Shadow Banking Success: Study finds hedge funds make pretty good lenders

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[1]A few years ago, we ran a story [2] about a couple of studies of the secret sauce used by activist hedge funds. These studies found that hedge funds weren't that great at managing businesses (compared to private equity firms), but that they were superb at picking eventual winners and hounding existing management until they liberated the value locked up in the firm. The studies looked at debt and equity positions taken up by activist hedge funds.

An academic paper [3] released in April of this year aims to explain the role of hedge funds a little higher in the capital structure as "primary lenders". In essence, the paper by Vikas Agarwal of Georgia State University and Costanza Meneghetti of West Virginia University examines what many policymaker have called the "shadow banking system [4]." According to Agarwal and Meneghetti, their's is the first study to look at hedge funds' activities in the primary loan market.

So what kind of company looks to hedge funds for loans? Companies with "lesser credit quality", that's who. In fact, the authors describe hedge funds as payday loan shops that "serve as lenders of last resort" to companies that can't borrow from banks or issue debt.

In fact, hedge funds seem to like to lend to companies with a negative return on assets, a negative cash flow, and higher leverage than banks do. Curiously, these companies also have a lesser ability to actually service the loans than bank borrowers. They also tend to be smaller than bank borrowers. We've collected a few of the 18 data points in the study below.

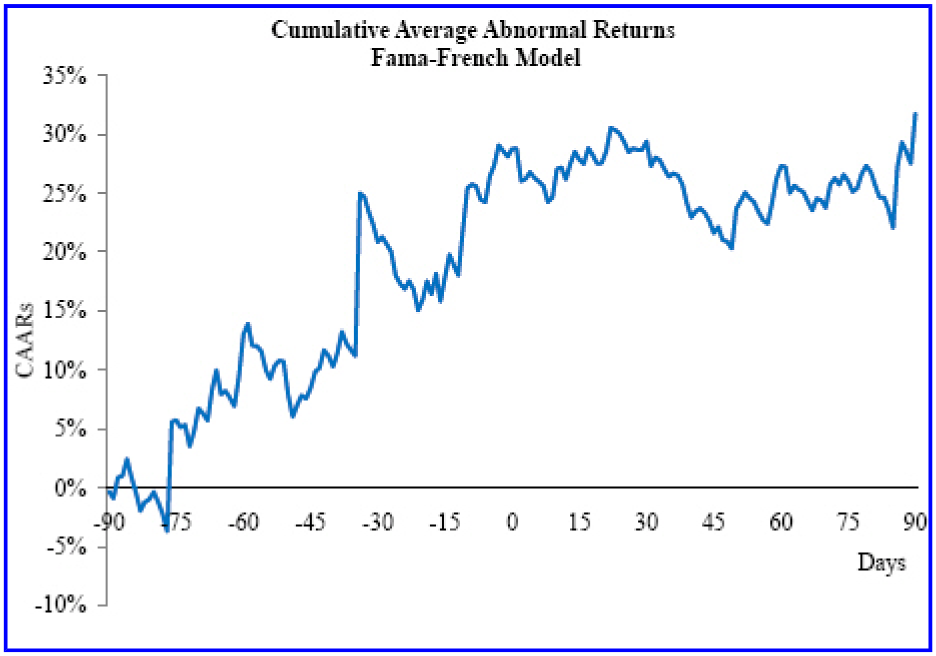
	Hedge Fund borrowers	Bank borrowers
ROA (Op Income / Total Assets)	-0.012	0.03
Cash Flow (Inc plus depreciation / Total Assets)	-0.14	0.061
Loss (1 if income < 0)	0.537	0.214
Leverage (LT and ST debt / Enterprise Value)	0.435	0.281
Interest Coverage (op inc / interest expense)	13.921	20.165
Size (Total Assets in $billions)	3.6	6

[5]

So why would a hedge fund want to lend money to a business whose ability to pay it back is questionable? One reason, according to Agarwal and Meneghetti is that primary lenders get more frequent information about the company than shareholders or debt holders. This, presumably, allows them to influence management a little easier.

So although activist hedge funds don't add value through managing businesses, they are apparently adept and forcing change. So adept, it turns out, that other investors seem to celebrate when a company borrows from a hedge fund manager.

In keeping with other studies that seemingly show markets as clairvoyant, the abnormal returns of a company's stock starts to rise months before a hedge fund actually issues a loan:



[6]As you can see, if you bought the company's stock the day the hedge fund loan was issued, you'd be treading water for months. If, however, you knew what was on tap, you could make a solid return.

But if you held these equities a little longer you'd continue to benefit from hedge fund oversight of the firm. Agarwal and Meneghetti find that there is a marked improvement in ROA after two years.

So is the "shadow banking system" really all that evil? After all, it would appear that hedge funds might make better banks than banks themselves.

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