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Special report - Titans of finance

Can anything stop America's superstar hedge funds?

Citadel and other giant funds have remade public markets

ILLUSTRATION: DANIEL JURMAN

KEN GRIFFIN was stunned. It was March 10th and America's markets had suddenly fallen out of love with Donald Trump. The NASDAQ index fell by 4%. Citadel, Mr Griffin's hedge fund, had lost money in the rout. "You have to tear apart and re-examine the portfolio," he told *The Economist* after markets closed. "And ask yourself in what ways we have positioned or mispositioned ourselves against the reality that the odds of a recession have gone higher."

Mr Griffin tried to explain what had gone wrong on a whiteboard. Three of his investment teams had been sure of something that turned out to be wrong, he said. When he reaches an explanation, it has to do not with the arcana of derivatives but with interpersonal dynamics. The one guy who was right, he said—"frankly the smartest" guy—also happens to be mild-mannered. "Just speak up next time, you know."

Citadel and its peers are as much a marvel of management as they are of finance. Mr Griffin and other senior executives allocate capital to different asset classes—equities and commodities are the largest at Citadel. Within each asset class executives allocate capital to portfolio managers, who have autonomy over investment decisions and paying their underlings. Each team tends to be a fief unto itself, but operates within limits on risk set at the centre.

Firms following some version of this model have grown while much of the hedge-fund industry has languished (see chart, next page). Since 2019 the number of staff employed by the five biggest "multi-managers" has increased from 6,000 to 15,000. Based on the notional value of their positions in markets (a measure used by regulators) the size of these firms has almost tripled to $1.6trn. Much as BlackRock and Vanguard dominate the "buy and hold" world of passive investing, Citadel and Millennium have achieved consolidation among active stockpickers and investors. Regulators now worry that the dominance of these firms brings new risks.

Whereas funds used to rise and fall with the performance of a single star trader, the multi-manager model inverts that structure. The idea is that, over the long run, it is more efficient for top investors—Mr Griffin at Citadel, Israel Englander at Millennium or Steven Cohen at Point72—to choose stockpickers and the conditions under which they operate than make all the trades themselves. Investors benefit from diversification across teams and types of assets. Portfolio managers enjoy economies of scale in technology and financing, but sign up for lengthy non-compete clauses and a level of subservience instinctively antithetical to placing billion-dollar bets. Bosses of these firms end up with a shot at that most elusive of things in the hedge-fund world: a firm that outlives them.

Investors clamour to get—or keep—money in Citadel. The firm has handed back $25bn in profits to investors since 2017. Visitors to Citadel's office in Miami (where the firm decamped from Chicago in 2022) are transported by a swaggering lift plastered with a sign reading: "#1 most profitable hedge-fund manager of all time". Demand for Millennium's services mean that it has raised capital which investors lock up for up to five years, far longer than is typical at hedge funds.

Paying top dollar

In an industry often chided for fees and leverage, multi-managers thrive on both. Funds "pass through" their operating expenses—such as wages and the cost of tech—to investors. A survey by Barclays, a bank, puts these annual expenses at a whopping 6.2% of their managed assets, in addition to the fees hedge funds collect when they perform well. In effect infinite budgets have resulted in an arms race for resources.

Competition to hire top investors is fierce between funds. Competition between funds and banks is extraordinarily one-sided. “For Citadel or Millennium, the cost of hiring our best traders, trying them out and keeping them if they’re any good is virtually nothing,” complains a bank executive.

The sheer size of the funds also enables them to get better prices from banks on the leverage they use to power their businesses. Funds can borrow upwards of ten times the capital they raise from investors. Data from the Office of Financial Research show that the share of borrowing concentrated in the ten largest funds has risen from 32% in 2014 to 41% today; in aggregate borrowing by hedge funds has reached a hefty $5.5trn, around half of which is supplied by banks, whose prime-brokerage divisions provide leverage through derivatives and margin loans.

When markets convulse without clear reason, many now assume a team at a multi-manager fund has breached its risk limits and is being forced to sell assets. In February Andrew Bailey, the governor of the Bank of England, said that funds selling “aggressively in a shock” could amplify big moves like the one that hit markets in April. Another regulator in Europe concurs, arguing that given the risk limits at multi-managers, they “are much quicker to cut and run, cultivating a hair-trigger approach to risk management.” (This is truer of firms like Millennium, which is known for imposing tight risk limits on its traders, than Citadel, which is less cut and dried.) The Financial Stability Board, the international regulatory body where Mr Bailey will soon take over as chairman, has been busily investigating the use of leverage by hedge funds.

Worries about hedge funds may be amplified in Europe, where the collapse of Archegos, an American fund which borrowed heartily and fraudulently to bet on media stocks, led indirectly to the collapse of Credit Suisse, a bank, in March 2023.

Archegos was a family office managing the personal fortune of Bill Hwang, a trader, rather than capital from outside investors and was subject to lighter regulatory supervision than big funds. Yet recent volatility across markets makes understanding the risks of these goliaths more important. The idea that the Trump administration could destroy investors’ faith in the safety of American assets is one existential risk to markets today. That possibility is not lost on Mr Griffin, a major Republican donor. “Our reserve currency status is intertwined with the sense that under American law, you will be treated fairly,” he says.

On what basis?

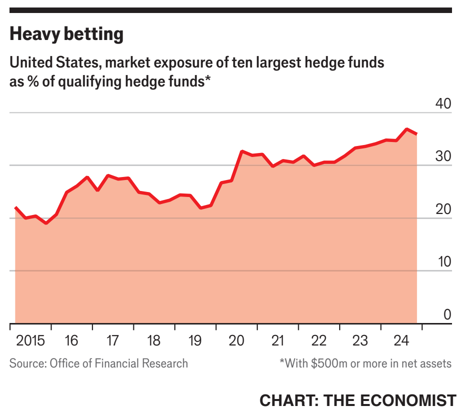
In April investors frantically sold America’s government debt. The role of hedge funds in that market has been under particular scrutiny. Some feared that, as happened in March 2020, there had been a blow-up in the “basis trade” conducted by hedge funds. The basis trade exploits small differences in price between Treasury bonds and related futures contracts. The trade is huge and highly leveraged. One imperfect measure for its size is the notional value of short positions in Treasury futures taken by funds, which currently sits at around $1trn. That is nearly twice as much as in 2020 when a chaotic unwinding of the trade led the Federal Reserve to step in to buy Treasury bonds, something which might be harder today as central banks attempt to reduce the size of their balance-sheets.

It turned out that this time the basis trade was not the culprit for the market turmoil. Instead it seems to have been the reversal of another highly leveraged trade which had bet that Mr Trump would cut the cost for banks to hold Treasuries. Banks help finance such Treasury market activities. A recent paper shows that when they lend to hedge funds against Treasuries, they often lend more than the Treasuries are worth—a sweetheart deal called a “negative haircut”.

Mr Griffin says that if regulators are so concerned they should impose a positive haircut of 2%. He is less sympathetic to more general worries about the industry’s risk-management capabilities, especially compared with the country’s banking system, which benefits from deposit insurance and periodic bail-outs. “I can assure you that when you don’t have the full faith and credit of your government you care a lot about the management of systemic risk. I don’t think anyone at Silicon Valley Bank cared about it a damn bit.”

Concerns about risk will dog the hedge funds as they get even bigger

In Citadel’s case that might be true. The firm has a diverse and, it argues, stable base of funding. “Instead of relying on a subset of the same eight to ten prime brokers like most hedge funds, we finance our portfolios with more than 40 institutional counterparties and banks around the world” says Gerald Beeson, Citadel’s chief operating officer. The firm has borrowed $1.6bn from bond markets—a small but unusually long-term source of funding for a hedge fund—and is the only one of its kind with an investment-grade rating.



Concerns about risk will dog the hedge funds as they get even bigger. One way they may do so is by expanding into new markets, as Citadel did with commodities. But Mr Griffin says he is wary of getting into private credit, as Millennium and Point72 are doing. “I have to become a better equity investor,” he says.

Another option is changing the structure of the business. Millennium is reportedly considering selling a minority stake in its business and has invested liberally in other funds, most of them spin-outs of Millennium’s own investment teams. According to research by Goldman Sachs, 40% of funds now seed external managers in this way. Just how big can these superstar multi-manager funds get? It is a question that vexes both regulators and the rest of the industry.