

Demystifying Hedge Funds

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Introduction

Hedge funds have just been “discovered.” Ordinary investors are clamoring to participate in rewards once the province of the very rich. Reporters are probing to expose what has been a closed culture of secrecy. Policymakers are asking the usual questions about risks to the unsophisticated investor and to the stability of the global financial system.

For those who live and work in the marketplace, hedge funds are no mystery. They are simply pools of money seeking the highest absolute rate of return across the capital markets with a management compensation structure that commands a high share of profits. They have been here for more than a generation and, like any financial innovation, are following a normal life cycle. First, a small number of pioneers garner excess profits; next, competition and capital are broadly attracted; finally, the concept moves into the mainstream, matures, and is winnowed out until the risk/reward ratio approaches that of other instruments.

When floating exchange rates and volatile interest rate movements transformed the capital markets in the late 1970s, hedge funds entered quietly with an irresistible formula for investment: make money whether the market rises or falls. These were small groups of innovative traders, some inside large investment banks funded by the bank’s own capital, others in independent firms financed by less than 100 rich individuals prepared to commit millions to a new technology.

Managers searched for anomalies as investment opportunities—momentary misalignments in the pricing of securities, currencies, and commodities around the world. They matched holdings with short sales to isolate generalized market risk. They borrowed heavily to leverage positions and magnify returns. Rewards were overwhelming and consistent at 40 percent per annum. Because the new technology was partnered with a new compensation structure geared to performance, managers became

the most highly paid people in the market. They received 20 percent of profits. As investors and managers plowed back their gains, small funds quickly grew into multibillion dollar forces.

Hedge funds are now a major influence in the global financial markets. Over 8,000 hedge funds hold \$1.5 trillion in assets, double the level in 2000. Leverage and the use of derivatives multiply their real impact many fold. They now dominate the trading arena: one-third of equity volumes; one-fifth of the bond and currency markets; one-half of the commodities sector. They are a mainstay of profits for the large investment banks through commissions on trading and interest on borrowing; when added to the revenues of in-house proprietary trading, hedge funds overall are the predominant source of Wall Street earnings.

Trading figures are no longer the sole measure of hedge fund power. As more funds chase the same opportunities and ever-larger amounts of money must be deployed, hedge funds have been forced into a broader arena. They challenge private equity firms, venture capitalists, and real estate developers. They lend to companies in distress. They take major positions as shareholder activists to force corporate restructurings. They search the world to manage infrastructure projects and to develop natural resources.

The client base has moved from a closed society of the very rich to embrace the entire investor spectrum. Large institutions that oversee the retirement savings of the nation's workforce and endowments that guard the resources of universities and charitable trusts now account for more than half of hedge fund capital. High rates of return were the initial attraction but even as returns tend toward lower equilibrium levels, hedge funds are still valued to reduce overall portfolio risk because their returns are uncorrelated with general market trends. Eighty-four percent of institutional investors now view hedge funds as an essential component in portfolio allocations.

A whole new layer of intermediaries has developed to proffer guidance through the maze of proliferating hedge fund choices and to distribute institutional investor assets among specialized funds. These “funds of hedge funds,” when marketed by banks and securities firms, provide a conduit for the retail investor with as little as \$25,000 to risk to. In the planning stages at Citigroup is a \$30 billion fund of hedge funds to be marketed to its retail client base with the frequent redemption options now offered by mutual funds. Funds of hedge funds now control 50 percent of industry assets and have brought in 60 percent of recent inflows. Each layer adds more fees and reduces investor returns.

The original hedge fund image was a “black box”: investors put their money in and asked no questions about what went on inside. Hedge funds depend upon secrecy to prosper. They have a large investment—in human capital from the world’s top mathematics, physics, and finance institutions; in technology based upon complex quantitative statistical models; in information costly to collect and process—that cannot be patented or protected. A strategy disclosed is a strategy destroyed as immediate imitation by the market wipes out the benefits of expensive proprietary innovation.

In a world that demands transparency, secrecy is a red flag for fear, suspicion, and calls for regulation.¹ But the public interest can be satisfied without driving hedge funds to pack up and resettle off-shore. The framework to monitor and safeguard the global financial system and to watch over the unaware investor is already in place.

Hedge funds do not operate in a vacuum. They only interact through a marketplace where their lenders, their trading counterparties, and the markets themselves are already under the scrutiny of an array of regulators—the SEC, the Federal Reserve, the Comptroller of the Currency, the Commodity Futures Trading Commission, and their counterparts in capital markets around the world.

¹ The SEC has recently required registration of most hedge funds with assets above \$30 million and with 15 or more clients.

Hedge fund objectives should not be confused with their tools. The hedge fund formula has always relied on leverage to magnify returns, whether through borrowing or derivative instruments, but as margins narrow there is the pressure to take on more risk to generate the same profit rates. Leverage alone does not add value and excessive leverage can disrupt markets. The danger to those that finance hedge funds and to the global system as a whole lies in ignorance of risks. Total exposure and total leverage across all lenders and across all national boundaries should now be aggregated and published to inform and improve the risk evaluations of market participants and regulators alike.

One final caution: central banks that watch over national currencies and economic trends must be reeducated. The hedge fund factor that dominates trading in many market sectors has altered the information content of the asset prices that are used as signals for policy. Short-term strategies and arbitrage do not reflect an assessment of long-term values.

Under U.S. securities law, all hedge fund clients—the very rich, the institutional investors, and the managers of funds of hedge funds who are stewards of the savings of small investors—are deemed to have the skills and clout to require the facts needed to inform their decisions without official help. Many analysts believe that the industry would benefit from standardized disclosure of fund structures and track records: performance and risk, areas of investment, background of managers, and their compensation formulas. But government agencies need not regulate. If they take the lead to establish uniform benchmarks, the market will enforce their use as funds that refuse to comply will lose capital to those that inform investors.

Has the advent of hedge funds brought a net gain to the global economy? Does the search for the highest absolute economic return work to eliminate inefficiencies in the marketplace? Or does it lead to excessive risk-taking that may one day entrain widespread crisis?

The debate continues. In Europe and Japan, political leaders denounce hedge funds as locusts, parasites, and predators who contribute nothing, neglect larger social outcomes in favor of quick profits, and disrupt the smooth workings of the economy. Many economists and central bankers extol their stabilizing role as a source of market liquidity. Supporters maintain that hedge funds provide balance against the flow, in contrast to index investors who mimic market trends. Critics label them fair-weather friends who dominate trading in good times but, when difficulties arise, liquidate in haste, accelerate the fall, and multiply the damage.

To increase understanding of the role of hedge funds in the international financial system and to address the policy issues their activities might raise, the American Enterprise Institute initiated a series of conferences in 2005. Leading members of the financial community were invited to choose topics they found central to the future of what is now a fast-maturing industry. The papers that follow formalize the discussion.

Michael Litt, a partner and portfolio strategist of FrontPoint Partners that manages \$6 billion dollar in hedge fund assets, finds a permanent role for hedge funds as risk diversifiers in investment portfolios because their returns are uncorrelated with general movements in the market.

Mohamed El-Erian, CEO of the Harvard Management Corporation that manages the \$25 billion endowment of Harvard University, notes that the hedge fund industry has important implications for the international financial system. The business models of other market participants must evolve. The information content of asset prices that central bankers use to set policy has changed because short-term technical trading strategies do not convey accurate signals about long-term economic prospects.

John Makin, a principal at Caxton Associates, a hedge fund group that controls \$12 billion in assets, and a visiting scholar at AEI, places hedge funds in the perspective of the larger marketplace and sees them now as asset managers like any other, but with compensation overwhelmingly tied to absolute performance.

Robert Pozen, chairman of MFS Investment Management that manages \$170 billion in assets on behalf of 5 million investors, focuses on the proliferation of "funds of hedge funds," finds too much layering of fees relative to investor benefits, and calls for better reporting of net performance by such intermediary funds.

Atanu Saha, managing principal of the Analysis Group that consults on the application of finance theory to complex business issues, criticizes hedge fund performance statistics as overstated and misleading, and calls for mandatory uniform risk/return information disclosure.

Chester Spatt, chief economist of the Securities and Exchange Commission, examines the public policy concerns raised by hedge funds: protection for the investor and systemic risk for world financial markets.

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