Do Hedge Funds Have a Future?

FRANKLIN R. EDWARDS

FRANKLIN R. EDWARDS is the Arthur F. Burns professor of free and competitive enterprise finance and economics at Columbia University's Graduate School of Business.

For a time during the Fall of 1998, hedge funds seemed to be on the front page of every newspaper in the world. Investors in some hedge funds took huge losses following the collapse of the Russian economy in August, which precipitated a stampede to quality, as investors everywhere tried to unload high-risk, illiquid securities and replace them with low-risk, liquid securities. The result was a huge widening of yield spreads between high-risk and low-risk bonds, causing some hedge funds to take big losses.

One of these funds was Long Term Capital Management (LTCM), which lost some $3.6 billion in the space of a few months during the Summer of 1998, which was nearly all of the $4.8 billion that it had under management. By September 1998, LTCM was no longer able to meet margin calls on its derivatives positions and was about to default on its $100 billion in loans, most of which were from major banks and securities firms. Fearing the worst, the Federal Reserve moved quickly to save LTCM from default by organizing a rescue by a sixteen-member creditor consortium, consisting of some of the biggest banks and securities firms in the world.

In justifying this action, Chairman Alan Greenspan said in his testimony before Congress:

> [T]he act of unwinding LTCM's portfolio in a forced liquidation would not only have a significant distorting impact on market prices but also in the process could produce large losses, or worse, for a number of creditors and counterparties, and for other market participants who were not directly involved with LTCM.... Had the failure of LTCM triggered the seizing up of markets, substantial damage could have been inflicted on many market participants...and could have potentially impaired the economics of many nations, including our own.

The potential message sent by this event was that hedge funds might be a lot more dangerous to both investors and the economy than was previously thought. Indeed, if the misadventures of a single wayward hedge fund with only about $4.8 billion in equity at the start of 1998 could take the U.S. or even the world economy so close to the precipice of financial disaster that the Federal Reserve felt impelled to step in, what might happen if a number of hedge funds got into trouble?

This fear, you probably remember, generated some pretty strong reactions following the LTCM debacle, ranging from what might be called the incredulous to milder assertions that "hedge funds are a

problem that needs fixing, probably with more government regulation and oversight." A flavor of the incredulity that followed the LTCM debacle can be seen in the following reactions:

- How could the collapse of a single hedge fund with less than $5 billion of money under management be such a threat to world financial markets that the powerful U.S. central bank felt impelled to organize its rescue?
- How could Long Term Capital Management, a hedge fund with superstar bond traders as managers and Nobel prize-winning financial economists as general partners, be so stupid as to lose almost $4 billion and in the process almost bring down the world's financial markets?
- When the extent of LTCM's leverage became known, how could so many of our best and brightest banks and securities firms have loaned so much money to LTCM?

There were also calls from regulators and politicians for more regulation to rein in hedge funds, such as:

- Assertions that hedge funds are nothing less than rogue, unregulated, out-of-control speculators, which pose a clear threat to financial stability. Indeed, some emerging market countries have even attributed crises in their currencies and securities markets to the actions of large hedge funds, going so far as to call certain hedge fund managers the modern-day equivalent of international highwaymen.
- Calls for more disclosure by hedge funds. In this vein, chairwoman Brooksley Born of the CFTC, in her recent congressional testimony, said:

> A lack of basic information about hedge funds' OTC derivatives positions, and the nature of their investment strategies and risk exposures potentially allows hedge funds to take positions that may threaten our regulated markets without the knowledge of any federal regulatory authority.

- A similar concern was raised by Representative James Leach, chairman of the house banking committee, who said:

> It would be imprudent and anti-intellectual not to seriously review the derivatives and hedge fund industries.

The issues raised by the collapse of LTCM are still very much alive, and are presently being studied by the President's Working Group on Financial Markets, as well as by virtually every other U.S. and international regulatory body. How these issues are resolved could have a substantial impact on the future of the hedge fund industry. What the eventual fallout from LTCM will be, of course, is anybody's guess. We must see what is proposed by the promised report on hedge funds by this group, and what the outcome of the Congressional hearings that will surely follow that report will be. We will see whether new regulations are in the offing, and, if so, whether these regulations will impinge on the future growth of hedge funds.

Also, once these issues are opened for public debate, and the politics and the interests of the competitors of hedge funds are introduced into the mix, anything can happen, and usually does. It is not hard to imagine the positions that some competitors of hedge funds might take.

Consider one example. The chief executive of none other than Fidelity Management and Research, Robert Pozen, said at an SEC-hosted conference in Washington that the lack of federal hedge fund regulation is a "total abdication" of regulatory responsibility. He added that this is a "class issue": Middle class investors, he claimed, are being harmed because many of the sharpest fund managers are forgoing mutual funds — which are open to any investor — to run hedge funds — which are open only to the rich. Mr. Pozen's solution? More SEC regulation of hedge funds and the requirement of symmetrical performance fees for hedge fund managers — in other words, make hedge funds like mutual funds.

The adoption of proposals such as these could put a serious crimp in the future growth of hedge funds. The key advantage of hedge funds is the freedom they enjoy from restrictive, costly, and, yes, misguided regulation. Hedge funds are lightly regulated for good reason: Their clients are wealthy and sophisticated investors. There is no good reason to protect these investors by constraining the activities of hedge funds. If competitors have their way, hedge funds will be brought under the same regulatory umbrella as mutual funds, the effect of which will be to eliminate hedge funds as we now know them. While the

possibility of restrictive and costly government regulation constitutes a serious threat to the future of hedge funds, it is not the only one. If hedge funds are to have a rosy future, they will also have to continue to provide the outstanding performance that they have in the past.

On average, hedge fund returns have been very good, even taking into consideration what happened in the Summer of 1998. In my study of more than 1,500 hedge funds over the period 1989 through August 1998 (Edwards [1999]), I find that an equally weighted portfolio of all hedge funds has an average annual return of 14.23%, while a value-weighted portfolio has an average annual return of 18.30%. These returns, which include some of the worst returns that hedge funds have ever experienced, compare very favorably to returns of 16.47% and 12.55% for the S&P 500 and the Russell 2000 indexes, respectively, especially given the unprecedented bull market we have had in stocks.

But how likely are hedge funds to be able to repeat this performance? To answer this question some thought must be given to at least three issues. First, do we have enough history to make accurate predictions about future hedge fund performance based on past hedge fund returns? We do not have much more than ten years of good data on hedge funds, and, as we all know, many investment strategies have been brought to grief by too great a reliance on such a short history of returns.

Furthermore, to the extent that hedge fund returns are related to stock market returns, placing too much reliance on the last ten years is even more suspect. Everyone agrees that the 1990s are probably an historical anomaly for stock returns. Second, are hedge fund returns high because they take greater risks? Alternatively stated, do hedge funds in fact earn abnormally high risk-adjusted returns? This is a difficult question to answer because it is not obvious just how to adjust for risk, or how to measure risk-adjusted returns. Should we use Sharpe ratios, or Jensen alphas, or four-factor capital asset pricing model alphas, or some other measure of risk-adjusted returns? Hopefully, further research will shed more light on this question.

Finally, assuming that we can agree that hedge funds have in fact earned exceptionally high risk-adjusted returns, we would still like to know "why?" What is it about hedge funds that enables them to generate abnormally high risk-adjusted returns? If markets are as efficient as academic research suggests, how is it that hedge funds can consistently earn above normal risk-adjusted returns? Any conceptional rationale for the high hedge fund returns, therefore, should probably begin with the premise that markets are not as efficient as many academics would claim. Indeed, even staunch believers in efficient markets will readily admit that price inefficiencies may exist when regulations restrict the flow of capital into particular sectors or into particular investment strategies.

Thus, one rationale for high hedge fund returns is what might be called regulatory arbitrage. Because hedge funds are relatively unregulated, they may be able to take advantage of market inefficiencies that exist because of regulatory constraints on other fund managers, such as mutual funds. Such restrictions might include constraints on short-selling, leverage, or the ability to take concentrated portfolio positions. This is certainly a plausible explanation. We have seen this kind of thing before in other industries and markets. Further, if this is the answer, it is good news for markets. After all, by doing what they do, hedge funds are making markets more efficient and are undoing inefficiencies due to what is probably unnecessary and unwise regulatory intervention in markets.

But there is another edge to this sword. To the extent that hedge funds are now exploiting market inefficiencies, how long can such high hedge fund returns persist? Will not the very success of the hedge fund industry itself succeed in eliminating whatever market inefficiencies exist, and, as a consequence, the abnormally high returns as well? As more money chases the price inefficiencies that now exist, such inefficiencies can be expected to disappear. Of course, there is no telling how long this might take.

Perhaps the more appealing explanation for high hedge fund returns is simply that hedge funds managers, as a whole, have superior skill. They may just be better than other fund managers. It is not, after all, unreasonable to think that the attractive fee structure used by hedge funds may succeed in enticing money managers with the greatest skill to the hedge fund industry. The remarks I cited earlier by Robert Pozen, who is head of the largest mutual fund complex, might be taken as evidence that this is in fact happening. Mr. Pozen, after all, is certainly in a position to know whether he is losing his best fund managers. A further benefit of the high incentive fees used by hedge funds may be that they provide a greater incentive for managers to perform well.

Among academics, the general topic of whether fund manager skill exists at all is a hotly debated one. Academic studies, in particular, have not had a lot of success in identifying and documenting manager skill in the mutual fund industry. But most of us would probably agree that those findings do not necessary rule out the existence of superior skill among fund managers. To start with, it is very difficult to measure and test for fund manager skill, and different performance measures and different statistical methodologies often yield quite different results. It is also not obvious which methodology is the correct one to use.

With respect to hedge funds specifically, it is certainly plausible that hedge fund managers may be found to have skill while mutual fund managers are found not to have skill. After all, the incentive fee structure used by hedge funds should be able to attract the most skilled managers to the hedge fund industry, just as Pozen says it does.

But let's return to the theme — do hedge funds have a future? Since the most immediate threat to the future of hedge funds is likely to come from overzealous regulators and politicians, it is important that we should have a view about how regulators and politicians should respond to LTCM's collapse and to the Federal Reserve's engineered rescue of LTCM.

First, despite LTCM's enormous losses and its near-demise, the problems associated with it should not be used to justify greater regulation of hedge funds. Hedge fund investors are by and large wealthy and relatively sophisticated investors, who need not, and above all, should not be protected by government. Wealthy investors have hundreds of alternative investment products to choose from, and thousands of mutual funds, hedge funds, and other money managers seek to manage their money. There is, therefore, no "investor protection" issue for hedge funds, like there is for investors in mutual funds or pension funds.

Hedge funds and wealthy individuals and institutional investors should be left free to strike their own deals with hedge fund managers, including just how much information they want managers to give them and what fees they are willing to pay to managers. Hedge fund investors have the ability and power to protect themselves — they should not be required to do it. If some investors fail to protect themselves, they will lose their money, which is as it should be.

In retrospect, it seems clear that the investors, creditors, and counterparties of LTCM may all have been blinded by the star-studded LTCM management team, and as a consequence, failed to take adequate precautions in their dealings with LTCM. They should, therefore, have suffered when LTCM tanked, and they did. That is the way we want markets to work. Thus, a healthy byproduct of the LTCM debacle is that it sends a strong message to investors, lenders, and counterparties that they need to protect their own interests when dealing with hedge funds.

The major issue raised by the collapse of LTCM, in my view, is not the inadequacy of hedge fund regulation but inadequacies in the regulation of banks and securities firms. It is the apparent vulnerability of some large banks and securities firms to an LTCM default that is the most worrisome aspect of the LTCM mess. This was clearly the impetus behind the Federal Reserve's engineered rescue of LTCM. The extent of the Fed's concern is a clear indication that there was a serious breakdown in the risk management procedures of banks and securities firms, and that the capital requirements imposed on these institutions, and the implementation and supervision of these requirements by regulators, were not all that they should be. Indeed, Chairman Greenspan's assertion that the Fed's assistance in rescuing LTCM was necessary to prevent markets from, in his words, "seizing up" can hardly be seen as a ringing endorsement of the present bank regulatory system. This system apparently did not work well enough to insulate some of our largest banks from the collapse of a single hedge fund.

A second issue raised by the Fed's intervention is whether there is something about the operation of off-exchange derivatives markets that makes these markets vulnerable to a major default by a major dealer or counterparty. Once again, banks and securities firms are at the core of the off-exchange derivatives markets. Trading in these markets is concentrated in the hands of a small number of banks and securities firms — the ten largest bank dealers, for example, are counterparties in almost half of all the contracts. The fear is that if one or more of these dealer/banks were either to fail or to withdraw from trading as a consequence of a major counterparty default, such as LTCM might have been, the results could be a chain reaction of defaults, possibly ending in a systemic breakdown.

The LTCM debacle reopens the issue of the role of banks and securities firms in off-exchange derivatives markets and whether the rapid growth of these markets constitutes a threat to international financial stability. A

proposal to strengthen the off-exchange derivatives market that has been made in the past is to create a clearing association for off-exchange derivatives (such as swaps) similar to the clearing associations in place for exchange-traded derivatives, such as futures contracts. While such a proposal may be worthy of consideration, what is clearly needed is more effective regulation of the banks and securities firms that serve as the core of this market. Their soundness is an obvious sine qua non for the stability of this market.

A related issue pertains to the accuracy of the mathematical value at risk (VaR) models that banks and bank regulators have been using to estimate the likelihood of the bank incurring a loss of a given magnitude, and which are increasingly being used to determine a bank's capital needs. LTCM had such a model; it clearly failed under stress. The estimates from any such model, of course, depend crucially on its underlying assumptions. But during periods of financial stress, such as August and September 1998, price volatilities may explode, asset prices that were thought to be relatively uncorrelated may become highly correlated, and common assumptions about the liquidation periods for assets become wildly optimistic. The result is often a far greater exposure than the model has predicted — which should inject a healthy skepticism about the wisdom of relying on such models to estimate exposures and to set capital requirements.

Finally, it is important to keep in mind that no amount of disclosure or rule-changing will subject banks and securities firms to more effective market discipline unless there are strong incentives for market participants to use this information. Short of a wholesale restructuring of the banking and regulatory system, such as adopting some form of collateralized bank system (Edwards [1996]), a proposal that deserves careful consideration is to require banks to maintain a certain proportion of their capital requirements in the form of uninsured, junior (or subordinated), short-maturity debt (for example, see Calomiris [1997]). Since subordinated debtholders would be subject to significant losses in the event of a bank insolvency, they would have a strong incentive to monitor banks and to demand the information to do this effectively.

Let me conclude, therefore, with a few recommendations for how I believe that regulators and policymakers should respond to the collapse and rescue of LTCM. First, they should ignore calls for more hedge fund regulation — such as calls for limits on hedge fund leverage or for limits on the fees charged by hedge fund managers, or even for more hedge fund disclosure. All of this just serves to divert the public policy debate away from where it should be. To the extent that hedge fund disclosure is inadequate or hedge fund leverage is excessive or fees are inappropriately high, the fault lies with those who are willing to trade with, or lend to, or invest in, hedge funds. Creditors and investors who make questionable judgments about hedge funds should bear the losses. Investor protection is not an appropriate rationale for hedge fund regulation.

Instead, public debate should focus on the risks of systemic financial fragility, and the ways in which the plight of LTCM became entangled with the solvency of some of our large banks and securities firms. The plight of LTCM's lenders and counterparties should serve as a wake-up call about deficiencies in the risk management practices of our largest financial institutions, and about deficiencies in the regulation and supervision of banks. These are the real threats to financial stability, not the aberrant behavior of a few hedge fund managers.

In short, the primary policy warning sent by the collapse of LTCM is clear: Neither bank regulation nor the risk management practices of our largest banks and securities firms are what they should be, and we need to find a way to fix what is wrong.

CONCLUSION

The question of whether hedge funds have a future depends primarily on whether my message gets through to regulators and policymakers. If new regulations strip hedge funds of their comparative advantages and make them more like mutual funds, their future will not be rosy. In the long term, of course, hedge funds also will have to continue to provide the kind of attractive returns that they have in the past if they are to have a future, and it will be especially important for them to do this when the returns on traditional asset classes are not as good as they have been in recent years. The next few years may provide the answers to both of these questions.

ENDNOTE

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