

Hedge Funds: The New Barbarians at the Gate

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The spectacular near-collapse of the hedge fund Long-Term Capital Management, along with its controversial rescue, has raised important questions about the operation and regulation of these high-flying funds. How can the firm's high-technology, "market neutral" arbitrage strategies have failed to protect against unsettled market conditions? Should hedge funds be regulated? What should the U.S. government do in the event of a collapse?

The term *hedge fund* is misleading, for such funds are not literally hedged. While there are many different kinds of hedge funds, operating in different capital markets, the general techniques they use are similar. Basically, they try to exploit temporary valuation differences between similar types of securities. They buy a security that appears "cheap" in the market while selling an equivalent amount of another security that appears to be relatively "overvalued."

Example: A fund might reason that as Europe moves toward a common currency, the yields on sovereign bonds of different countries would tend to move together. Thus if, say, Italian bonds yielded considerably more than German bonds, the hedge fund might buy Italian bonds while selling short German bonds of an equivalent maturity. Similarly, a hedge fund might notice that risky bonds (including mortgage-backed securities) had yield spreads relative to U.S. Treasuries that were unusually large. In that case, the fund would buy the high-yield securities while selling short U.S. government securities, counting on the spread to narrow.

These hedge funds often advertise themselves as being "market neutral": If interest rates as a whole go up or down, the fund is hedged, since it is long one bond and short another. All the hedge funds are counting on is that the spread between the two securities will narrow. But the term *market neutral* is another misnomer. If risk premiums increase, as they have done dra-

matically in recent weeks, the yields on "cheap" bonds may rise at the same time a "flight to quality" lowers the yield on U.S. Treasury securities. In this case, the "hedged" two-way bets could be riskier than the one-way bets placed by unhedged funds, because losses could mount on both sides of the leveraged trades.

This is, of course, precisely what caused the virtual collapse of Long-Term Capital Management. While in "normal" market conditions the empirical mathematical formulas used by the hedge funds would indicate that spreads are likely to narrow, it is precisely during the unusual periods of a market that the hedge funds lose out.

Faced with the potential collapse of the fund, together with its hugely leveraged investment portfolio reported to total nearly \$80 billion, the Federal Reserve stepped in and organized a private rescue. The rationale was that a sudden liquidation of the Long-Term Capital Management portfolio would create unacceptable systemic risks. Tens of billions of illiquid securities would be dumped on an already jittery market, causing potentially huge losses to LTCM's numerous lenders and counter parties.

We got some indication of the staggering losses that could be involved with last week's announcement that the Swiss bank UBS had taken a write-off of some \$700 million because of its involvement with LTCM. Moreover, other hedge funds controlling trillions of dollars worth of securities (as well as the trading departments of many banks) may have taken similar positions, and further failures could endanger the entire world financial system. Thus these hedge funds may properly be considered the barbarians at the gate of global capitalism.

But the arguments against intervention are powerful. First, there is the matter of setting a dangerous precedent. It is estimated that some \$200 billion of capital has been invested in hedge funds. The capital of Long-Term Capital Management is perhaps 1% of the total. If LTCM is to be helped out, why stop there? Why aren't other,

larger hedge funds entitled to the same treatment?

Such intervention creates major moral-hazard problems. If unsuccessful hedge funds are not allowed to fail, if brokerage firms believe they will somehow be protected from the effects of far too liberal margin requirements, if banks believe help will be forthcoming should loans go sour during unsettled market conditions, how will we discipline future decisions of investors and lenders? Will such intervention make our financial system even more fragile later? By offering a helpful hand to hedge funds, will their activities in speculating against certain currencies, such as the Brazilian *real*,



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make the international financial system even more fragile?

To be sure, the current intervention resembles a bankruptcy reorganization more than a true bailout. What distinguishes this rescue, however, is the active role played by an agency of the U.S. government. Anything that weakens the effect of market discipline and that lessens the punishment the market affords speculators when they have made incorrect decisions is likely in the long run to lead to more instability.

The rescue has also seriously damaged America's credibility as the world leader in pushing for market reform and financial accountability. Now that U.S. leaders have used the weight of government to help persuade financial institutions to help out a private hedge fund, how can they tell their Japanese counterparts to swiftly clear their troubled banking system and let the weaklings fail? How can they lecture the governments of Hong Kong and Malaysia that they should not intervene in the free capital market?

The policy implications of the Fed's role in keeping Long-Term Capital Manage-

ment alive are thus troubling. We recognize the difficult trade-off involved. The failure of LTCM and a liquidation of its portfolio would clearly unsettle markets, and could lead to the bankruptcy of some large financial institutions. In such an event, we can be sure that the amount of capital provided to hedge funds would shrink dramatically and that risk standards would be tightened throughout the world financial community. A rescue may temporarily stabilize markets, but in the long run it can only encourage excessive risk taking and lax risk management. The next crisis could be even worse, and the long-term implication of intervention is unambiguously negative.

The threat to the stability of the world financial system has predictably generated congressional calls for regulation of the hedge-fund industry. Such a "solution" is not feasible, since many hedge funds operate offshore, beyond Washington's jurisdiction. The most effective strategy to minimize their threat and constrain their activities, then, is to let LTCM, and perhaps others, fail. What regulators can do is to ensure that U.S. banks and brokerage firms set clear risk guidelines concerning hedge-fund lending and encourage better risk management through full disclosure of risky positions. The key is to ensure that the risks taken by hedge funds are not shared by government-guaranteed deposit institutions.

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