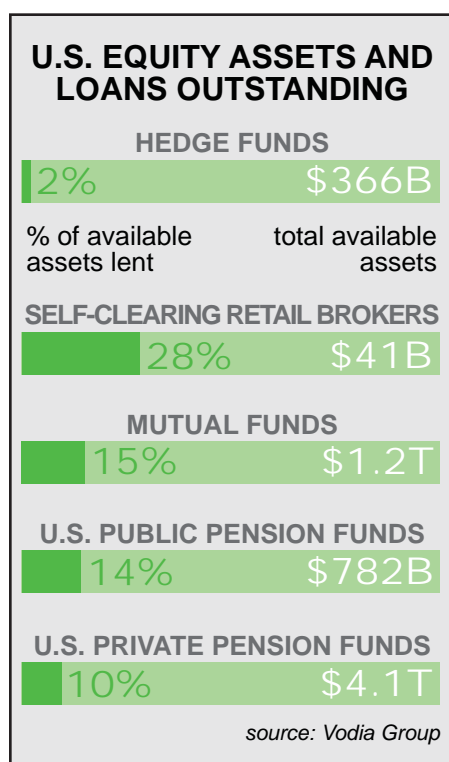
stable inventory, long-term lenders are generally the best option. A hedge fund may trade rapidly and may need to recall their inventory with little notice. Second, only the largest funds attract the attention of their prime brokers; smaller funds lack large enough position sizes to warrant substantial interest. Lastly, most prime brokers want to keep inventory in-house.

Brokers have been most inclined to call a hedge fund to borrow only to meet the needs of their own client base. A few brokers now offer fully-paid lending programs, whereby a hedge fund can direct where it wants its securities to be lent, although this has been slow to generate major interest.

For hedge funds that know they will be holding positions for one month or more, lending may require either advertising to their prime broker or seeking out alternatives in the market.

Although hedge fund investments in U.S. equities may decrease in the years ahead, this group will become more active in lending their assets into the market. We project a five-fold increase in hedge fund assets on loan between now and 2010 due to the desire to capture the most return out of a portfolio. As small businesses with tight cost controls, this revenue for hedge funds can be the difference between keeping pace with the crowd and excelling.

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that lends to its prime or arranges to lend directly to another hedge fund can offer price improvement to its borrowers without lowering their rates. However, hedge funds must be proactive in order to make their lending practices successful.

Prime brokers looking for inventory view hedge funds as an acceptable, though not necessarily ideal, source of loans for three reasons. First, as any borrower is looking for