

THE ECONOMICS OF HEDGE FUNDS

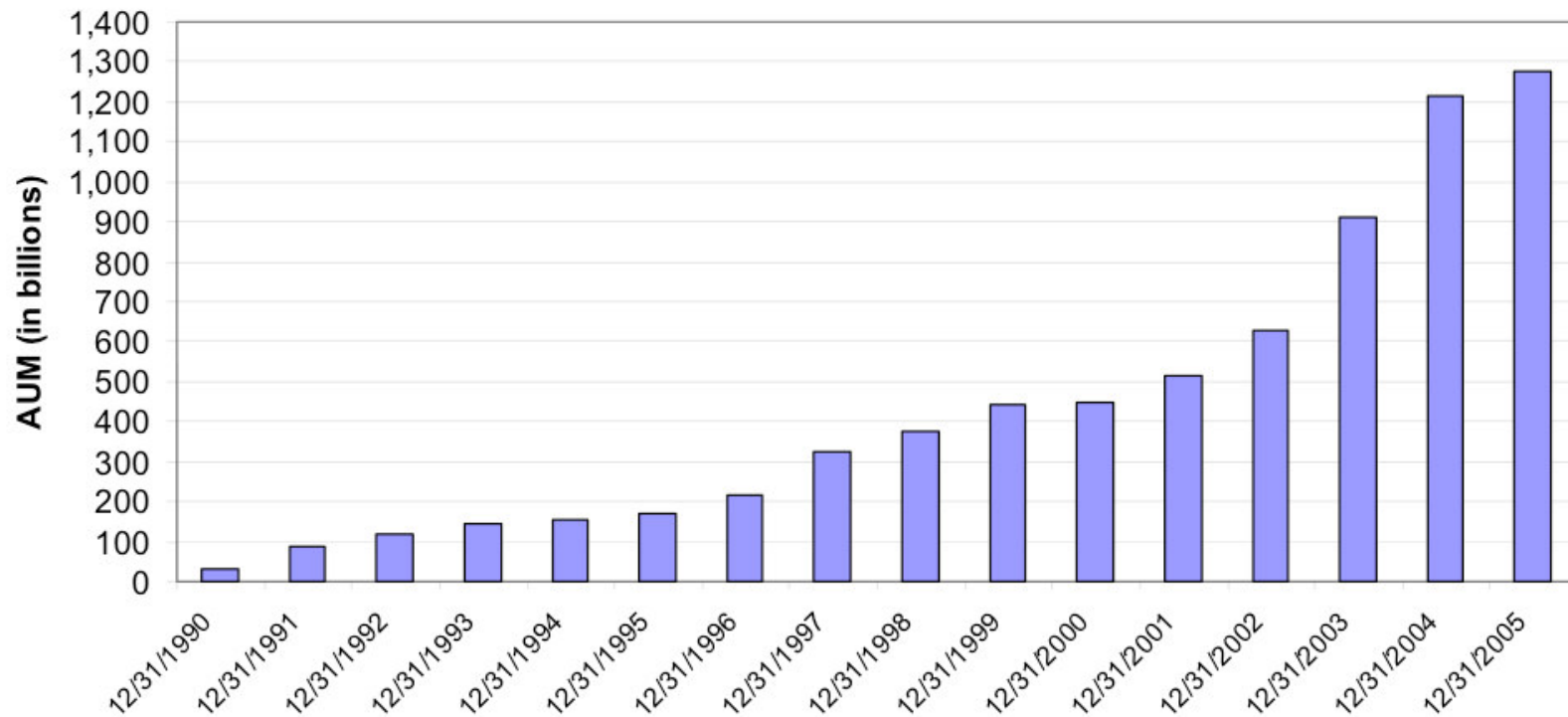
Principles and Policy

Houman B. Shadab
Senior Research Fellow,
Mercatus Center



Hedge Fund Growth

**Growth of Hedge Funds: Assets Under Management
(1990-2005)**



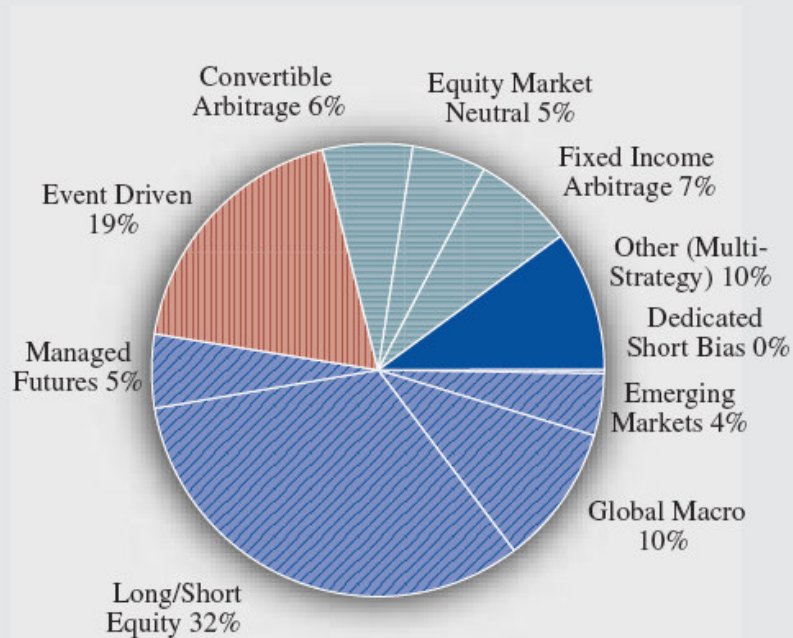
Source: CISDM

Source: "The Benefits of Hedge Funds: 2006 Update," by the Center for International Securities and Derivatives Markets (May 2006).

Strategies and Size

Chart 20 Hedge fund capital structure by strategy

(December 2004; % of total capital under management)

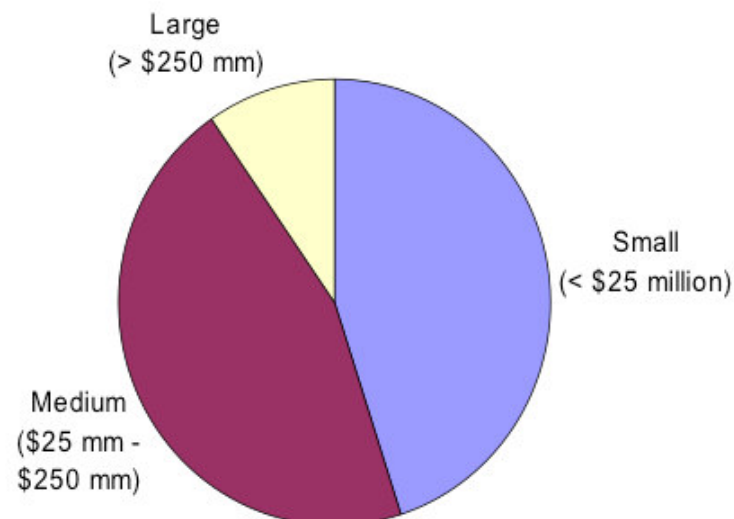


Source: TASS Research.
Note: Excluding FOHFs.

Source: "Hedge Funds and Their Implication on Financial Stability." European Central Bank, August 2005.

Go To Next Page

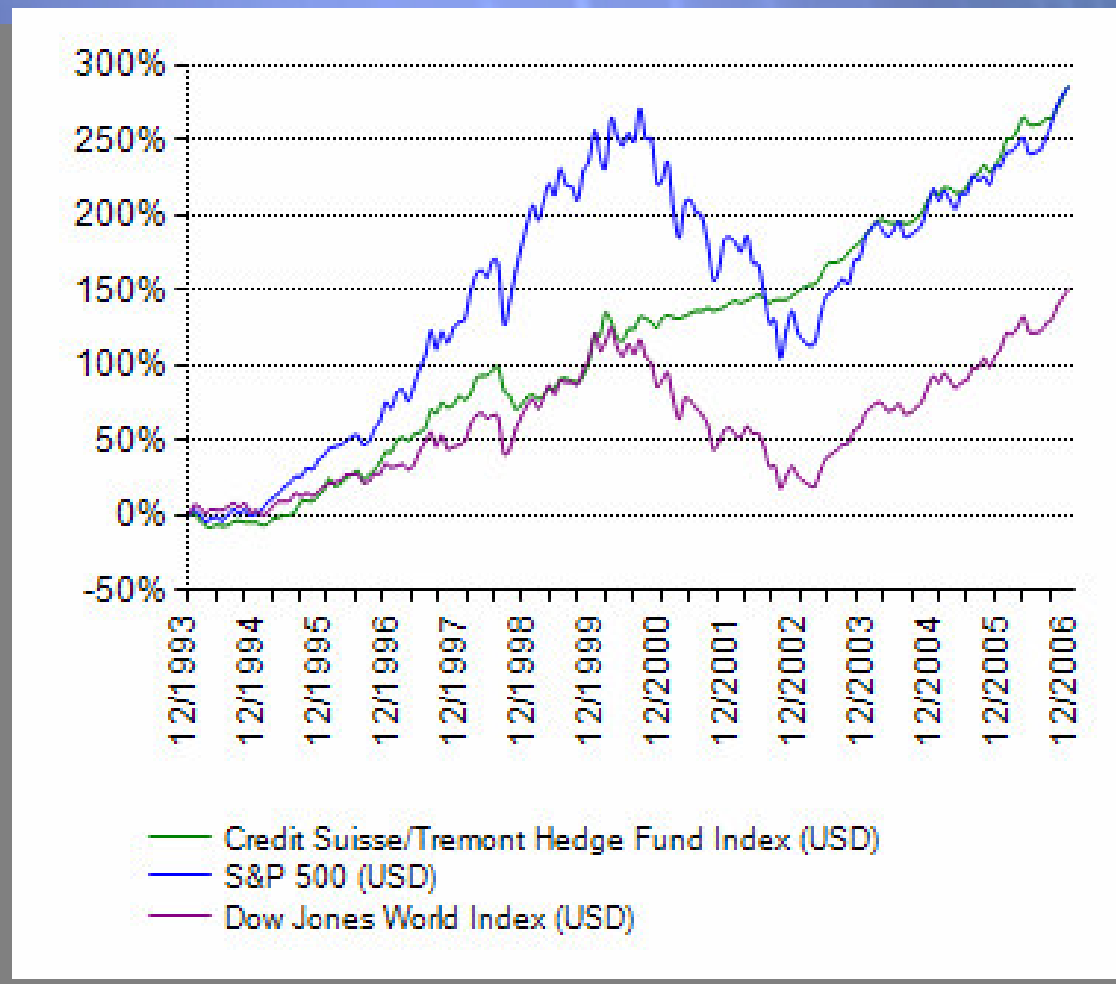
Hedge Funds SIZE DISTRIBUTION



Source: Van Hedge Fund Advisors as of December 31, 2002; grouped by Crestmont Holdings.

Source: "Perspectives on Hedge Fund Investing." Copyright 2002-05 Crestmont Research

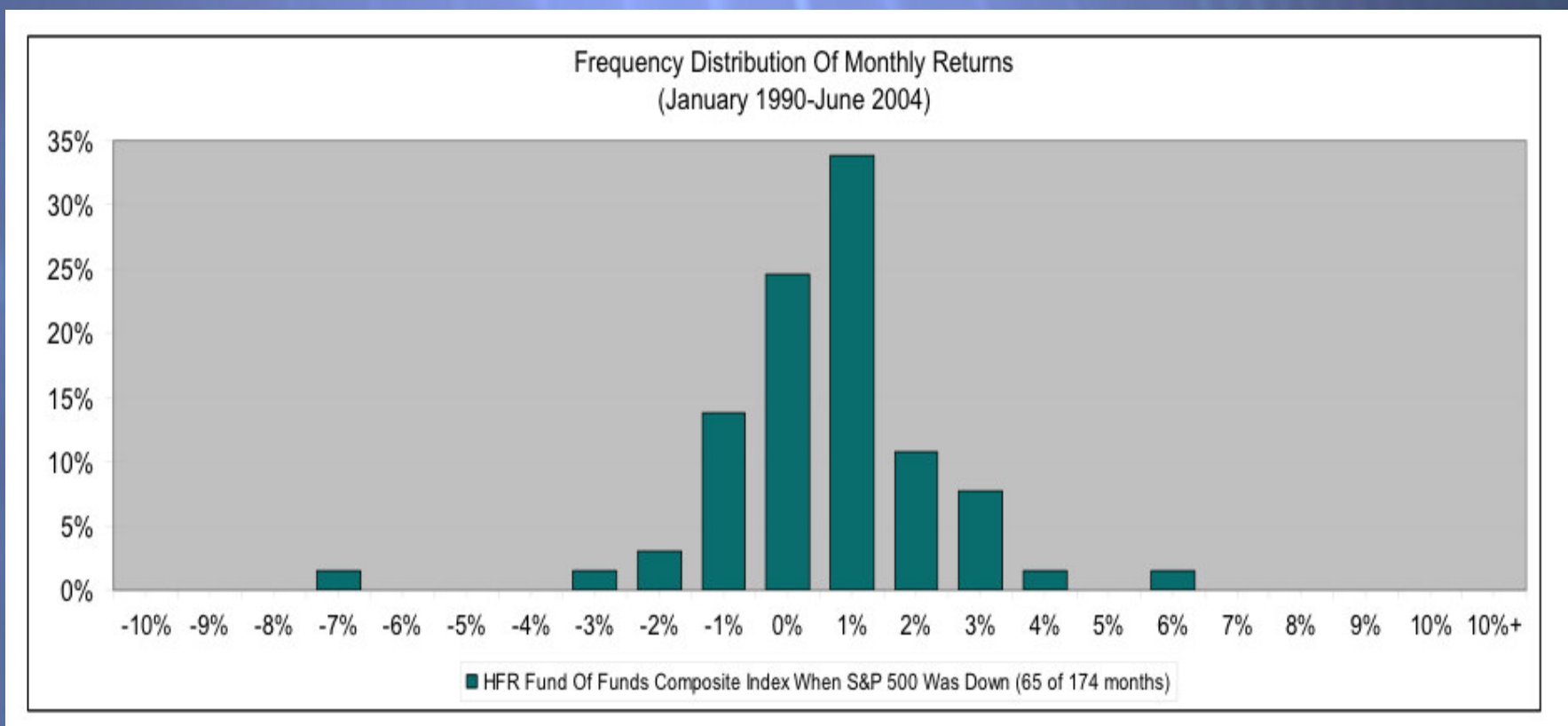
Hedge Funds in Good and Bad Times



Source: ©1999-2006 Credit Suisse Tremont Index LLC.

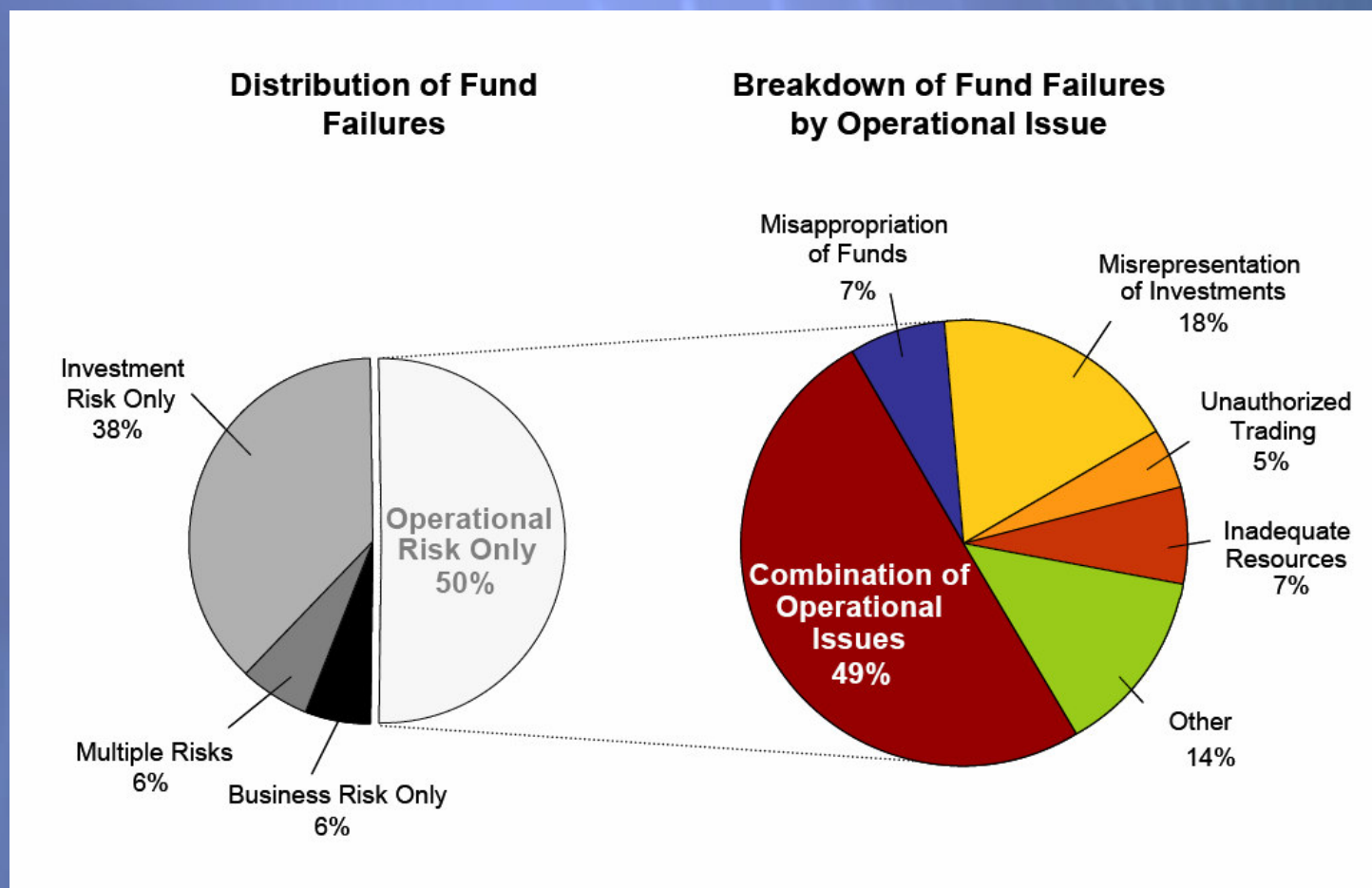
Hedge Funds in Bad Times

- ★ distribution of HF returns when S&P index declined



Source: "Perspectives on Hedge Fund Investing." Copyright 2002-05 Crestmont Research

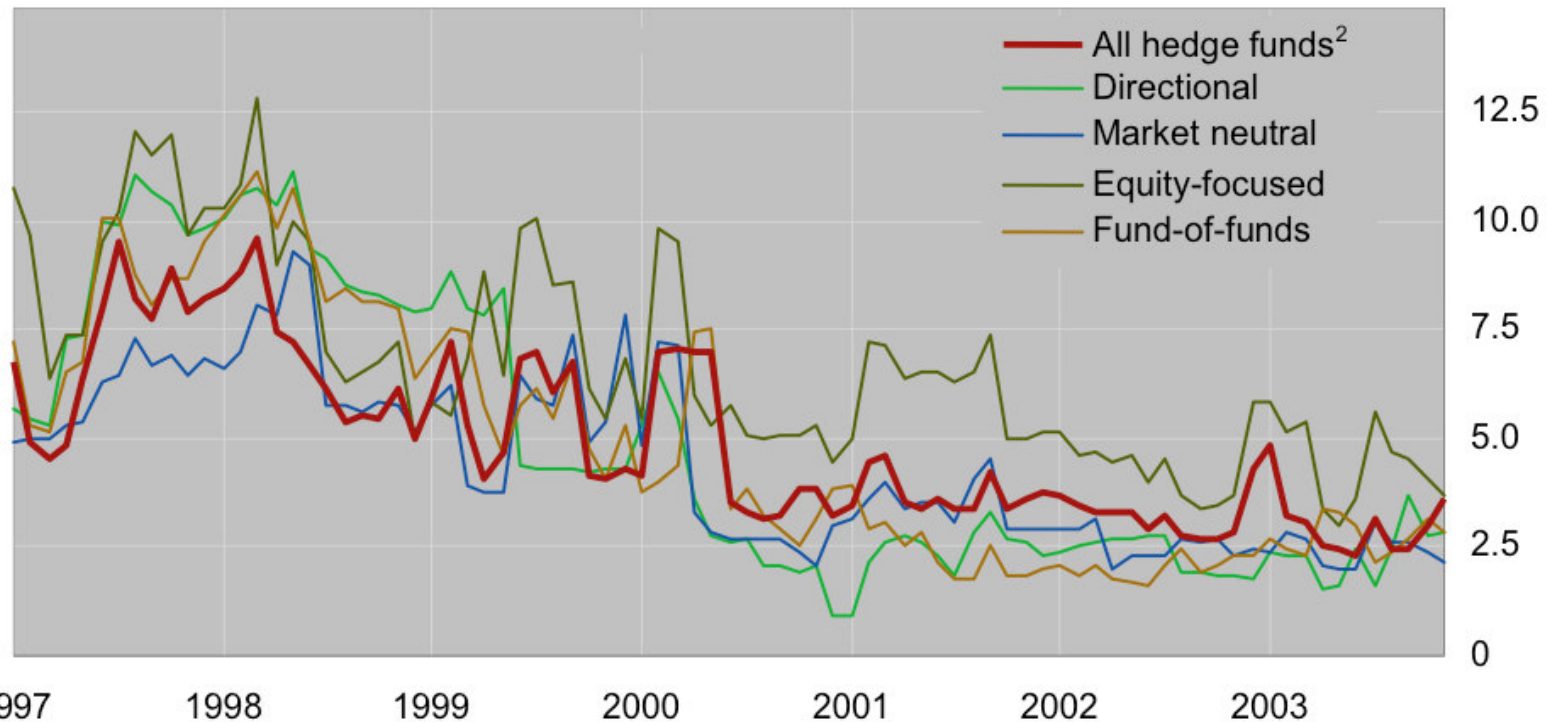
Why Hedge Funds Fail



Source "Understanding and Mitigating Operational Risk in Hedge Fund Investments" by Stuart Feffer and Christopher Kundro. Capco, The Capital Markets Company Ltd., 2003.

Hedge Fund Leverage Decreasing

Estimated leverage measures¹



¹ Based on a 24-month rolling regression window. ² Includes equity-focused, market neutral and directional style families.

Sources: HFR; BIS calculations.

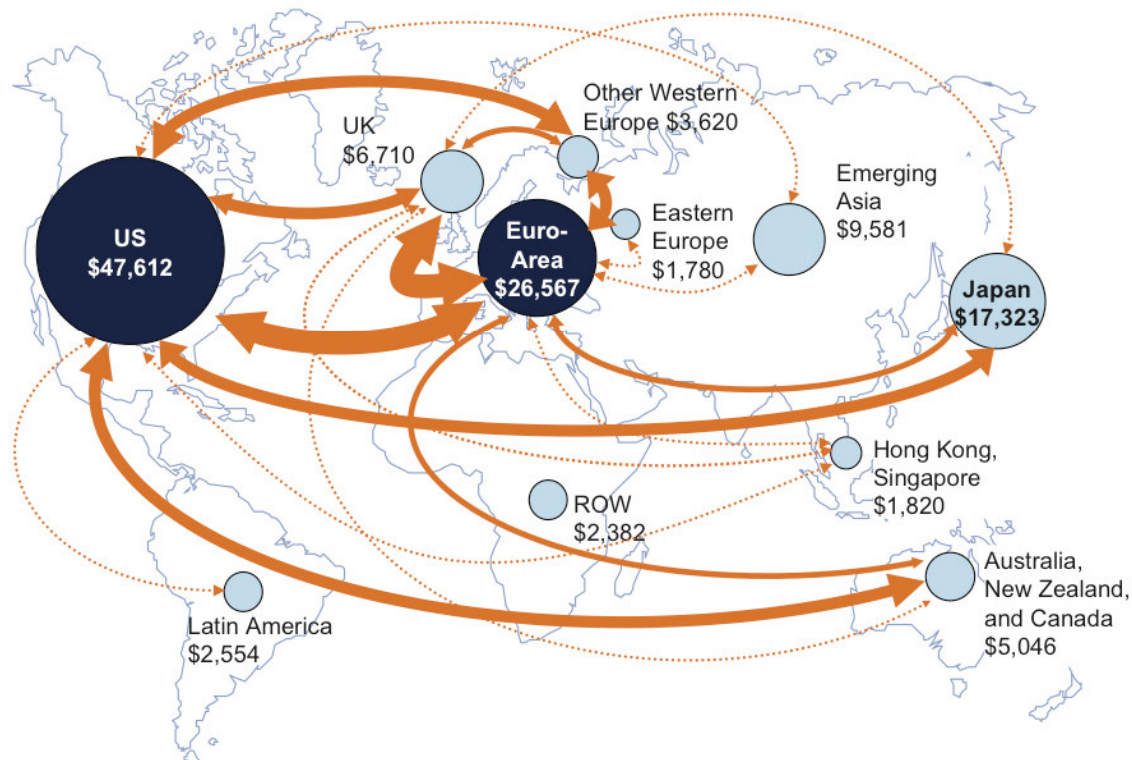
Graph 5

Source: "International banking and financial market developments," *BIS Quarterly Review*, March 2005.

Flows by Region

Map of cross-border financial holdings, 2004*

Figures in bubbles show size of total domestic financial assets
2005, \$ billion



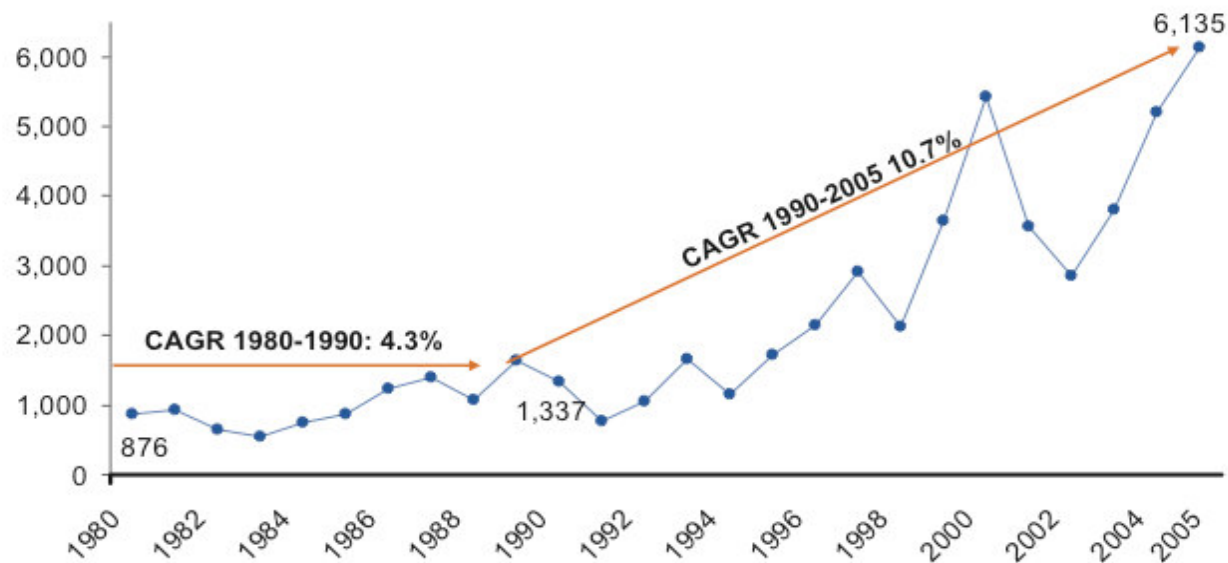
* Includes cross-border equity, debt, lending and foreign direct investment.
Source: McKinsey Global Institute Capital Flows Database

International Capital Flows

Go To Next Page

Total cross-border capital flows

\$ billion, 2005 constant \$ and constant foreign exchange



% of
global
GDP

4.6	3.4	3.6	5.5	4.4	5.0	3.7	3.8	6.5	6.0	14.2	7.2	12.1	13.9
-----	-----	-----	-----	-----	-----	-----	-----	-----	-----	------	-----	------	------

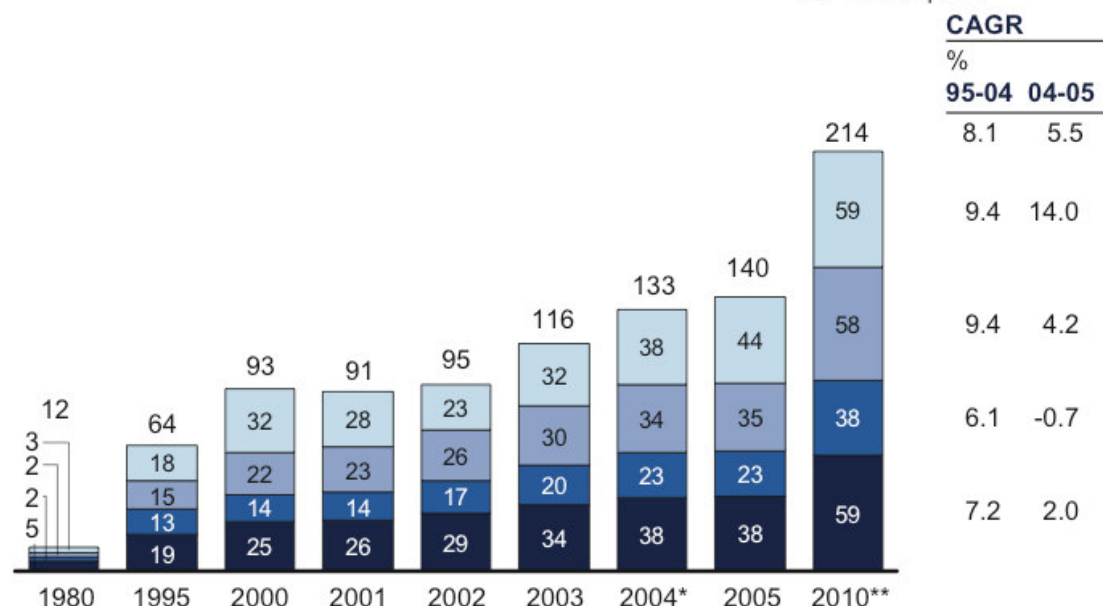
Source: McKinsey Global Institute Capital Flows Database

Global Financial Assets

Global financial assets

\$ trillion

- Equity securities
- Private debt securities
- Government debt securities
- Bank deposits



Nominal GDP	10.1	29.4	31.7	31.6	32.8	36.9	41.4	44.5	63.3	4.2	7.5
\$ trillion											
Depth	109	218	292	289	290	315	322	316	338		
(FS/GDP), %											

* Our 2004 figure dropped from \$136 trillion to \$133 trillion due to restatement of data by individual countries.

** Extrapolation off of 2005 base, with components grown at 2000-05 CAGRs.

Source: McKinsey Global Institute Global Financial Stock Database