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Story

Hedge funds may pose a risk to U.S. economy

By Kevin G. Hall and Robert A. Rankin | McClatchy Newspapers

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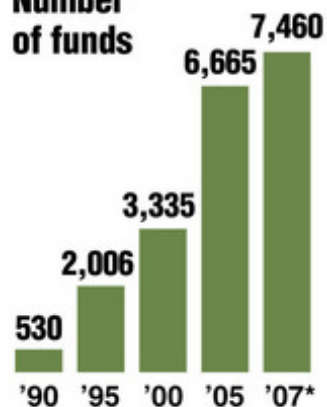
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Hedge funds

The growth of hedge funds has been rapid, but assets under management are less than stocks or mutual funds.

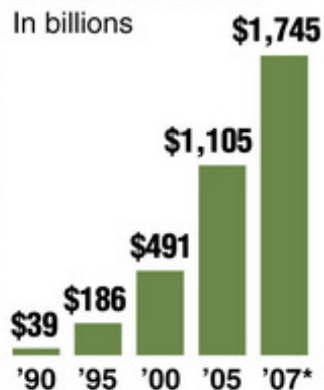
Number of funds



*Second quarter

Estimated assets

In billions



**Number of stocks traded times their value as of Dec. 2006

Others

By comparison, investment assets in 2006

- Mutual funds, **\$10.4 trillion**
- N.Y. Stock Exchange,** **\$15.4 trillion**
- Global exchanges, **\$44 trillion**

Hedge funds invest large pools of capital for those with a net worth of more than \$1 million and are free of direct federal regulation by law

Source: Hedge Fund Research Inc., Investment Company Institute, New York Stock Exchange, World Federation of Exchanges
Graphic: Angela Smith

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Hedge Funds | [View larger image](#)

WASHINGTON — Wild mood swings on Wall Street are nothing new, but the recent quaking in financial markets has a worrisome new wrinkle: It's being driven more by what isn't known than by what is.

That's because a huge share of the money that's flowing through U.S. financial markets is being invested by giant "hedge funds" that aren't subject to much regulation. No one really knows what they own. And there's a chance that some of what they own is worthless.

The funds — managed pools of investors' money, often supplemented with huge borrowings from banks — often bet on highly speculative and exotic financial derivatives, such as "options," which more regulated mutual funds aren't allowed to buy, and that poses risks to all the U.S. financial institutions that are tied to them, as much of Wall Street is. It poses risks to the broader economy as well, and those risks are impossible to measure because no one knows how risky hedge fund assets are.

The big systemic risk is that "people don't know anything about (hedge fund) activities," said Steven Brown, a finance expert at New York University's Stern Business School. "When you have a complete lack of disclosure, everybody is locked in the same category, and the sins of the few are visited on the many."

Brown was quick to add that he doesn't expect cataclysmic problems to emerge, but his point is that in the absence of transparency, they might. That possibility magnifies the anxieties on Wall Street and contributes to the markets' volatility.

The Dow Jones Industrial Average hit a record high of 14,000 points July 19. Almost every day since, it's jolted up and down in huge swings.

Some 7,500 hedge funds controlled \$1.6 trillion in assets as of the end of June. That's equal to about 10 percent of the total value of the New York Stock Exchange. Much of what they own was bought with money they borrowed from big banks, sometimes up to 80 percent of their holdings.

If the banks can't collect the debts that hedge funds owe because the assets that the funds bought turn out to be worthless, then the banks are in trouble. If the banks are in trouble, so is the economy.

But nobody knows how much trouble.

When two Bear Stearns hedge funds went bankrupt last month — the mortgage-backed assets they held were judged worthless — investors lost more than \$1 billion, a flu-like shiver chilled Wall Street and the fever remains.

Some analysts think that the problem — along with its solution — is rooted in transparency, or the absence of it. Most investment funds must report details of their finances to the government, which shares much of the information with the public. That's a lesson learned after the 1929 stock-market crash. The logic is that investors will make better bets if they have a better idea of what they're buying, and can calculate the risks.

Hedge funds have been excused from this transparency principle, and now some analysts think that's a mistake.

"I think they are a big anomaly. Basically they are not overseen by anybody," said Charles Bowsher, who was the U.S. comptroller general,

the nation's chief auditor, from 1981 until 1996.

When hedge funds were created under the Investment Company Act of 1940, they were deliberately limited to the wealthiest Americans, who could absorb losses.

They're different now. For one thing, there are lots more of them. There were 530 as recently as 1990; today there are almost 7,500, according to Chicago-based Hedge Fund Research Inc.

Here's a more important difference: They're not just for millionaires anymore. Pension-fund managers invest pension assets in them now. So do university endowments. They do so because, when they're successful, hedge funds pay big dividends. But when they're not, every investor in them is at risk, just as in regulated funds.

"It has evolved into something quite different than just rich people," Bowsher said. "There are a lot of ordinary people who are going to be hurt if these big private funds go under. Then, the question really is, should there be more transparency?"

Some analysts think that Washington's failure to make hedge funds obey rules of transparent disclosure, just as mutual funds do, is a failure of public policy to protect the public.

"I think that there has been a serious regulatory failure, and the depths of the problem will become clearer when we see the next financial crisis, which may not be far off," said Dean Baker, an economist with the liberal Center for Economic Policy and Research.

Conventional wisdom has long held a sanguine view that hedge funds don't pose much risk, and in fact spread risks efficiently among diverse investors.

John Makin, a principal of New York-based Caxton Associates LLC, which manages \$14 billion, thinks that the current hedge-fund woes show that the markets are working as they should.

"I think we are seeing a lot of volatility and the right people are getting punished," he said. "The ones who are really punished and out of business are the people who are making leveraged bets on risky assets."

To be sure, Alan Greenspan and Ben Bernanke, the previous and the

current chairman of the Federal Reserve, have said that direct regulation of hedge funds is unnecessary.

Similarly, a presidential working group concluded in February that existing market discipline and investor awareness of risks are sufficient. So did one under President Clinton. Former Wall Street bankers shaped both administrations' economic policies.

Increasingly, however, some lawmakers aren't sure that such a laissez-faire attitude is right.

"I think we have an uneasy consensus that there's a potential problem here that we wish we were more sure about how to approach," Rep. Barney Frank, D-Mass, the chairman of the House Financial Services Committee, said during a July hearing on potential risks from hedge funds.

"I don't think anybody can be confident that all is entirely well here, but neither is there any obvious thing we ought to be doing," he concluded.

Such indecision over how to head off possible economic danger is normal in Washington. U.S. economic history shows that regulators rarely move ahead of a crisis. They didn't before the stock-market crash of 1929. They didn't during the savings and loan meltdown in the 1980s. And they didn't before Enron's accounting scandal in 2001.

Only after the scandals exploded — and claimed many innocent victims — did the government move to stiffen regulation of market activity.

For now, regulatory efforts focus on forcing greater disclosure, and hedge funds are resisting.

When the Securities and Exchange Commission tried to force hedge funds to register and disclose information, the industry sued. Last year a federal appeals court ruled that the SEC lacked the authority to regulate hedge funds. To gain it, Congress would have to give the SEC more clout.

Many hedge funds register voluntarily with the SEC, but they don't share details on their earnings or investments. That stands in sharp contrast to mutual funds, which managed \$10.4 trillion in assets last year. They must publicly disclose what stocks or bonds they own and how much cash they have on hand.

Victims of hedge-fund losses, such as public employees in San Diego

County, Calif., may wonder why hedge funds don't have to as well. Their pension fund had invested heavily in the \$9.2 billion hedge fund Amaranth Advisers, which collapsed last year, losing around \$6 billion in bad bets on natural-gas trades. San Diego County public employees lost \$175 million in retirement money.

Testifying before Congress last week, Securities and Exchange Commissioner Christopher Cox acknowledged that his agency is working to create better reporting standards for how hedge funds handle pension-fund money.

Cox said he thought the SEC was "increasingly getting a clearer picture of what's going on."

That's not enough for some critics.

During a July hearing on hedge-fund risks, Rep. Richard Baker, R-La., complained that what little disclosure there is comes annually. That's of limited use, he said, if there's been a financial calamity in the meantime.

- [Graphic | Hedge funds](#)
Because then "all you would be able to do is get the license-tag number of the truck that just ran you over."

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