CHAPTER 1

Hedge Funds Are the New Banks

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In testimony before the Senate Banking Committee in February 2004, Federal Reserve Chairman Alan Greenspan expounded on why he thought hedge funds should stay, for now, beyond regulation: "The value of these institutions is to create a very significant amount of liquidity in our system." When he says "liquidity," I don't think he means it in the traditional sense that hedge funds are simply providing more buyers and sellers for stocks in order to make a more efficient stock market. Rather, I think he's referring to all the illiquid areas within traditional banking where, because of risk aversion or just plain fear, the banks are losing valuable opportunities to generate returns and the hedge funds are stepping in to take their place.

Trading strategies obey the same laws that particles do in quantum physics: When you observe them (i.e., index a hedge fund strategy) they change. By definition, funds are alternatives. To institutionalize them is to damage them. The reality is, for fund of funds managers (I'm one of them) looking to diversify into a group of uncorrelated hedge fund strategies, the traditional strategies of merger arbitrage, fixed income arbitrage, and convertible arbitrage are no longer good enough. With market-neutral strategies I'm getting half the return at twice the risk. The market-neutral, trading-oriented hedge funds that have typically been uncorrelated with all other assets are now correlated with a flat line or worse due to the enormous amount of inflows combined with the lack of volatility in the market. However, with the overall decline in interest rates since the late 1990s, the risk aversion of trading-oriented hedge funds and banks alike, and the dot-com bust, which also flushed out

many of the third-tier investment banks, many hedge funds have gone from traders to what could be called "alternative banking."

Can you get a car loan from a hedge fund? a loan to buy a TV? a loan to pay for a life insurance policy? a school loan or financing to fund a movie? The answer is yes. Hedge funds specializing in alternative financing rather than alternative trading have sprung up in every category of asset-backed lending and have taken up the banner in areas where banks have either been too bureaucratic or too risk-averse to make the leap. The end result has been funds that are completely uncorrelated to the traditional financial markets and have so far been delivering above average returns at lower volatility.

SUBPRIME AUTO FINANCE

For example, Centrix Financial, a Denver, Colorado–based hedge fund that provides subprime auto financing, is interesting. Often commanding yields of 15 to 20 percent, each loan is insured via an A-rated insurer to help in dealing with default risk. The typical borrower has limited credit history or impaired credit and is unable to qualify for a loan from the typical bank or auto lender.

The due diligence issues when examining a hedge fund in the auto finance space include examining the loan origination and servicing operation (since a fund could have thousands of loans outstanding and need to service each one) and the relationship between the lender and the insurer. Is the legal agreement regarding defaults lock-tight?

An investment in a pool of subprime auto finance loans has several interesting features:

- Largely a lack of correlation to the traditional asset classes such as stocks and bonds.
- High diversification. The average loan size is $16,000 and loans are diversified both geographically and by risk quality.
- Low volatility. The loans are not really interest rate sensitive since they are starting off at a much higher rate than where interest rates are. Also, since the loans are relatively short-term (two to five years), it is unlikely that any move in interest rates will occur so quickly as to affect the loans. Additionally, the loans have fixed rates and do not change regardless of interest rate levels.

Centrix Capital Management has had no down months since 1999 in its managed accounts. It launched its hedge fund in December 2003, and the

returns show the fund's success. Centrix ended 2004 up 9.987 and expects to achieve similar results in 2005.

Why don't banks offer subprime auto financing? "They are simply not set up to collect and service a subprime loan portfolio, as opposed to a prime portfolio," said Clark Gates, president of Centrix Capital Management. "We view these loans as investments and our entire business is set up to service these investments, [whereas] the banks would view them as receivables on their balance sheets in a diverse portfolio of receivables."

TRADE FACTORING

Another example is IIG Trade Opportunities Fund, a trade finance–focused hedge fund with $330 million in assets. An example of a trade finance transaction could occur when a large discount retailer buys a large shipment of electronics from a manufacturer. The retailer doesn't want to pay until the shipment arrives, but the manufacturer doesn't want to ship until the goods are paid for. Enter the trade finance fund, which loans the money for a two- to six-month period while the goods are assembled, shipped, and confirmed delivered. The loan terms are typically 15 percent annual interest. The main due diligence issue is not necessarily that there is default risk (is a Wal-Mart or Costco really not going to pay?) but that the fund manager is clearly aware of all the details of each transaction ("Where are the remote controls we ordered for these TVs?"). Since IIG's inception in August 1998, the month Long-Term Capital Management (LTCM) suffered its collapse, they have not had a down month. In 1999, IIG's first full year doing business, the company ended up 10.982, with results improving even further in 2000 when they ended the calendar year up 13.240. While IIG's results have not since reached the levels they did in 2000, they continue to end each month on the plus side. Palm Beach Finance Partners, another fund in the trade finance arena, also has yet to see red in any month since establishment in 2002. Again, this company shows extraordinary results, finishing 2003 up 12.526 and 2004 up 11.583.

HARD-MONEY REAL ESTATE LENDING

Another area where hedge funds are popping up is in hard-money lending on real estate. Michael Druckman, who also invests in delinquent credit card debt, runs the fund Equity Income Partners, which lends money to credit-impaired individuals using real estate as collateral. An example of this might be a person who has bad credit (perhaps a bankruptcy in the

past, perhaps no income) who owns a $2 million home and needs to borrow $1 million. Druckman will lend the $1 million, at a fairly high double-digit interest rate, and the $2 million home will be collateral. If the borrower defaults, Druckman has no compunction about foreclosing on the asset. “I tell my friends not to borrow money from me,” Druckman told me, “because I will foreclose and then we won’t be friends. Some of my best months are when I foreclose.”

Equity Income Partners will never lend more than 67 percent loan to value. In other words, on a $1 million home the maximum they would lend would be $670,000. Why wouldn’t banks do this lending? A couple of reasons:

- Banks tend to focus on the individual. They want long-term, creditworthy customers. They don’t care as much about the assets because they do not view themselves as being in the business of foreclosing and having to liquidate those assets.
- These hard-money loans tend to be short-term, one- or two-year loans. If banks can’t wrap it up into a 30-year piece of paper and securitize it, they aren’t interested.

Druckman’s results since the inception of his fund in 1989 aren’t so bad. The fund has never had a down month, and has ended calendar years up as much as 13.348 in 1990. Similar success was repeated in 2004 when the fund ended up 13.072.

An interview with Michael Druckman of Equity Income Partners on hard-money real estate lending follows.

> ***How do you identify loans?***
> Perspective loans are brought to us by independent mortgage brokers for consideration. Galileo [Druckman’s fund] does first position mortgage loans at no more than 67.5 percent loan to value. Careful analysis is done on the liquidation value of the property that is the security for the loan.
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> ***How do you value property?***
> Liquidation value of properties is provided by an independent third party appraisal and, more importantly, due diligence on my part as to the actual liquidation value.
>
> ***Why aren’t banks doing this?***
> The sole reason that we make loans of this nature and banks don’t is that the banks’ criteria are based upon the borrower’s ability to demonstrate that they can service the debt. Although banks require an appraisal and a deed of trust, the actual property is in-

consequential to the loan approval process. They look at the borrower's ability to pay. We, on the other hand, really do not care about the borrower's ability to service the debt. We look solely to the value of the collateral (property). Based on our criteria, one could assume that we are making high-risk loans. Quite the contrary. In the 18-plus years that we have been making these loans, we have had 13 foreclosures. It just so happens that we have made a profit on each of the 13 foreclosures.

What are typical interest rates?
The interest rates that we are able to charge on these loans are not affected by what the Fed fund rate does or what Alan Greenspan does. These are strictly driven by current market forces. In 18 years, the lowest rate we have charged is 11 percent, and the highest is 14 percent. We are currently [mid-2005] loaning at 12.5 percent to 13 percent.

What happens in a Japan-style crash of real estate?
We have been making loans since 1987. From 1987 to about 1994, the Arizona real estate economy was severely depressed. The savings and loan debacle put severe pressure on real estate values and yet we were able to make profitable loans. Current times are much better and we are able to make profitable loans. Because we loan no more than 67.5 percent loan to value, property values would need to drop by 32.5 percent before we would be affected.

Is real estate in a bubble?
Real estate bubbles are generally created by speculators, and the real estate bubble that existed in the late 1980s was in fact due to speculation. I can only speak to the Arizona economy. I cannot speak to other parts of the country, but we don't make loans there. The Arizona real estate economy is driven by demand and it is my feeling that as long as the sun continues to shine, and the aging baby boomers in upstate New York, Chicago, and Wisconsin continue to relocate to the sunbelt, our real estate economy will remain healthy. This is not to say that it is not cyclical, because it is. We have loaned through good times and bad, and I remain optimistic for the future.

What happens when interest rates rise? Do your rates rise along with them?
Our loans are for very short duration—two to three years. They are interest-only loans with a balloon. Increasing or decreasing prevailing interest rates have no effect on us, nor do we have interest rate risk.

Have you ever lost money on a loan?
No.

How did you get into the business?
The hard-money mortgage business represented a viable alternative to the equity and bond markets for my investment clients. One day I was approached by a mortgage broker who was looking for investor capital and we struck up a relationship. I saw the advantages of low correlation, low standard deviation, and high Sharpe ratio, and knew that this would be a positive alternative investment for my clients.

LIFE INSURANCE PREMIUM FINANCING

Much has already been written about the growing secondary market for life insurance policies, but the latest twist in this burgeoning market is an innovative asset-backed lending strategy called life insurance premium finance. Essentially, there is a class of seniors who would like to have life insurance policies for various reasons but acquiring a policy at that age can result in expensive premiums. However, because the secondary market in life insurance policies establishes a market and means for valuing policies, it is possible for the seniors to borrow the money to pay for the premiums and use the policy itself as the asset backing the loan.

Why would seniors want to do this?

- Most of their assets could be illiquid or tied up in other investments.
- They could have large estates for which the death benefit would help pay the estate tax.
- They could be approved for a larger policy than they can afford the premiums for.
- A traditional bank might not allow them to use their policy to back the loan and may force the senior to liquidate assets in the case of a default.

Why would investors want to lend?

- The lender will typically receive 10 to 15 percent interest on the loan.
- The lender is provided with an alternative investment opportunity to traditional asset classes.

However, as with any investment, there are certain risks, which include liquidity in the secondary marketplace, changes in the regulatory environment, and increased life expectancies.

Several hedge funds have started up in this area, on the basic idea that the fund will lend to senior citizens 65 or older the premiums to pay for their life insurance policies. These seniors are often wealthy, looking to protect their estate, and often qualify for large insurance policies. The loans are five-year loans paying 10 to 15 percent interest and are nonrecourse. In other words, if there is a default then the fund can foreclose on the policy and continue paying premiums or sell the policy in the secondary market. If the insured party decides to keep their life insurance policy they would have to pay back the loan plus interest. Should the insured elect not to keep the life insurance policy they can relinquish the policy to the fund instead of paying the interest payments. If the insured dies during the loan period, then the loan is likely to be paid back from the death benefit and the insured's estate will owe a prepayment penalty that is paid out of the death benefit.

In addition, this strategy has numerous barriers to entry for successful implementation and execution. The following skills and capabilities are essential:

- The ability to value and source life insurance policies with set criteria.
- The ability to sell the policies in the secondary market to life settlement firms or institutions at competitive prices.
- The ability to coordinate with medical underwriters, actuaries, and other service providers to assess the mortality rating on individual policies as well as to create a diverse portfolio of policies.
- Expertise in the insurance regulatory environment that differs from state to state.

The secondary market for life insurance has evolved remarkably over the past six or seven years as institutional buyers have entered the market, purchasing pools of life settlements—life insurance policies for seniors age 65 and older. They are investing based on the law of averages and life expectancies. The investors who buy a pool of these policies with the expectation of paying premiums until they receive the death benefit, which averages around $2 million, are aiming to receive a 10 to 15 percent internal rate of return (IRR) over an average holding period of seven to eight years. Investors range from hedge funds to banks to endowments, and all use life settlements not only as a source of (sometimes significant) returns but also as a way to diversify away from the traditional asset classes of equities, bonds, and commodities.

Currently a $15 billion market, it is estimated by Bernstein Research that the life settlement industry will grow to $160 billion within the next several years. Factors driving the growth include:

- Individuals outliving the usefulness of their policies.
- Potential elimination of estate tax may result in the sale of many survivorship policies.
- Low interest rates that result in lower cash values within existing policies.
- Increasing use as a financial planning tool whereby an insured party sells his policy and then buys a new, cheaper policy with the assistance of the cash received from the old policy.

What are the risks in buying life settlements?

- Insured parties may live past their life expectancy, resulting in a lower return as more premiums are paid out. However, this risk is minimized when the investor buys a pool of policies where the law of averages is expected to play out.
- The investor in a pool of life settlements is initially cash flow negative. While all the insureds are still alive the investor is paying out the premiums. Eventually the death benefits become greater than the premium payments.
- Policies on the secondary market are inversely correlated with interest rates. Increasing interest rates will impact the prices that investors are willing to pay for policies.

The value of a policy is determined as a function of several criteria:

- The life expectancy of the insured.
- The type of policy.
- The amount of the premium payments.
- The amount of the death benefit.
- The rating of the insurance company.

As it has matured, this secondary market, which was almost nonexistent 10 years ago, has grown to $15 billion and will continue to grow exponentially. It has ultimately led to new profit opportunities for investors while indirectly allowing more people to afford life insurance.

TAX LIENS

While hedge funds can often be considered the “new banks” due to their ability to take financing risks where banks are either unwilling or unable

to, hedge funds can also take on the role of the "new tax collector." The government is often in a position where it effectively lends its citizens money in the form of uncollected taxes that accrue interest. These are not loans in the traditional sense in that no money was ever extended to the citizen. Nevertheless, the amount due on property taxes has all the components of a distressed senior secured loan:

- It usually pays a high interest rate, ranging from 8 to 50 percent depending on the laws of the state or the city where the tax is supposed to be paid. Part of the reason for this is that although the tax is usually a small percentage of the overall value of the property, there is no way to value the creditworthiness of the people who owe the debt to the government. Everybody who owns a property must pay a tax, regardless of creditworthiness.
- It is usually the senior debt on the house, in front of even bank loans. However, IRS obligations may come first and again, depending on the state, a bankruptcy might interfere with the debt being repaid. Most likely, though, if a tax lien is not paid, then the owner of that lien can begin foreclosure proceedings on the property. Since the lien is usually worth between 3 and 7 percent of the value of the house, it is somewhat rare that a house owner will allow a foreclosure just to avoid paying the lien. Hence liens have a high probability of being paid and defaults are rare.

Typically, if a property owner is more than one year late on paying his property taxes, the state may sell the tax lien in an auction. Just as banks are loath to collect on every single piece of credit card debt or subprime auto loan, the government is not really set up to aggressively collect delinquent property taxes and would rather have a portion of the money to immediately use for whatever the taxes were budgeted for in the first place—schools, road development, fire department services, and so forth.

As with any investment, due diligence is required before buying a lien. Here are some of the areas that need to be covered:

- Make sure the auction is not so competitive that your yield goes down to a level where some other investment-grade vehicle might be a better use of your money.
- Although the ratio of the lien to the value of the property is typically so low that the property owner will not want to default, this is not always true. Make sure the property is not sitting on the site of a pollution dump, for example, where the property owner would be ecstatic if it went into foreclosure.

- Although the lien is senior to just about any other debt, make sure the IRS doesn't have a much bigger lien sitting over you, or that the bankruptcy laws of the state don't allow the property owner to drastically delay paying before a foreclosure can happen.
- Determine if there are any lawsuits against the property owner that would need to be settled before the lien is paid.

Tax liens are uncorrelated to any other asset class. Even if interest rates step up, it is unlikely the value of liens will go down because the yields on a tax lien could be upwards of 2,000 basis points, or 20 percent, higher than Treasury bill yields. Real estate values have little bearing on the value of tax liens. Even if the lien is as high as 10 percent of the property value, that's still a steep drop (over 90 percent) that the value of the house would have to fall before affecting the value of the lien. Consequently, hedge funds are quickly entering the arena and making the purchase of tax liens competitive. MD Sass, a New York–based family of hedge funds that has a primary focus in asset-backed securities, has a hedge fund that focuses on tax liens and has racked up returns ranging from 8 to 14 percent annually. Orion Capital, run by former Citigroup vice president Richard Chen, is another hedge fund focused on the tax lien space. Optimum Realty Corporation of Elmhurst, Illinois, offers a fixed 8 percent return and uses the money invested to purchase tax liens.

TAXI MEDALLIONS

Although this chapter is titled "Hedge Funds Are the New Banks," it is not unusual now to see public companies participating in the alternative lending game, particularly in areas that banks would not touch with a 10-foot pole. I've lived in and around New York City nearly all my life, but I don't like to drive. I'll be honest, I drive only a few times a year. I almost always use some form of public transportation. The subway is the fastest way to get from one end of New York City to the other. But in a taxicab you can work, talk on the phone, relax, and so forth, even though it takes longer and is more expensive. In New York City there are 12,187 licensed cabdrivers. Everybody who works in Manhattan, at 5 P.M. on a rainy day, wishes there were 100,000 cabdrivers. But there are not, nor will there ever be. The supply of cabdrivers is limited by law. In order to drive a cab in New York City you need a city-issued medallion.

In 2004 the city decided to add 900 more cabdrivers, 300 per year. The process by which it made that decision took years. The New York City

government even commissioned environmental studies showing that an extra 300 cars each year wouldn't result in a massive increase in car pollution. Mind you, there are some 2 million cars driving around Manhattan every day, but this is the kind of bureaucracy it takes to add even 300 cars. So the number of cabdrivers is going to stay largely capped.

Because the supply of medallions is severely limited and the demand is so high (why not take a job with no boss, set your own hours, meet new people all day long, etc.), the price of medallions has soared ever since the first day they were issued. However, many of the people who would like these jobs and medallions cannot afford them. Often they are immigrants looking for work, or people who have become unemployed when other industries have experienced a downturn. These are not the type of people who can typically get loans from the mainstream banks.

This brings us to NASDAQ-traded TAXI Medallion Financial Corporation, which finances taxicab medallions. Medallion prices have gone from $200,000 in 1997 to almost $400,000 now. Since medallions first originated in 1937 they have gone up in value an average of 13 percent per year, beating the Dow's 10 percent per year. A company like TAXI operates by borrowing money and then using that money to lend to the people buying the medallions, typically at 60 percent loan to value (in other words, if a medallion costs $300,000, the most TAXI would lend would be $180,000). Its profits are the spreads between the interest it is being paid and the interest it is paying.

Additionally, TAXI started Medallion Bank so it can take in deposits. Other than creating an insurance company (and one where you can keep cost of float at zero), starting a bank is the best way to get cheap money (think about how much interest you get in your checking account—almost nothing). In fact, during 2004 the margin spread between TAXI's borrowing costs and the interest payments it receives has risen from 372 to 437 basis points. This occurred despite the Fed raising interest rates.

TAXI is run by father and son team Alvin and Andrew Murstein. To say they know the taxicab business in New York City is an understatement. In 1937, their grandfather bought one of the first medallions for $10. They have been in the business in one shape or another ever since. In addition to their business of lending against medallions they also own 150 medallions and will probably increase that inventory with the current release of new medallions. The last time the city sold medallions, in 1996 and 1997, it sold 400, and the price of medallions went up more than 10 percent over the next year, demonstrating that the slight increase in supply did not dampen the demand.

The fact that the city has, in the early 2000s, passed several price in-

creases will also increase demand for the new medallions being offered. An interesting feature of this business is that economic weakness is not immediately bad for TAXI—more people losing their jobs means more people wanting to become cabdrivers who will need medallions.

In later chapters I will cover other forms of financing being taken up more recently by hedge funds.