Contemporary Issues in Finance
Hedge funds

Martin Upton

Let's now turn to the subject of hedge funds; again, another well publicized area of finance in recent years. These funds have grown in size significantly in recent years. What do you think the future holds for them? Graham ?

Graham Honeybourne

I see hedge funds were originally set up to try and benefit from absolute return opportunities in the market where the volatility of the market was not on the underlying assets, and try and arbitrage opportunities. In the initial phases that was tremendous and it grew significantly in the market place. But now we have such a wide range of hedge funds, one of my problems is the actual use of the words 'hedge fund' because of the different areas that they're going into. I do feel that hedge funds are providing a tremendous liquidity into the markets; they're actually reducing some of the volatility in the markets. But, as they do that more and more, they are moving more towards being market assets and should actually see the returns come down to market levels and also see their actual role diminish.

Marcus Davidson

My view is that the growth of hedge funds may contain seeds of their own destruction. They began life as niche operators who by going contrary to market opinion could seek out profitable opportunities to earn excess returns. As each hedge fund found such opportunities and exploited them, nothing gets round the market as quickly as how people are dealing, so profitable opportunities are arbitraged away very rapidly and, as we saw in the most spectacular case of long-term capital management which began life as a genuine arbitrage operation - a very blue-blooded operation indeed – as opportunities for arbitrage, for making excess returns disappeared the fund was forced into more and more one way bets, directional trades and indeed, as is well known, a few months before it nearly collapsed; it actually returned a lot of capital to its shareholders, on the grounds that it just could not fight the opportunities any more to earn the returns which they'd come to expect.

Graham Honeybourne

I just feel there's one or two other points that we shouldn't forget here. The first thing is, during this period of hedge fund growth that we have had ever since LTCM, is that the monetary stimulants have been pumped into the economy quite significantly over that period and brought down the cost of capital, and that the hedge funds have been very successful in this period. We have yet to be proven when the cycle turns the other way, whether they will survive. In addition to that, the hedge fund's opportunity to exploit arbitrage opportunities in the market is that they can have better information than the market. And I'm very cautious, given the EMH theory and portfolio theory, how much or how long they can continue to exploit better information than the market to actually be successful in their operations.

Marcus Davidson

I see hedge funds also as a symptom of the problems that investors are having with lower rates of return worldwide - particularly, looking around this table – if I might say mature investors who cut their teeth in the financial markets at times of high and volatile rates of return. The rates of return now are lower and I think there's evidence that many investors are suffering continuing withdrawal symptoms. They're used to earning double digit returns – or near double digit returns – from relatively risk-free assets. And private investors are not swayed by academics saying the risk-free rate of return is 4% - you can only earn more than 4% by taking risk. They hanker after their 8%s and their 10%s and we've seen in the United Kingdom a couple of very spectacular scandals in recent years – not to do with hedge funds, but to do with the infamous precipice bonds and the split level investment trusts, where private investors were clearly very gullible. They were very, very anxious to get back to their high returns. There is a lingering belief that maybe there are free lunches out there still. And the respectable basis for that, which Graham just hinted at, is of course if the market is inefficient. If the market is inefficient then there is some respectable basis for these excess returns which the hedge funds say they can attain. But if, in course of time, either general level of returns revert to the levels we saw in the 70s and 80s, or people just get used finally to 4% and 5% risk-free rates of return, perhaps either way hedge funds will lose their attraction and become, if you like, a hallmark retrospectively of a particular transition period in the development of the markets.