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Testimony before the
U.S. House of Representatives
Committee on Financial Services
“Hedge Funds and Systemic Risk in the Financial Markets”
Hearing held on March 13, 2007

The President’s Working Group on Financial Markets tells us that “private pools of capital bring significant benefits to the financial markets.” What are these benefits? Some would tell us that their only objective is to enrich themselves and their rich clients. The industry needs to show that these benefits outweigh the problems they cause. A premise of the PWG is that hedge funds do ***not*** pose a systemic risk for the financial markets.

What is a hedge fund? The term actually comes from Carol Loomis, a *Fortune* journalist writing in 1966 about the strategy of AW Jones who invested in undervalued companies financed in part by short positions in companies he felt were overvalued. In this sense the investment was “hedged” against general market movements. The term “hedge fund” was a stretch even for AW Jones as his short positions never equalled the size or economic significance of his long positions.

Subsequent funds adopted the regulatory form of AW Jones, but not his investment philosophy. Indeed, the term “hedge fund” belies their considerable risk. Sophisticated investors should be allowed to do as they please, provided they not hurt innocent bystanders. Unfortunately, the industry interprets the general solicitation ban as limiting all kinds of public disclosure. Indeed, some view lack of transparency as part of their business model. I argue that it is this lack of information, this lack of transparency at an industry level, that is of greatest concern.

Absent industry wide disclosure, the only reliable information we have is the purely voluntary disclosure to data vendors such as Lipper TASS. According to their numbers U.S. domiciled funds have grown from close to $20 Billion assets under management in December1995 to $131 Billion today.

The data show a remarkable diversity of styles of management under the "hedge fund" banner. The AW Jones long-short strategy captures about 30 to 40 percent of the business. The style mix has been fairly stable (in terms of percentage of funds) although there has been a dramatic rise in assets managed by funds of funds. These diversified portfolios of hedge funds are attractive to an institutional clientele. Event-driven funds focussing on private equity have risen in market share from 19% to 25% over the past decade, while the global macro style popularized by Soros has actually fallen from 19% to 3%.

There is concern about the role of hedge funds in the credit derivatives and CDO markets. How big is this issue? We don’t know since the industry is not required to tell us. But based on TASS fixed income arbitrage is just 4 percent of the hedge fund business. The industry should make the case that entering this market, their ‘rich clients’ are taking on significant risk which would otherwise fall on the banking system. They are thus reducing systemic risk, not increasing it.

What about leverage? According to TASS the fraction of funds that use leverage has fallen from 69 percent in 2002 to 57 percent today. In addition, there are vast differences in the degree of leverage across funds. Strategies that report the highest degree of leverage have quite small market share.

More information would certainly help. But does the general lack of transparency detract from the due diligence of sophisticated investors? With colleagues I studied the recent controversial and ultimately unsuccessful SEC attempt to increase hedge fund disclosure. We examine disclosures filed by many hedge funds in February 2006. Leverage and ownership structures as of December 2005 suggest that lenders and hedge fund equity investors were already aware of hedge fund operational risk revealed in these forms. However, operational risk does not mediate the naive tendency of investors to chase past returns. Investors either lack this information, or regard it as immaterial

What is the role of government? Perhaps Congress needs to revisit the '40 Act. The "sophisticated investor" exemption seems quaint. The industry argues that the ban on direct solicitation inhibits disclosure. However, Congress can mandate any level of selective disclosure necessary for 3C1 or 3C7 exemption. There is no need to know proprietary trading information. However, by being more forthcoming, the industry could allay public concern about systemic risk and operational risk.

Appendix to the Testimony of Stephen Brown 3/13/2007

Assets under management ($Million) U.S. Domicile Hedge Funds

	12/31/1995		12/31/2000		12/31/2005		12/31/2006	
Convertible Arbitrage	$720	4%	$2,282	4%	$1,529	1%	$809	1%
Dedicated Short Bias	$191	1%	$881	1%	$897	1%	$592	0%
Emerging Markets	$528	3%	$495	1%	$1,518	1%	$1,093	1%
Equity Market Neutral	$340	2%	$3,293	5%	$5,677	4%	$4,585	3%
Event Driven	$3,624	19%	$9,630	16%	$35,894	26%	$32,279	25%
Fixed Income Arbitrage	$517	3%	$1,490	2%	$5,931	4%	$4,980	4%
Fund of Funds	$1,699	9%	$7,399	12%	$25,169	18%	$17,190	13%
Global Macro	$2,532	13%	$488	1%	$2,103	2%	$3,303	3%
Long/Short Equity Hedge	$7,537	39%	$30,838	50%	$42,901	31%	$45,921	35%
Managed Futures	$1,476	8%	$2,026	3%	$9,625	7%	$10,644	8%
Multi-Strategy	$367	2%	$2,619	4%	$8,143	6%	$9,629	7%
Total	$19,531	100%	$61,440	100%	$139,386	100%	$131,024	100%

Number of U.S. Domicile Hedge Funds

	12/31/1995		12/31/2000		12/31/2005		12/31/2006	
Convertible Arbitrage	24	4%	37	4%	40	3%	36	3%
Dedicated Short Bias	10	2%	15	1%	12	1%	11	1%
Emerging Markets	15	3%	23	2%	25	2%	25	2%
Equity Market Neutral	17	3%	52	5%	75	6%	68	6%
Event Driven	63	11%	118	11%	142	11%	118	11%
Fixed Income Arbitrage	13	2%	29	3%	62	5%	48	4%
Fund of Funds	87	16%	146	14%	221	17%	184	17%
Global Macro	18	3%	22	2%	43	3%	35	3%
Long/Short Equity Hedge	191	35%	473	46%	524	40%	429	39%
Managed Futures	97	18%	82	8%	94	7%	87	8%
Multi-Strategy	13	2%	39	4%	64	5%	50	5%
Total	548	100%	1036	100%	1302	100%	1091	100%

Source: Lipper TASS Database 3/5/2007