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A hitchhiker's guide to hedge funds

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The villains of global finance deserve a better reputation

MAHATHIR MOHAMAD, prime minister of Malaysia, called them the "highwaymen of the global economy". Others have described them as "buccaneers" and "gunslingers". Modern currency crises—the fracturing of Europe's exchange-rate mechanism in 1992, the Mexican peso crash in 1994, the collapse of East Asia's currencies in 1997, and the recent attacks on the Russian rouble—are often blamed on them. By placing aggressive bets on currencies, the argument goes, hedge funds destabilise financial markets and drive fragile economies to the wall. Many politicians clamour for greater regulation. The more extreme suggest that the world would be better off without them.

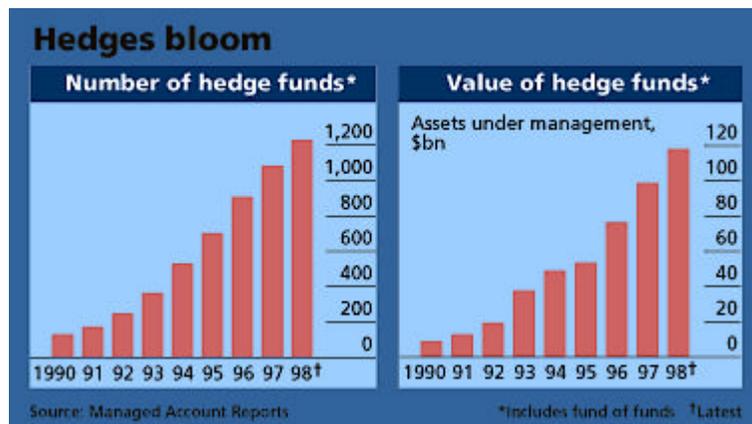
It is easy to see why hedge funds are hated. By accepting money from limited numbers of very rich individuals or institutional investors, and (in many cases) by basing themselves in places where regulation is lax, hedge funds escape the standard reporting requirements faced by mutual funds. This makes it hard to gauge hedge funds' size or understand their strategies. Their most publicised activities, such as using derivatives to speculate heavily on interest-rate or exchange-rate movements, are hardly the kind of activity that will endear them to politicians. But much of the opprobrium hedge funds face is based on ignorance. As a new study by economists at the International Monetary Fund* shows, many of the charges laid against them are incorrect. In general, the IMF reports, hedge funds make financial markets more stable, not less so.

The term "hedge fund" dates from the early 1950s. Initially, it described collective investment vehicles, often organised as private partnerships, that specialised in combining two investment techniques, short sales (borrowing a security and selling it in the hope of being able to repurchase it more cheaply before repaying the lender) and leverage (buying securities with borrowed money) in a way that reduced risk. By shorting a basket of stocks to protect against a general drop in equity prices, and then borrowing money to buy particular shares they deemed undervalued, these funds "hedged" their positions so as to prosper whichever way the market moved. Hence the name.

Modern hedge funds are a far more eclectic group. They share only one important characteristic: compensation strategies. Typically, hedge fund managers are paid a modest management fee, but receive a hefty 15-20% or so of any profits the fund makes. Some critics, including the most noted hedge-fund manager of all, George Soros, argue that this structure creates incentives to take inordinate risks, because managers share the upside if the risks pay off but not the downside should the risky strategies fail. However, the fact that many hedge-fund managers put their own capital into their funds may mitigate this risk.

Some hedge funds pick individual securities in a very traditional way. Those denounced by politicians do something different. These "macro hedge funds" like to take positions in currencies, usually unhedged, based on an analysis of various countries' macroeconomic fundamentals. If a country's economic policies look inconsistent, and its ability to sustain its exchange rate is questionable, the funds take a bet on devaluation, usually by selling the currency short.

The IMF researchers, led by Barry Eichengreen and Donald Mathieson, find that these "macro funds" are not to blame for currency crises. For a start, there are relatively few funds, and the amount of money they control is small. Precise numbers are impossible to obtain as the funds are not subject to rigorous reporting requirements, but according to one estimate (see [chart](#)) there are about 1,200 hedge funds worldwide, of which only about 60 are macro funds. Altogether, hedge funds have about \$118 billion under management, with macro funds containing approximately \$30 billion.



That may sound a lot, particularly if hedge funds leverage their capital. But consider that the assets of rich-country institutional investors exceed \$20 trillion. Hedge funds are bit players compared with banks, mutual or pension funds, many of which engage in exactly the same types of speculation.

Follow the leader

Some critics have suggested that hedge funds are disproportionately important because other investors follow their lead. The IMF's study finds that this may have happened in the 1992 European crisis, when hedge funds were the first to sell certain currencies short. But it finds no evidence that hedge funds were similarly far-sighted in Mexico in 1994 or in Asia last year. If anything, hedge funds trailed the pack. Most hedge funds' forward sales of the Thai currency, the baht, occurred in May 1997, well after domestic firms and international banks had bet that the baht would collapse.

Equally mistaken is the idea that hedge funds' actions are always destabilising. Hedge funds have more freedom than other institutional investors, allowing them to take more contrarian positions. Nor are there internal controls that might force them to sell into a tumbling market. There is evidence that hedge-fund purchases helped support the Indonesian rupiah last autumn, when other investors were dumping the currency.

Another recent study published by the National Bureau of Economic Research** uses careful statistical analysis to examine the role of hedge funds in the Asian crisis, particularly their impact on the Malaysian ringgit. Hedge funds did take large positions in the ringgit and other Asian currencies last year, and the actions of some of the largest funds do seem to have been correlated. But there was no evidence that the fund managers "moved" exchange rates. In fact, many hedge funds seem to have been buying ringgit rather than selling. Not only are hedge funds less consequential than their reputation, but they are also less omniscient.

*?"Hedge Funds and Financial Market Dynamics". IMF Occasional Paper 166. May 1998.

**?"Hedge Funds and the Asian currency crisis of 1997". By Stephen J. Brown, William N Goetzmann and James Park. NBER Working Paper No 6427. February 1998.