How competitive are hedge funds, and are they a help or a hindrance in driving the economy out of recession?

JONATHAN SHORTMAN*

Hedge funds are in principle the only form of investment which can profit from bear markets, that is a stock market where prices are expected to fall, though in practice most do not (Black 2002)[1] . In this essay I will argue that, in general, considering that hedge funds are designed to yield instant returns, they are quite competitive. In addition, because hedge funds can support entrepreneurship and business in general, they are more of a help than a hindrance in driving the economy out of recession. In this essay I will, amongst other issues, focus on the fact that hedge funds have had to adapt to the recession. As a result of evolving strategies hedge funds are becoming increasingly competitive. Although the recession has led to numerous investor concerns, it has ensured that profit is not the only consideration in the industry and that risk is properly accounted for. In addition the downturn in the economy has led to the strongest hedge funds remaining, with risky investments not being as frequent as before.

Hedge funds can be interpreted as an aggressively managed portfolio of investments that uses advanced investment strategies such as leveraged, long, short and derivative positions in both domestic and international markets with the goal of generating high returns (either in an absolute sense or over a specified market benchmark).[2] Legally, hedge funds are most often set up as private investment partnerships that are open to a limited number of investors and require large minimum investment. Investment in hedge funds is illiquid, as they require investors to keep their money in the fund for at least one year.

The purpose of hedge funds is that absolute returns focus strategies. It is very easy to understand the risks and profits of hedge funds. The higher risk is compensated by adjusted returns. Hedge funds allow for capital progression which has lower draw downs. There is also a lower correlation between equity and bond market returns, this means that they are not tied to each other, if one is performing badly; the performance of the other is not directly affected. The volatility of hedge funds is lower than equity markets, which is another advantage of hedge funds.

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* 2nd year BSc Student in Politics & Economics

[1] Oxford Dictionary of Economics p.208

[2] Investopedia.com

There are seven main ways in which hedge funds operate. The first is event driven, this strategy involves taking different positions in companies which are involved in takeovers, mergers, or acquisitions, or are in distress, in the hopes of predicting the effect that the event will have on their share prices. The second is known as global International which is investing either in established markets, or in more risky emerging economies. The third is global macro which seeks to benefit from global macro-economic changes and developments. The fourth method is simply known as long. This is simply taking a long position in a stock is what most traditional investors and mutual fund managers do - they predict that the value of the stock will rise. However, in a hedge fund, alternative financial instruments can be used. The fifth operative is market neutral, this involves taking both long and short positions in the same market or sector in order to offset risk - basically like betting on two sides of the same coin. The sixth convention is known simply as sector which is, as the name suggests, investing in a specific sector, for example financial services, real estate, or technology and communications. The seventh and final investment process is called short. This strategy involves finding overvalued companies, and selling borrowed stock in them in the hopes of buying it back later at a lower price.

When considering how helpful or dangerous hedge funds are it is important to bear in mind that hedge funds are mostly unregulated because they are targeted towards sophisticated investors and not the average consumer. In the U.S laws require that the majority of investors in the fund be accredited, this is a form of due diligence. The criteria is that investors must earn a minimum amount of money annually and have a net worth of more than $1 million, along with a significant amount of investment knowledge.[3] Hedge funds are seen by some as mutual funds for the super rich, though I believe this to be a simplistic idea of the concept. I would explain the concept of hedge funds as a means of investment with quick returns, into businesses that have the potential to grow extraordinarily quickly. This is shown by the growth of hedge funds making the medium more widely accessible, and if hedge funds boost entrepreneurs and businesses the wider economy benefits. Hedge funds are similar to mutual funds in that investments are pooled and professionally managed, but differ in that the fund has far more flexibility and perhaps less transparency in its investment strategies.

It is important to acknowledge that hedge funds do not necessarily make the economy vulnerable just by their intrinsic nature. Hedging is actually the practice of attempting to reduce risk, though the goal of most hedge funds is to maximise returns to investment, with risk not the main concern. Hedge funds first appeared in the USA on Wall Street in the 1940’s (Brown 2005).[4] The first hedge funds tried to hedge against the downward risk of a bear market by shorting the market (mutual funds can’t generally enter into short positions as one of their primary goals).[5] Nowadays hedge funds use several strategies which I will come onto next. Hedge funds do not simply just ‘hedge risk,’ because hedge funds make speculative investments, these funds can carry more risk than the overall market.

[3] Investopedia.com
[4] http://news.bbc.co.uk/1/hi/business/4499290.stm
[5] Investopedia.com

The strategies for hedge funds are constantly changing. Investors are now looking for long and short equity to take out the market risk. The global recession has had a massive impact upon hedge funds, with there being a clear difference between strategies pre and post 2008. Since 2008 the industry has shrunk from $2 trillion to $1.5 trillion and as a whole is relatively small. There has also been an increase in institutionalisation and returns are converging. 50% of all hedge fund assets are managed by 100 investment groups (Patel 2010)[6]. This could be argued to be not very competitive since an elite is emerging in the industry, since the competition base is being narrowed.

The global recession has led to numerous investor concerns. There is generally low confidence and an increase in redemptions. Hedge funds are experiencing losses in certain strategies, with fraud and fund closures. Bernard Madoff being a prime example of this. Investors are demanding higher due diligence from advisors. There has also been an increase in demand for transparency and reporting. The concerns of regulators have also risen as well as the general public. As well as a general demand for more regulation there is also seen to be a need for increased supervision and separation (Patel 2010)[7]. If this does takes place it may lead to increased competition in the industry.

There have been many evolving dynamics to hedge funds, partly because of the recession. Short selling had been banned (subsequently reinstated) and liquidity has been increased to stabilise the system. There has also been a desire for leverage and increased transparency. In the past there has certainly been a mismatch between expectations and strategy. As a result hedge funds are operating new strategies. 2008 was the first time there was negative growth in hedge funds, the previous 10 years had seen lots of growth particularly in London. High net funds are now declining. Pension funds are now an increasing share (Patel 2010)[8]. But the principle idea of supporting innovation remains, which is one of the main benefits of hedge funds. New technologies, markets and instruments are being used. Regulation has allowed for the opening up of local markets for allocation and specialisation.

When answering the question of this essay, I would certainly argue that hedge funds do not pose a risk to the economy. This is because hedge funds do not have a big enough footprint in the financial markets to bring the system to the brink of collapse- in the way that the demise of the merchant bank Lehman Brothers did. “Hedge funds do not pose a potentially destabilising credit counterparty risk across the surveyed banks” according to the FSA report dated 23rd February 2010, after questioning 50 London hedge funds and 14 investment banks (Moya 2010).[9] It can certainly be argued that hedge funds help to stabilise the economy. At the time the industry welcomed these findings as evidence which should silence criticism of hedge funds as a destabilising factor in markets. Certainly I would agree with this point because London Funds surveyed by the FSA, which have about $50 billion of assets under management, or 20% of the industry barely control 1% of the entire European equity market. This surely indicates that if the industry were to collapse, which I believe is highly unlikely, a sale of their assets

[6] Lecture by Tushar Patel
[7] Lecture by Tushar Patel
[8] Lecture by Tushar Patel
[9] www.guardian.co.uk/business/2010/feb/23/hedge/-funds-pose-no-risks-fsa

would not pose a big enough risk to destabilise the system. Although hedge funds were blamed for making the credit crunch worse by betting on falling shares such as the Royal Bank of Scotland's, by 'going short' which was temporarily banned, this strategy has now been re- introduced so 'going short' can't be felt by the regulator to be entirely undesirable otherwise it would have been banned permanently. Contrary to market perception, the average 'leverage' or debt used by hedge funds to invest, is about twice their assets- compared to about 30 times used at large retail banks (Moya 2010).[10] 'While these are large numbers, they are manageable in the context of the overall credit risks and capital requirements of the surveyed banks,' the FSA report states. When faced with statistics and quotes like this it is hardly surprising that hedge fund participants have warned that regulators should focus on activities other than hedge funds,- such as selling of derivatives, which is a multi- billion dollar market where investment and trading is not recorded on any public exchange.

Returning to the competitiveness of hedge funds, apart from the narrowing of the competitive base itself (as discussed earlier) it can certainly be argued that hedge funds are becoming increasingly competitive in other respects. This is shown by growth in the sector, and rising demand from institutional investors. Hedge fund managers, once preoccupied only with performance, are now just as concerned about the impact that infrastructure, and risk management issues can have on their business (ftmandate.com 2005).[11] As a result of the pressure of competition, firms are finding it harder to differentiate between each other and have to demonstrate risk managements skills as well as performance. The market is in effect gradually maturing. David Butler, founding member of Kinetic Partners a London based asset management consultancy firm, who have surveyed hedge funds has said: "I think that managers and investors influence each other, What we are seeing now is a level of maturity among the largest players. With that maturity there is a need to understand risk management processes and procedures. With the education of investors - and the influx of institutional assets - comes another driver for risk management processes (ftmandate.com 2005)."[12]

There are many advantages to hedge funds. As I earlier indicated hedge funds are a lot more flexible than mutual fund counterparts. This is because they are governed by a different and more accommodating regulatory system than traditional funds. This enables them to use instruments and strategies not available to conventional mutual funds in order to secure greater profits and investment opportunities, and minimise risks. Hedge fund managers are able to change style or strategy used without prior investor consent, and the types of styles available are large. Hedge fund managers are able to adjust and change strategies as market conditions change and events take place. Hedge fund managers are usually highly skilled and experienced, as the system and rates of remuneration and compensation

[10] www.guardian.co.uk/business/2010/feb/23/hedge/-funds-pose-no-risks-fsa

[11] http://www.ftmandate.com/news/fullstory.php/aid/915/Hedge_funds_grow_up_under_pressure_from_competition.html

[12] http://www.ftmandate.com/news/fullstory.php/aid/915/Hedge_funds_grow_up_under_pressure_from_competition.html

for successful managers tend to be very attractive (Maxwell 2008).[13] Hedge fund managers are heavily invested themselves into the performance of investments so have a very strong incentive to make sure the hedge fund performs well as they are personally involved. This is in stark contrast to mutual funds managers who base their fees on the volume of assets invested in, rather than performance.

There are however many disadvantages to hedge funds such as a lack of competitiveness in some areas and a risk to the economy. The way that hedge fund managers are paid can encourage shrewd investment. However it can also lead to excessive risk taking and over exuberance, in order to try and ensure that the fund is productive. The relative modest regulation of hedge fund sectors in most countries can lead to investment in very volatile areas and even the collapse of large firms. An example of a large firm's demise is the disintegration of Long Term Capital Management (Maxwell 2008).[14] This can also enhance the public's perception of excessive risk in the industry and create general panic. Another disadvantage is that managers are secretive about their investments and there is not a lot of reporting in the industry. However the nature of the industry dictates that this needs to be the case more often than not. Regulators have always been keen that domestic inexperienced investors are not exposed to any more risk than is necessary. A further negative perception of hedge funds is that they can be seen as a privilege for the super rich, whilst everyone else is exposed to their risks. However I believe this is a very narrow view as it does not take into account the fact that the growth of hedge funds is leading to more individual investors taking part. Also people in general, through the economy, all benefit from hedge funds. This is shown by the fact that academic research conducted over the past few years has shown that hedge funds have had higher historical returns than traditional stock and bond investments of similar risk (Maxwell 2008).[15]

Although I believe that despite the disadvantages to hedge funds these are clearly outweighed by the benefits, there is a very recent case study which illustrates that the costs of hedge funds can be quite dominant. The recent sale of Cadbury's to Kraft can be used as an argument to disenfranchise hedge funds. During the sale of Cadbury, short- term traders and hedge funds increased their holding in Cadbury during the course of the takeover battle from just 5% to 31% (Peston 2010).[16] These holders wanted only one outcome, the sale of Cadbury, because only through a sale could they lock in their capital gains. Here there is a clear conflict of interests. Roger Carr, who has just stepped down as Cadbury's Chairman has said: "It was the shift in the [share] register that lost the battle for Cadbury. The owners were progressively not long- term stewards of the business but financially motivated investors, judged solely on their own quarterly financial performance. At the end of the day, individuals controlling shares which they had only owned for a few days or few weeks determined the destiny of the company that had been built over almost 200 years." If this is seen as a problem, and there are those who believe it is not, though I would argue that at least a close eye needs to be kept on situations like these, then there may need to be action taken. Vince Cable, Liberal Democrats' Treasury spokesperson

[13] http://www.investorsoffshore.com/html/features/feature_hedge.html
[14] http://www.investorsoffshore.com/html/features/feature_hedge.html
[15] http://www.investorsoffshore.com/html/features/feature_hedge.html
[16] Robert Peston article

has argued on the Today Programme (Wednesday 10th February 2010) that investors should have to hold shares for a few months before being able to vote with them (Peston 2010)[17]. A disadvantage to this though is that differentially weighting votes on shares based on longevity of ownership would tend to entrench incompetent managers and poor performing companies. The counter- argument to this is that managers nowadays are more highly skilled than ever before. I would suggest the main thing to bear in mind from this case study is that while hedge funds can help drive the economy forward, some traditional institutions may need protection. This will enable British jobs to be protected, - most importantly in this present uncertain economic climate, although this may be criticised as uncompetitive behaviour.

In conclusion, when answering the question I would argue that hedge funds are reasonably competitive and are more of a help than a hindrance in driving the economy out of recession. Hedge funds are simply investment strategies designed to yield maximum returns. With their main purpose that absolute returns focus strategies. The main arguments in support of hedge funds being competitive are that they drive and are driven by economic growth, growth in the sector and increased demand by institutional investors. However the counter argument to this is that there is a narrowing of a competitive base with a smaller amount of larger firms dominating the industry. However I believe that hedge funds on the whole are competitive because firms have to find new ways to differentiate themselves and profit is not the only concern. Although there is relatively modest regulation and other disadvantages to hedge funds such as they can be excessively risk taking and can be perceived as a privilege for just the super rich, I believe the benefits outweigh the costs. This is because advantages such as the evolving nature of the industry, attempts to reduce risk and the fact that the industry is not large enough to damage the economy should it collapse are more significant than the drawbacks. However the takeover of Cadburys does demonstrate some disadvantages of hedge funds, whereby relatively new shareholders can have most influence and not have the company's long term interests at heart. To surmise I would argue that hedge funds are specialised investment designed to maximise returns, are very competitive by nature and are more of a help than a hindrance in driving the economy out of recession.

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[17] Robert Peston article

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