Lars Nyberg: Hedge funds and the recent financial turmoil

Speech by Mr Lars Nyberg, Deputy Governor of the Sveriges Riksbank, at the Nordic Hedge Fund Investment Forum, Stockholm, 28 January 2008.

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Hedge funds have come to play an increasingly important role in the financial system. In the past decade the assets managed have quadrupled and now stand at around USD 2 000 billion; growth of between 25 and 30 per cent per year.[1] But it is not just the fact that the hedge funds have grown in number and size that makes them important. They also have different trade strategies and more liberal investment rules than many other types of investor. This makes them important players on several of the world's financial markets.

Many have said (and some have perhaps hoped) that hedge funds would cause the next financial crisis. As we know, the past autumn saw a number of unpleasant surprises in the financial markets. In this context I believe it may be of interest to note that the hedge funds have not contributed to amplifying the problems in the market. To date, if anything they have had the reverse effect, that is, their actions have generally had a stabilising effect in the markets.[2] At the same time, many hedge funds, like many other financial market agents, can surely learn some lessons from recent events.

I will reflect on this today. This also brings me to the current animated debate on the regulation of hedge funds. My main message is that recent events support rather than oppose my opinion – namely that further regulation is not necessary as long as the major banks manage their exposures to the hedge funds correctly.

I shall shortly discuss the role the hedge funds have played – and not played, during last autumn's unrest in the financial markets. However, let me first say a few words as to why hedge funds as a group are important to financial stability.

Hedge funds spread risk and improve pricing

Hedge funds are, as we know, a broad concept and one that covers managers with a number of different working methods and strategies. However, a common denominator for most hedge funds is that they have as a goal an absolute return rather than a relative return and have far more liberal investment rules than other funds. Also they often have highly leveraged portfolios with the aim of increasing the return.

For those who reflect on the way in which financial stability develops, and all central banks do so, it is, of course, of particular interest to see what advantages and risks hedge funds as a group can convey – once again being aware that this is an extremely heterogeneous group.

In my opinion, hedge funds fulfil several useful functions in the financial markets. They contribute to spreading market risk and credit risk to more agents. Further, since they can act swiftly and in a flexible manner, they can often help improve the pricing for different products. For example, hedge funds that specialise in identifying mispriced assets contribute to prices that better reflect the underlying risk. When the prices are more correct, resources may also be distributed more efficiently and the risks may be better managed. In new and complex markets hedge funds are often important agents with the opportunity and will to take on risk. This, in turn, improves liquidity in these markets.

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[1] According to the Barclay Hedge database.

[2] See also the ECB Financial Stability Review 2007:2.

But there is often little insight

But the flexibility hedge funds have also entails risk. Problems that arise in a hedge fund can spread to the fund's counterparties; in the first instance the major banks. What is often highlighted in this context is the hedge funds' high leverage. High leverage of course increases the risks, and the effects of a fund failing.

Hedge funds are often accused of showing herd behaviour, that is, of imitating one another's behaviour and taking similar positions. But I find it difficult to believe that hedge funds to a greater extent than other investors just follow the prevailing trend. The fact that the required rate of return is absolute rather than relative in most hedge funds should actually indicate the opposite.

Another source of concern is that there is little public insight into hedge funds' activities. To take one example, in the United States hedge funds do not need to publicly report their activities or even register them. This means that major risks can arise without either counterparties or authorities being aware of this. Two well-publicised cases in this context are the LTCM and Amaranth hedge funds. Both of the funds collapsed and the lack of insight appears to have contributed to the problems. LTCM was permitted a very high degree of leverage by its counterparties, which is remarkable and reflects the fact that there was no overview of the fund's size and total risk. In the same way, no one observed in time the risks on the energy market that were being built up in the Amaranth hedge fund.

The funds' high leverage and lack of transparency has contributed to a lively debate about further regulation of hedge funds. I shall return to this in a while, but first of all I shall discuss the turmoil we have experienced in the financial markets in the past six months. What has this entailed for the hedge funds and how have they been affected by developments?

Several hedge funds have been affected negatively by the recent turmoil

As we know, the unrest in the financial markets has its origin in the US mortgage market, the subprime market. The problems in this relatively limited part of the US mortgage market spread to several financial markets at the end of last summer. A large share of the subprime loans had been re-packaged in various structured products and sold on to investors around the world. When subprime borrowers experienced problems in paying their credit, it became difficult to value products with subprime loans as underlying assets. At the end of the summer the credit rating institutes also began to downgrade credit instruments containing such loans. This resulted in the financial markets more or less losing confidence in anything that might contain subprime loans. This, in turn, fuelled price falls.[3]

A common denominator for many of the investors, both hedge funds and others, who have experienced problems, is that they have had a high share of securities with subprime content, often in combination with high leverage. Considerable attention, as we all know, has been focused on the US investment bank Bear Stearns' hedge funds, where the situation was such. When the financiers wanted to pull out, the funds were forced to sell their assets. The problem was that it was no longer possible to sell these assets, since liquidity in the market had disappeared. Quite simply, there were no buyers at prices anywhere near those that were previously listed or calculated. The funds therefore collapsed with substantial losses. Bear Stearns' funds have received considerable attention, not merely because the losses were extensive, but also because they were among the first to experience problems.

But there is also another category of hedge fund, which without having any actual exposure to subprime, was particularly affected by the turmoil. This was a type of fund that mainly relied on quantitative models for their investment decisions, so-called quant funds. Many of

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[3] For a more detailed description see the Riksbank's Financial Stability Report 2007:2.

these funds belonged to the group of hedge funds with a strategy that is normally called a long/short equity strategy. In principle, with the help of quantitative methods as a basis for investment, their strategy entails both long and short positions in equity. At the same time they are neutral to the stock market as a whole. If we disregard quant methods, this strategy was one of the first to be used by hedge funds, and which, more than 60 years ago, gave them their name.

Over a number of days in August several quant funds were however forced to close positions and to realise significant losses. They were forced to do so because of the sudden emergence of large price fluctuations in parts of the stock market. The large fluctuations entailed that the quantitative links, which were based on historical data and statistical probability analyses, no longer worked. But what was it that triggered the initial fluctuations in prices? It was probably the case that other types of hedge funds or investors, in order to meet the banks increasing collateral requirements, were forced to reduce their risk exposure.[4] If trading is thin in the shares concerned, that is, if liquidity is weak, the price fluctuations can be significant.

That is the normal pattern. The fact that unrest in a market, in this case the mortgage market, spread rapidly to other markets should not surprise anyone who follows financial events in the world.

However, on the whole hedge funds have fared well and played a positive role

In an efficient market where competition is permitted there will always exist companies who fail in their strategies and default. There are always winners and losers in the financial markets. This time, for example, the winners have been the hedge funds with a short position in the subprime sector, that is, those who have sold securities with subprime content that they have not owned. After the price fall they have been able to acquire the assets at a significantly lower price than they sold them at and have thus earned substantial amounts of money. The losers have had opposite positions or just had strategies in the stock market that did not work.

In those instances where individual hedge funds have experienced problems, this has not spread to the financial system overall. As a group, hedge funds have overcome the turmoil relatively well. Indices of the hedge funds' return fell a few points in August but in September hedge funds as a group once again showed a positive return. During the whole of 2007, the hedge funds have performed better than share indices generally.[5] The reason for this is partly that the hedge funds have not to any great extent been exposed to the subprime sector and partly that they were flexible and could rapidly close positions where they lost money.

In addition, the hedge funds generally seem to have had a stabilising role in the financial markets. In some cases hedge funds have had considerable liquidity, seen the large fall in prices as an opportunity, and taken advantage of this to go in as a buyer. In this way they have contributed to, rather than consumed liquidity. It does not appear as though the hedge funds have played a specifically negative role during the turmoil we have seen to date. Nor have the hedge funds triggered it.

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[4] For instance, see Khandani and Lo (November 2007) "What happened to the Quants in August 2007?", http://ssrn.com/abstract=1015987.

[5] The two indices of hedge funds' return, the HFRX Global Index and the HFRI Composite, showed an upswing of 4.2 per cent and 10.4 per cent respectively in 2007. For example, this can be compared with the S&P 500 index which rose by 3.5 per cent.

Some reflections on events

There are always experiences to reflect upon when unrest arises in the financial markets. It is already possible in this crisis to point at certain weaknesses that have come into focus. Firstly, we have had a clear reminder as to how events can turn suddenly and unpredictably. This element of surprise illustrates the need to carry out stress tests, that is, to test positions against extreme and unforeseen events – such events that may perhaps have a one in a million chance of happening according to the statistical correlations. Stress tests are being carried out to a greater extent, but there is a need to work on and refine the methods.

Another weakness lies in the difficulties in identifying the risks that are associated with structured products and the valuation of these. Too many investors have relied on the rating institutes' ability to assess risk and have thereby failed to make their own assessments. In some cases they appear to have relied on the credit rating institute to such an extent that they have failed to take liquidity and market risk into account, that is, risk that is not captured by the credit rating institutes.

In this context one may also note with some surprise that the innovative development has gone so far that certain more or less tailor-made products are not traded and thus cannot be priced on the market but must be valued with the aid of complicated mathematical and statistical models. This creates problems when regulations and auditors demand a valuation of the products to market price. Perhaps it is so that not all ideas from the first years of this millennium deserve to survive.

There is need of better transparency rather than further regulation

The debate about regulation of hedge funds' activities has gained fresh impetus in the wake of the crisis – somewhat surprisingly, since the blame can hardly be placed on the hedge funds. My view in this matter is that there is no reason to introduce specific regulations for hedge funds, apart from greater insight where it is lacking. Such measures threaten the positive contribution hedge funds make, not least under the conditions which we have now experienced.

For those of us who reflect on stability in the financial system, it is however extremely important that the major banks' and the hedge funds' other counterparties can manage their risk. If they manage their counterparty exposures in a correct manner, that is they take sufficient collateral and can manage any liquidity problems, there is no reason to specifically regulate the hedge funds.

However, periods of market turmoil tend to entail certain unpleasantness. I consider that the ensuing debate should focus on market discipline in a broad sense. Transparency is a key word in this context. By means of clear and open information about strategies and risk taking conditions are created for good market discipline. Good insight is also of the utmost importance to those of us who oversee financial stability. This gives us a chance to decide where the risks are.

Now that I speak of the need for market discipline, I would like to mention the global association, the Financial Stability Forum (FSF).[6] FSF has urged the global hedge fund industry to review and enhance existing practices. In order to meet this challenge, a working group has been formed by private initiative, the Hedge Fund Working Group. Most of the members of the working group are based in London, but Swedish agents are also represented. The work of the group has resulted in recommendations for the hedge fund market. They focus on areas such as transparency, but also on valuation, accounting and risk management and they give recommendations for the hedge fund market. The final report

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6 See the Update of the FSF's Report on Highly Leveraged Institutions (May 2007).

was presented last week. Although this report does not have any official legal status, it will be an important starting point for further discussion on the subject.

Insight in Sweden is relatively good

I have for some time now kept to the international arena. Let me now say a few words about Swedish conditions. In Sweden, too, the market for hedge funds has grown rapidly. In this context, Sweden is an advanced market with some 70 funds that manage close to 5 per cent of the total assets managed by funds in Sweden. This makes Sweden the most developed market in the Nordic region. Swedish hedge funds were also affected by market conditions during the summer, but recovered during the autumn.

In Sweden we do not have the same problems with transparency as in other parts of the world. In this country hedge funds are obliged to register. Previously, the hedge funds reported all their holdings to Finansinspektionen, the Swedish Financial Supervisory Authority, which then published the positions with a three-month time lag. But since hedge funds often have very complicated strategies this public information became far too detailed and difficult to process. Neither was it particularly meaningful. Instead they have now gone over to regularly reporting different measures that describe the risk in the hedge funds. This is a more transparent means of gaining information about individual hedge funds' risk. This information does not however show how large, direct or indirect, exposures the hedge funds have to the banks, for example. Information about this must come from the banks themselves and the risk must also be managed by the banks. At present we know that these exposures in the Swedish banks are extremely limited.[7]

The uncertainty remains

To summarise: On the whole the hedge funds have recovered rapidly from the August downturn which hit a number of different strategies. And it does not seem as though the hedge funds have played a decisive role in the most recent turmoil – not a negative role anyway. The hedge funds have functioned roughly as one could expect. In the Riksbank's view, nothing has occurred that speaks for further regulation. However it is important that good market discipline can be maintained and that hedge funds in other countries are as transparent as the Swedish ones.

We have not yet seen the end of the turmoil that characterised the financial markets during the autumn. Unfortunately it cannot be ruled out that the crisis will be both more profound and longer than we previously believed. Perhaps some hedge funds will be hit in this process. But overall I believe that the hedge funds can contribute to resolving the crisis, not aggravating it. The future will show if the hedge funds can meet these expectations.

Thank you!

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7 See also Hedge funds and private equity firms – The exposure of banks and insurance companies, Finansinspektionen, July 2007.