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Could a Few Hedge Funds Spoil the Party?

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WHEN the Long Term Capital Management hedge fund was sinking in 1998, leaders of the Federal Reserve were worried. They feared that if the fund failed, a major disruption could be set off in financial markets, with dire consequences for the global economy. Indeed, that worry was the impetus for the hastily arranged bailout of the fund. Since then, the financial system hasn't faced a similar test. At least not so far.

Lately, though, there have been signs that hedge funds are again taking on big risks. That's not to suggest that a crisis is imminent, but the situation does raise important questions: While the rewards of hedge fund investing are well known, what about the downside? Could the actions of hedge funds again threaten the economy?

The numbers involved are enormous. At its near-collapse in 1998, Long Term Capital Management held \$5 billion of its investors' money. In the seven years since then, the hedge fund industry as a whole has nearly tripled in size, now wielding more than \$1 trillion in invested funds. With so many more funds and so much more money, it is becoming a lot harder to be confident that the industry is being responsible.

And the incentive to take risks with all that money is huge. A typical fee structure, called "2 and 20," gives managers 2 percent of the assets under management and 20 percent of gains realized by the fund. At large funds, this means that a single year's winnings can set up the managers for life. But as more funds pile into the winning strategies of the past, competition inevitably shrinks profit margins. And that has tempted managers to find new, sometimes riskier ways to maintain their spectacular returns.

The crowding effect is visible in some markets, particularly fixed income and convertible arbitrage, which hedge funds have come to dominate. In May, in its latest report on global financial security, the International Monetary Fund found that hedge funds might account for 80 to 90 percent of all participants in those markets. Because of that high concentration of hedge funds, the I.M.F. warns of trouble. It found that those funds, if stressed, might find themselves all selling at once, putting a strain on the entire financial system.

How can outsiders judge the risks of hedge funds? Ever since the Long Term Capital bailout, hedge fund leverage has been a concern for regulators and parties dealing with the funds. Leverage is attractive to hedge funds because it lets them make much bigger bets than they could otherwise. By taking large leveraged positions, hedge funds benefit handsomely when things go right. But when things go wrong, losses are similarly multiplied.

Return to Long Term Capital for a moment. Starting with just \$5 billion in capital, the fund was able to get \$125 billion in additional funds. Using that leverage, it took on trading positions with an estimated potential value of \$1.25 trillion. Despite the fund's seemingly brilliant strategy, the high leverage meant that it didn't take much of a setback to wipe out the fund's underlying capital. And the potential freezing of \$1 trillion worth of positions, even temporarily, was seen as a major risk to the system.

What is happening to leverage today? Timothy F. Geithner, president of the Federal Reserve Bank of New York, discussed the issue in a recent speech. In his view, leverage in the industry has decreased, on average, since the 1998 bailout. Over the last year, though, the Federal Reserve and the I.M.F. have noticed that leverage is creeping back in some areas, probably because of heightened competitive pressure.

The trouble is that average leverage isn't really a good indication of the risks involved. Even if the industry is generally healthy, a couple of very bad apples could spoil everything. After all, the Long Term Capital Management crisis started with just one fund, not the whole industry.

On that score, there has been talk on Wall Street about risky hedge funds. In particular, some traders who deal with hedge funds suspect that leverage in some cases today exceeds that of Long Term Capital Management. And borrowed money isn't the only reason. Traders concern themselves with a broader measure called economic leverage, which takes borrowing into account but also includes risks like those arising from derivatives and other complex financial arrangements. Economic leverage can be high even when borrowing, or balance-sheet leverage, is moderate.

Another concern involves hedge funds that invest not in the markets, but in other hedge funds. These "funds of funds" sometimes employ leverage as well, creating a layering effect. The financial partners who lend to or trade with funds of funds take on some of the extra risk, increasing overall risk to the financial system. Similarly, leverage is created by offering specially constructed products to hedge fund investors.

FOR regulators and the public, the available information on leverage is not terribly comforting. Hedge fund research groups rely on voluntary reporting from the funds. This means that the data they collect reflects only a self-selected slice of the industry putting its best foot forward. A 2003 study by the Center for International Securities and Derivatives Markets found balance-sheet leverage at hedge funds ranging from less than one times capital to 25 times capital. But because hedge funds can shift positions or increase leverage almost instantly, it's not clear that a static snapshot conveys the information needed.

True economic leverage is nearly impossible to understand without full disclosure of all of a hedge fund's commitments. This means that many decision makers - at banks, in government and on Wall Street - are merely guessing at the risk components they can't see. Individual funds have all the relevant facts pertaining to themselves, but nobody has the complete picture. And that may be the biggest risk of all.