WSJ 10/1/98

Most Hedge Funds Play It Safe

A22

By Mark Gerson
And Thomas Lehrman

The spectacular collapse of Long-Term Capital Management—and the subsequent bailout orchestrated by the New York Fed—is causing ripples all the way to Washington. USA Today editorialized that "hedge funds can't be allowed to blindside the rest of the economy," and House Banking Committee Chairman Jim Leach (R., Iowa) holds hearings today to determine whether hedge funds should be more tightly regulated. Before Congress does anything hasty, it ought to ask itself, just what is a hedge fund anyway?

George Soros

This may seem like a trivial question, but language is crucial. In the 1980s high-yield debt made companies like MCI, CNN and News Corp. possible, yet in popular parlance these instruments became demonized as "junk bonds." There is reason to fear that a similar abuse of language is at work today with the term *hedge fund*. In an effort to prevent another LTCM-style debacle, federal regulators may very well link the reckless quasibank based in Greenwich, Conn., with financial institutions whose only similarity to LTCM is that people who don't know any better call them all hedge funds.

The term *hedge fund* really applies to three broad and distinct categories of investment vehicles. The first category consists of low-risk funds that are more or less market neutral. They invest primarily in U.S. and foreign stocks and rarely leverage their partners' capital more than 2-to-1—about the same as a normal operating company. These funds are truly "hedged" because they go long and sell short: They buy stocks they think will go up, and they borrow and sell stocks they think will go down only to buy them back later . . . hopefully when the stocks are cheaper.

Over time the performance of these funds is less volatile than the Standard & Poor's 500. On average, if the market goes up, a market-neutral hedge fund's longs will win and its shorts will lose; if the market goes down, the converse will happen. Creditors—namely investment banks—get their money back unless a market-neutral fund loses half its value.

How likely is this? Suppose a market neutral fund has $1 billion in assets, is leveraged 2-to-1 and holds $1.2 billion in longs and $800 million in shorts. Its net exposure is, therefore, 40%. Let's say the market goes down 20% in one day, more than it ever has in the post-World War II era. How does this fund do? Assuming the fund's portfolio follows the market, it loses 8% (40% of 20%). Not bad for investors. What do investors sacrifice for this security? Not much: These funds have consistently outperformed the S&P 500 with no statistically significant correlation to how the market is doing as a whole.

The second type of hedge fund is a hybrid fund. These are generally not leveraged more than 4-to-1. These funds buy long and sell short in global equity markets, just like market neutral funds, and they also speculate in bond and currency markets. The two best-known hybrid funds are Julian Robertson's Tiger Management and George Soros's Soros Fund Management. Let's take the Soros fund as an example. In 1997, Soros fund management made the right bet that Southeast Asian currencies would fall. In 1998 Soros made the wrong bet that the Russian currency would hold its value. The Russian bet cost the funds more than $2 billion. Did the Fed bail out Soros? No, and actually its funds are up on the year. How is that possible? Because Soros hedges its macro bets with long and short investments in global equities.

The third type of hedge fund is not really a hedge fund at all—it's a quasibank. Like a bank, such hedge funds hold assets against their liabilities and equity. The equity capital in this quasibank is simply the partners' investments. The assets include all investments made with the partners' capital plus investments made using leverage arranged by financial counterparties—namely, the major investment banks.

Commercial banks are usually leveraged in the vicinity of 20-to-1, meaning that their equity capital equals 5% of their total assets. In order to control the potential losses from such leverage, the Federal Reserve stipulates minimum capital-to-asset ratios based on the riskiness of a bank's investments. LTCM was leveraged as much as 300-to-1, and is subject to no comparable regulations.

The argument can be made that the creditors of LTCM—billion-dollar banks—do not need the government to police their investments and are in a position to bail out their worst mistakes. A contrary argument can be made that the convergence of investment and commercial banking demands that this type of fund be regulated so that an LTCM of the future does not pierce through the investment bank and threaten individual deposit accounts. Both arguments make sense to us; by all means, Congress should debate the issue and come down as it may.

However, no one should conclude from the LTCM debacle that the market-neutral and hybrid hedge funds need more regulation. Unlike the Nobel Prize winners and high-flying traders at LTCM, most hedge fund managers know that markets are notoriously fickle and, like the sea, humble those who do not respect them. Wealthy individuals, pension funds and university endowments have all prospered greatly by investing in hedge funds. This consistent record of success should not be interrupted by federal regulators who stand before a Volvo and a Corvette and only see cars.

Mr. Gerson and Mr. Lehrman are co-CEOs of the Gerson Lehrman Group, a business publishing company.