

Could hedge funds hurt the U.S.?

The money invested worldwide now dwarfs the GDP of many developed countries. Isn't that risky?

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NEW YORK (CNMMoney.com) - Do hedge funds harm or help the economy?

That question was raised recently not by concerned regulators or central bankers but by one of the most famously successful hedge fund managers in the world.

Speaking at a forum on the capital markets in New York last week, David Shaw, whose D.E. Shaw firm runs about \$19 billion in assets, noted that the total pool of assets run by firms described as hedge funds stands at an estimated \$1.3 trillion world wide -- bigger than the gross domestic product of many countries and large enough to move markets around the world.

But could the combined capital of some funds actually swing the markets in ways that could hurt you?

"The short answer is, I don't know. Nobody knows," said Andrew Lo, director of the MIT Laboratory for Financial Engineering and a principal at the hedge fund Alpha Simplex Group. "The reason for that is, we don't have enough data on the particular exposures we need to measure to answer that question."

In his speech last week, Shaw noted that as more and more people start hedge funds -- there are an estimated 8,000 world wide -- it becomes harder to generate so-called alpha, or big, returns.

That can lead less experienced managers to venture into areas that fall outside their realm of expertise in the hope of generating big performance-related fees, managers say.

"The fact that hedge funds have become so important is really the flip side of problems that could be generated," said Lo. "If they ceased to function in the way they are designed, that would create a fair amount of systemic risk."

Jim Melcher, who runs a New York-based hedge fund called Balestra Capital, said hedge funds have the potential to cause "enormous disruption."

"I'm not worried about 8,000 hedge funds," said Melcher. "I'm worried about 400 or 500 of them -- that's what could start the ball rolling down the hill. While most hedge fund managers are pretty smart and knowledgeable, it doesn't take too many to start a rout. One nervous cow and you could start a stampede."

But there are benefits too

Mike Hennessy, managing director at North Carolina-based fund-of-funds shop Morgan Creek Capital Management, called for perspective on the role hedge funds play in the capital markets.

"They're still a much smaller part of the market than traditional equity and bond markets," he said. "There are too many players who are not skilled, and if you take the industry as a whole, returns are tepid, but like any alternative asset class, if you look at the top quartile, you are getting superior money management."

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What makes a fund a hedge fund? It's usually only open to wealthy investors, worth \$1 million or more, and managers charge eye-popping fees to get in. Investors typically pay a 1 percent management fee and at least 20 percent of profits.

Capturing data on hedge funds is difficult, but the funds have grown exponentially, considering that in 1990 they managed a collective \$38.9 billion, according to Chicago-based hedge fund tracker Hedge Fund Research.

"One of the important aspects is to recognize what a broad universe of investment strategies hedge funds comprise," said Robert Birnbaum, president of Third Wave Global Advisers, a Greenwich, Conn., hedge fund that focuses on broad economic trends, so-called global macro trading.

Birnbaum noted that while some funds invest in hedged stock portfolios, others buy the debt of developing companies and still others invest in distressed companies.

"So many managers act in such different ways that it's almost impossible to imagine every fund that's classified as a hedge fund acting in a similar manner," he said.

Shaw noted hedge funds can and do provide benefits to financial markets worldwide.

They make capital markets more efficient by finding inefficiencies in the markets. For example, hedge funds that employ "arbitrage" strategies simultaneously buy and sell separate but related instruments to profit from the difference, helping close discrepancies in some prices, Birnbaum pointed out. And they help banks and other institutions unload some of their risk.

In addition, short sellers at hedge funds have uncovered fraudulent activity at public companies, while activist hedge fund managers have held corporate boards of directors accountable to shareholders.

Hedge funds also provide liquidity to the capital markets. Alan Greenspan has publicly supported hedge funds for this reason.

Still, some managers remain concerned.

Balestra's Melcher, whose firm manages about \$150 million, says his fund has had very good gains -- about 300 percent since its start seven years ago -- but he has always made risk control the number one priority.


"That's not necessarily the way a lot of funds are managed," he said.

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