Why Fear Hedge Funds?

By Christopher Mayer

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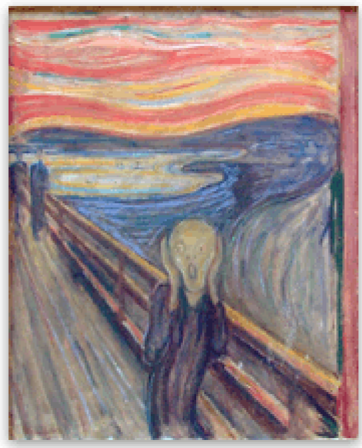
In the great American game of poker, the best players think in terms of mathematical expectation and long-term probabilities. It is the hallmark of a bad player to think in terms of immediate results to the exclusion of the long-term.



Poker players well understand that the best players can be beaten in any specific instance. In a famous and often-retold episode, world-class player Bobby Baldwin had a substantial lead over the eight remaining players going into the last day of the 1981 world championship. But, as recounted in David Sklansky's *Theory of Poker*, he was eliminated in a matter of hours when two opponents outdrew him on 22-to-1 shots.

Government officials and the advocates of increased financial market regulations are like those players that consistently draw at those 22-to-1 shots.

There are certain economic fundamentals that simply cannot be ignored. While the effects of ignoring them may be muted or altogether undetectable for awhile, repeated intervention into the natural workings of markets can only lead to disaster.

New York Attorney General Eliot Spitzer must not play poker; certainly he doesn't read Mises. Spitzer is a man that sees the world as a moviegoer watches a film. He sees it as a world of good and evil, a world with protagonists and antagonists, and a world with simple resolutions. In this view, he has much in common with everyday folks who think little upon economic events and their underlying natures.

As Mises wisely observed, "a large segment of public opinion looks upon economic events…with the eyes of the public prosecutor looking for guilty parties who need to be punished." Particularly, it might be added, during bear markets.

For bear markets manufacture nothing if not villains. Hedge funds are one such manufactured villain. Hedge funds are pools of lightly regulated capital that are free to, as Roger Lowenstein writes in *When Genius Failed*, "sample any or all of the more exotic species of investment flora, such as options, derivatives, short sales, extremely high leverage and so forth."

They are private partnerships, often for the very rich (although this is changing, see *The Wall Street Journal's* January 23rd piece titled "Hedge Funds for the Masses"). They do not have to register with the SEC, though they are still subject to securities laws and rules that pertain to who may invest in such vehicles.

The number of hedge funds in existence has tripled over the last decade and there are now over 6,000 such funds, reports *The Wall Street Journal*. The assets under their command have also grown, from $67 billion to over $600 billion.

A famous example of a hedge fund would be Long-Term Capital Management. Yes, that's Long-Term

Capital Management—the collapse of which caused much financial distress in 1998.

And yes, hedge funds are prominent short-sellers—those widely detested market players that profit when a stock declines. As Holman Jenkins of *The Wall Street Journal* recently observed, "short-selling is a business widely unpopular with everyone who has a stake in seeing stock prices go up—not least because of the suspicion that short sellers are engaged in the business of self-fulfilling prophecy."

And so, many companies have long complained about these hedge funds for disseminating negative information about their companies. Another *Journal* piece ("Regulators Review Complaints About Hedge Funds," January 22nd) notes that such complaints now have the ear of regulators. "Mr. Spitzer and the SEC are examining complaints from companies whose stocks were hit after negative research by hedge funds. The companies include MBIA, Inc.; Federal Agricultural Mortgage Corp., known as Farmer Mac; and Allied Capital Corp."

These companies say that several hedge funds were "working in concert…to spread negative information about their stocks". No one ever worries about brokerage houses "working in concert" to disseminate positive information.

Now the average man on the street is not going to get worked up over what happens to hedge funds. His coffee is not going to taste any better, his wife is not going to look any prettier and his life, he will think, will go on largely as it has before whether hedge funds exist or not.

In his "History of Hedge Funds," Mario Gabelli writes, "if asked to define a hedge fund, I suspect most folks would characterize it as a highly speculative vehicle for unwitting fat cats and careless financial institutions to lose their shirts." And that is part of the public relations problem that hedge funds have.

John Brooks, in his book *The Go Go Years*, could write that in 1965 hedge funds were "Wall Street's last bastion of secrecy, mystery, exclusivity and privilege," a statement that is perhaps still true today. (Never lacking for good metaphors, Brooks wrote that hedge funds were the "parlor cars on the new gravy train").

Therefore, for men trying to build a public reputation—like sheriff Spitzer et al.—hedge funds provide a soft easy target. They are not likely to have many defenders and they are shadowy figures anyway in the eyes of the public.

By such small measures, though, markets begin to lose their potency.

First, there must be some words said for the simple freedom of men to associate and pool resources to take risks that they desire and choose.

If hedge funds can be regulated or inhibited from selling short, for example, what is next? Ban mutual funds that invest in tobacco companies or other sin stocks? Ban investors from betting against a rise in the dollar? Prohibit investors from owning gold? (Oops, that's already been done before.)

There can be no end to the machinations used to achieve some policy goal. And that's what the regulatory witch hunt against hedge funds amounts to—the desire to achieve a policy goal: a rising stock market. Like any policy goal—eliminating unemployment or eradicating poverty—it is unachievable with the blunt instruments of government force. Worse, they have the usual effect of backfiring.

Short-sellers, as a recent *Economist* article noted, "are among the first to spot trouble." David Tice, a prominent short-seller, was long harangued by Tyco for his negative view on the company. As the *Economist* reports, "Not long before Tyco went bankrupt it was still buying full-page advertisements to campaign against short-selling."

There is also the example of Jim Chanos, another short-seller, who detected problems at Enron well-before its meltdown. Manuel Asensio, another well known short-seller, wrote a book a couple of years ago titled *Sold Short* in which he relates many episodes in which his quest to make money on the short side uncovered stock fraud and other brands of corporate mischief.

Suppressing short-selling with tighter regulation of hedge funds amounts to stifling the market's ability to police itself. Tying down short-sellers is like dimming the lighthouses in the midst of a storm. *The Economist* opined that "Constraints on short-selling allowed stocks to become more overvalued during the most recent bull run...More short-selling then might have made the bear market less painful now."

A market is only a means to an end; it a process set in motion by the actions of individuals and their valuations. It works as a means to satisfy various ends because, when unfettered, the pricing mechanism has a wonderful way of allocating scarce resources. Financial markets also provide strong built-in incentives to police themselves, since there is money to be made doing it.

Regulating hedge funds may result in no immediate discernable effect on financial markets. Life goes on as it has before. The public cares not a whit. Those who take the path that government should not intervene in financial markets will find it lightly traveled.

Repeated interventions, however, pile up over time. Leonard Read, I believe, used the analogy of a sponge. It can soak up only so much mess before it loses its ability to perform its basic function. It is the same with markets. What we need is more freedom in our financial markets; less regulation, not more.

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