Preface—Hedge Funds: Creators of Risk?

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The author is a vice president and head of the financial team in the Atlanta Fed's research department. This preface provides an overview of the Atlanta Fed's 2006 Financial Markets Conference, "Hedge Funds: Creators of Risk?" held May 15–18.

As luck would have it, the Federal Reserve Bank of Atlanta's 2006 annual financial markets conference focused on hedge funds just as such funds became the subject of numerous news articles and discussions at regulatory agencies. The conference was held in May, when registration of hedge funds recently had become required, the amounts flowing into hedge funds was mushrooming, and many people were wondering when new regulations were to follow.

It may seem like a question with an obvious answer, but what is a hedge fund anyway? Many, including me before the conference, would answer that a hedge fund is similar to a mutual fund except that it may accept investments only by relatively well off people. More precisely, only investors who have more than a million dollars in assets or earn more than $200,000 per year may invest in hedge funds. In fact, thinking of hedge funds as being particularly similar to mutual funds is not a useful way to think about hedge funds.

As William Fung and David Hsieh show in their paper, hedge funds are far more than mutual funds with some complex financial strategies. Hedge funds specialize in buying and selling numerous kinds of risks, a fact that is well known in the industry but is not widely known outside it. In their very interesting paper in this issue of the *Economic Review*, Fung and Hsieh go far beyond dispelling this common misperception. They discuss a substantial amount of data on the hedge fund industry and provide an informative discussion of the economics of the industry.

Arguably, one reason that hedge funds have received so much attention is participation by more and more people. One reason more people are using them is because, when the definition of accredited investors as those with substantial wealth or high incomes was written, a million dollars was a substantial amount. But a million dollars today is not what it used to be. In the 1950s, on the television drama "The Millionaire," everyday people received a million dollars tax free from an anonymous donor. The show's premise was that the recipient was very rich after this gift.

Watching lotteries today, it clearly takes quite a few millions before someone can regard herself as having become rich overnight.

Franklin Edwards discusses the rationales for allowing only relatively wealthy people to participate in hedge funds. He suggests that, rather than limiting participation in hedge funds, the public would be better served by removing some of the regulatory restrictions on the financial strategies available to mutual funds.

In their paper, Nicholas Chan, Mila Getmansky, Shane M. Haas, and Andrew Lo note that many banks now operate proprietary trading units that are organized much like hedge funds. As a result, the hedge fund industry's risk exposures may significantly affect the banking sector, creating new sources of systemic risk. To quantify this potential impact on systemic risk, the researchers develop several new risk measures for hedge funds and apply them to individual and index data. They interpret their provocative findings as suggesting that hedge funds may be heading into a period of lower expected returns with systemic risk on the rise.

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Hedge funds have been criticized for the compensation received by the funds' managers, which seems quite high compared to that for mutual fund managers. Hedge funds' role in the market for corporate control has also been criticized, with a common interpretation effectively likening hedge funds to bandits who come in, lay off employees, and sell the corporation's assets, all in the name of making a quick buck.

Bruce Lehmann argues that little will be learned about hedge funds' governance or their role in the market for corporate control by looking at mutual funds. Instead, he suggests that more can be learned by comparing hedge funds to firms with similar assets and liabilities. Starting from this premise, he proposes that many hedge funds can usefully be compared to proprietary trading desks at investment banks. In that regard, he notes that the much-criticized compensation schemes at hedge funds compare reasonably well with the schemes used in that environment. He also argues that hedge funds' efforts to improve corporate government benefit all shareholders unless the target firm pays the hedge fund an outsized payment—greenmail—at the expense of other shareholders.

All in all, the conference—as the papers in this issue of the *Economic Review* demonstrate—provided a substantial amount of information and thoughtful analysis on a little understood industry.