Hedge Funds
Risks and Regulation

Institute for Law and Finance Series

Edited by

Theodor Baums
Andreas Cahn

De Gruyter Recht · Berlin

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Proceedings of a Conference held in Frankfurt am Main on May 22, 2003
Co-Sponsored by the Institute for Law and Finance, Johann Wolfgang Goethe-Universität, and Deutsches Aktieninstitut e.V.

⊗ Printed on acid-free paper which falls within the guidelines of the ANSI to ensure permanence and durability.
ISBN 3-89949-149-1

Bibliographic information published by Die Deutsche Bibliothek

Die Deutsche Bibliothek lists this publication in the Deutsche Nationalbibliografie; detailed bibliographic data is available in the Internet <http://dnb.ddb.de>.

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Cover Design: Christopher Schneider, Berlin
Data Conversion: jürgen ullrich typosatz, Nördlingen
Printing and Binding: AZ Druck und Datentechnik GmbH, Kempten

Printed in Germany

Preface

The number of hedge funds and the assets they have under management has increased in recent years. This increase became significantly more pronounced after the market downturn in 2001. Hedge funds can help investors to benefit from volatile and even sinking stock markets. However, despite the prominent use of the word "hedge" in their name, such funds rarely offer a safe hedge against risk, given that they depend heavily on skill-based investment techniques and often invest in highly speculative financial instruments. Nevertheless, such funds received no specific treatment in the legislation of such major markets as Germany and the United States for years.

Against the backdrop of international regulatory concern for hedge funds, the Institute for Law and Finance (ILF), in cooperation with Deutsches Aktieninstitut e. V. (DAI), brought together leading scholars, lawyers and bankers in Frankfurt in May of 2003, to assess the risks, opportunities and regulatory challenges that hedge funds present. At the time of the conference, German lawmakers were still discussing the need and possible content of a new law. The fruit of their discussions was the German Investment Modernization Act (*Investmentmodernisierungsgesetz*), which entered into force on January 1, 2004, and increased the attractiveness of offering hedge fund products on the German market.

This inaugural volume of the *Institute for Law and Finance Series* contains the proceedings of our May 2003 conference, and serves the ILF's mission to act as a centre for policy studies in capital markets, financial and corporate law. It is the ILF's desire to contribute to the quality of capital markets, banking and company legislation in Europe by facilitating the discussion and dissemination of the economic and legal policies on which such legislation is formulated. We therefore hope that our conferences, Working Papers and this *Institute for Law and Finance Series* will stimulate discussion and add to the quality and diversity of policy discussions in international law and finance.

The editors of this volume would like to thank our partner in the hedge funds conference, DAI's managing director, Prof. Rüdiger von Rosen, for his valuable support, as well as the many staff members of both the DAI and the ILF whose tireless attention to detail made the conference possible.

Frankfurt am Main, March 2004

Theodor Baums *Andreas Cahn*

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Part One: From an Economic Perspective

On Myths, Bubbles and New Paradigms in the Hedge Fund Industry

Alexander M. Ineichen

Introduction

To some, hedge fund investing is a bubble, to others absolute return strategies is a New Paradigm in asset management. Reality is probably somewhere in between. Expectations of high positive absolute returns from hedge funds when equity markets fall are probably exaggerated. However, the balancing act of managing investment opportunities with capital at risk might be in the process of replacing the relative return approach.

Demystifying Hedge Funds

In the first section of this paper we highlight some myths regarding hedge funds and more importantly regarding the investment in hedge funds. Occasionally hedge funds are considered secretive. This is actually not a myth but true. The hedge funds industry—to some extent—*is* secretive. One of the reasons for this secrecy is that there are no talking heads of the industry who appear on CNBC or CNN on a regular basis. Information started to flow more efficiently only in the year 1998. The reason for the absence of talking heads or regular hedge fund manager forums is to some extent obvious. Hedge fund managers have different incentives than Wall Street talking heads where self-promotion is a key to success. If you have a trading strategy or investment process with superior risk/reward trade-off in absolute return space, why do you want to tell it to the world for free or for a small fee?

Myth: Investing in Hedge Funds Is Unethical

According to the myth, investing in hedge funds is speculative and therefore unethical. We would like to turn the argument around and postulate that for a fiduciary not considering investing in alternative investment strategies (AIS) in a portfolio context in general or absolute return strategies in particular is, if anything, unethical. The empirical evidence from absolute return managers exploiting inefficiencies and producing high risk-adjusted returns is overwhelming, and academia is in the process of confirming that market inefficiencies exist (i. e., migrating to a very weak form of market efficiency).[1]

Views and definitions of ethics vary across countries and cultures. Any view, therefore, is subjective and has a strong home or cultural bias. The following view is based on the Prudent Expert Rule from the Employee Retirement Income Security Act of 1974 (ERISA) and the Code of Ethics from the Association of Investment Management and Research (AIMR)[2]. According to the AIMR Code of Ethics (AIMR 1999) members shall:

1. Act with integrity, competence, dignity, and in an ethical manner when dealing with the public, clients, prospects, employers, employees, and fellow members.
2. Practice and encourage others to practice in a professional and ethical manner that will reflect credit on members and their profession.
3. Strive to maintain and improve their competence and the competence of others in the profession.
4. Use reasonable care and exercise independent professional judgment.

Under ERISA, fiduciaries must discharge their duties with respect to the plan:[3]

1. Solely in the interest of plan participants and beneficiaries.

[1] There are hardly any investment professionals who experienced the 1987 crash and believe in the efficient market hypothesis.

[2] The AIMR is a global nonprofit organization of more than 41,000 investment professionals from more than 90 countries worldwide. Its mission is to advance the interests of the global investment community by establishing and maintaining the highest standards of professional excellence and integrity.

[3] From AIMR (1999).

2. For the exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable plan expanses.
3. With the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims (the Prudent Expert Rule).
4. By diversifying the investments of the plan so as to minimize the risk of large losses, unless doing so is clearly not prudent under the circumstances.
5. In accordance with the governing plan documents, as long as they are consistent with ERISA.

Assuming ERISA's Prudent Expert Rule is some indication of how a fiduciary should act and AIMR's Code of Ethics is a reference for ethical conduct and integrity of a financial professional, investing in hedge funds cannot be categorized as unethical. Taking this argument one step further, one could argue that, if anything, ignoring absolute return strategies and the benefits of its inclusion to a portfolio might be unethical.[4] The fourth of ERISA's points listed states that a fiduciary should diversify and reduce risk of large losses. In a portfolio context, risk is reduced by increasing the allocation to less volatile assets or introducing assets with low or negative correlation to the core of the portfolio. The strategies by relative value managers exploiting inefficiencies have proven to be conceptually sound as well as empirically characterized by high risk-adjusted returns and low correlation to traditional assets.[5] In addition, once risk to single hedge funds is diversified (idiosyncratic risk), large losses hardly occur especially when compared with traditional investments that are essentially long the asset class outright. Some U.S. and U.K. pension funds (mostly long-only investors) have gone from overfunded to underfunded (liabilities exceeding assets) in only three years after the equity market peaked in 2000.

In the United Kingdom a precedent from 1883 dictates that the unpaid

[4] Amin and Kat (2001), for example, stress that it is important to view hedge funds in a portfolio context and not in isolation.

[5] The fact that nondirectional absolute return strategies have return distributions that do not match a normal distribution does not automatically mean that the strategies are conceptually unsound. Returns from equities or cash flows from insurance companies are not normally distributed, either.

laymen who make up the majority of most trustee boards must take all the care "an ordinary prudent man of business would take in managing similar affairs of his own."[6] In the first quarter of 2002 the Department for Work and Pensions issued three consultation papers, one of which is aimed at raising the quality of investment decisions taken by pension fund trustees. In the United Kingdom it is often noted that the average pension fund trustee spends around 12 hours per year[7] thinking about themes related to investment management. This fact introduces a lemming-like peer group driven investment process and a "tabloid bias." Putting it crudely: Equities and bonds are good, and derivatives and hedge funds are bad. This is why "conservative" is defined as having a 70 to 80 percent allocation to equities with the majority invested in the domestic market.[8] This is probably the reason why the U.K. institutional involvement (on the demand side) in absolute returns is one of the lowest in Europe. However, there is a trend to the better. First, the government is aware of the issues arising from the world moving from defined benefit to defined contribution pension schemes. Second, the

[6] A common market for pensions in Europe is a long-sought goal within the European Union (EU). The European Commission (EC) proposed to base pension regulation on the "prudent person" principle in October 2000. The United Kingdom, Ireland, Sweden, and the Netherlands backed the EC proposals whereas most of the remaining member states, led by France and Germany, have expressed some doubts. This despite the EC stressing that funds in member states where the prudent person principle has been applied—namely the United Kingdom and the Netherlands—have achieved returns over the past 15 years that were twice as high as those subject to quantitative restrictions. The Spanish delegation came up with the idea to create a "prudent person plus" principle. This new principle would combine the basic principle with some fortified quantitative restrictions.

[7] Occasionally a figure of 20 hours per year is quoted as the average time spent on financial matters by the average U.K. pension fund trustee. Given the complexity of asset/liability management and solvency issues it is unlikely that 12 or even 20 hours per year are sufficient.

[8] Note that during the technology, media, and telecommunications (TMT) expansion, some U.K. pension funds had a larger allocation to a single U.K.-domiciled company than to the whole of the U.S. stock market. An allocation of more than 5–10 percent to a single stock could be in breach of modern portfolio principles, which state that idiosyncratic risk should be eliminated through diversification. It is probably also in violation of point four of AIMR's Code of Ethics and certainly in violation of ERISA's Prudent Expert Rule. In other words, running strongly concentrated portfolios and avoiding hedge funds because the local tabloids suggest they are dangerous is certainly not the result of a professional and prudent expert thinking about risk.

Myners Report[9] suggests, among other issues, that U.K. pension funds should move away from finding comfort in the peer-group consensus and seek idiosyncratic solutions to their financial requirements, that is, become a little bit more open-minded with respect to the financial innovations of the past 30 years.

The relationship between institutional funds and the agents engaged to manage the portfolio assets has always provided a fertile breeding ground for conflicts of interest. Yale endowment fund manager *David Swensen* puts it as follows:

Institutions seek high risk-adjusted returns, while outside investment advisers pursue substantial, stable flows of fee income. Conflicts arise since the most attractive investment opportunities fail to provide returns in a steady, predictable fashion. To create more secure cash flows, investment firms frequently gather excessive amounts of assets, follow benchmark-hugging portfolio strategies, and dilute management efforts across a broad range of product offerings. While fiduciaries attempt to reduce conflicts with investment advisers by crafting appropriate compensation arrangements, interests of fund managers diverge from interests of capital providers even with the most carefully considered deal structures.[10]

Myth: Hedge Funds Are Risky

Hedge funds, examined in isolation, are risky—as are technology stocks, or energy trading companies, or airline stocks. However, most investors do not hold single-stock portfolios. They diversify stock-specific risk (idiosyncratic or nonsystematic risk) by investing in a range of stocks with different characteristics. To most investors, it is regarded as unwise not to diversify idiosyncratic risk. It should be similarly unwise not to diversify risk to a single hedge fund. Note that many critics of hedge funds do not distinguish between systematic and nonsystematic risk when demonizing hedge funds.

Schneeweis and *Spurgin* (1998) and many others have shown that hedge funds offer an attractive opportunity to diversify an investor's portfolio of stocks and bonds. This is true even if the returns earned by hedge funds in

9 The government sponsored Paul Myners (executive chairman of Gartmore Investment Management in the United Kingdom from 1987 to 2001) for an independent review of the United Kingdom pension fund industry. Myners is promoting the so-called Myners code of best investment practice, which fund management houses are supposed to sign up to by March 2003.

10 *Swensen* (2000), p. 5.