Hedge Fund Wizards

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Scarcely a day goes by without another story of some large hedge fund blowing up due to bad bets. While many of the latest hedge fund casualties are linked to the subprime mortgage crisis, investors should not be lulled into thinking that the problem will be solved once the mortgage mess is mopped up.

Hedge funds are risky for another reason. It is extremely difficult to tell, based on past performance, whether a fund is being run by true financial wizards, by no-talent managers who happen to get lucky or by outright scam artists.

To illustrate how easy it is to set up a hedge fund scam, consider the following example. An enterprising man named Oz sets up a new fund with the stated aim of earning 10 percent in excess of some benchmark rate of return, say 4 percent. The fund will run for five years, and investors can cash out at the end of each year if they wish. The fee is the standard '2 and 20': 2 percent annually for funds under management, and a 20 percent incentive fee for returns that exceed the benchmark.

Although he has no investment track record, Oz has a smooth manner, a doctorate in physics and many rich acquaintances. He raises $100 million and opens shop. He then studies the derivatives market and finds an event on which the market places fairly long odds, say 9:1. In other words, it costs $.10 to buy an option that pays $1 if the event occurs and $0 otherwise. The nature of the event is unimportant: it might be a large fall in the stock market, Florida getting hit by a Category 5 hurricane or Russian President Vladimir Putin dying before the end of the year.

Next Oz writes some covered options on this event and sells 110 million of them in the derivatives market. This obligates him to pay the option holders $110 million if the event does occur and nothing if it does not. He collects $11 million on the options. To cover his obligations in case the 'bad' event occurs, he uses the investors' money plus the proceeds from the options to buy $110 million in one-year Treasury bills yielding 4 percent, which he deposits in escrow. This leaves $1 million in "pocket money," which he uses to lease some computer terminals and hire a few geeks to sit in front of them, just in case his investors drop by.

The probability is ninety percent that the bad event does not occur and Oz owes nothing to the option holders. With a gross return (before expenses) of $15,400,000, the investors are thrilled, and so is Oz. He collects $2 million in management fees (of which he has only spent $1 million), plus a performance bonus equal to 20 percent of the 'excess return', namely, 20 percent of $11,400,000. All in all, Oz nets over $3 million for doing absolutely nothing.

Oz can then repeat the same gambit next year. When the fund terminates after five years, the chances are nearly 60 percent that the unlucky event will never have occurred. Oz looks like a genius and gets paid like a genius.

While most hedge funds probably don't operate in such a nakedly self-serving way, the underlying logic of Oz's strategy is quite common: take a position that yields high returns with high probability and extremely poor returns with low probability, and keep your fingers crossed. Credit default swaps are one example, so are bets on interest rate spreads. Such strategies are risky but not fraudulent; the manager can always argue that his opinion about the odds differed from the market odds (he was simply engaging in arbitrage).

Eliminating such scams through regulation is not going to be easy due to the unusual nature of the product. Yet, some steps toward protecting investors can -- and should -- be taken.

All hedge funds should be required to register as soon as they are established and to report their returns on a regular basis. Such tracking would allow potential investors to study the records. New rules could also require managers to keep investors apprised of the fund's downside exposure. Alternatively managers could guarantee that losses not exceed a certain level, similar to a car manufacturer offering a warranty.

Although individual hedge fund managers may drag their feet, it is actually in the industry's best interest to encourage greater regulation and transparency. Otherwise, a rising tide of failed funds could cause a collapse in investor confidence, putting both the good and the bad wizards out of business.

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