

Response to the "Statement of the Financial Economists Roundtable on Hedge Funds"

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Abstract

Following its meeting in Sonoma, California on July 10-11, 2005, the Financial Economists Roundtable (FER), an international group of senior financial economists, issued a statement in which it warned about the risks involved in investing in hedge funds. The FER notably considers that the investment strategies of hedge funds are very risky, with a small likelihood of extreme loss, and that the management fees are very high. The FER feels that these and other risks are not understood by all investors.

The recommendations put forward by the FER include a limitation on investment in hedge funds to a low percentage of assets under management; a commitment by regulators not to rescue troubled hedge funds; and the standardization of performance and risk measures among hedge funds.

In this paper, the EDHEC Risk and Asset Management Research Centre, which has carried out a multi-faceted research programme on hedge funds over the past three years, provides its response to the abovementioned statement and comments on the FER's recommendations.

The full text of the FER statement can be found in Appendix 1. For more details on the role and composition of the FER, please refer to Appendices 2 and 3. The structure of this paper follows that of the FER's statement.

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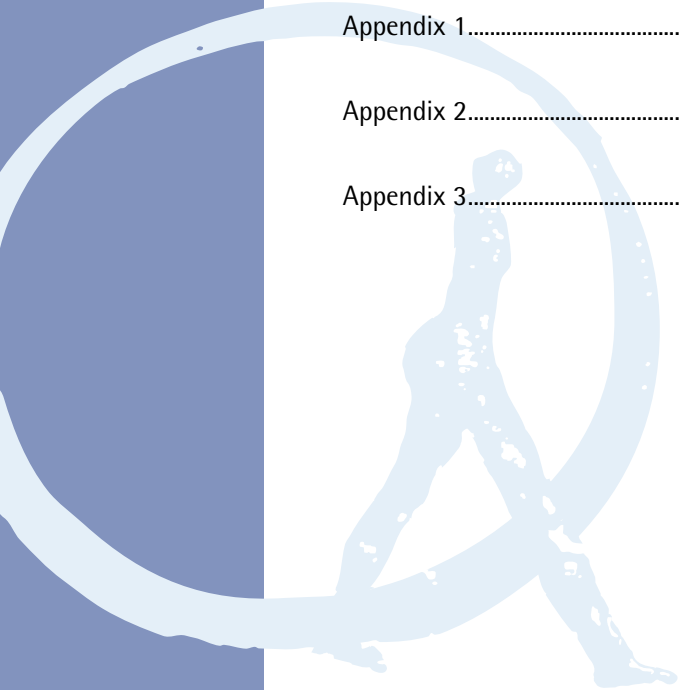
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1. Observations and Concerns

1.1. Understanding returns, expenses, and risk

The FER's statement stresses investors' lack of understanding of the risk/return profile of hedge funds. We agree with this, but we would be inclined to be slightly more nuanced in our analysis. A recent study by EDHEC (see EDHEC (2005a)) has highlighted the fact that despite an increasing awareness of the pros and the cons of hedge fund investing, institutional investors are still at a loss when it comes to assessing the risks of their hedge fund investments, and to integrating the results of this assessment in the risk analysis of their global portfolio.

The FER statement then emphasizes the so-called 'exit risk'. It points out that investors often underestimate one of the side effects of hedge funds' asymmetric remuneration contracts, i.e., the probability that a fund manager will close down the fund if its net asset value lies too far from the high watermark. We believe that such behavior, though theoretically possible, is anecdotal in practice. As regards funds of hedge funds (henceforth FoHF), we argue that the FER analysis does not take into account the fact that:

- 1) raising money implies high costs (i.e., this opportunity cost is liable to cause the so-called 'hysteresis effect'), and that
- 2) investors will be long gone by the time the manager considers quitting (i.e., exit risk is more threatening for fund managers than investors).

As regards single hedge funds, we believe that the FER analysis does not take into account the fact that:

- 1) the alternative arena has become extremely competitive (i.e., over 8,000 funds are competing for investors' attention and money) and more transparent (i.e., more information means an improved fund selection process),
- 2) only sophisticated investors (i.e., high net worth individuals, funds of hedge funds, or institutional investors) have access to them.

The FER statement then stresses that hedge funds' asymmetric remuneration contracts create an incentive for fund managers to adopt high-risk investment strategies. We believe that the FER

analysis does not take into account the fact that hedge fund managers are entrepreneurs running small boutiques (i.e., nearly half of all hedge funds have less than \$25m in assets under management according to the TASS database). They thus systematically balance the extra performance that they can expect to generate through riskier strategies with the fact that the value of their own franchise (i.e., their reputation) is at stake (we recall that the fund manager's background is thoroughly reviewed on a systematic basis during the due diligence process). Moreover, as evidenced in Agarwal et al. (2005), higher managerial incentives (i.e., proxied by the delta of the hedge fund manager's call-option-like incentive fee contract, the hurdle rate, and high watermark provisions) are associated with higher returns. These funds are also shown to be more likely to exhibit persistently good returns, and less likely to exhibit persistently poor returns. FoHF, on the other hand, are by nature more risk-averse than single hedge funds as they have to bear the costs of larger structures (i.e., FoHF manage around \$300m on average according to the AAC database). On top of that, it is worth noting that institutional investors - who are known to be particularly risk-averse - represent an increasing share of FoHF assets; it is thus highly probable that an increase in the level of risk would trigger a wave of redemptions (i.e., this is a strong deterrent to following extremely aggressive strategies). This is all the more true in that, as stressed in Baquero and Verbeek (2005), investing in FoHF does not require the same amount of expertise and time as investing in single hedge funds.

Furthermore, the FER statement highlights the short life-time of hedge funds, which is estimated at around 3 years. First of all, as highlighted in Rouah (2005), most studies of hedge fund lifetimes treat all fund exits as liquidation, whereas a significant proportion of hedge funds stop reporting to databases for other reasons (e.g., critical size has been reached, merger with another fund, etc.) which leads to upwardly biased estimates. When only liquidations are taken into account, the average life-time increases to

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5.63 years (i.e., from 3.54 years for Convertible Arbitrage funds to 7.68 years for Equity non-hedged funds). Secondly, as highlighted in Fung et al. (2005), the survival rate strongly depends on the capacity of the fund to generate alpha, suggesting that the relatively high attrition rate observed in the alternative arena can in part be attributed to a natural selection process, i.e., the market does not let the worst-performing funds survive long. This hypothesis is confirmed in Baquero and Verbeek (2005); while investors are unable to exploit the persistence of winners, they are fast and successful in de-allocating from persistent losers.

As pointed out in the FER statement, another source of concern in the alternative arena is the presence of extreme risks. Ample evidence can be found in the literature on this topic (see Brooks and Kat (2002) among other examples). We argue that it is all the more important to take this feature into account in that traditional investors integrate hedge funds into their portfolio to reduce risk (i.e., for diversification purposes). That being said, hedge funds should not be stigmatized. First, the returns of traditional asset classes are not normally distributed either when typical holding periods are considered (e.g., 3 to 5 years for stocks). If we measure the extreme risks of hedge fund strategies over the last ten years, we find that they are lower than those of equities for the vast majority of strategies. Second, it simply means that on top of normal risks (i.e., volatility), investors have to take the presence of extreme risks (i.e., skewness, and kurtosis) into account. This can be done explicitly in the portfolio construction process by using the higher moment betas introduced in Martellini and Ziemann (2005). A pragmatic application can be found with the optimal diversification benchmarks designed by EDHEC (see www.edhec-risk.com). It can be carried out in the performance measurement/attribution process by using:

1) adjusted versions of traditional ratios (see the Modified Sharpe Ratio introduced in Gregoriou and Gueyie (2003) or the Alternative Sharpe Ratio introduced in Lee and Lee (2004) among other examples),

2) alternative ratios (e.g., the Omega ratio introduced in Keating and Shadwick (2002), the Stutzer Index introduced in Stutzer (2000)).

The FER statement surprisingly overlooks the issue of operational risks. This is all the more surprising in that in 8 out of 10 cases, as highlighted in Giraud (2005), "operational weaknesses are the root cause of the failure or have prevented a fund from managing a crisis situation appropriately in an unexpected financial context". Fortunately, advanced managed account structures can help reduce the risk of hedge fund collapses due to operational risks by up to 85%. It is also worth stressing that managed account platforms allow the liquidity issue mentioned in the FER's statement to be addressed by providing investors with weekly as opposed to monthly, or even quarterly, liquidity.

1.2. Systemic risk

Total assets managed by hedge funds are relatively small compared to world market capitalization, i.e., around 5% of total assets under management worldwide. However, hedge funds account for between a third and a half of daily activity on the New York Stock Exchange (NYSE) and the London Stock Exchange (LSE). Furthermore, according to a recent survey by Greenwich Associates, hedge funds account for 15-30% of the trading volume in each of the high yield bond, credit derivatives, collateralized debts (CDO), emerging bonds, leveraged loans markets and for more than 80% of trading in distressed debts. For these reasons, some concerns over systemic risks have arisen among market participants.

As mentioned in the FER statement "[...] systemic risk of a cascading nature that would jeopardize financial institutions is now small, but we recognize the inherent difficulty in drawing any firm conclusion in this regard". We basically agree with this statement.

As explained in a recent study by the ECB (see ECB (2005)), hedge funds could affect financial stability through three channels:

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- 1) "the failure of a large individual or a group of hedge funds could lead to far-reaching repercussions for exposed banks and financial markets",
- 2) "the serious mismanagement of exposures to hedge funds at an individual bank or banks might lead to a systemic crisis via contagion effects",
- 3) "instability could be initiated through the impact of hedge fund activities on financial markets".

Unfortunately, as stressed in Chan et al. (2005), "A definitive assessment of the systemic risks posed by hedge funds requires certain data that is currently unavailable, and is unlikely to become available in the near future, i.e., counterparty credit exposures, the net degree of leverage of hedge fund managers and investors, the gross amount of structured products involving hedge funds, etc. Therefore, we cannot determine the magnitude of current systemic risk exposures with any degree of accuracy".

Furthermore, as highlighted in a recent discussion paper by the FSA (see FSA (2005)), "the risk of an individual hedge fund posing a threat to the financial system on the scale of the LTCM episode, or even approaching it, has significantly diminished since 1998. This is primarily a consequence of enhanced risk management by hedge fund counterparties and the seeming absence of hedge funds with the level and nature of exposures taken on by LTCM". The same conclusion was drawn in a recent study by the ECB (see ECB (2005)). Despite some evidence that hedge funds may engage in "crowded trades", the situation today is certainly better than before the LTCM crisis because:

- 1) banks use more sophisticated techniques to manage their exposures to hedge funds,
- 2) as more players have entered the market, positions are probably much less concentrated in one or a few funds,
- 3) leverage levels taken on by funds are now lower.

On top of that, we would like to insist on a few points.

Firstly, no study has been able to demonstrate the implication of hedge funds in any systemic crisis, so far. As a matter of fact, the Financial Stability Forum (see Financial Stability Forum (2000)), in its report on highly leveraged institutions declined to conclude that hedge funds had compromised market integrity in the episodes it analyzed, since more often than not large international or domestic financial institutions and not hedge funds turned out to have led or precipitated market crashes. In other words, traditional investors adopting herd-like behavior, such as institutional investors, appear to have a much more disruptive impact on market stability than hedge funds. This phenomenon was clearly illustrated in the aftermath of the bursting of the Internet bubble.

Secondly, it is high time that market participants recognize the positive role played by hedge funds in financial markets. As stressed in a recent study by the ECB (see ECB (2005)), "[...] hedge funds have a role as providers of diversification and liquidity, and they contribute to the integration and completeness of financial markets. [...] As active market participants they often take contrarian positions, thus contributing to market liquidity, dampening market volatility and acting as a counterbalance to market herding. [...] They thrive on perceived inefficiencies by arbitraging away price differences for the same risk across markets. In this way, hedge funds contribute to the price discovery process. It might also be argued that in this way, hedge funds have contributed to the further integration of financial markets".

Finally, it is worth noting that systemic risks are already indirectly controlled by regulators. We recall that hedge funds borrow money from regulated financial institutions, i.e., institutions that must monitor and control their counterparty risk. Had these financial institutions followed their internal risk control procedures properly, LTCM would not have been able to increase its leverage in such extreme proportions and the collapse would have been avoided, or in the worst-case scenario, its bankruptcy would have remained an

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idiosyncratic event. Unfortunately, investors were dazzled by LTCM's "dream team", and lost sight, in a way, of common sense.

1.3. Fund of Funds

When investors gain exposure to hedge fund strategies through FoHF they benefit from the diversification effect reserved for large investment pools and from the expertise of a professional investor. The flipside is that they have to bear both visible (i.e., management and incentive fees) and invisible costs (i.e., agency costs due to the fact that they delegate both the portfolio construction and fund selection processes). We therefore agree that FoHF are costly investment vehicles. However, this does not necessarily mean that they do not provide investors with appealing investment opportunities. As shown in Amenc and Vaissié (2005), a majority of FoHF, namely 57%, succeed in creating value. This figure even increases to 89% if we focus on the value added at the strategic allocation level. On top of that, it is worth stressing that the decrease in operational risks resulting from investing in a FoHF as opposed to a portfolio of single hedge funds does not appear in such performance attribution studies. In this respect, we would like to add that the development of managed account platforms creates new opportunities for investors to add value in the form of a reduction in operational risks, and at a lower cost than the fees charged by FoHF.

2. Recommendations

2.1. Fiduciaries should carefully limit their investment in hedge funds.

It is true that hedge funds are complex investment vehicles. However, that is not a sufficient reason to stigmatize them. The authors seem to forget the frauds and bankruptcies of companies such as Parmalat, Enron, Refco, etc. These were not hedge funds.

We should recall that traditional investors invest in hedge funds primarily for their diversification properties (see EDHEC (2005a)). In other words, their objective is to improve the risk/return profile of their core portfolio significantly. One cannot reasonably believe that this can be done with a tiny allocation to hedge fund strategies. We thus believe that constraining the hedge fund allocation to an insignificant portion of total assets is not the solution.

An appealing solution for investors who dispose of limited resources and experience in the alternative arena is to invest the appropriate amount of capital in investable hedge fund indices. The reason is twofold. First, investable hedge fund indices are generally made up of managed accounts as opposed to single hedge funds, which implies greater transparency and liquidity as well as limited operational risks. Second, provided that the selected hedge fund indices are representative of their investment universe, they provide investors with the normal returns of the strategy, i.e., investors are protected against the selection risk engendered by the wide dispersion of hedge fund performance.

2.2. Regulators should vow not to bail out hedge funds.

In the FER statement, it is argued that "banking regulators should not rescue hedge funds". As far as we know, banking regulators were never meant to rescue hedge funds.

As stressed in FSA (2005) "the focus of our concern is not that funds, or even clusters of

funds, may fail but rather about the significantly disruptive consequences those failures may have on the financial system through:

- 1) their impact on counterparties,
- 2) their impact on markets and market confidence".

Banking regulators are the ultimate safeguards for the integrity of the financial system. Whatever the origin of the crisis, they have to intervene if the integrity of the financial system is at stake. This is precisely what the FED did during the LTCM crisis. As mentioned in the report of the President's working group on financial markets, "The Federal Reserve Bank of New York provided the facilities for these discussions and **encouraged the firms involved** [i.e., the major counterparties making up the consortium that recapitalized the LTCM fund] **to seek the least disruptive solution** that was in their own collective self-interest." In other words, contributing to the rescue of the LTCM fund was not for the FED an objective per se but a means to protect the integrity of the financial system.

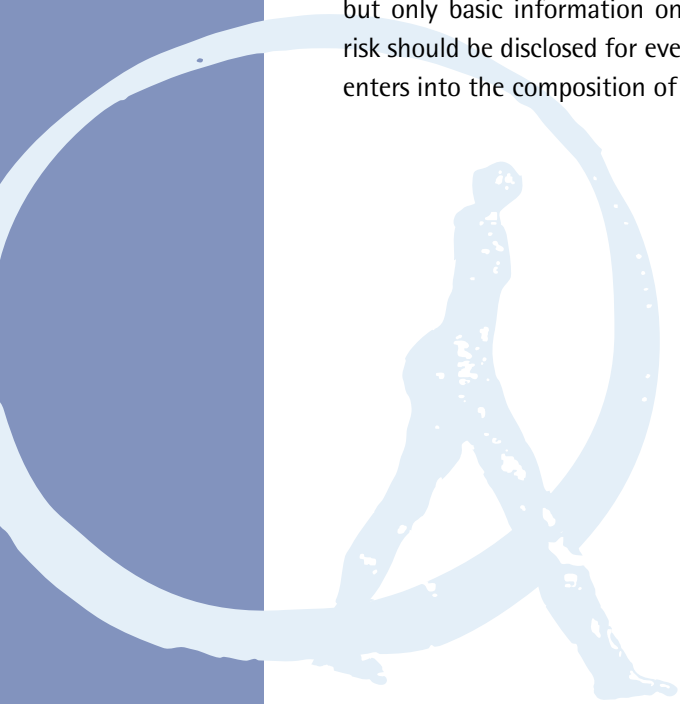
2.3. Performance and risk measurement should be standardized.

We completely agree that information is a crucial issue for the future development of the alternative industry. Up until recently, only accredited investors had been allowed to invest in hedge funds. Now, however, the range of potential investors has widened considerably. The time has come for a better definition of the level of information that investors should be provided with on a regular basis. In an attempt to fill the void, EDHEC recently published a study aiming to reconcile the often-conflicting interests of fund managers and investors (see EDHEC (2005b)).

The key findings of this study can be summarized as follows. Activity reports should first inform investors about the levels of risk (i.e., normal, extreme and risk of loss) and performance of the FoHF. To this end, a series of risk and return measures with corresponding risk-adjusted performance indicators should be disclosed to measure the returns per unit of risk (e.g., volatility, VaR, drawdown, etc.) that the fund generated.

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FoHF reports should also offer more insight into the way the fund is managed. Investors should for example be informed on the effective style mix of the fund through a style analysis. In the same vein, factor analysis should be provided to inform investors about sources of risk. Performance attribution, finally, could inform investors about sources of value-added. However, it is worth stressing that in an attempt to avoid data overkill, we suggest adapting the degree of detail to the level of aggregation. Detailed information should be available at strategy group and strategy levels, but only basic information on performance and risk should be disclosed for every single fund that enters into the composition of the portfolio.



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Appendix 1

Statement of the Financial Economists Roundtable on Hedge Funds

The following statement on "Hedge Funds" is the result of a discussion at the Financial Economists Roundtable's annual meeting on July 10-11, 2005 in Sonoma, California. A list of members approving the statement and their current or most recent affiliation is listed.

Executive Summary

Hedge funds have grown rapidly in recent years and are now about one-eighth the size of mutual funds. But these largely unregulated limited partnerships give rise to a number of concerns. Their management expenses are very high and their investment strategies are often risky with a small probability of very large losses. This and other risks are not understood by all investors. In response, the Financial Economists Roundtable recommends that fiduciaries for retail investors should limit their investments in hedge funds to a modest percent of assets under management, that regulators should not rescue troubled hedge funds, and that measures of performance and risk be standardized among funds. Caveat emptor should still apply, but more rational and informed investor behavior should result.

Introduction

Hedge funds typically are private, largely unregulated, limited partnerships with wealthy individuals and institutional investors as limited partners and the manager/investment advisor as the general partner. A hedge fund can employ leverage, thereby amplifying the variability of outcomes. It restricts redemptions so the investment is largely illiquid. Reportedly, the first hedge fund began in 1949, and it adopted a long/short equity strategy. Not until the mid 1980s did hedge funds swell in importance. By 1985, approximately 40 hedge funds existed. This number expanded to over 1,000 in 1995 and to some 8,000 in 2005. Currently, hedge funds manage about \$1 trillion in assets, roughly one-eighth of the amount managed by mutual funds.

A. Observations and Concerns

1. Understanding returns, expenses, and risk.

Some worry that investors in hedge funds do not fully understand the true returns nor the risks they bear. Expenses are high. The management fee to the general partner usually is 1 to 2 percent of assets, payable annually, and there often is an asymmetric performance fee in addition. This incentive, or carried interest, fee usually is 20 percent, and is often structured to be paid only if cumulative returns over time exceed a threshold return, known as the "high-water mark." When cumulative returns fall below this mark, the general partner can close the fund, then start a new one in order to establish a new base mark for generating performance fees. This exit risk is easily overlooked by new investors. The asymmetric fee structure creates an incentive for the general partner to adopt a high-risk investment strategy, since he/she stands to make a large return if the strategy is successful but not to suffer losses if the strategy fails. Offsetting this incentive to some extent is the fact that investors generally insist on the general partners investing in the hedge fund. Nonetheless, the average life of a hedge fund is only about 3 years.

The returns on many hedge-fund strategies are not normally distributed, but have a distribution characterized by fat tails. Some refer to this risk as the "peso problem." That is, the Mexican government does not devalue the peso for a long period of time and then one day devalues it sharply so that peso holders lose a lot. Expressed differently, day by day there is a small probability of a large loss. Tail risk makes standard measures of return volatility and performance, such as the Sharpe ratio, inappropriate guides to investors. By its very nature, tail risk is difficult to measure. In addition, risk-adjusted average returns tend to be overstated, because of survivorship bias and other reporting and data problems, making it difficult to compare hedge-fund performance with competing alternatives. Another risk is the illiquidity associated with particular positions undertaken by hedge funds.

The investor, particularly the retail investor and his/her agents, should be wary; available performance data make it difficult to judge true hedge-fund returns and risk for this high-cost vehicle. While reputation may serve as a disciplinary device, it has not always been effective. Simply put, the investor needs to be extraordinarily careful.

2. Systemic risk.

By systemic risk, we mean the risk that failure of one counterparty to a transaction will trigger failure of other counterparties: A cannot pay B, who then cannot pay C, and so on. The FER believes that systemic risk of a cascading nature that would jeopardize financial institutions is now small, but we recognize the inherent difficulty in drawing any firm conclusion in this regard. More recently, back-office delays in processing trades have made it difficult for hedge funds to know accurately their actual positions in real time. Outsiders cannot observe who the counterparties to transactions are and this uncertainty, together with the tail risk, is a concern for investors seeking to understand the risk of any cascading type of meltdown. The difficulty of assessing the potential exposure to systemic risk reinforces the need for caution in determining portfolio allocations to hedge funds. On occasion, liquidity in particular markets can be temporarily frozen as a result of hedge-fund activity. However, since the Long Term Capital Management (LTCM) episode in 1998, many hedge funds have become more cautious in their choice of counterparties and no single hedge fund is as large relative to the market as LTCM was at the time. Moreover, bank regulators now monitor the credit and counterparty exposure of financial institutions to hedge funds much more carefully.

3. Fund of Funds.

Funds of (hedge) Funds can play useful information and disciplinary roles. A Fund of Funds allocates capital among a number of individual hedge funds, giving investors access to managers they might not otherwise know and giving them diversification as to style and as to the law of large numbers. For such services, a Fund of

Funds will charge additional management and incentive fees, up to another 50 percent of the underlying funds' fees. This added cost must be evaluated relative to the information efficiency and discipline they bring to the process. Some of us suspect that the services provided by some Funds of Funds are worth the cost, and that they make the market for hedge funds more efficient. Others of us believe that with some 8,000 hedge funds playing against each other in many of their strategies, there surely will be losers – particularly when the high costs are taken into consideration. All of us believe that Funds-of-Funds-of-Funds, F3s, which invest in Funds of Funds, do not have a favorable cost/benefit ratio.

B. Recommendations

1. Fiduciaries should carefully limit their investment in hedge funds.

With the tail and exit risks involved, together with a lack of transparency, the FER has concerns about whether a large exposure to hedge funds is appropriate for pension funds and other fiduciary investors who make investments on behalf of others, particularly retail investors. The recent Bayou hedge fund fraud attests to what can go wrong. Money managers face incentive conflicts that might prevent them from adequately representing the interests of the beneficiaries whose funds were entrusted to them. The difficulties in assessing the full range of hedge-fund risks should dictate a limitation on investments in hedge funds to a modest proportion of the total assets under management. The FER fears that some fiduciary boards, particularly those composed largely of non professionals, do not adequately understand the true returns, risks and costs associated with investment in hedge funds.

2. Regulators should vow not to bail out hedge funds.

The FER believes that banking regulators should not rescue hedge funds. No one or two hedge funds pose systemic risk, though an individual failure might temporarily disrupt the market. The prospect of free government "bail-out" insurance creates adverse incentives for speculative behavior.

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Expressing a “no bail-out” policy would reduce those incentives. While tail risk is a problem, we do not foresee likely scenarios in which the monetary authority would need to intervene in its capacity as lender of last resort.

3. Performance and risk measurement should be standardized.

The FER recommends that institutions, such as the CFA Institute and the Chartered Alternative Investment Analyst Association, develop standards for measuring performance and risk for hedge funds as has happened for other investment vehicles. That is to say, there should be standardized measures pertaining to gross and net returns, expense ratios, leverage, volatility of returns, credit risk and liquidity. While some hedge funds

are reputed to have developed good internal risk measures, they have not made them available to investors. With better measures of risk and return, more understanding and rational investing will be possible. Comparisons of hedge funds will be more uniform. Finally, the FER encourages research on the asymmetric fee structure and its effect on investment behavior by hedge funds.

The adoption of these recommendations should improve the climate for hedge funds, and result in a better understanding of performance, expenses and risks. We are hopeful the industry will provide more standardized information voluntarily. Caveat emptor will still apply, but more rational investment behavior should ensue.

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Appendix 2

Role of the Financial Economists Roundtable

The Financial Economists Roundtable (FER) is a group of senior financial economists, who have made significant contributions to the finance literature and seek to apply their knowledge to current policy debates. The Roundtable focuses on microeconomic issues in investments, corporate finance, and financial institutions and markets, both in the U.S. and internationally. Its major objective is to create a forum for intellectual interaction that promotes in-depth analyses of current policy issues in order to raise the level of public and private policy debate and improve the quality of policy decision.

FER was founded in 1993 and meets annually. Members attending a FER meeting discuss specific policy issues on which statements may be adopted. When a statement is issued, it reflects a consensus among the majority of the attending members and is signed by all members supporting it. The statements are intended to increase the awareness and understanding of public policy makers, the financial economics profession, the communications media, and the general public. FER statements are distributed to relevant policy makers and the media.



Appendix 3

Composition of the Financial Economists Roundtable

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