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Do Hedge Funds Calm Markets or Inflate Bubbles?: Matthew Lynn

Dec. 1 (Bloomberg) -- Have hedge funds made markets work better or worse?

With the explosion of hedge funds -- there are now more than 7,000, controlling almost \$900 billion in assets -- there is no hotter issue in global finance.

To some, hedge funds are reckless gamblers, using weird financial instruments to blow apart currencies and stocks, pushing up prices and creating speculative bubbles.

To others, they are benign new pools of capital that help investors by spreading their risk, and they stabilize the market by taking up contrary positions.

Who's right? A study in the October issue of the *Journal of Finance*, an academic publication produced by the American Finance Association, suggests the funds are inflating bubbles, not damping them. If it is right, one of the main defenses of hedge funds has been weakened. And much of the marketing hoopla in which the funds like to cloak themselves will have been punctured.

``Hedge Funds and the Technology Bubble'' by Stefan Nagel, assistant professor of finance at the Stanford Graduate School of Business, and Markus Brunnermeier of Princeton University, takes a look at how hedge funds actually trade. They took a sample of more than 50 hedge-fund managers -- including big names such as Soros Fund Management LLC and Tiger Management LLC -- and examined the public records of how they bought and sold stocks during the period 1998 to 2000.

And what were the funds up to? Piling into every passing dot-com they could find, it turns out.

Technology Boom

``There is no evidence that hedge funds as a whole exerted a correcting force on prices during the technology bubble,'' Nagel and Brunnermeier wrote. Indeed, among the few large hedge funds that did resist the bubble, the manager with the least exposure to technology stocks -- Tiger Management -- didn't survive to see the bubble burst, they added.

They found, for example, that in March 2000 when the Nasdaq Composite Index peaked, ``hedge funds had devoted 31 percent of their stock portfolio to this segment. For comparison, these stocks only commanded a weight of 21 percent in the market portfolio at that time.''

Their conclusion is ``that hedge funds did not engage in a persistent attack on the technology bubble. In contrast, it seems that at least until late 1999, their trading mostly supported rather than undermined the bubble. Hedge funds were riding the bubble, not fighting it. From an efficient markets perspective, these results are puzzling. Why would some of the most sophisticated investors in the market hold these overpriced technology stocks? And why would they devote a larger share of their portfolio to these stocks than other investors?''

Puzzling indeed.

Commodities Speculation

True, it's just one study. Yet there is other evidence that hedge funds are essentially riding bubbles. For example, look at the levels of speculation by hedge funds in commodities this year. Or look at the way many within the oil industry have accused hedge funds of helping ramp up energy prices. It

looks as if they are helping inflate a bubble -- just as they did with technology stocks.

Certainly the results strike some analysts as fair. `` It makes a lot of sense because a lot of the evidence suggests this is how funds actually trade," said Jacob Schmidt, a director at Allenbridge Group, a hedge fund research company in London. `` The most basic principle of trading is that trend is your friend. If you don't go with the trend, you aren't going to make money."

Yet Tim Price, senior investment strategist at Ansbacher & Co. in London, isn't so sure. `` One of the most interesting strategies in hedge funds is trend-following and it can be very profitable. But it's a pretty small sample, and the vast majority of hedge fund managers are not just following trends."

` Major Contributors'

And that is the nub of the issue. Hedge funds are meant to be doing something rather than just hopping on board every bubble they can find.

First, they are meant to be the contrary force in the market. Who thinks so? Well, U.S. Federal Reserve Chairman Alan Greenspan for one. He told a Senate Banking Committee hearing earlier this year: `` Hedge funds have become major contributors to the flexibility of our financial system." Their strategy `` tends to eliminate the abnormal profits and the inefficiencies by aligning prices across markets," he said.

Next, with the exception of a few specialists, investors don't really buy hedge funds just to chase trends. The main purpose is to provide exposure to a range of different investments and strategies. After all, we can all take a look at what's hot this week, borrow some money, and buy as much of it as we can. We don't really need to pay some guy a 20 percent performance fee to do that.

Momentum Investors

Yet the main message of the Nagel and Brunnermeier research is that hedge funds are precisely that: momentum investors (although with the important caveat that they are very skilled momentum investors who mostly managed to get off the bus before it crashed).

That matters, for two reasons.

One, lots of people would like to regulate hedge funds. If it can be proved they are inflating bubbles, their case will be a lot stronger.

And if the hedge funds are to grow further they need to convince investors they genuinely have new approaches to investment.

In fairness, the technology bubble of 1998 to 2000 was an exceptional period. Riding that wave probably was the best strategy. Yet if the hedge funds are to keep prospering, they need to show they can do something more than hitchhike a ride on every passing investment bubble.

Because if they are making the market less stable, there are plenty of people who would like to stop them.

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Last Updated: December 1, 2004 03:25 EST

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