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CONSUELO MACK: This week on WealthTrack, are they demons or angels, raiders or protectors? Hedge funds have been called a lot of names, but what impact are these huge investment funds having on the financial markets and your portfolio? Everything you need to know about hedge funds is next on Consuelo Mack WealthTrack.

Hello, on welcome to this edition of WealthTrack. I'm Consuelo Mack. How much do you know about hedge funds? How much should you know about them for financial self-preservation? These enormous hidden pools of money, the domain of institutional investors and wealthy individuals are our focus this week. They've been making headlines for the fortunes their managers make and the billions their investors can lose when their bets prove wrong, as some have been doing recently in energy and subprime mortgages. Hedge funds are everything mutual funds are not- they're private, not public, they're unregulated, not regulated. They can invest anywhere in anything. Mutual funds have strict investment guidelines. Hedge funds can short stocks betting that they go down, not just buy and hold. They can borrow as much money as their lenders will let them, and they borrow a lot. Mutual funds cannot leverage up. The so-called hedge funds for wealthy and sophisticated investors have been around for decades, but they did not become a formidable market force until the '90s. In 1990, there were about 610 of them with about $39 billion under management. Today there are more than 9,000 worldwide, managing more than $1.5 trillion.

As our guests will tell you, that isn't even close to estimating their market reach. The funds borrow five to ten times or more the amount of money they manage to buy more securities. It is that leverage, and how hedge funds use it, that is a particular concern of government officials around the world. Wall Street has created trillions of dollars worth of complex trading strategies and securities called derivatives, which hedge funds invest in, and they have already caused the downfall of several funds. Its estimated hedge funds are responsible for 40% of all U.S. stock trading, more than 50% of all U.S. bond trading. They make fortunes for the investment firms that serve them, an estimated $50 billion a year in fees and interest for investment banks on Wall Street and London alone. And the personal fortunes being amassed by the top hedge funds managers are staggering. Last year, the 25 highest paid managers earned more than $14 billion as a group. The top three each earned more than $1 billion. Are these mighty funds a threat to the markets and investors, or the creators of unprecedented wealth and prosperity? The answers are next on Consuelo Mack WealthTrack.

What should you know about the impact hedge funds are having on the financial markets? What if anything should you be doing differently with your investments because of their enormous influence? Joining us are two guests with years of firsthand experience in the field. Ph.D. economist Richard Bookstaber has worked in several of the largest hedge funds, overseen risk management at Salomon Brothers, and has created some of the complex securities he is warning about in his new book. It is called <u>A Demon</u>

of Our Own Design: Markets, Hedge Funds, and the Perils of Financial Innovation and it is causing quite a stir on Wall Street. Our other guest is also a Ph.D. economist, is multi-tasking professionally, and he is a Visiting Scholar at the think-tank American Enterprise Institute where he is studying the role of hedge funds on the capital market, and is an economics professor at Carnegie Mellon. But Adam Lerrick also spent years as an investment banker, first at Salomon Brothers and several other firms where he specialized in new product development. Welcome to both of you.

RICHARD BOOKSTABER: Thank you, Consuelo.

CONSUELO MACK: I tried to describe kind of what hedge funds are not and some of what they are in the opening remarks. But what is a hedge fund? How would I know a hedge fund versus a private equity fund or any other fund that is privately managed?

ADAM LERRICK: It would be very hard for you distinguish them. A hedge fund is simply a pool of money that can invest anywhere in the world, and where the management compensation structure is such that the managers receive a large percentage of the profits as compensation.

CONSUELO MACK: So that's the two and 20?

ADAM LERRICK: That's the two and 20. But it is not only the classic rules of two and 20, where there’s a fixed fee of 2% of assets under management, plus 20% of the profits, but some of the hedge funds have reached the 3 and 30, and 4 and 40, and even the 5 and 50%, where they receive 50% of the profits.

CONSUELO MACK: So, Richard, why are they so popular? Why is it that suddenly in the 1990s we've seen an explosion of these funds?

RICHARD BOOKSTABER: Well, one reason is the fact that the compensation is richer. So the talent tends to flow to where the compensation is higher. And the other reason is that they're not as constrained as other funds. As you pointed out, they can go short, as well as long. So they can bet on stocks or markets that might go down. They can lever so that if they think there is an opportunity, they can double up and make more money if they're right. And obviously, lose more if they're wrong. And they're not as constrained in the assets they can go into. They can go into emerging markets, and they can use innovative derivative instruments. So if you have the combination of the compensation structure that allows -- that leads the more talented people to move into that area, and once they're there, they have more freedom in how they invest, you have a recipe for a very popular and thriving market.

CONSUELO MACK: Right. So let me ask you each -- the question on the table is what impact the hedge funds are having now on the financial markets, that have to date, and then the next part of that, what impact do you think they're going to have in the financial markets? Adam Lerrick, we showed 40% of U.S. stock trading, 50% of U.S. bond trading. What's happened in those markets because of hedge funds that would not have happened without their enormous presence?

ADAM LERRICK: Well, without their enormous presence -- as you said, Consuelo, they now dominate trading, in almost all the arenas. In addition to bonds and stocks, they're key players in currency markets, in emerging markets, bond markets, in the stressed markets and the commodities market. What they're doing -- and this is one of the key issues: what does a hedge fund do? A hedge fund is basically searching the world for the highest absolute return. They don't care if they're trading pork bellies or Malaysian ringets or U.S. treasury bonds. They're looking, in theory, for temporary aberrations in prices, where they can seize the discrepancy, profit by it, capture it and bring it home. What does that mean for the market? It means you're having hedge funds setting the prices in the markets. They're what we call the marginal price setters. It has extraordinary ramifications for investors and for policy-makers. If you're Ben Bernanke and you're trying to figure out how to guide the economy and monetary policies, one of the key pieces of information you use are prices of assets. The price of an asset is very different when it is being set by a hedge fund, which is looking at a short term trading strategy or arbitrage opportunity, as opposed to a long-term investor who is a long only fund, who is thinking "this is an asset that is going to appreciate over time." The hedge fund could be setting the price not because he believes this is an attractive investment in itself. He may not even know what the investment is. His computer model is just picking that asset out of thousands or hundreds of thousands of assets around the world, saying this price is going to move in this direction based on some correlation where the series of other assets on the other side of the world, and he doesn't know that it's investing in toll roads in Indiana, or investing in U.S. Treasury bonds or investing in defaulted securities of Argentina.

CONSUELO MACK: One of the things you told me when you and I talked earlier, the old adage is you follow the money. If you follow a company that Carl Icon is investing in for instance, or Warren Buffett, you're going to make money. But in this case, you just said following hedge funds where they're going doesn't necessarily mean it is a good investment.

ADAM LERRICK: Not necessarily. It may mean temporarily it is a good investment --

CONSUELO MACK: That day?

ADAM LERRICK: That day or in nanoseconds. In essence, hedge funds trade based on fractions of seconds. When I was at Salomon Brothers, we used to joke the short-term is next week. In hedge funds, the hedge fund is measured in milliseconds.

CONSUELO MACK: What difference has this kind of trading made on the value of assets? If they're setting the marginal price of an asset, what difference are they making in the markets?

RICHARD BOOKSTABER: One positive difference they make in the market which Ben Bernanke alluded to is, they do add liquidity in the market. If I want to sell or buy an asset, I probably don't have to move the market as far to do it as I would if there weren't hedge funds there on the other side of the market. So for the individual investor trying to get in or out of a trade, there are more people sitting there focused on the stock who are ready to take the other side.

CONSUELO MACK: Okay.

RICHARD BOOKSTABER: And that leads, possibly, to lower volatility day by day in the market.

CONSUELO MACK: Which we've seen, right, in the last several years.

RICHARD BOOKSTABER: Right. The cause and effect is still not completely clear, but it could be that having more liquidity in the hedge funds leads to lower volatility because prices don't have to move as much for somebody to take the other side. The problem is that what you see day by day in volatility doesn't necessarily map to what could occur in the case of crises. We can get into that a little later. The one point, though, I want to make though with hedge funds is, there are hedge funds that are very short-term in their orientation, and they're called high frequency trading funds. But a lot of hedge funds in the equity space are similar in their approach to how they trade to what you would see with mutual funds, in the sense they're value-oriented. The difference is when they find value, they can buy more than one to one. And if they find negative value, they can short. So part of what is going on with hedge funds is sort of the displacement of what is done typically by mutual funds. They're in the same game, but they really have more tools at their disposal. And because of the fee structure that they have, a lot of the better people will naturally migrate to them. So I think you also have direct competition…

CONSUELO MACK: That's interesting. I know there has been a talent drain, right, of kind of the best and the brightest, now, certainly coming out of business schools are going into hedge funds, rather than mutual funds, so longer term that might not have a great effect on individual investors investing in mutual funds possibly, but that might be a stretch.

RICHARD BOOKSTABER: Or what you may find -- we're seeing this with some strategists that are occurring with mutual funds, you may find that the mutual fund industry adapts. There is a type of fund called -- the typical name for it is 130/30. You go long 130%, and you can go short up to 30%. As opposed to a typical mutual fund, which is just long 100%. Well, a 130/30 strategy can go short, up to 30%, which often is more than enough, and it is leveraged because its net -- its gross exposure-- is more than 100%. So insofar as you find mutual funds or only-long funds migrate to the 130/30 type of strategies, they're moving more into the hedge fund space.

CONSUELO MACK: Do you think we're going to see more mutual funds that are going to be like hedge fund-like?

RICHARD BOOKSTABER: I think you almost have to because as you were pointing out, if they don't do that, they're behind the game.

CONSUELO MACK: Right.

RICHARD BOOKSTABER: In terms of incentive fees, in terms of the tools they have at their disposal to trade. So five years from now, I don't know that what we'll see are hedge funds and mutual funds. I think we may see sort of a melding of the two.

CONSUELO MACK: So let me ask you, as well, about this $1.5 trillion in assets that I mentioned at the opening of the program, and the fact that when people talk about hedge funds, and certainly recently when we've had a couple of hedge funds at Bear Stearns being dissolved, that they talk about the leverage. Explain how that works and why many government officials around the world are concerned about the borrowing that hedge funds are doing.

ADAM LERRICK: I think that's the main concern of governments. Governments have two concerns about financial markets: one is investor protection, protection of the unsophisticated investor, and their hedge funds are really not a major issue because to access a hedge fund directly, you need to be basically what the FCC is a high net worth individual. The other issue is how do hedge fund activities, or any investment activities affect the stability of the financial system. And there the concern is really about leverage. Because if you have a fund that -- or an investor that buys $100 million dollars of bonds with $100 million of cash. If the price of the bonds falls from $100 to $90, they will lose 10% of their money, but there is no trigger, there is not like a margin call and they suddenly have to liquidate in order to reach their margin. But if the same investor buys $100 million in bonds with $2 million of cash and borrows $98 million from his banker or investment bank, then if the bonds fall by three points, suddenly that collateral is going to be seized and it is going to be sold. And so suddenly on to the market will come $100 million of bonds, and that's what they're worried about.

CONSUELO MACK: And that has been happening in a subprime mortgage market, and an analogous situation would be the individual and the high risk mortgages- you put up just a little bit, and you basically borrow a ton, and then if the value of your asset goes down, you've got to put up more equity.

ADAM LERRICK: That's right. And that's the question. You touched upon it earlier, when you said, do they provide liquidity? And that's the same thing. This is the big debate, certainly in good times, hedge funds provide a huge amount of liquidity. Small changes in prices, they come running in to buy or sell to minimize the volatility. The question is what is going to happen in a crisis, because you don't really care about the liquidity if you’re a policymaker or an investor in good times. You care about it in a crisis. And there is a debate, and it's an unanswered question. Because as absolute rate of return investors- investors that don't care whether the market is going up or the market is going down- they just want to get the highest absolute economic returns. In theory, they will be a stabilizing force because they will go against the trend. If the market is falling, an index fund sells, and that just continues the trend downwards.

CONSUELO MACK: But it is not tested yet?

ADAM LERRICK: It is not tested because the other possibility is when the crisis comes, the hedge funds either themselves, or their lenders, when prices start falling, will liquidate their holdings on a massive scale, exacerbating the crisis.

CONSUELO MACK: This is where you come in, because in A Demon of Our Own Design, it is the financial innovations that you said are the problem and the hedge fund uses it. Explain what you're concerned about.

RICHARD BOOKSTABER: My concern is the leverage is half of the equation, and derivatives and complex instruments is the other half. I completely agree that the issue -- where the risk in the market comes, and that’s where the title of the book, a demon of our own design -- it doesn't come from the economy. If you look at the market crisis that occurred over the last 20 years, they haven't been due to economic events. They've been due to market events. The two elements of the design of the markets that cause the problems are high leverage and complex instruments. You know, the leverage is an issue because it can force you to liquidate. Even if you know an asset has value, you might have to liquidate it because you have to make good on your borrowing on your loans that you got from the bank.

CONSUELO MACK: Right.

RICHARD BOOKSTABER: And then you can -- what can happen is as you liquidate, it forces the prices down to where the bank says, hey, remember the collateral that you had? It used to be worth $100 million, and now it is only worth $90 million, and you have to put up more and you have to sell more --

CONSUELO MACK: This is what happened with Amaranth in the energy space, and the Bear Stearns funds that are working out among themselves --

RICHARD BOOKSTABER: Right. And those were pretty well contained. But the horror stories that can occur, you have to look farther back. Those two were well-contained to, say, what happened with LTCM, long term capital management, in 1998; the Russia crisis was the trigger for the problems with LTCM, and LTCM didn't even have exposure in Russia.

CONSUELO MACK: We only have a couple of minutes left. How concerned are you that we're going to have some sort of a financial blowup, and what should individual investors do to protect themselves?

ADAM LERRICK: First of all, I'm not terribly concerned we're going to have a major financial crisis. I think the danger to the financial system lies in ignorance of risk. Markets hate surprises. Surprises are what cause crises. The more than information you can give to the market, the less likely you're going to have a crisis, or have a surprise.

CONSUELO MACK: And there is not a whole lot of information coming out of hedge funds right now. You think there should be more.

ADAM LERRICK: I think what should happen is we need to know -- when I say we, all investors and policymakers, need to know the amount of leverage in the system, the concentrations of the positions, the concentrations of exposures, and then once you know those potential risks, investors and policy-makers can take action, precautionary action. So if one of those risks actually materializes, the crisis will be far less severe.

CONSUELO MACK: We're not there yet.

ADAM LERRICK: Right, they're not there yet.

CONSUELO MACK: Do you think that's a solution as well?

RICHARD BOOKSTABER: I think -- yeah, having information is sort of risk management 101.

ADAM LERRICK: Right, and we don't have it.

RICHARD BOOKSTABER: Right, and we don't have it. What you do after you have the information is another issue. One of the problems I see with the approach to regulation right now, and this is sort of the end point of my book, is that the tendency is to wait until the risk occurs, and then figure out, “oh, we have high leverage, what should we do about it?”

CONSUELO MACK: Right.

RICHARD BOOKSTABER: Or “oh, we have a lot of complex instruments out there, and we can't really understand how they may react, what should we do about it?” I think it's critical for regulators to get ahead of the game and say, we're going to control the amount of complexity in the market and we're going to control the type of derivatives that are issued, we're going to control leverage. We're not going to let leverage go as high as the broker dealers or the investment banks are willing to if we think there are negative externalities to it. How it gets done is a difficult question. I think maybe I'm smart enough to stop before you get to that point. But I think somehow it has to be done.

CONSUELO MACK: The most important thing an individual investor can do to protect his or herself in the event there is a financial blow up in the financial system. One thing we can do?

ADAM LERRICK: The question is, if there is a blowup, obviously if you can be one of the first ones out, you certainly should liquidate everything. On the other hand, individual investors are very seldom the first ones out.

CONSUELO MACK: Right.

ADAM LERRICK: So what you really should think about is what type of asset should I own in good times and bad times that, over the long haul, is going to serve me well?

CONSUELO MACK: And that is?

ADAM LERRICK: Basically that is having a diversified equity portfolio- an equity fund, let's say an index equity fund that would focus on the U.S. stocks. And then a similar holding that focuses on international stocks, both in industrialized countries and in emerging markets.

CONSUELO MACK: And that's basically your one investment for long-term diversified portfolio. I know you don't recommend funds, but Morningstar has recommended two that Vanguard puts up because they're very low cost and there is an international fund (VGTSX) and a domestic fund (VTSMX). You basically -- it is so interesting, Richard, you have the same type of approach, to be really extremely well-diversified, is essential in stocks.

RICHARD BOOKSTABER: Right. I would say -- first of all, individual investors are in a great situation. When we talk about prices and hedge funds, because an individual investor is not leveraged in terms of their equity portfolio, so they can wait out a crisis.

CONSUELO MACK: So hold?

RICHARD BOOKSTABER: So hold. Usually in a liquidity crisis -- typically the liquidity-driven crises, crises that come due to leverage, wash over once everything has been worked out. So for an individual investor, the main point is look at the long-term and don't panic.

CONSUELO MACK: Buy and hold. We're going to leave it here, and I look forward to having you both back again because the hedge fund world and certainly the demons of our own design, all of these financial innovations, are going to be with us for a long time and could cause some problems and opportunities. Richard Bookstaber, thank you for being with us, and Adam Lerrick, we appreciate you being here as well.

ADAM LERRICK: My pleasure.

CONSUELO MACK: At the conclusion of every WealthTrack, we give you one suggestion to help you build or protect your wealth over the long-term. In this case it is about a relatively new investment you might actually want to avoid. This week's action point: don't rush into a fund of hedge funds. These so-called funds of funds are now being marketed to less wealthy individual investors and they raise several issues. First, as numerous studies have proven, chasing yesterday's hot performers has historically been a loser's game, and hedge funds have been hot for several years. And second, as our guests discussed, the halcyon days of spectacular hedge funds performance are probably behind us. That is something we've heard from many of our guests. There are now too many players trying to do the same thing, and many of the newer entrants lack experience. And third, the biggest and oldest hedge funds with the best long term records are not participating in these funds of hedge funds directed to the smaller individual investor. And fourth, the high fees involved in investing in multiple hedge funds performance, that's according to Mark Kritzman, a contributor to Peter L. Bernstein Inc's in his highly regarded newsletters, *Economics and Portfolio Strategy*. Kritzman and some of some of his students at MIT's Sloan School of Management study the impact portfolio fees had on investing in baskets of hedge funds and found them to be, quote, "unfavorable," and adding the fund of fund management fees weighs the returns down even more.

We are counting down to the close of this edition of WealthTrack. We hope you can join us next week, we'll have two super smart personal finance guys who will share their roadmaps to financial success: the multi-talented Ben Stein, and *Money Magazine's* Jason Zweig will take us on the road to financial freedom. And you should feel free to see this program starting on Monday, go to our website, wealthtrack.com to view it as a podcast or a streaming video. Until next time, make the week ahead a profitable and productive one.