Demystifying Hedge Funds

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by

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Every day, somewhere in the global marketplace, hedge funds are shaking up the comfortable *status quo* and voices from high places are raised in protest. The Governor of China's central bank Zhou tried to deflect G7 censure of the under-valuation of the yuan by pointing at unruly hedge funds as a greater threat to the world economy. In the American heartland, Warren Staley, CEO of agricultural giant Cargill, accused hedge funds of distorting fundamentals and roiling the commodities markets. In Germany and Japan, politicians denounced hedge fund corporate activists as "locusts" that destroy and disrupt in order to extract quick profits.

Are hedge funds really to blame for all the ills that befall the international financial system? Are they disruptive speculators or dispassionate agents that expose fundamental flaws and speed up inevitable change? Does their search for the highest absolute economic return eliminate inefficiencies and bring balance and liquidity to the market? Or does it lead to excessive risk-taking that may one day entrain widespread crisis?

Hedge funds 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 offer to investors: 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 momentary anomalies 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% per annum. Managers were paid for performance: they received 20% of profits. As investors and managers plowed back their gains, small funds quickly grew into multi-billion dollar forces.

Hedge funds are now a major force 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 derivative instruments multiply their real impact many-fold. They 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 and more money chase the same opportunities, hedge funds are constantly moving money around the globe to where it is most productive. They challenge private equity firms, venture capitalists and real estate developers. They lend to companies in distress. They take large 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 valued to reduce over-all portfolio risk because their returns are uncorrelated with general market trends.

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. 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% of industry assets and have brought in 60% 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 continue to 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 interact through a marketplace where their lenders, their trading counter-parties and the markets themselves are already under

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

the scrutiny of an array of regulators--the SEC, the Federal Reserve, the Comptroller of the Currency, the CFTC and their counterparts in capital markets around the world.

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.

Under US 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--have the skills to inform their decisions without official help. Many analysts believe that the industry would benefit from standardized disclosure of fund structures and track records. 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 clients and capital to those that inform investors.

The marketplace is the ultimate regulator and will control the hedge funds' future. Ever more money is competing for a diminishing set of opportunities. Average profitability is already approaching rates on more commonplace assets when risk is factored in. Industry leaders are raising fees, returning money to their long time deep-pocketed backers and focusing on their own capital. Of the 8,000 current hedge funds, 20% will close their doors within one year. Retail investors, enticed by now-outdated headline returns, will move on as profits fall. During the shake-out, players with weak risk management will be winnowed out. There will be fewer but better hedge funds.