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Before the Senate Banking, Housing and Urban Affairs Subcommittee on Securities and Investment

Chairman Hagel, Ranking Member Dodd, Members of the Subcommittee, good afternoon, it is a pleasure to be here today. Let me first thank you for holding this hearing and allowing the Treasury Department to present its views. I am particularly pleased to be here because our discussion today is an effort to gain a better understanding of a critical component of our financial markets.

Our charge today is to examine the role of hedge funds in our financial markets. I note at the outset that this topic is different from an issue about which there has been considerable discussion in the past few years: the regulation of hedge funds. I think your choice of topic for today's hearing is the right one – if government addresses the question of regulation of any financial institution or activity without a clear understanding of the place it plays in our financial system, the risk of unnecessary, excessive, or inappropriate legislation is increased. While I am sure we will touch on certain regulatory aspects, I intend to focus my remarks on what hedge funds do for and in our financial markets.

As we consider this issue, we should also keep in mind that the role of hedge funds in our financial markets is continuously evolving; and in recent years it has been evolving rapidly. While change like this often brings about improvements and efficiencies, it can also create insecurity or concern. The lens through which we examine the evolution of hedge funds' role in the financial markets often shapes our view of what, if anything, the government needs to do to react to the changes so we should ensure that this lens is as clear and polished as possible.

Hedge funds are not a recent invention. Their history is typically tied to the fund created by Alfred Winslow Jones in 1949. During this time period, these new investment vehicles were created mainly as a reaction to significant regulatory restrictions on investment funds embodied in the Investment Company Act of 1940 (the '40 Act). Unlike mutual funds registered under the '40 Act, an unregistered fund could sell securities short, buy securities using leverage, and use diverse financial instruments and strategies. The name "hedge fund" was used to identify these new funds that were able to hedge or protect against loss of capital in down markets.

Today, the term hedge fund is used to describe much more than a fund that employs hedging techniques. There is, however, no universally accepted definition of a hedge fund. In the late '90s, for example, the President's Working Group on Financial Markets (PWG) defined a hedge fund as "any pooled investment vehicle that is privately organized, administered by professional investment managers, and not widely available to the public." This is a useful working definition for some purposes, but it does not distinguish hedge funds from other forms of unregistered capital pools that generally are recognized to have distinctive features, such as private equity funds and venture capital funds.

Perhaps the most useful approach is to identify a list of features that distinguish hedge funds from other capital pools, recognizing that the list is evolving, that various combinations of such features are possible, that some are shared with other investment vehicles, and that no single feature is a defining characteristic. Such features would include legal structure (a private entity with unlimited life and with pass-through tax benefits); investment objective (positive absolute return in all market conditions, rather than measurement against an industry benchmark); investment strategy (flexible, including the ability to use short selling, leverage and derivatives in a wide variety of markets); compensation structure (usually 1-2% management fee and 15-25% performance fee, calculated annually on the basis of accrued gain); investor base (high net worth individuals and institutional investors; high minimum investment; not widely available to the public); investor capital commitment (full commitment paid at time of subscription rather than drawn down over time; withdrawals regularly available, usually monthly or quarterly); and disclosure (generally restricted to that contractually agreed upon between the manager and the investors, with limited public information).

Hedge funds have experienced phenomenal growth during their history especially in recent years. They have grown from an estimated $50 billion in assets in 1988 to about $300 billion in 1998 to over $1 trillion in assets today.[1] Current estimates suggest that there are about 9,000 hedge funds.

Today, hedge funds employ a variety of investment strategies that vary considerably depending on the goals and needs of the investors and the types of instruments in which the fund invests. Much, if not all, of this growth has been market driven, and, as a

[1] The data about the hedge fund industry are not precise. Therefore, many of the figures noting the size and growth of the industry are estimates and Treasury has not independently verified them.

consequence, it has been subject to a significant amount of market discipline. For example, as hedge funds have grown, their investor base has evolved. The original hedge fund investors were wealthy individuals. Then, university endowments began investing in hedge funds – most likely because the individuals that typically sit on these boards were already exposed to these types of investments. Later, institutional investors such as pension funds seeking greater diversification wanted to participate. Through this growth process, each of these investor groups imposed certain forms of discipline on hedge funds. Thus, the hedge fund market has become much more "institutionalized" as it has grown and evolved.

Hedge fund growth and practices also have been tempered by significant market events, most notably, the failure of Long Term Capital Management (LTCM) in 1998. As a result, hedge fund investors now demand more transparency of their fund managers (you might recall that LTCM principals notoriously provided little transparency). Post LTCM, investors also recognize the need for more discipline regarding the use of leverage and collateral.

Therefore, while the hedge fund market has grown drastically in the past twenty years, there is at least some reason to believe this growth has been subject to private sector discipline.

What role this very large, trillion-dollar group of alternative investments plays in our financial markets is a very important question. While hedge funds provide certain benefits to the financial markets, they can also put stresses on it that need attention.

Benefits to the Financial Marketplace

Liquidity Provision

One of the reasons that the U.S. financial markets are so attractive to investors is because of their liquidity. In general, the U.S. financial markets are the deepest and most liquid markets in the world. Hedge funds are significant liquidity providers in many marketplaces.

Because of the varying strategies employed by hedge funds, they are often the willing buyers or sellers that provide additional liquidity to financial markets. For example, hedge funds' desire to seek arbitrage opportunities adds significantly to a markets' liquidity. In fact, some reports suggest that hedge funds account for between one-third or one-half of the daily volume on the New York and London stock exchanges. Hedge funds contribute even more significantly to marketplace liquidity in less traditional markets. For example, hedge funds represent the overwhelming majority of trading volume in the distressed debt markets, the convertible bond markets, and the exchange-traded fund markets.

Price Efficiency

Many hedge funds seek to create returns by targeting price inefficiencies. Such price inefficiencies might occur when there is discrepancy between two or more markets. A sophisticated investment manager can enter both of these markets and profit by taking advantage of this pricing anomaly. Former Federal Reserve Chairman Alan Greenspan characterized the ability of hedge fund managers to obtain profit from these inefficiencies as picking the "low-hanging fruit" in the marketplace. While this activity certainly benefits the hedge funds that are profiting from the trades, it has the salutary effect of creating more efficient markets.

Similarly, hedge funds also target wide bid/ask spreads as ways to generate positive return, which generally has the effect of narrowing them. This private, profit-making activity on the part of hedge funds produces the public good of better price discovery and more efficient markets.

Risk Distribution

Concentration of market-wide risk is one of the greatest threats to a smoothly-functioning marketplace. Hedge funds can help mitigate this risk by helping to transfer and distribute market risk. For example, when financial institutions seek to lay off some of the very large risks inherent in their normal business activities by buying or selling derivatives, hedge funds are often the counterparties to these trades. Without market participants that are willing to trade these derivatives in significant quantities, financial institutions would have to retain more risk, which could have a ripple effect throughout the financial markets.

There is no question that hedge funds are one of the dominant participants in the re-distribution of market risk. Among the most common risk distribution instruments used by hedge funds are credit default swaps. Most simply, these are insurance-like products that provide protection against default or bankruptcy, in that they pay bondholders some form of compensation after a defined credit event. Use of these instruments has grown substantially from about $631.5 billion in 2001 to about $17.3 trillion in 2005. The significant growth in these securities does raise some important public policy issues, which I will address below.

Further Globalization

Because of the dynamic and evolving nature of hedge funds, I have tried to avoid over-generalizing them. However, I am comfortable making the observation that, in general, one attribute that is common across the entire hedge fund community is that the managers are involved in a relentless search for the next profit opportunity. In such a competitive marketplace, hedge funds often lead the way to identify new and emerging markets. These markets often provide opportunities that no longer exist in more mature marketplaces. This, in turn, leads to further globalization of our marketplace which provides more choice for investors and greater efficiency of markets globally.

Potential Investor Benefits

Hedge funds can have a direct positive impact on the investing community. Speaking broadly, hedge funds can provide investors with opportunities for diversification, "alpha" or excess returns, and capital protection in down markets.

Hedge funds provide more choices to the investing community. More choices allow investors the ability to diversify their investment portfolios, which is a common goal of many investors. A recent survey suggested that almost half of institutional investors had more than 10 percent of their assets in hedge funds. Most of these allocations were made by reducing allocations to active and passive equity strategies. All of the surveyed investors said that their diversification needs were being met and over three-quarters of surveyed investors saw reductions in overall portfolio volatility.

Historically, most non-professional investors were limited to investment vehicles that employed traditional "go-long" strategies. These funds attempt to outperform a particular index, such as the S&P 500. Notably, these funds typically profit only in positive markets and try to mitigate losses in down markets. Some hedge funds try to fill the obvious gap here with strategies that attempt to produce positive returns in both bull and bear markets. The flexibility in the hedge fund structure can provide many opportunities to outperform indexes, even in thriving years. This is often referred to generating "alpha" or excess returns. A common technique employed by many hedge funds attempting to generate excess returns is employing leverage, which, of course, presents its own specific set of concerns.

Producing positive returns in a down market is also assisted by the nimble structures of hedge funds. Indeed, many expected the high-flying hedge funds to be crippled after the bursting of the internet bubble in the late nineties. Some funds were punished, of course. However, many funds exploited their natural flexibility to short stocks and, importantly, to move to cash during market dislocations limiting exposure and mitigating loss.

Therefore, hedge funds have the potential to provide investors with opportunities for excess returns or capital protection, but, of course, this is not always the case.

It is worth noting that as the hedge fund industry grows and becomes more institutionalized, excess returns have become harder to find. Indeed, as more market-based demands are placed on hedge funds for added transparency, investors will demand significant higher returns to justify the hedge fund manager's fee. Armed with this added transparency, some observers suggest that there might be a shake-out of sorts with underperforming hedge funds suffering the consequences.

Marketplace Risks

While hedge funds can provide benefits to investors and the overall marketplace, they present some risk as well. There are risks that hedge funds' aggregate employment of large amounts of leverage or over-concentration of certain positions could have negative consequences for the marketplace. Certain valuation risks also are present in the hedge

fund industry. Other risks involve operational challenges associated with the over-the-counter (OTC) clearance and settlement systems. Many of these risks, however, are not unique to hedge funds.

Large Use of Leverage

Leverage refers to the use of repurchase agreements, short positions, derivative contracts, loans, margin, and other forms of credit extension to amplify returns. With increased leverage, of course, comes increased risk. We learned much about this topic after the LTCM failure.

As discussed by the PWG in its report after the LTCM failure, excessive leverage can greatly magnify negative effects of market conditions. For example, the LTCM failure demonstrated the risks of extraordinary leverage when adverse financial market conditions occur. At the time of LTCM's downfall, it had an implied balance-sheet leverage ratio of more than 25-to-1 (assets of $125+ billion over equity capital of $4.8 billion). As market conditions worsened, LTCM's size and leverage, combined with the sheer number of trades it had on its books, contributed to a serious deterioration in the liquidity of many markets as LTCM and countless other market participants sought simultaneously to unwind losing positions.

The magnitude of LTCM's leverage, and its dependence on numerous creditors and counterparties, heightened the threat that its problems could spill over to these other institutions and possibly lead to a general breakdown in the functioning of the markets. LTCM's excessive leverage posed very real systemic risks for our financial markets. It is important to note, however, that even though LTCM was a hedge fund, this issue is not confined to hedge funds. Many other types of market participants use leverage in their trading strategies, and some may be more highly leveraged than hedge funds. Moreover, it should be noted that innovations in the market are expanding the ways in which market participants can apply leverage. Many of the complex derivatives and other structured products in which there have been strong growth over the past few years have embedded leverage, which in certain circumstances can amplify changes in portfolio valuations to a greater degree than other forms of leverage.

In its report, the PWG cautioned that problems can arise when financial institutions do not employ sufficient discipline in their credit practices with customers and counterparties. To this end, the PWG made several recommendations designed to help buttress the market-discipline approach to constraining leverage. Numerous public and private sector groups, such as Counterparty Risk Management Group II (also known as the Corrigan Group), also took up the cause of enhancing counterparty credit risk management, and many have continued to focus on emerging developments such as the growth of products containing embedded leverage. These efforts and others have had the positive effects that I alluded to earlier.

Concentration of Positions

Linked closely with the issue of leverage and the potential for impaired liquidity in a period of market stress is the issue of concentration of market positions or "crowded

trades." Sometimes referred to as "herding," crowded trades can arise to the extent that hedge fund managers are inclined to pursue the same or similar investment strategies. Talented hedge fund managers are constantly searching for new opportunities and devising new strategies to exploit those opportunities, while simultaneously trying to anticipate crowded trades. But as more hedge fund managers open funds and more money flows in from new investors, crowded trades may become more likely. If numerous market participants establish large positions on the same side of a trade, especially in combination with a high degree of leverage, this concentration can contribute to a liquidity crisis if market conditions compel traders simultaneously to seek to unwind their positions. The risk, of course, is market disruption and illiquidity, possibly exacerbating the risk of a systemic financial market crisis.

Valuation Techniques and Models

As hedge funds become larger, their valuation policies and procedures become more important to the marketplace as a whole. Valuation of many financial instruments, particularly complex or illiquid instruments, can be difficult. Indeed, valuation is often dependent on complex proprietary models. Because of their proprietary nature, these models have not been subject to broad-based scrutiny and there is a concern that there could be unanticipated changes that might only present themselves in certain market conditions. Moreover, valuation concerns are exacerbated in the hedge fund industry because hedge fund adviser compensation is tied to period returns which, of course, requires periodic asset valuations.

Valuations and correlations can change rapidly in unexpected ways and these changes can have a ripple effect in the marketplace, especially if the instruments are concentrated and illiquid. There have been some reports on this topic. In July 2005, the Corrigan Group issued a number of "guiding principles" and recommendations for all types of participants. It recommended that: 1) investment in risk management systems should continue, with full model testing and validation and independent verification; and 2) analytics should include stress testing, scenario analysis, and expert judgment, with special attention to the inputs and assumptions.

Treasury and the PWG can contribute significantly to this debate in the first instance by facilitating communication in the official sector and with industry participants and academics regarding valuation techniques and models.

Settlement and Clearance Systems

Hedge funds as a group do not pose a greater operational risk to the OTC settlement and clearance systems than any other group of market participants. However, operational risks can be posed by certain market conditions and certain technological conditions in certain *products*, particularly *new* products, where technological and legal infrastructures tend to lag product development and volume growth. These acute "growing pains" have developed most recently in the credit derivatives market across a wide spectrum of participants.

Thus, hedge funds, or any other group of participants, potentially could have a disruptive impact if there were concentrations of positions or attempted mass liquidation in illiquid markets. As I noted earlier, hedge funds are major participants in many of these markets such as distressed debt, collateralized debt obligations, and credit derivatives.

The Federal Reserve Bank of New York, Counterparty Risk Management Group II, Bank for International Settlements, International Swap and Derivatives Association, The Bond Market Association, and Depository Trust & Clearing Corporation all have made recommendations and/or undertaken efforts to strengthen the technological and legal aspects of the settlement and clearance systems for all market participants. The International Monetary Fund has also raised issues generally related to market concentrations and illiquidity and the potential for systemic risk in its recent "Global Financial Stability Report," and member countries and regulators continue to develop and coordinate policies and approaches to deal with these issues globally. The PWG also continues to discuss these issues and formulate and coordinate actions and plans. We are encouraged by these positive developments.

Conclusion

Thank you again for allowing the Treasury Department to participate this afternoon. As I have mentioned, hedge funds play an important role in our financial marketplace. We are also aware that they can present certain risks as well.

As a consequence, as I have noted elsewhere, we at Treasury will be examining in detail the issues I have discussed this morning, with a view to evaluating whether the growth of hedge funds – as well as other phenomena such as derivatives and additional alternative investments and investment pools – hold the potential to change the overall level or nature of risk in our markets and financial institutions. We will be engaging in a broad outreach to the financial community in the coming months to help us examine these questions. In addition, we plan, in concert with the PWG, to bring key government officials together to discuss these financial market issues. As I discussed, the PWG has already undertaken a detailed analysis regarding the causes and consequences of LTCM's failure. The PWG can and should build on this work to help develop a measured and market-based approach to the impact hedge funds have on our financial markets.

Looking forward, we will be focused on seeking to understand in the most comprehensive way possible whether and how changes in the structure of the financial services industry – of which the rapid growth of new forms of capital accumulation, such as hedge funds, is just one example – have materially affected the efficiency with which markets intermediate risk, whether risk is pooled in different ways or in different places than it has been in the past – and if so, what appropriate policy responses might be. We will seek to be forward looking and to think about these changes not in a fragmented fashion, but in a comprehensive way. At the moment it is too soon to say what initiatives will result from this focus, but this is the lens through which we will filter the various ideas and efforts with which we will all be grappling over the next few years.