With a bang or a whimper?

Inconsistent pricing across traditionally segmented markets has been greatly reduced in recent years. Much of this improved market efficiency is due to the efforts of hedge funds. David Rowe argues, however, that the very success of these funds may be laying the foundation for a major shake-out, with potentially serious consequences

An old joke has an economist and a trader walking down the street. The trader says to the economist: "There's a $20 bill lying on the sidewalk." The economist replies: "No there's not." The trader responds: "But it's right there!" "No," the economist patiently explains, "if there was a $20 bill lying there someone would have picked it up already." At this point, the trader leans down, picks up the $20 bill and they continue on their way.

The point of the story is that all too often economists begin with the assumption of efficient markets and proceed to work out the implications of such a regime. Usually this is based on the related assumptions of perfect information, no institutional or legal barriers to trading across markets and low or zero transaction costs. Analysis based on such assumptions can be useful in many ways. The practice of stripping away complexity and focusing on certain core structural considerations is at the heart of most scientific inquiry. Nevertheless, one must always remain alert to the assumptions being used and how they limit the applicability of conclusions.

In the past 30 years, economists have devoted considerable time to analysing the implications of relaxing some of these traditional assumptions. In particular, the effect of imperfect or asymmetric information has received much attention. The importance of this work was affirmed by the Nobel Prize Committee when they awarded the 2001 prize in economics to George Ackerlof, Joseph Stiglitz and Michael Spence. In practice, of course, market efficiency is not some free gift from the gods. Even in the absence of explicit legal barriers to competition, market efficiency is the result of a continuous and resource-intensive process. Markets are kept efficient only by self-interested parties constantly searching for, discovering and capitalising on arbitrage opportunities. There is, however, one crucial conclusion of the traditional economic model that remains compelling. This is that the very process of profiting from market imperfections tends to reduce or eliminate the arbitrage opportunities that made these profits possible.

The very name 'hedge fund' is somewhat misleading. Hedging is a classic risk-reducing strategy, as in 'always hedge your bets'. Why, then, are hedge funds considered especially risky? The answer, of course, is that they are really leveraged market-neutral investment funds (although this doesn't exactly roll smoothly off the tongue). Rather than take investors' money and allocate it to a long-only investment portfolio, hedge funds use investors' resources for margin requirements to support leveraged long and short positions.

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The objective is to profit over time from the narrowing of what is considered an inconsistency in pricing across two instruments. Since the proceeds from the short sale of one instrument effectively fund the purchase of a corresponding long position, the maximum gross size of the portfolio may be many times the value of investor subscriptions. The size of this multiple depends on the minimum margin requirements demanded by a fund's brokers.

Hedge fund impact

Memories of the dramatic demise of Long-Term Capital Management (LTCM) in 1998 still hover very close to the hedge fund market. Nevertheless, despite struggling in 2001 and 2002, hedge fund returns were well into double digits in the other three years since 1998. Combined with a sluggish stock market constrained by considerable geopolitical uncertainty, these impressive returns have fuelled continued growth in hedge fund assets under management. These now stand at over $800 billion, more than twice the 1998 level. As hedge funds have become more institutionalised, they have also begun to attract a small but growing investment allocation from traditionally conservative entities such as pension funds and endowments. If this trend continues, some predict that total hedge fund assets under management could more than double again by the end of the decade.

If such continued growth does materialise, it poses a serious question as to the long-term impact of hedge funds. It is the superior returns of these funds that continue to attract new resources. Clearly, however, the huge expansion in resources seeking profitable arbitrage opportunities causes such opportunities to become less common and less lucrative. Even today, hedge fund managers talk about the need for multiple strategies in order to maintain their performance. Funds with only a limited specialised strategy are apparently having problems sustaining competitive returns.

As increasing resources continue to be dedicated to finding market-neutral arbitrage opportunities, maintaining double-digit returns will only become harder. At some point, the irresistible force of unbridled investor expectations will meet the immovable object of shrinking arbitrage opportunities. As one senior pension fund manager recently said, this could end with either "a bang or a Libor-plus whimper".

Perhaps it is the cynicism of age, but my instinct says the end game is going to have more fireworks than just a Libor-plus whimper. If it is only hedge fund investors who are harmed, then *caveat emptor*. The bigger concern is that, in reaching for continued high returns in the face of shrinking available opportunities, we could have an even more severe systemic problem than was presented by LTCM. It is no wonder that regulatory agencies are seeking greater oversight, better risk controls and improved transparency in this industry. I know these initiatives are not welcomed by many hedge fund managers, but they are necessary nonetheless. ■