Hedge Funds Are Growing: Is This Good or Bad?

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When the ratings agencies downgraded General Motors debt to junk status in early May, a chill shot through the $1 trillion hedge fund industry. How many of these secretive investment pools for the rich and sophisticated would be caught on the wrong side of a GM bond bet? Could trouble with hedge funds ripple through the stock and bond markets, ultimately hurting ordinary people by undermining pensions and mutual funds?

It was hard to forget the 1998 collapse of the Long-Term Capital Management hedge fund. That crisis had so threatened to trigger a cascade of bond selling that the Federal Reserve jumped off the sidelines to broker a $3.6 billion bailout to keep the financial markets safe.

In the end, the GM bond bomb was a dud. Hedge funds were not as exposed as many had thought. And, as luck would have it, a stock market rally helped hedge funds eke out small gains for the month. But the scare did help fuel the growing debate about hedge funds. Are they a benefit to the financial markets, or a menace? Should they be allowed to continue operating in their free-wheeling style, or should they be reined in by new requirements, such as a Securities and Exchange Commission plan to make them register?

"Originally, I was opposed to the requirement that they be registered as investment advisors," says Marshall Marshall E. Blume, professor of financial management and finance at Wharton. "But I'm not so opposed anymore. I think there are some shenanigans going on, particularly with respect to the pricing of the assets that they hold. Some of these are really exotic [securities] for which there is no market. And there are incentives for the managers to make a lot of money real quick."

According to Wharton finance professor Jeremy Siegel, there is a risk that many hedge funds making similar bets could suffer big losses all at once, damaging other investors. But that risk has to be balanced against the funds' contributions to the market. For example, hedge funds produce a market for securities that investors might otherwise find difficult to trade. "I think they might make the market a little less volatile.... Overall, they are providing a tremendous amount of liquidity."

Disagreement about hedge funds should come as no surprise, considering there is never a clear picture of what they are up to. Nonetheless, says Richard Marston, professor of finance and economics at Wharton, there is always the chance that many of them are doing the same thing, threatening the markets if a number of bets go bad at once. "There are a limited number of arbitrage opportunities, and [hedge fund managers] have similar ideas," he said. "It's not herd mentality so much as everyone is looking for good ideas, and they often come up with the *same* ideas."

Hedge funds are no-holds-barred investment pools for wealthy individuals and institutional investors who are considered to be sophisticated enough to take risks that ordinary investors should not. These investment vehicles are allowed to do things that mutual funds are barred from doing: They can place bets through exotic currency, debt, commodity and equity derivatives; they can take short positions, borrowing shares in hopes of replacing them later with ones bought at lower prices; and they can leverage, or borrow, so they can bet many times the amount of money their shareholders have put into the fund.

In May, for instance, many analysts believed hedge funds were long on GM debt and short on its equity -- that they owned the bonds, hoping their price would rise, and had borrowed the stock, betting its price would fall. The surprise debt downgrade caused the bonds to fall instead, and the share price rose unexpectedly when investor Kirk Kerkorian used the weak moment to boost his GM stake.

One of the biggest differences between hedge funds and mutual funds: hedge funds are not required to publicly disclose their holdings. Hence, it's nearly impossible to know at any given time whether they are adding risk to the markets or reducing it.

Adding Risk to the Market

Blume believes hedge funds may be a factor in the peculiar behavior of the bond markets over the past year. Despite eight hikes of short-term interest rates by the Federal Reserve, long-term rates have not followed suit. They have gone down. Since short-term rates are almost always lower than long-term ones, hedge funds and other investors can make money by borrowing through short-term bonds and using the money to buy long-term bonds, pocketing the difference in yields. The high demand for long-term bonds produced by this strategy would drive prices up, causing yields to fall. "If there is a lot of money doing that, it could actually affect the market," he says. "It's quite possible that hedge funds have affected asset prices" and contributed to the flattening of the yield curve.

If hedge funds are helping to keep interest rates low in defiance of the Fed's efforts, they are contributing to the housing boom that some believe is becoming a speculative bubble. In that case, they would be adding risk to the market.

Many hedge funds play with complex custom-designed derivatives which are not traded often and are not listed on the exchanges. Not only are outsiders in the dark about these matters, but even the hedge funds may be unsure what these instruments are worth. Requiring these funds to register with the Securities and Exchange Commission and to submit to audits would enable the markets to "determine the accuracy of the pricing of these exotic [instruments] that hedge funds frequently hold," Blume says. That would make it easier to determine if the funds are pumping too much risk into the markets.

In earlier decades, hedge funds used their freedom to hedge against risk. By holding both long and short positions, for example, they tried to make money regardless of whether the markets moved up or down. Hence, hedge funds were seen as relatively conservative investments, used to dampen the jarring ups and downs of the market. In the 1990s, however, many became more aggressive, using their freedom not to reduce risk but to embrace it in hopes of stellar gains, Marston says. That's what led to the Long-Term Capital Management collapse -- a leveraged bet, which was wrong, that historic relationships between various short- and long-term bond yields would reassert themselves.

In recent years, Marston adds, the funds have gone back to a more conservative approach. Many investors have turned to them in hopes of doing better in the bond markets, which have been paying historically low yields. Though these investors are presumably not reaching for the stars, some surveys have shown that they do tend to have unrealistically high expectations for these fixed-income proxies, he says. "On average, the returns reported by the institutional investors are very low, and they still expect to make a lot over the next three years."

Since hedge funds are essentially unregulated, there are no definitive statistics, but by some estimates there are about 8,000 hedge funds with combined assets of about $1 trillion, up from $400 billion in 2001. Because hedge funds can leverage, their impact on the markets is probably far larger. The mutual fund industry has about $8 trillion in assets, which cannot be leveraged.

Class Dropouts

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From 1987 through 2004, the average hedge fund returned 14.94% a year after fees were deducted, compared to 11.88% for the Standard & Poor's 500, according to The Hennessee Group, which tracks the industry funds. In 2004, hedge funds returned 8.3%, versus 10.87% for the S&P 500. This year through May the funds were down about 0.27% while the index was off 0.96%.

Hennessee's figures come from reports by the funds themselves, and some critics wonder whether hedge fund performance data makes them look better than they are. In the typical fund, managers get an annual fee of about 1.5% of the fund's assets, about the same as mutual funds charge. But hedge fund managers also get an incentive fee of about 18% of the fund's profits, Marston says.

Because a major source of managers' income is a share of profits, managers have a strong financial incentive to close funds that do poorly and open new ones. The bad funds thus drop from the database, leaving the hedge fund indexes with a strong survivorship bias, like figuring a class's performance by ignoring the fact that half the students dropped out. In the stock, bond and mutual fund markets, poor performers are much more likely to linger on, so that their performance indexes are more accurate.

Imagine, says Blume, a hedge fund manager who starts eight funds, four to go long in a security and four to go short. At the end of a year, four will have made money and four will have lost. Since the losers have a lot of ground to gain before they can get back into the black and start paying incentive fees, the manager closes them. Each year, the losers would be winnowed. "Notice: A lot of money got transferred from investor to manager," he says. "There's a lot of incentive to do that."

To Register, or Not

Last year, William Donaldson, chairman of the Securities and Exchange Commission pushed for a requirement, planned to take effect in February 2006, that hedge funds register with the SEC, submit to audits and inspections and disclose information on their executives, trading strategies and methods for valuing items in their portfolios. Currently, about a third of hedge funds are registered, mostly the bigger ones.

As hedge funds have attracted more and more investment from pension funds, charities and college and university endowments, Donaldson argued that stricter regulation would protect ordinary people. "If you are a pension fund and you invest your money in some of these hedge funds and you lose a lot, you [turn the pension fund over to] the Pension Benefit Guarantee Corp. and the taxpayers pick it up," Blume says.

In making the case for registration, Donaldson also noted that increasing numbers of Americans meet the $1 million net worth requirement for investing in hedge funds, although they are not the kind of savvy investors that this threshold envisioned. Therefore, said Donaldson, oversight is needed to protect ordinary people.

Early in June, Federal Reserve Chairman Alan Greenspan warned that investors who have flocked to hedge funds for better returns than they can get elsewhere are likely to be disappointed. The funds had already picked the "low-hanging fruit" and were likely to find fewer and fewer good investments, he said. But Greenspan opposes stricter regulation, arguing that hedge funds contribute to financial stability by providing liquidity. He agrees with the hedge fund industry that such regulations would boost hedge fund costs and discourage formation of new funds.

Now the registration issue is up in the air. Donaldson announced at the start of June that he would leave the SEC at the end of the month. To replace him, President Bush has nominated Rep. Christopher Cox, a California Republican who has generally opposed regulation.

Siegel says he is with Greenspan on this issue, arguing that the markets themselves will help discourage dangerous practices. "Sure, some [hedge funds] are trend-followers and momentum-setters," he said. "But

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if they do that too often they are going to get spanked and they are going to lose some money." Although a trillion dollars invested in hedge funds is a lot, many of their "market neutral" strategies -- going long and short at the same time -- reduce risk in the markets rather than enhance it, he notes. Short selling contributes to the market's process of finding correct prices, and it's valuable to have hedge funds doing this, since mutual funds cannot. "I'm for a greater liberalization of hedge funds," he states.

Marston takes the middle ground. The threat of loss will discourage most excess, and the government can step in to guarantee liquidity in a crisis, assuring that financial institutions will be able to borrow money at reasonable interest rates, as it did in the Long-Term Capital Management case. Requiring hedge funds to register with the SEC and setting up minimal oversight should be good enough, he says, although he also believes that the $1 million net worth requirement for investing in hedge funds should be raised to $5 million.

"A million dollars... really isn't that much money, and doesn't really mean you are a sophisticated investor," Marston notes. "You can now get what I call mom and pop investors in hedge funds. My feeling is that, in a perfect world, you would limit these partnerships to wealthy people."

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