

## **The Changing Landscape\***

Mohamed A. El-Erian\*\*

\* This article contains the opinions of the author but not necessarily those of PIMCO. Such opinions are subject to change without notice. This article has been distributed for educational purposes only and should not be considered as investment advice or a recommendation of any particular security, strategy, or investment product. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed. No part of this article may be reproduced in any form, or referred to in any other publication, without express written permission. ©2005, PIMCO.

\*\* Mohamed A. El-Erian was recently appointed president and chief executive officer of the Harvard Management Company. Before joining Harvard, he was a managing director of PIMCO.

## **Introduction**

In asking us to help “demystify hedge funds,” Adam Lerrick identified three aspects to focus on: the role of hedge funds in financial markets; the manner in which they differ from other investment managers; and the appropriate approach to hedge fund regulation. My objective is to partially address the first two and to do this from the perspective of a portfolio manager at PIMCO, an organization with a longer-term investment horizon as reflected in both its philosophy and process.

For presentational purposes, and following a definitional clarification, this presentation will postulate four hypotheses associated with the recent hedge fund phenomenon. They speak to the nature and current drivers of the phenomenon and its likely evolution. The discussion will then focus on the implications, delineating major participants in international financial markets.

## **A Simple Characterization**

At the outset, let us specify a few simple analytical characteristics of hedge funds. As investment vehicles, hedge funds may be thought of as involving an approach that combines the possibility of leverage, long/short positioning, and a relatively liberal set of guidelines that govern allowable sectors and instruments. This combination allows many of them (though not all) to be marketed as offering the possibility to generate absolute returns *irrespective of the directional moves in the underlying markets*; or, to use the more common description, the typical “absolute return” hedge fund aims to deliver positive returns to investors in both rising and declining markets. In this context, they charge relatively high fees when compared to more traditional investment vehicles, typically involving a base fee (usually 1–2 percent) and a share of the returns (20–30 percent) after funding cost (usually LIBOR) and subject to a high-water mark.

While exact numbers vary, it is generally agreed that hedge funds have grown very rapidly in recent years. They are said to now account for over \$1 trillion in assets. Their

investment footprint and influence are, of course, a multiple of this in view of both the leverage they use and the tendency to trade more frequently. (As regards the latter, it is reported that hedge funds now account for over half of the daily turnover at the New York Stock Exchange.)

### **The Hypotheses**

Given this simple characterization, let us focus on four hypotheses pertaining to the hedge fund phenomenon. These address durability, evolution, diversity of style, and influence on marginal price setting dynamics.

**First Hypothesis: The Hedge Fund Phenomenon Is Here to Stay.** On the one hand, it is supported by growing investor interest in absolute return strategies—motivated in great part by the recognition that, from an historical perspective, both nominal and real returns from traditional investment vehicles are likely to be significantly lower in the years ahead. Meanwhile, the supply of hedge fund strategies is consistently expanding as investment managers react to the attractiveness of a fee structure that offers the possibility of large compensation, and quickly, should performance be both immediate and strong. Indeed, there has been a notable migration of investment professionals to hedge funds from broker-dealers and from more traditional money managers. Finally, these demand and supply factors are being facilitated by the explosion in derivative-based instruments. These instruments expand the universe of instruments to go beyond the limitations imposed by the availability of the underlying cash instruments.<sup>1</sup>

**Second Hypothesis: While Expected to Remain a Significant Feature of the Landscape, the Nature of the Hedge Fund Phenomenon Will Inevitably Evolve in the Period Ahead.** This evolution will be impacted by two factors in particular. First is the manner in which the regulatory agencies around the world play “catch up” to a

---

<sup>1</sup> The rapidly growing use of single-name credit default swaps (or CDS), has been accompanied by a mushrooming of related products. These serve to “bundle” names (as in the case of the CDX, the typical multiname index product) and/or slice risk components (as in the case of the various tranche products). They also feed into first-to-default products (FTDs) and other constructs.

phenomenon that is attracting increasing popular interest (including its gradual expansion from institutional to retail channels), as well as becoming politically sensitive (especially in Europe). Second, the industry itself is likely to face some important compositional changes as the recent proliferation of hedge funds confronts the reality of “the fallacy of composition” (this is, the difficulty of generating adequate returns in the context of more crowded trades and greater herd behavior).

**Third Hypothesis: In Most States of the World, Hedge Funds Will Be the Short-Term Marginal Price Setter.** This is not only due to the larger market presence associated with the growth in assets under management, leverage, and frequency of trading. It is also a reflection of the growing disparity in liquidity and risk appetite between hedge funds and the broker-dealer community.

**Fourth Hypothesis: At the Edges of the Industry, We Could Well See Some Isolated Incidents That Intensify Noise about the Extent to Which Risk Management and/or Investment Behavior May Deviate Significantly from What Is Generally Expected.** At play here is the old-fashioned adverse selection and moral hazard dynamics.<sup>2</sup> Specifically, in a world of partial transparency/information dissemination, the typical hedge fund fee structure may inadvertently lead to a higher risk of isolated “financial accidents.” In addition to stressing the importance of appropriate investor due diligence and possibly raising some investor protection issues, this will likely involve periodic questions about the extent of systemic risk to the financial system as a whole.

### **Implications**

To the extent to which these four hypotheses are valid, they imply a significant change in the investment landscape in the next few years. This has implications for the actions, and interactions, of the major players. Simply put, business models are having to evolve for the range of other participants: broker-dealers, more traditional investment managers, and corporate and sovereign issuers. They also have implications for the manner in which

---

<sup>2</sup> For the original discussion, see Stiglitz and Weiss (1981).

policymakers interpret high frequency market information, as well as the role of multilateral agencies.

### **Blurring of Boundaries with Broker-Dealers**

Let us start with the broker-dealer community. The hedge fund phenomenon has significantly altered the outlook for their sources of revenues, and related activities. Indeed, a growing share of resources is now being devoted to service hedge fund clients. This is consistent with the latter's higher rate of trading, as well as the broker-dealers' desire to "be in the flow" with hedge funds. But with so many broker-dealers chasing the hedge fund business, questions could arise as to overall consistency, as well as areas where discretion overwhelms rules (for example., the allocation of hot new issues, the design of bond re-openings, etc.).

Interestingly, at a time when hedge funds have become a much more important client base for Wall Street, the boundaries between them and the Street are blurring. On the one hand, hedge funds are disintermediating broker-dealers in certain areas—a trend that is most apparent in the way hedge funds have taken a more direct role in corporate restructurings, arranging private equity deals, etc. On the other hand, Wall Street firms are trying to replicate internally certain hedge fund strategies as a means of enhancing their profitability—thus the resurgence of interest in proprietary trading activities.

### **Changing Information Content**

This blurring of boundaries is also feeding another set of dynamics: the increasing divergence of high frequency market indicators from underlying economic fundamentals. Put another way, intra-day and intra-week movements in market prices have become more sensitive to technical, as opposed to fundamental factors. Moreover, the spaghetti bowl of derivative structures being used (see first footnote) has enhanced the technical linkages across markets overall, and among subsegments of different markets. As a result, both absolute and relative valuations now involve a high degree of technical

influences. Faced with this outcome, policymakers will need to qualify what they regard as the traditional information content embedded in high frequency market movements.

The change in the information content of market indicators is perhaps most extreme in the new issuance area. With so many hedge funds chasing similar opportunities, there is a tendency for some to pre-empt the likelihood of having their order cut by investment banks, thereby initially overstating their real demand for a new issue. When aggregated among several investors, the result of this approach is that the book building exercise ends up significantly overstating the *effective* (as opposed to *notional*) demand for the transaction. As such, the exercise no longer transmits the traditional information regarding the nature of the effective investor demand. Indeed, attempts by issuers to rely on this information have resulted in rather strange outcomes—for example, a (seemingly) seven-time “oversubscribed” deal trading poorly in the secondary market.<sup>3</sup>

In this world, issuers who target the widening and deepening of their base of long-term investors will likely develop an appropriate degree of “healthy paranoia.” Specifically, they will spend more time scrutinizing raw data on the level and composition of the book for their new deals. Indeed, they may also get more involved over time in the structuring and pricing of their new deals.

This will not be much of a problem for those issuers that regularly tap the international capital markets. It will be more of a challenge for the infrequent issuers. Indeed, and specifically for sovereigns, this constitutes a related challenge for the multilateral public organizations since they are understandably regarded as being the least biased entities in the issuer-investor complex. It truly is an area where the multilaterals can, and should, play the role of “trusted advisor.”<sup>4</sup> They are best placed to supplement an unbiased technical analysis with insights from cross-country experiences.

---

<sup>3</sup> For additional information, refer to the discussion in El-Erian (2005).

<sup>4</sup> For background, refer to El-Erian (2006).

## **Market Liquidity and Other Systemic Considerations**

The final implication, and perhaps the most challenging one from an analytical perspective, pertains to the longer-term implications for market liquidity, risk management, and systemic stability. It is undeniable that, in the first instance, the hedge fund phenomenon has served to enhance the general liquidity of markets—both directly and by encouraging the development of new instruments that lower the barriers of entry to various market segments. The impact has been accentuated by the fact that, due to the trading of the new derivative-based index products, we are seeing a greater involvement of broker/dealers who were previously excluded from active market participation due to the absence of a meaningful team of dedicated analysts and traders

The drivers of valuations are evolving accordingly. Absent major name-specific credit news, the importance of individual credit differentiation within each market segment has recently declined in favor of top-down considerations. As a result, the relative importance of macro drivers of spreads has increased (particularly those pertaining to general liquidity considerations).

The jury may still be out, however, on the longer-term impact. Lower entry barriers to markets also imply lower barriers to exit—a development that could become particularly notable in the event of a major disruption to a “crowded trade.” Also, after a period in which top-down factors have blunted individual credit differentiation, the latter would be expected to assert itself over time with a vengeance in the event of a severe deterioration in name-specific default risk conditions. Finally, default workouts are likely to become more complicated and protracted as the usual set of considerations is accentuated by broader index influences, including decomposition effects.

It is therefore not surprising that regulators have become more interested in recent developments. This is most visible in the increased pressure being placed on the financial industry to deal with the large stack of unsigned swap confirms—an occurrence that

mushroomed in recent years as the use of derivative-based instruments ran ahead of both procedures and capacity. And, judging from the isolated dislocations of the second quarter of 2005 triggered by the debacle in the “correlation trade” in the auto sector, regulators will no doubt also be interested in the extent to which the system can withstand a major change in the liquidity paradigm.

### **Concluding Remarks**

The hedge fund phenomenon has been driven by the powerful trio of greater investor demand looking for “absolute returns,” a robust supply of new hedge fund managers, and a proliferation of new investment products and instruments. Its exact nature, however, is likely to evolve in the period ahead as some of the excesses come to light and are addressed. As this maturation process continues, other participants in financial markets will increasingly have to assess and tweak their business models—particularly to take into account the impact of hedge funds on liquidity, cross-market correlations, and price-setting dynamics. There are also implications for public policy, particularly as it relates to the appropriate strengthening of the financial system framework, including enhanced information dissemination and analysis.

## References

El-Erian, Mohamed A. (2005), "Journey," *Emerging Markets Watch*, November 2005, PIMCO.

El-Erian, Mohamed A. (2006), "IMF Reform: Attaining the Critical Mass," in *Reforming the IMF for the 21<sup>st</sup> Century*," edited by Edwin M. Truman, IIE.

Stiglitz, J. and Weiss (1981), "Credit Rationing in Markets with Imperfect Information," *American Economic Review* 81.

**Mohamed A. El-Erian** was recently appointed president and chief executive officer of the Harvard Management Company. Before coming to Harvard, Mr. El-Erian was a managing director and a senior member of PIMCO's portfolio management and investment strategy group. In addition to serving on the firm's Investment and Partner Compensation Committees, he headed the Emerging Market and Diversified Income portfolio management teams, and also had oversight responsibilities for the mortgage, investment grade, high yield, convertibles, and money market desks. Mr. El-Erian joined PIMCO in May 1999, having been associated with Salomon Smith Barney/Citibank in London where he was managing director heading the emerging markets economic research team. He previously spent fifteen years with the International Monetary Fund (IMF), leading policy work on debt and country issues. He has published widely on international economic topics. He has served on several boards, including the Emerging Market Traders Association (EMTA) and the Emerging Markets Creditors Association (EMCA). He is also a member of the IMF's Capital Markets Consultative Group and sits on the board of the International Center for Research on Women (ICRW). He serves as a faculty member of the Harvard Business School and as deputy treasurer of the University.