



FINANCIAL POLICY FORUM

DERIVATIVES STUDY CENTER

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Introduction

Investors of many stripes – including pension funds – are moving away from traditional lines of investments in order to pursue potentially higher yielding investment opportunities. This has come to be known as “chasing yield.” In an efficient financial market, chasing yield means moving along the securities line so as to capture higher rates of return by taking on greater amounts of risk. As long as the rate of return is sufficient to justify the greater risk, it is an efficient investment activity. Where an investor, even an institutional investor, chooses to be along that frontier of risk-return trade-offs depends on the needs and circumstances of the investor.

Whether certain levels of risk are suitable for a particular investor, or institutional investor, is also an important policy decision. Given the importance of retirement income for economic and social stability, the decisions about risk and the prudential management of pension funds is paramount.

The public interest in pensions funds is clearly identified in the Employee Retirement Income Security Act of 1974 which stated the “national public interest” of pension funds and recognized that they “effect the well-being and security of millions of employees and their dependents” and are “an important factor affecting the stability of employment and industrial relations.” The Act also recognized that there is otherwise a lack of employee information and adequate safeguards in pension fund management.

Deciding the terms of what constitutes prudential pension fund investment is a matter of judgment for policy makers, and I hope the following insights into the concerns with high yield investments will help inform those decisions.

Potential Problems

One of the key policy issues raised by pension funds' pursuit of higher yield has been the large rush into hedge fund investments. According to a report by Greenwich "Associates, *"By far the biggest contributor to the current hedge fund boom is the widespread participation of pension funds."*¹ Similarly, *"The fastest growing share is pension funds,"* stated a Hennessee Group report.

The benefits of investing in hedge funds are apparent. Table 1, at the end of this document, includes data from the Hennessee Group which shows that hedge funds have generated risk-adjusted rates of return that are superior to traditional assets as measured by the major stock and bond indices. The comparison, at first glance, is impressive.

One should, however, approach the comparison with the following qualifications. Although Hennessee does an excellent job in collecting the data, there are some inherent problems to measuring hedge fund performance. The data is reported on voluntary basis and tends to reflect the more successful funds rather than the laggards or failures. The risk on the returns is measured by a simple calculation of the standard deviation which does not distinguish between the same sized negative and positive changes in yields nor does it reflect whether the distribution of returns has a fat tail. Still, they are impressive figures.

The costs or potential problems with investment in this asset class known as hedge funds are not as apparent. The following identifies several potential problems arising from pension fund investment in hedge funds.

1. Fraud

Many hedge funds are under investigation, in court, or have settled charges of financial fraud. SEC Commission Campos stated, *"Over the past seven years, the SEC has brought 96 enforcement cases against investment advisers for defrauding hedge fund investors, or using hedge funds to defraud others."*² In addition to those charged there are many more under investigation by the SEC or States Attorneys General. The fraud usually involves the misuse of investor funds, and in some instances the fraud arises in response to crushing losses on investments that lead to outright embezzlement and flight.

There are two principle reasons that hedge fund investments are especially prone to financial fraud. These key features distinguish hedge funds from other more established investments.

¹ Greenwich Associations, "For Hedge Fund Investors, New Notes of Caution." 2004.

² Speech to SIA Hedge Funds & Alternative Investments Conference, June 4, 2006.

1. Fund managers are not subject to the same registration and reporting requirements as securities brokers and some other investment fund managers. They are not required to undergo background checks, pass series 7 exams, maintain records, and disclose reports from independent auditors.
 - The Securities and Exchange Commission explained it like this. “Like mutual funds, hedge funds pool investors' money and invest those funds in financial instruments in an effort to make a positive return. However, unlike mutual funds, hedge funds are not registered with the SEC. This means that hedge funds are subject to very few regulatory controls. In addition, many hedge fund managers are not required to register with the SEC and therefore are not subject to regular SEC oversight.

This distinction, combined with the fact that there are many new start-up hedge funds and hedge fund managers – creating what Forbes magazine called “amateur hour” in the hedge fund industry – means that other means of market discipline that come from reputation risk, references and referrals does not work as effectively as in traditional segments of financial markets.

– *HedgeFund.net* reports that 10% of the hedge funds it tracks “became defunct” in the 12 months ending May 2004.

2. The investment strategies of many hedge funds – though certainly not all – make it difficult for the funds’ assets to be marked to market. This is known as the “valuation problem.”³ When investors cannot effectively monitor the performance of fund managers by frequently observing the returns on the funds, then it decreases the ability to detect fraud and crippling losses that sometimes leads to fraud.
 - One such example comes from Ohio Bureau of Workers’ Compensation which invested in MDL Capital Management and lost \$215 million in just a few months.⁴

2. Liability

Some hedge funds have engaged in illegal trading strategies, and these expose the investors not to the criminal liability but to substantial losses from the cost to the fund from fines, penalties, legal fees and restitution. These losses are in addition to any reputational losses to investors.

– A study by the Bank of New York surveyed market participants and found that over 50 percent of respondents identified hedge funds as “most likely to be at the center of an investment controversy” in the next five years.⁵

– SEC Final Rule on Hedge Fund Regulation stated “Our staff counts almost 400 hedge funds (and at least 87 hedge fund advisers) involved in these [mutual fund trading] cases and others under investigation.” That is a lot of potential investor losses from hedge funds’ illegal trading activities.

³ For a good discussion see Susan Mangiero. 2006. *Journal of Compensation and Benefits* (July/August).

⁴ AP, June 8, 2005

⁵ Bank of New York. “Restoring the Trust”, July, 2004.

– One current hedge fund investment strategy – in the merger arbitrage area – is to go after corporate governance control in a manner that treads on the edge of legality concerning the voting rights of encumbered shares. This may result in ‘headline risk’ as well as potential litigation costs.

3. Market Risk

Hedge funds are not like traditional asset classes. The following are some distinguishing features that raise concerns about the levels of risk and the ability to manage it.

- The best hedge funds are closed to new investments or new investors. New entrants are often left to choose amongst the second tier fund managers and new start-up funds.
 - “It’s amateur hour in the hedge fund business” – Hedge Fund Research reported that 900 hedge funds are less than one year old. That may be an understatement as the Cayman Islands Monetary Authority (CIMA) reports that over 900 new funds have registered with it in the first nine months of 2005. CIMA previously reported that hedge fund registrations was up 112% from 2003 in 2004.⁶
 - Moreover, as an increasing amount of new investment moves into this asset class, it not only must move into newer or lower tier fund managers but the amount of remaining high yield investment opportunities will be exhausted or will disappear from the greater inflow of funds.
- Given this characterization of the hedge fund industry, the following results should not be surprising:
 - A study by Brooks and Kat estimates that 30% of new hedge funds do not make it past 36 months due to poor performance.⁷
 - A study by Baquero, Horst, and Verbeek finds an annual attrition rate of 8.6% for the period 1994-2000.⁸
 - A study of 100 liquidated hedge funds by Feffer and Kundro shows that half of all failures are due to “operational risk alone” and that “The most common operational issues related to hedge fund losses have been misrepresentation of fund investments, misappropriation of investor funds, unauthorized trading, and inadequate resources.”⁹
- Fat tails. Some hedge funds take large naked positions in order to capture higher rates of return. As a consequence they are sometimes devastated by large, but unlikely price movements. Just this Monday one of the world’s largest hedge funds, twice the size of Long Term Capital Management, suffered a 50% loss on its investments by taking the wrong position on changes in natural gas prices. Those losses lead to intense

⁶ See Hedge Fund Street for February 2006.

⁷ Brooks, C. and H. Kat. 2002. “The Statistical Properties of Hedge Fund Index Returns and Their Implications for Investors.” *Journal of Alternative Investments* 5 (2), 25-44.

⁸ Baquero, G., Horst, J. and M. Verbeek. 2002. “Survival, Look-Ahead Bias and the Performance of Hedge Funds.” Erasmus University Rotterdam Working Paper.

⁹ Feffer, S. and C. Kundro. 2003. “Understanding and Mitigating Operational Risk in Hedge Fund Investments.” Working Paper, The Capital Markets Company Ltd.

“discussions” – read negotiations – with its primary broker, Goldman Sachs, and also affected one of its major investors, Morgan Stanley. Directly appropriate to this discussion the San Diego County Pension Fund – voted public pension plan of the year in 2005 – had 20% of its assets in hedge funds including \$160 million invested in Amaranth. The county Treasurer was quoted as saying that he still did not know how big the loss would be.¹⁰ The week before, it was reported that the \$430 million hedge fund MotherRock – operated by a former NYMEX president – lost \$230 million on energy trades in a few weeks.

- The investment strategies of hedge funds are often not well known, or are so lacking in transparency – even to their own investors (prospectuses are often written to allow funds a great deal of latitude in crafting their investment strategies) – that the investors cannot adequately assess the hedge fund investment’s contribution to their overall portfolio risk. Without thorough knowledge of the hedge fund investment strategy, the investor can determine whether they are diversifying into independent, uncorrelated assets or not. Alternative investments are supposed to offer uncorrelated returns, but that investment property should not be – although it too often is – taken on faith. This is not consistent with the behavior of a prudent investor.
 - According to the Financial Economists Roundtable, “available performance data make it difficult to judge true hedge-fund returns and risk for this high-cost vehicle.” The report goes on to advise fiduciaries, “The difficulties in assessing the full range of hedge-fund risks should dictate a limitation on investments in hedge funds to a modest proportion of the total assets under management.”¹¹
- Hedge funds charge high fees and sometimes incur large transactions costs. The risk-adjusted rates of return on these investments need to be considered net of these fees and costs. These fees are usually 1% to 2% of invested capital plus 20% (or more) of returns. Investing through a fund of hedge funds will cost another 0.5% of invested capital. If the investment strategy generates a return of 10%, then 2% fixed fees and 20% fee on returns leaves the investor with a 6% rate of return. A 20% rate of return on investment will leave the investor with a 14% rate of return – which is high compared with major market indices, but is likely to involve greater risk. Their transactions costs are estimated to generate over 12% of all brokerage commissions.

As a consequence of the structure of these fees, investment managers have a great incentive to pursue high yield (and thus high risk) investment strategies since their 20% to 25% share of the returns sometimes does not kick-in until the rate of return has exceeded a specified threshold.

¹⁰ New York Times, September 20, 2006.

¹¹ FER, 2005.

Conclusion

The point here is not that all hedge funds are out to commit fraud. Nor is it to say that they do not offer in many instances a good risk-adjusted rate of return (see Table 1 below for some comparisons).

The point is that investing in hedge funds poses various potential problems and that these problems are different than those of traditional investment classes. The point is to recognize that this investment class is fraught with a different set of investment challenges – if not dangers – and that a different and more appropriate approach is needed in order to maintain fiduciary responsibilities towards pension fund investments.

In recognizing this distinction between hedge fund and traditional investment vehicles, the protection of the public interest inherent in pension funds requires that investments in hedge funds and similar alternative investment strategies should be treated with appropriately higher prudential concerns. One straightforward way to maintain this protection is limit the extent of such investments – a policy also recommended by the conservative Financial Economists Roundtable. Similarly, another way to maintain this protection is to continue to extend the ERISA prudential framework for fiduciary responsibility of funds to these new, but increasingly important investment targets.

Table 1

	RoR S.Dev								
	1987-2005	2005	2004	2003	2002	2001	2000	1999	
Hennessee Index	13.7	9.5	7.9	8.3	18.8	-2.9	4.4	8.2	30.8
LONG/SHORT	13.8	9.2	6.8	7.8	19.4	-6.5	2.9	10.2	33.9
Arbitrage/Event	13.2	8.8	5.2	8.5	13.9	2.2	9.0	9.5	19.4
GLOBAL/MACRO	15.1	16.9	14.2	8.7	27.6	-1.5	1.5	1.3	42.7
S&P 500	11.6	17.1	4.9	10.9	28.7	-22.1	-11.9	-9.1	21.0
NASDAQ	10.2	31.4	1.4	8.6	50.0	-31.5	-21.0	-39.3	85.6

	1998	1997	1996	1995	1994	1993	1992	1991	1990
Hennessee Index	1.4	18.2	19.1	17.7	0.2	25.7	15.6	25.8	12.0
LONG/SHORT	7.3	20.0	18.1	21.1	3.5	20.0	15.7	22.3	11.1
Arbitrage/Event	2.7	16.3	18.5	17.8	1.5	22.6	16.6	24.1	11.7
GLOBAL/MACRO	-12.2	18.3	21.3	9.7	-5.5	46.9	16.6	36.7	16.5
S&P 500	28.6	33.4	23.0	37.6	1.3	10.1	7.6	30.5	-3.1
NASDAQ	39.6	21.6	22.7	39.9	-3.2	14.8	15.5	56.9	-17.8

	1989	1988	1987
Hennessee Index	24.6	20.2	12.0
LONG/SHORT	22.7	17.6	14.8
Arbitrage/Event	12.9	36.7	7.5
GLOBAL/MACRO	41.9	18.4	5.09
S&P 500	31.7	16.6	5.3
NASDAQ	19.3	15.4	-5.3

* Source: Hennessee

** ROR is rate of return, S.Dev is standard deviation (simply measured)

Appendix I

Some Examples: Hedge Fund Scandals

Mutual Fund

Not necessarily found guilty, but under investigation, subject to subpoena by state or federal regulator, or named as participant in market timing or late trading.

- Canary Capital Partners (traded with Bank of America, Janus, Strong, Bank One)
- Da Vinci Fund (also managed by Edward Stern)
- Veras Investment Partners (Texas based, trading abuses with Fred Alger Management and Federated)
- Millennium (pleaded guilty to fraud following Spitzer investigation)
- Chronos Asset Management (mentioned in Galvin complaint against Prudential executives as having a market timing account; traded through Prudential from referral by CIBC)
- Head Start Advisors (trading abuses with CIBC)
- Samaritan Asset Management (investigation by Illinois state regulators, also trading with CIBC)
- Atlantique Capital Advisors (trading abuses with CIBC)
- Alliance Capital Management hedge fund
- Tidewater Capital (related to a SEC subpoena of brokerage A. Brean Murray)
- Peconic Capital Fund (related to a SEC subpoena of brokerage A. Brean Murray)
- Diamant Asset Management (related to a SEC subpoena of brokerage A. Brean Murray)
- Diamant Master Fund (related to a SEC subpoena of brokerage A. Brean Murray)
- Lighthouse Multi-Strategy Fund (related to a SEC subpoena of brokerage A. Brean Murray)
- Ritchie Capital Management (mentioned in Galvin complaint against Prudential executives as having a market timing account; related to a SEC subpoena of brokerage A. Brean Murray)
- Headstart Advisers (mentioned in Galvin complaint against Prudential executives as having a market timing account; related to a SEC subpoena of brokerage A. Brean Murray)
- Trout Trading Fund (renamed Tewksbury Capital Management, related to a SEC subpoena of brokerage A. Brean Murray)

Fraud against investors

Not necessarily found guilty, but under investigation, subject to subpoena by state or federal regulator or private suit for fraud.

- Fountainhead Asset Management, Fountainhead Fund LP
- House Edge Fund
- Sterling Watters Group LP, Sterling Watters Capital Management, Sterling Advisors
- Simpleton Holdings Corporation, Signature Investments Hedge Fund
- Beacon Hill Asset Management LLC
- Epic Investment Partners
- JB Stanley
- Lancer Management
- Track Securities, Condor Fund

- Integral Investment Management
- Paramount Financial Partners
- Double T Investment Group
- Marque Millennium, Marque Partners, Marque Fund
- Clinton Hedge Fund

Appendix I

About the Financial Policy Forum

Mission Statement

The Financial Policy Forum and Derivatives Study Center were created out of the concern that financial markets disruptions and inefficiencies have become a barrier to improvements in living standards in the U.S. and around the world. Our mission is to conduct economic policy research into financial markets, analyze how they impact the overall economy and then formulate policy recommendations for the most appropriate level of regulation and market oversight. We will disseminate this information to policy makers, journalists, academics and concerned citizens, and we will provide expert advice, training and policy briefings for policy makers, journalists, NGOs, labor unions and farmers.

Preamble

The Financial Policy Forum (FPF) is a non-profit educational institute established under section 501(c)3 of the federal tax code. Its principle funding is a grant from the Ford Foundation which allows it to maintain an independent perspective. The FPF does not receive funding from any Wall Street firm.

The FPF and the Derivatives Study Center (DSC) was established to engage in economic research and outreach activities in order to interject a new, critical voice into the policy debate over financial market regulation. Derivatives and other financial markets have become critically important to the U.S. economy and their presence and importance is growing throughout the world of developing economies. Financial markets have acted in recent years as major sources of disturbances and economic distortions, and have thereby raised instability and hampered the pace of economic growth. The rapid growth of derivatives and other financial markets, together with their continuous innovations and reorganizations, warrants on-going analysis and investigation into how this impacts overall economic prosperity and how to address such changes with the most appropriate level of regulation and oversight.

Brief biography of FPF Director Randall Dodd

Randall Dodd is the founder and director of the Financial Policy Forum and teaches in the Department of Finance at Johns Hopkins University and at the Maxwell School of Syracuse University. He previously worked as an economist for the U.S. Commodity Futures Trading Commission. Prior to the CFTC, he served the U.S. Congress as a senior economist for the Joint Economic Committee and the Democratic Study Group and he was the Legislative Director for Congressman Joe Kennedy who serviced on the House Banking Committee. Before moving to Washington, D.C., he worked at Citicorp Investment Bank writing financial market reports and conducting econometric tests of forecasting models. He has taught economics, finance and political philosophy at Columbia, Johns Hopkins, Rutgers, Maryland, and American Universities as well as Columbia's Graduate Business School and CUNY's Baruch College Business School. He received his PhD in economics from Columbia University where he specialized in international trade and finance, labor and development.