

HEDGE FUNDS, INVESTORS AND THE ECONOMY

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Overview

- ✦ Hedge fund basics
- ✦ Hedge funds and the economy
- ✦ Hedge funds and investors
- ✦ Hedge funds and subprime lending

HEDGE FUND BASICS

- ✦ What are hedge funds?
 - ✦ Diverse group of private investment funds
 - ✦ Private
 - ✦ Not req'd to register under the Investment Co. Act of 1940
 - ✦ Not req'd to register under Securities Act of 1933

HEDGE FUND BASICS

- ✦ Not req'd to register and disclose under Securities and Exchange Act of 1934
- ✦ Not req'd to register under Investment Advisors Act of 1940
 - ✦ Failed 2004 SEC registration rule; 2 current bills
 - ✦ Most register with some regulatory body
 - ✦ About 2,000 registered with SEC (500 deregistered)
 - ✦ Requires basic info about the advisor, investment strategies
 - ✦ Examinations by SEC, written compliance and ethics rules

HEDGE FUND BASICS

✦ Diverse

✦ different strategies

- ✦ Directional or trend-following
- ✦ Corporate event-driven
- ✦ Arbitrage

✦ Invest in

- ✦ Traditional stocks and bonds
- ✦ Real estate, commodities, ForEx, films
- ✦ Derivatives

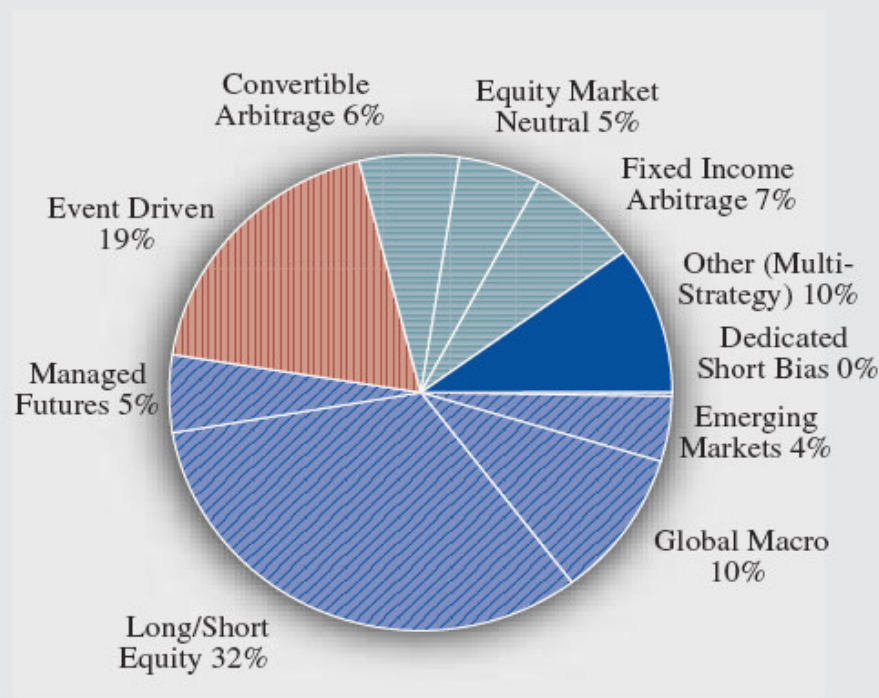
- ✦ Use different amounts of leverage
 - ✦ Most use 2:1
 - ✦ Most use derivatives to reduce risk, not speculate

- ✦ May or may not “hedge”

Strategies and Size

Chart 20 Hedge fund capital structure by strategy

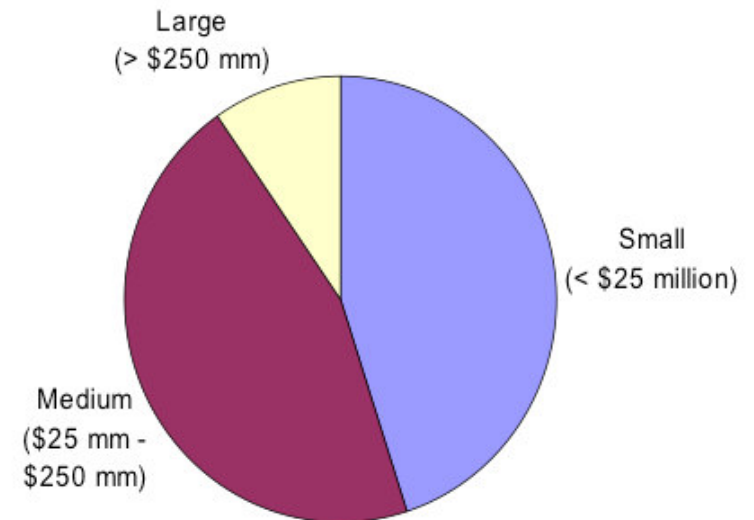
(December 2004; % of total capital under management)



Source: TASS Research.
Note: Excluding FOHFs.

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Hedge Funds SIZE DISTRIBUTION



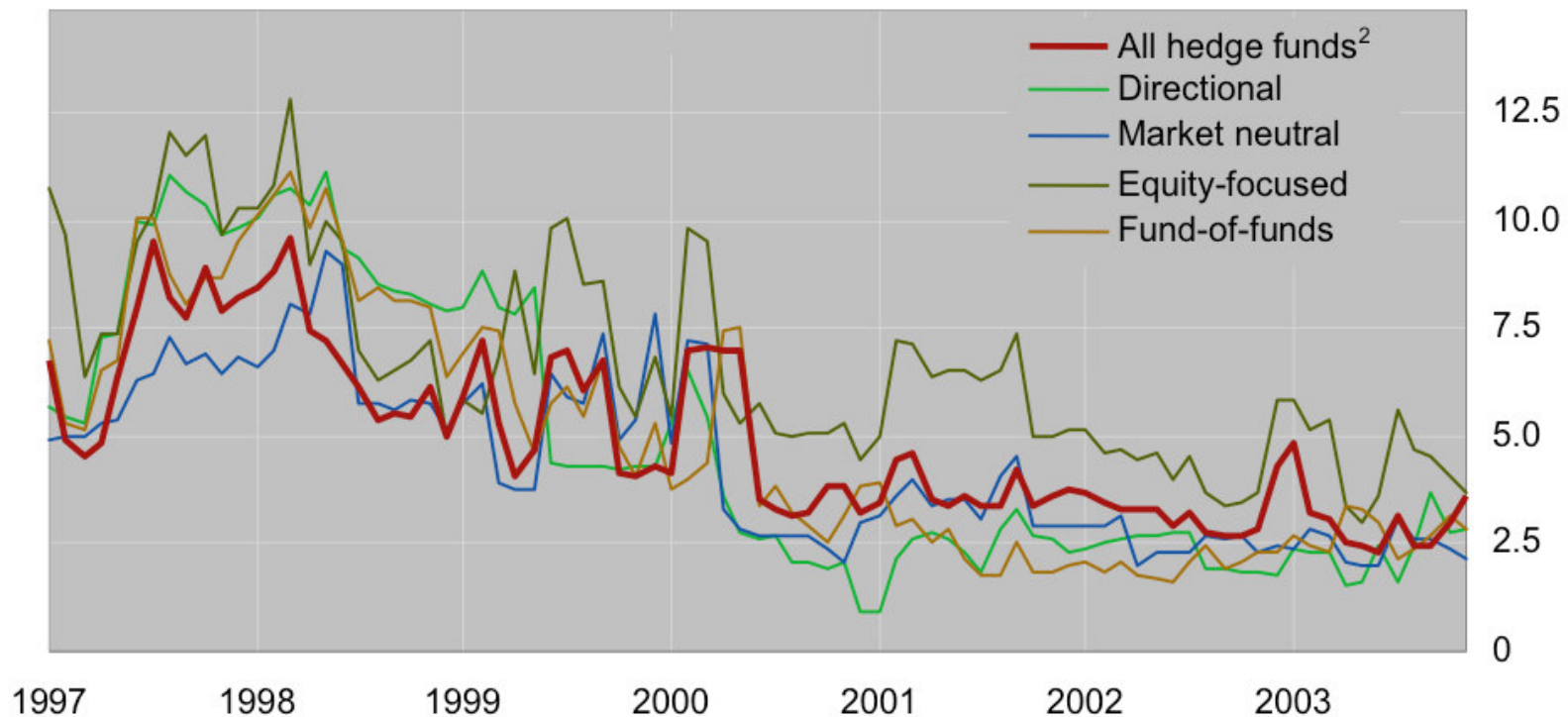
Source: Van Hedge Fund Advisors as of December 31, 2002; grouped by Crestmont Holdings.

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

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

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.

HEDGE FUND BASICS

- ✦ Private, yes. Unregulated and secret, no.
 - ✦ Subject to anti-fraud provisions
 - ✦ Subject to prohibitions on insider trading
 - ✦ Must quarterly disclose equity holdings if total is greater than \$100MM (Form 13F)
 - ✦ hedge funds or their managers must disclose any purchase of stock exceeding 5% of a voting class of a public company's securities
 - ✦ Disclosure when enter proxy process
 - ✦ Indirectly through bank regulation and supervision
 - ✦ Books, articles, research
 - ✦ Regulation under the Commodities. Exch. Act
 - ✦ Regulation and disclosure under ERISA
 - ✦ Market monitors
 - ✦ Prime brokers monitor hedge fund positions
 - ✦ Securities firms monitor and requirement capital minimums
 - ✦ media

HEDGE FUND BASICS

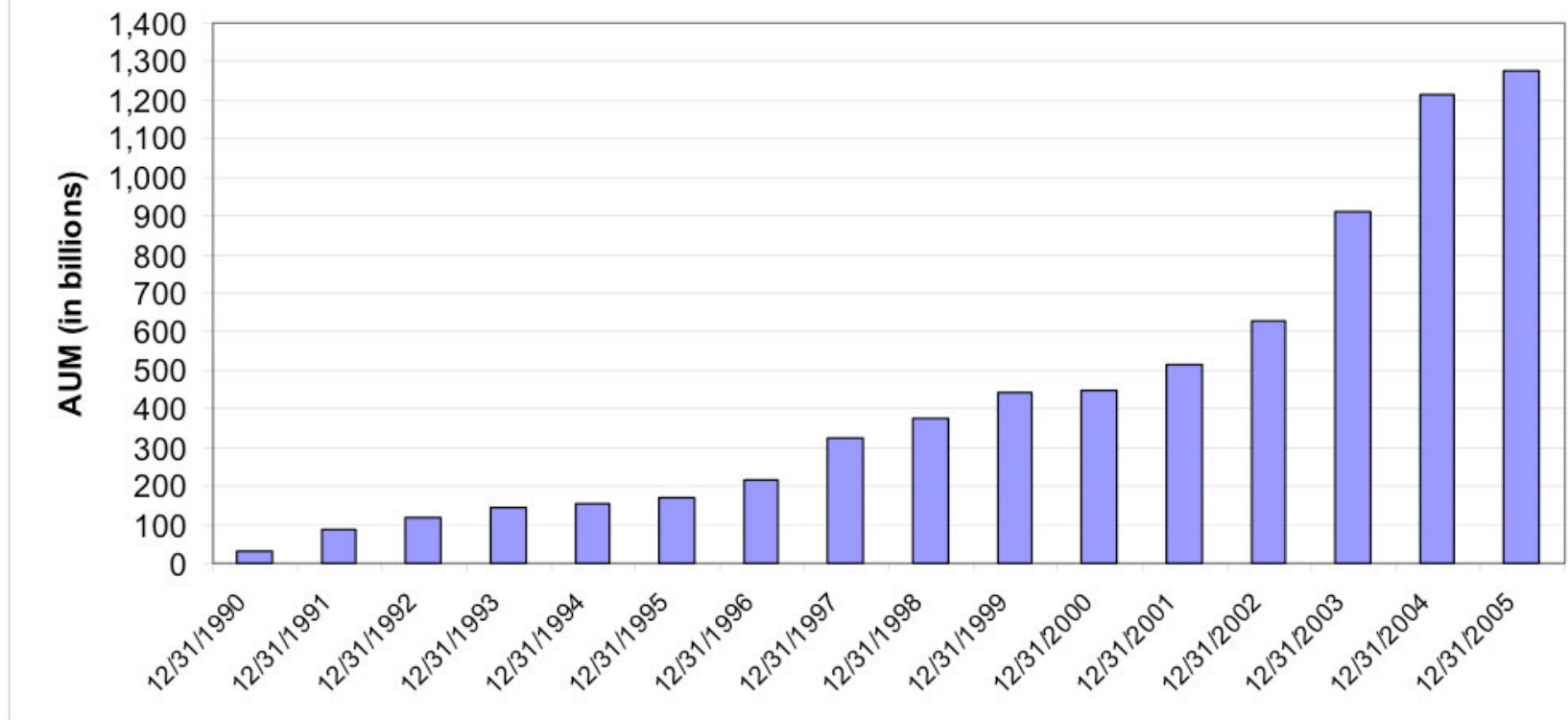
- ✦ Unique structure and practices
 - ✦ Substantial, accessible disclosures to investors
 - ✦ Do not disclose positions or trades as they happen
 - ✦ Investors don't demand this
 - ✦ Regulators could not make sense of it
 - ✦ Managers earn management fee and performance fee
 - ✦ Lock-ups and redemption notice
 - ✦ Performance fee aligns interests
 - ✦ More incentives/control better performance
 - ✦ But maybe last-period incentive
 - ✦ Overcome by managerial investment
 - ✦ Career concerns

HEDGE FUND BASICS

- ✦ Industry characteristics
 - ✦ Manage about \$2 trillion in assets globally
 - ✦ Over 13,000 funds
 - ✦ Institutional investment on the rise
 - ✦ Institutionalization by providers
 - ✦ Largest funds run by large investment banks
 - ✦ Prime brokers and other services providers are large established firms
 - ✦ Institutionalization has made funds more accountable, transparent, sophisticated and stable

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).

HEDGE FUNDS AND THE ECONOMY

- ✦ Widespread agreement that, on the whole, hedge funds play beneficial role in economy:
 - ✦ Lower overall volatility and risk
 - ✦ Reduce price inefficiencies
 - ✦ Take on risks that others will not
 - ✦ Add liquidity to the system
- ✦ Result:
 - ✦ Less volatility, more stability, depth and liquidity, risk-spreading and allocation
- ✦ Risk of contagion
 - ✦ Hedge fund losses spread throughout the economy

HEDGE FUNDS AND INVESTORS

- ✦ Must be an accredited investor to purchase
 - ✦ AIs are sophisticated or at least afford to purchase informed advice
 - ✦ \$1MM in net worth, or \$200k income
 - ✦ \$5MM if an institution
- ✦ Policy: investors deserve registration and transparency unless can fend for themselves
- ✦ SEC recently proposed to raise to \$2.5

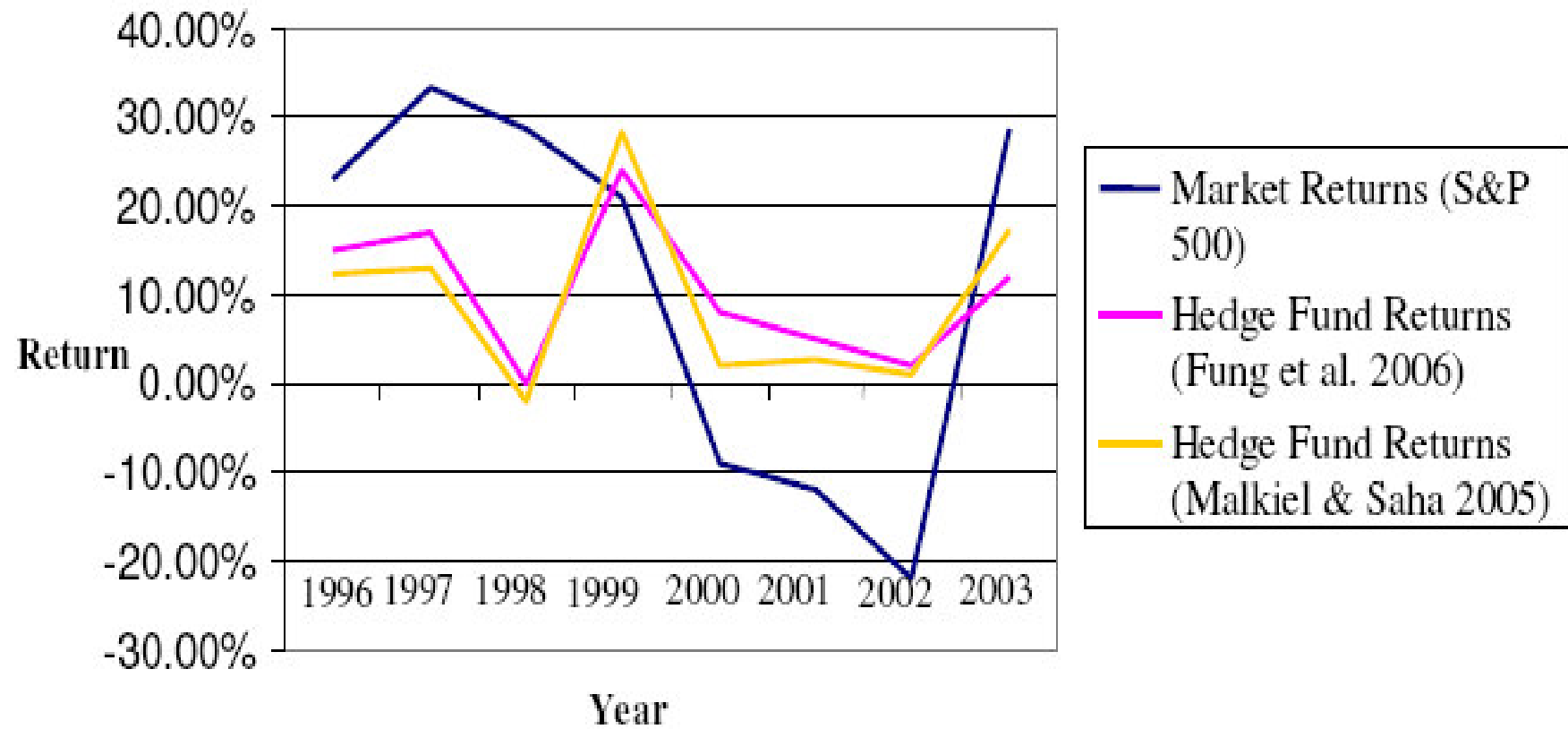
HEDGE FUNDS AND INVESTORS

- ✦ Should investors be limited?
 - ✦ Hedge funds are not riskier*
 - ✦ Hedge funds are not more complicated
 - ✦ Derivatives, short-sells, options, foreign exchange, ETFs, issuer complexity
 - ✦ Plenty of information about hedge funds
 - ✦ In public domain
 - ✦ Hedge funds could release more if were not prohibited from "general solicitation and advertising"
 - ✦ Other nations make it easier to invest
 - ✦ Australia, Ireland, Hong Kong, Singapore

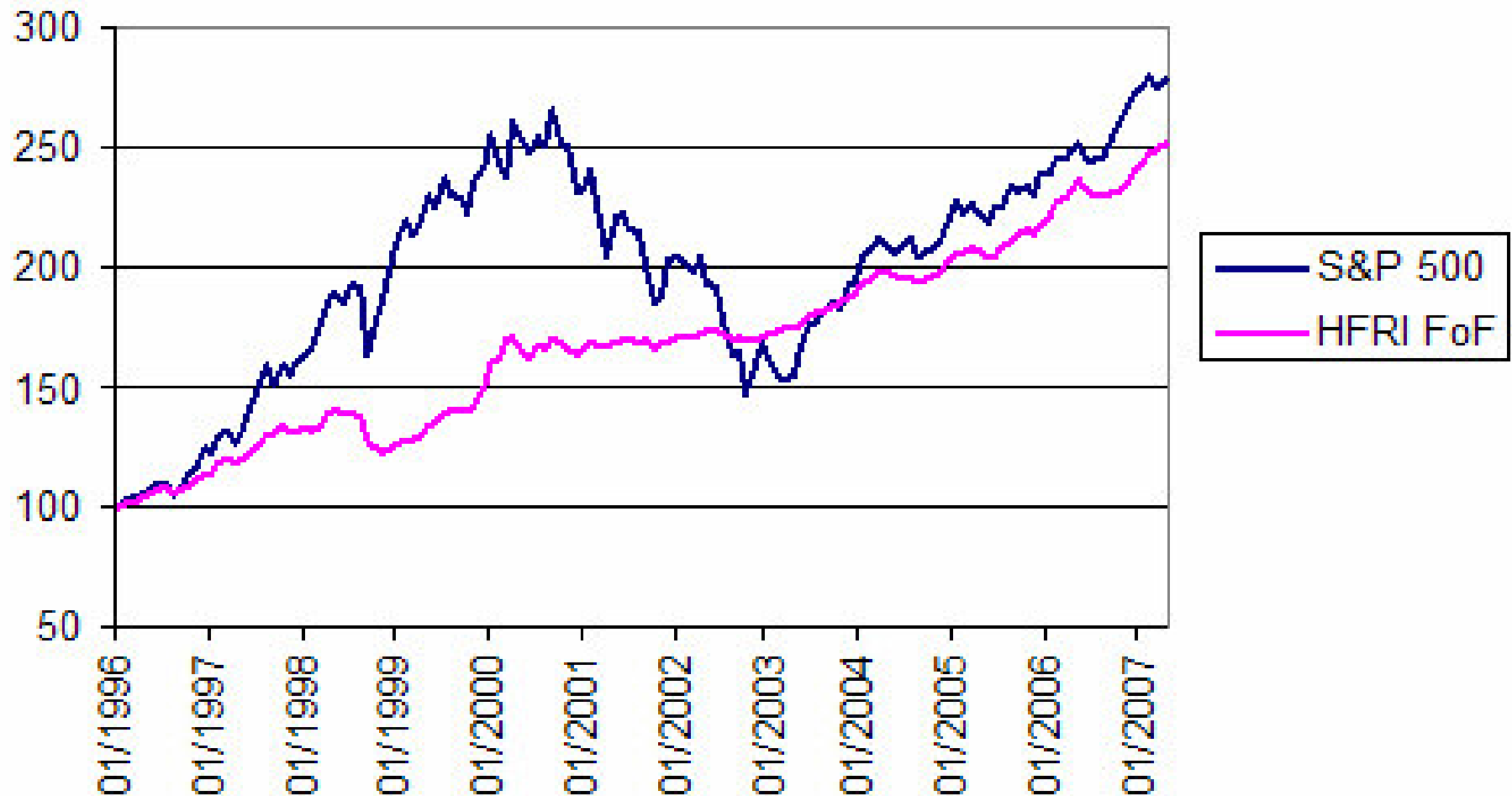
Hedge funds not riskier

- ✦ Risk: chances that your entire portfolio will decrease; not chance of single investment decreasing
 - ✦ Risk/return
 - ✦ Risk cannot be eliminated
 - ✦ Low probability events happen all the time
 - ✦ Risk should be spread and concentrated among those who desire it
- ✦ Diversification reduces portfolio risk
- ✦ Hedge funds diversify a traditional portfolio
- ✦ Hedge funds pursue and achieve "absolute return" strategies
- ✦ Investors can purchase hedged mutual funds with same risk and complexity

Hedge Fund Mean Annual Returns vs. Market Returns

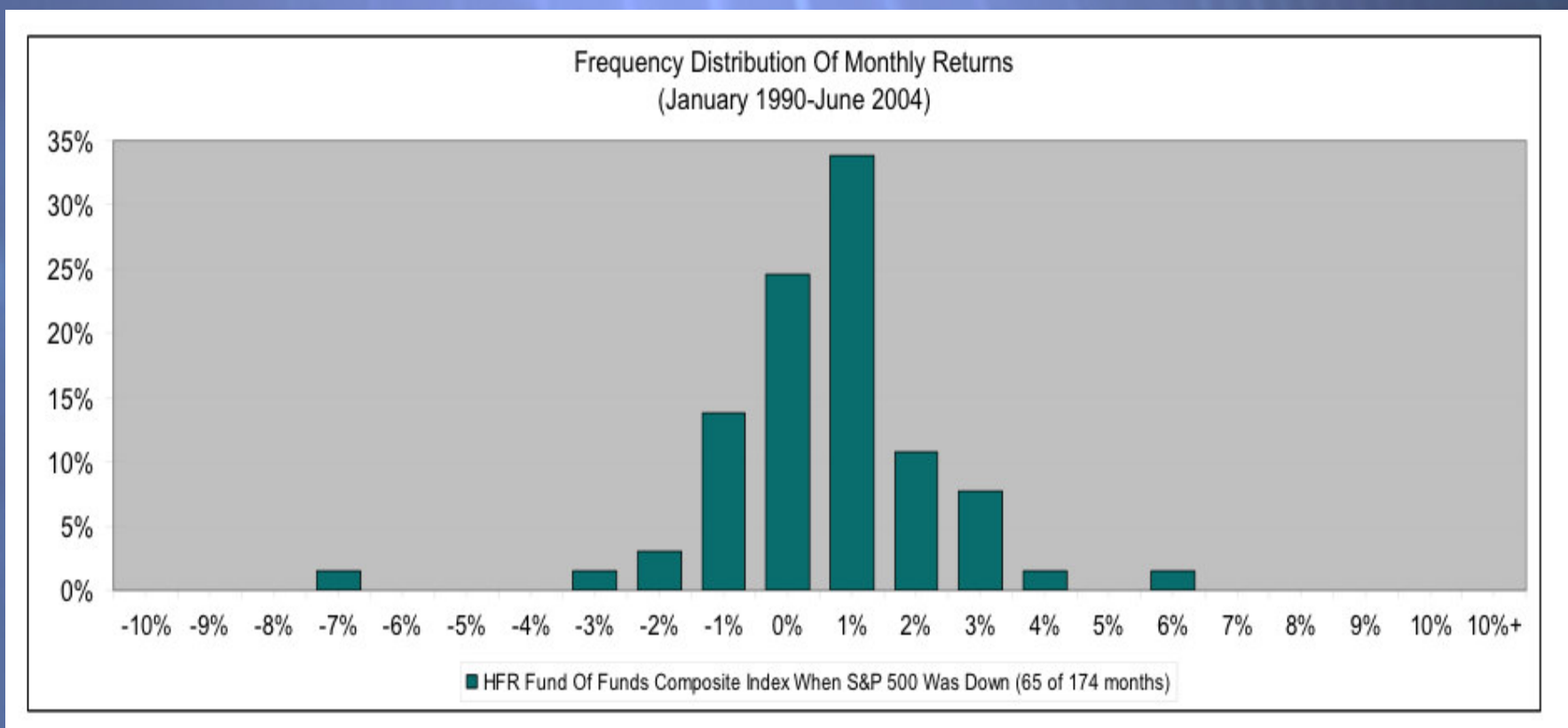


S&P 500 and HFRI Fund of Funds index, 1996 - 2007



Hedge Funds in Bad Times

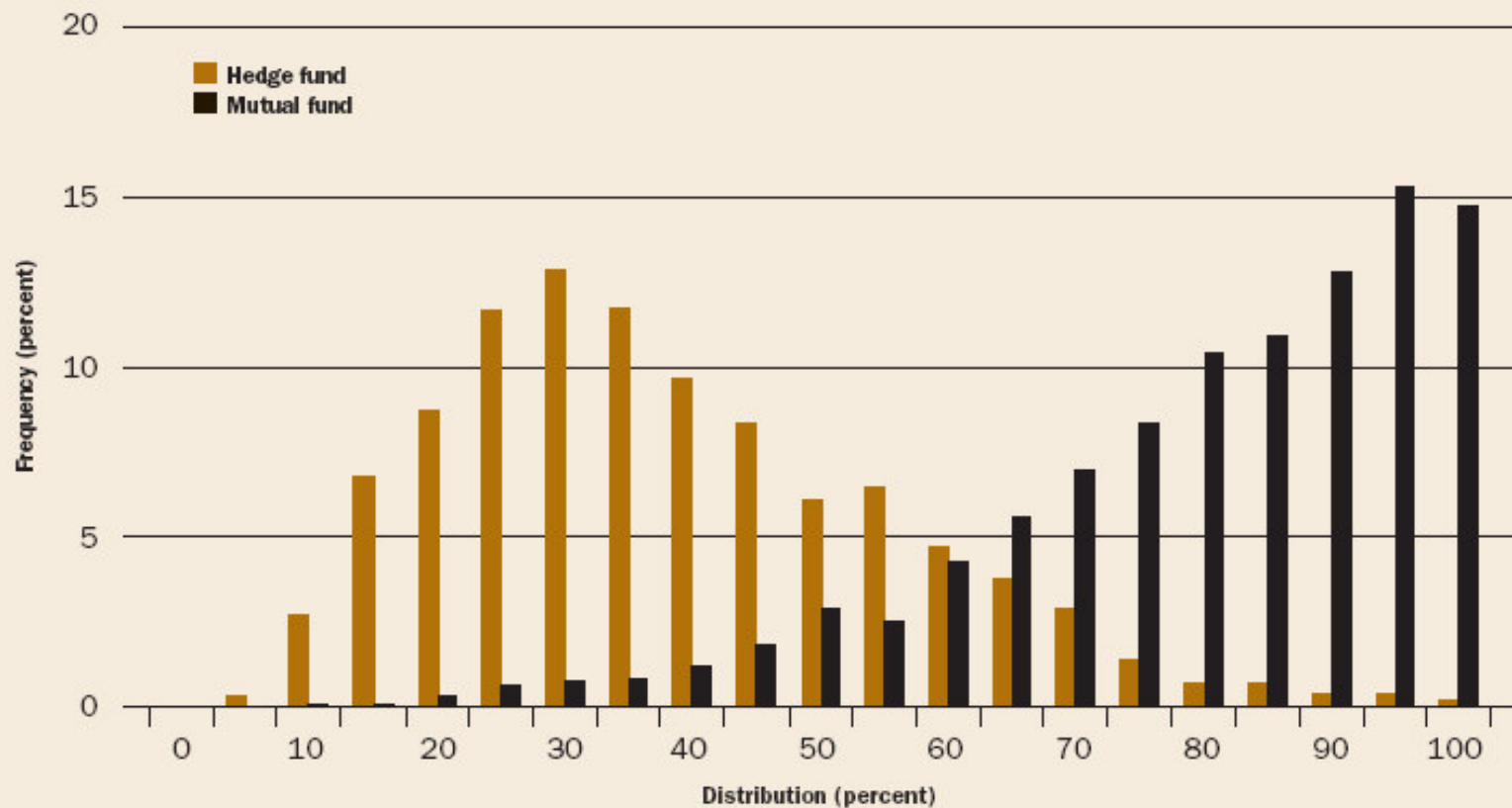
- ★ distribution of HF returns when S&P index declined



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

Generally uncorrelated to mutual fund returns

Distribution of R^2 versus Eight Asset Classes



Source: CISDM, HFR, TASS, Morningstar, Datastream

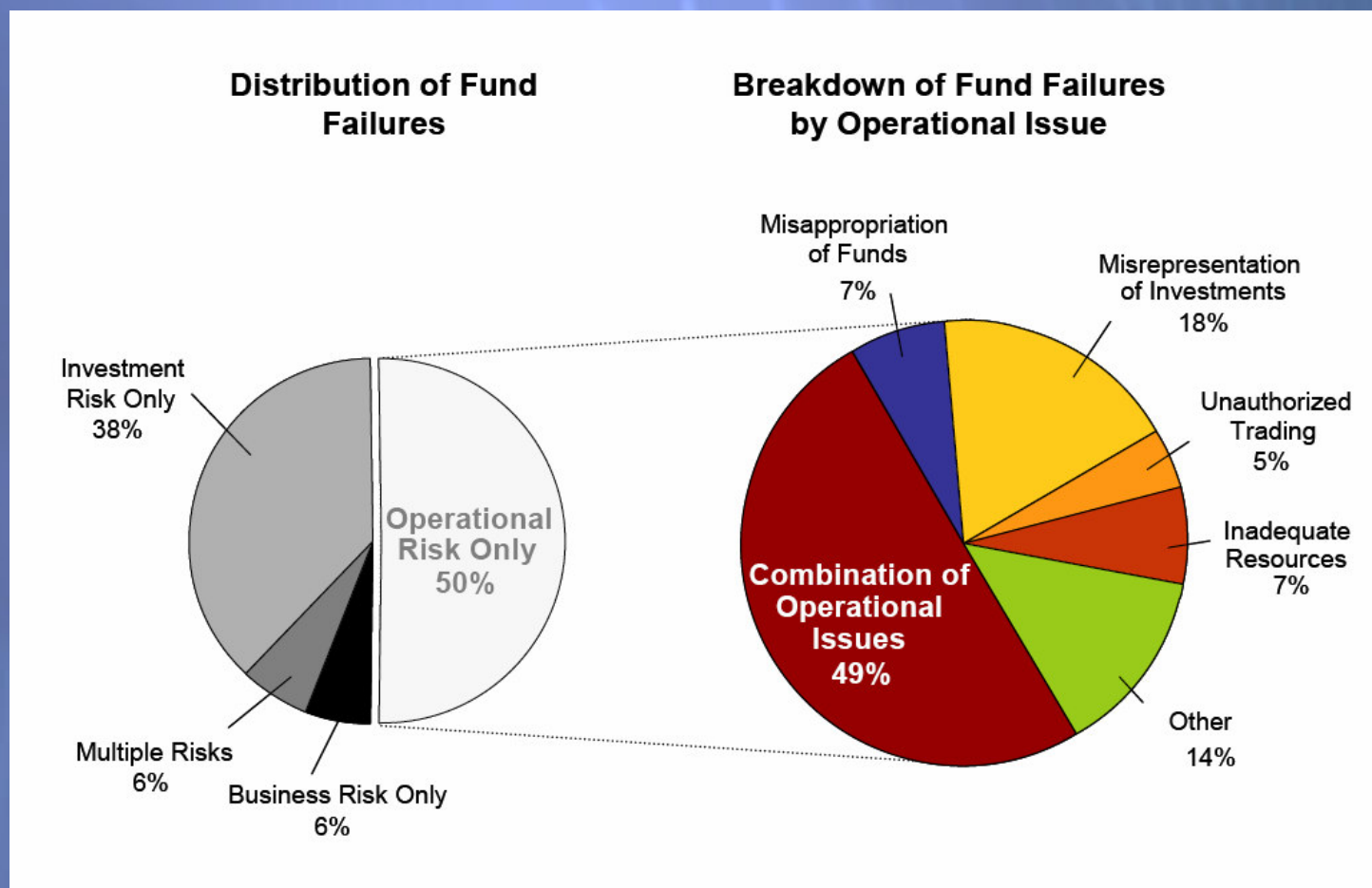
Recent Fund Performance

- ★ **Internet bubble burst**
 - ★ 2000 to 2002: S&P 500 had an average annual loss of 15.5 percent and the NASDAQ Composite Index lost 10.6% annually
 - ★ The average annual return for hedge funds during the same period was a gain of approximately 2.5%
- ★ **2004-2006**
 - ★ 2004 9%; S&P: 11%
 - ★ 2005: 9%; S&P: 5%
 - ★ 2006: 12% S&P: 15.8%
- ★ **February 2007**
 - ★ S&P 500: - 2%
 - ★ hedge funds: + 0.5-1%
- ★ **June 2007**
 - ★ S&P 500: -1.8 %
 - ★ DJIA: -1.6 %
 - ★ HFs: :+1.11 (HFR); + 0.8 (Hennessee Group)

Risks of Hedge Fund Investing

- ✦ Limitation on ability to diversify
 - ✦ Are correlated to markets to some extent
- ✦ Unique risk properties
 - ✦ When lose, relatively large losses
 - ✦ Increase correlation in downturns
 - ✦ May be correlated to each other
- ✦ Adding hedge funds may exacerbate such risks
- ✦ Tax issues may make funds less attractive

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 FUNDS AND SUBPRIME LOANS

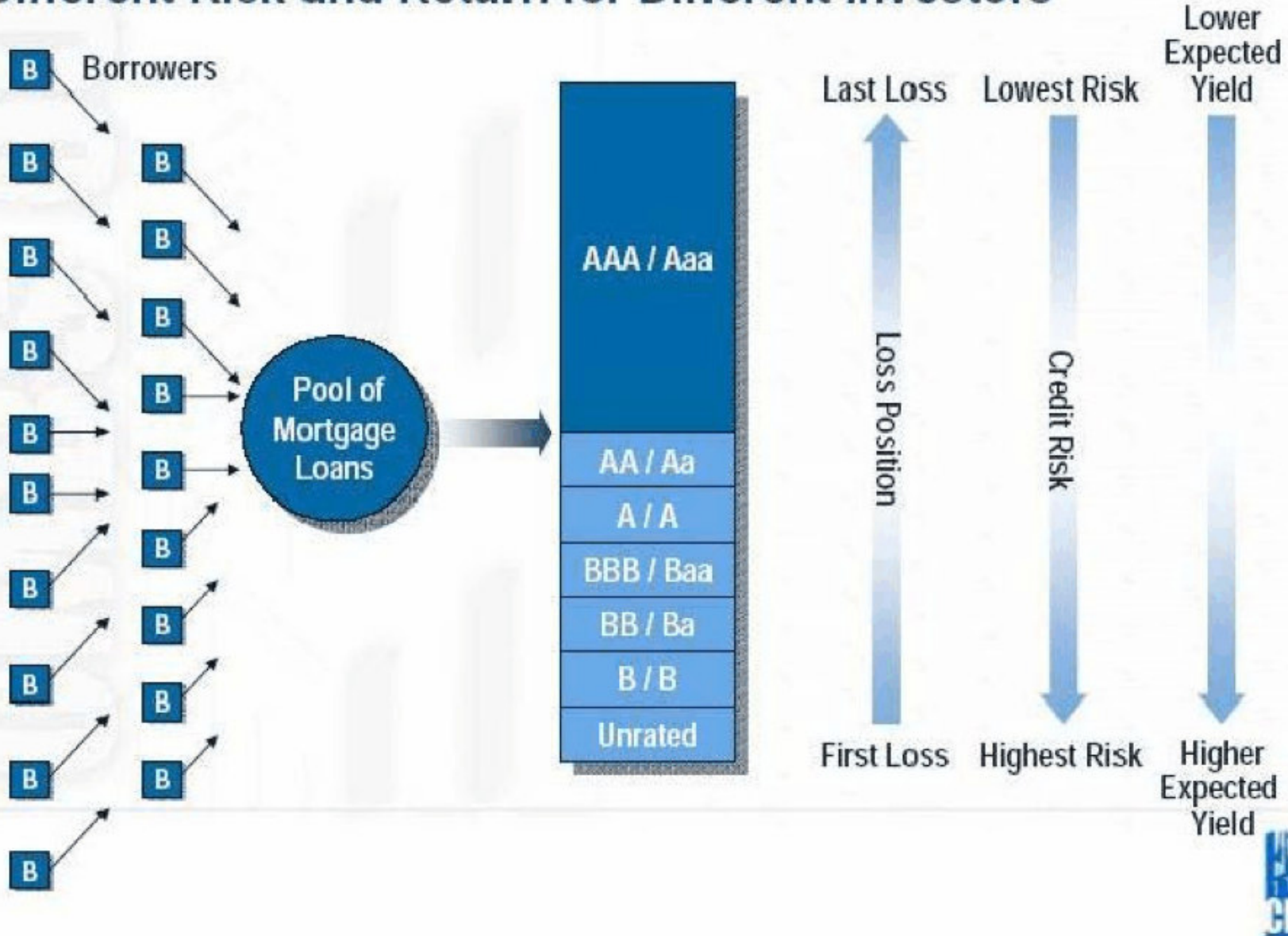
✦ Subprime loans

- ✦ Subprime loans are those to borrowers unable to qualify for standard loan
- ✦ Easy credit due to Fed lowering interest rates
- ✦ \$2.3 trillion issued from 2002-06
- ✦ Overall foreclosure rates at 2.43%, historic high
 - ✦ 4% for subprime; may go to 20-30%
 - ✦ 13.77% delinquency rate; may go higher
- ✦ Still net benefit to (subprime) home buyers

✦ Subprime and Hedge Funds

- ✦ Subprime loans are pooled into RMBS - residential mortgage backed securities
- ✦ RMBSs are rolled into CDOs and sliced into different tranches
- ✦ Hedge funds purchase riskiest tranches of CDOs using leverage from investment bank
- ✦ Value increases when housing market increases...
- ✦ ...value decrease as defaults increase and banks require funds to sell CDOs

Different Risk and Return for Different Investors



- ✦ Contagion?
- ✦ Bear Stearns hedge fund CDO losses
- ✦ losses seems to be contained to hedge funds investing subprime-backed CDO
- ✦ Downgrading of CDOs
- ✦ overall losses from subprime fallout
- ✦ The role of hedge funds in subprime losses
 - ✦ Spared mortgage brokers from having to absorb losses
 - ✦ Good to have HFs absorb concentrated risk of subprime
 - ✦ If subprime borrowers are going to default, best to have hedge funds and large financial institutions absorb the losses
 - ✦ By creating a market for subprime, added to the loans being extended in the first place
- ✦ Hedge fund regulation?