
Consequences of Hedge Fund Meltdown: Luxury Market Faces a Prolonged Contraction

Scene: The hearing room of the Senate Banking and Finance Committee. On the dais sits an impeccably-attired, dark-haired man with piercing eyes, flanked by assistants and reams of documentation. At the table facing him sit the chairman and president of the nation's largest banks, names well-known to the public through their frequent commentary on financial issues as well as through regular news footage of their extravagant lifestyles. The room shimmers in the rapid fire of flashbulbs. The record has just revealed the chairman shorted his own company's shares during the crash to profit from the falling stock price and the president authorized interest-free loans to senior executives while rank-and-file employees were laid off.

Although it sounds like last night's news, the above scene took place in 1933, in hearings conducted by Banking and Finance Committee Counsel Ferdinand Pecora¹ which led to the passage of the Glass-Steagall Act of 1933 and the Securities Exchange Act of 1934. Now, 76 years and some \$750 billion later, the stage is set for a revival.

After more than a decade, the salad days of easy money changing hands on Wall Street in an unregulated environment are over – as well they should be. Of course, there have been many victims, and will be many more. While the middle class has taken much of the economic punishment to date, the future looks particularly bleak for more affluent investors.

Hedge funds gained substantial popularity when the Internet bubble of 2000 finally popped, increasing from under 1,000 funds in the year 2000 to over 8,000 in the summer of 2008. Restricted to “preferred” investors, to protect small investors from assuming the high level of risk, hedge funds avoid capital requirements and regulatory restrictions. There are no professional standards for hedge fund managers.

Not surprisingly, the number of fund players, encouraged by the investment banks, grew at a rapid pace, as did the assets under management, estimated at \$2.5 trillion as of the summer of 2008. As hedge funds grew, they became not only a home for the very wealthy (\$5 million or more in invested assets), but were also marketed to investors of more modest (though substantial) means.

But the salad days are over for the affluent, too. In recent months, hedge funds have been closing their doors or eliminating redemptions. In a few cases the funds are shutting down because they recognize the lack of opportunity. However, in most cases funds are liquidating because their asset values are deep underwater.

Of greatest concern are those hundreds of funds that have stopped permitting redemptions. This is a clear indication they hold assets that are not only illiquid but, most likely, are carried on the books at values for in excess of current market value. In 2008, hedge funds lost \$350 billion globally². It would not surprise us if an additional \$750 billion evaporates over the next 12 months.

This financial meltdown has significant impact on the future of hedge funds and their prime brokers, and will also impact the spending patterns of the affluent. This has already been seen in the disastrous results of high-end retailers through Christmas, 2008. Revenues were down 35%, according to *Spending Plus*.

¹ “Where Is Our Ferdinand Pecora?”, *The New York Times*, January 6, 2009

² “Hedge Funds Lost \$350 Billion in 2008 Amid Global Market Rout,” *Bloomberg.com*, January 13, 2009

We expect this trend to continue through 2009 and to actually accelerate on the downside. The following is a list of service providers who cater to the high-end consumer, together with their most recent AGR[®] risk rating.

Company	Ticker	AGR Rating	AGR %tile	Market Cap	Close Price 1/13/2009	Industry	Notes
Harley-Davidson, Inc.	HOG	VA	2	3.25B	14.13	Recreational Products	Depends on affluent buyers
Morgan Stanley	MS	VA	6	19.76B	18.79	Investment Services	Prime broker
Goldman Sachs Group, Inc.	GS	VA	7	37.82B	77.67	Investment Services	Prime broker
The Talbots, Inc.	TLB	VA	8	112.26M	2.07	Retail (Apparel)	High-end retail
Coach, Inc.	COH	AGG	10	5.62B	17.26	Apparel/Accessories	High-end merchandise
Perry Ellis International, Inc.	PERY	AGG	11	72.42M	4.51	Apparel/Accessories	Higher-end clothing mfg. and retail
Textron Inc.	TXT	AGG	14	3.34B	14.87	Conglomerates	Private plane manufacturer
Constellation Brands, Inc.	STZ	AGG	15	3.29B	15.14	Beverages (Alcoholic)	High-end wines
Tiffany & Co.	TIF	AGG	16	2.71B	22.06	Retail (Specialty)	Luxury jewelry
Starwood Hotels & Resorts Worldwide, Inc	HOT	AGG	17	3.37B	19.05	Hotels & Motels	Luxury hotels
Polo Ralph Lauren Corp.	RL	AGG	20	4.05B	40.78	Apparel/Accessories	Luxury retail
Saks Incorporated	SKS	AGG	21	511.46M	3.72	Retail (Department & Discount)	High-end retail
Brunswick Corporation	BC	AGG	22	345.46M	4.11	Recreational Products	Exposure to boats and yachts
Blue Nile, Inc.	NILE	AVG	35	315.74M	21.09	Retail (Specialty)	Diamonds
Las Vegas Sands Corp.	LVS	AVG	35	2.29B	5.93	Casinos & Gaming	High-end entertainment
Liz Claiborne, Inc.	LIZ	AVG	39	259.49M	2.97	Apparel/Accessories	High-end designer
MGM Mirage	MGM	AVG	39	3.54B	12.4	Casinos & Gaming	High-end entertainment
bebe stores, inc.	BEBE	AVG	48	516.23M	5.98	Retail (Apparel)	High-end retail
True Religion Apparel, Inc.	TRLG	AVG	49	287.45M	12.27	Apparel/Accessories	Luxury clothing manufacturer
Wynn Resorts Ltd.	WYNN	AVG	51	4.08B	41	Casinos & Gaming	High-end entertainment
Ann Taylor Stores Corp.	ANN	AVG	60	294.82M	5.09	Retail (Apparel)	Higher-end retail
Nordstrom, Inc.	JWN	AVG	64	2.82B	13.37	Retail (Apparel)	Higher-end retail
Toll Brothers, Inc.	TOL	AVG	73	3.12B	19.52	Construction Services	Luxury builder
Whole Foods Market, Inc.	WFMI	AVG	75	1.85B	12.67	Retail (Grocery)	High-end supermarkets
Royal Caribbean Cruises Ltd.	RCL	CON	84	2.52B	11.36	Recreational Activities	Higher-end cruise line
Vail Resorts, Inc.	MTN	CON	93	951.76M	25.37	Recreational Activities	Luxury resorts
Callaway Golf Co.	ELY	CON	95	563.78M	9.27	Recreational Products	Higher-end recreational
International Companies not rated by Audit Integrity							
BENETTON GP S P A	BNGPY.PK				15.58		High-end clothing manufacturer
Bombardier	BBD-A.TO				4.78		Private planes, recreational
DAIMLER AG	DAI				34.33		Luxury automobile maker
Four Seasons Hotel	FSH.MU				60.66		Luxury hotel
LVMH	LVMH				40.84		Luxury goods
Mandarin Oriental	MOIL.SI.				0.91		Luxury hotel
Nestle Corp.	NESN.VX				40.40		Luxury goods
Richemont	RITB.MU				13.8		Luxury goods

We caution our clients to be particularly aware of those companies that display a less than total candor with their shareholders. In most instances these companies may still have some very nasty surprises to reveal.

The Audit Integrity Accounting & Governance Risk (AGR®) Model

Audit Integrity is the leading provider of accounting and governance risk analysis on public companies. Through the forensic study of the factors behind fraud, Audit Integrity proprietary modeling effectively detects and measures fraud and transparency-related risks in more than 7,000 publicly traded corporations.

The proprietary Accounting & Governance Risk (AGR) rating is a measure of corporate integrity based on forensic accounting and corporate governance metrics, and is an indicator of aggressive corporate behavior which can put stakeholders at risk. The AGR Score is based on a quantitative model which weights specific accounting and governance metrics derived from corporate reporting. The score ranges from 0 to 100, with lower scores indicating higher risk.

The Audit Integrity AGR Equity Model

The AGR Equity Factor (EQF) is based solely on the AGR score, plus additional variables related to AGR persistence and volatility, to provide a better measure of equity risk than the AGR on a stand-alone basis. Extensive research has shown a clear relationship between Audit Integrity's primary risk measure, the AGR rating, and equity returns. Consistently, the lowest-rated companies underperform the market and highest-rated companies outperform. The results are consistent with prior research showing that corporate integrity, as measured by the AGR rating, is a significant factor in equity returns, with low correlation to other factors.

To validate the AGR Equity Factor, the model was back-tested over the time period of 1998-2007. Key findings include large and persistent equity returns spread between the highest and lowest-rated companies, with a 17.5% spread between the best and worst decile over the prior 10 years. From a quantitative modeling standpoint, the Equity Factor provides risk-adjusted, well behaved returns, as validated through key statistical measures.



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