Extended Project for Introduction to Securities & Investment.

Are Hedge Funds and Proprietary traders, the use of derivatives and the prevalence of increasingly complex investments ruining the market for traditional investors? | TJM

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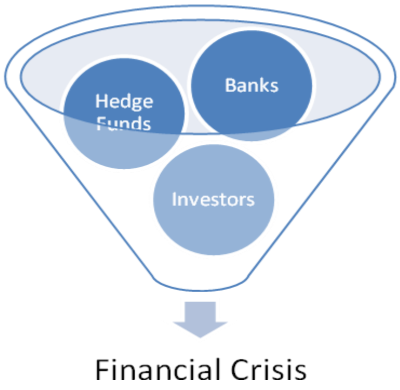
Executive Summary

The aim of this report is to consider the role that Hedge funds and Banks have had in a series of events that have occurred since 2007 collectively known as the 'Financial crisis'. It looks at Derivatives and Sub-Prime investments, as well as traditional investment techniques. It takes into account historical and proposed political and regulatory reform and includes commentary from a number of well regarded sources. Eventually concluding that there is 'blame' on all sides including, but not limited to, Banks and Hedge Funds.

Introduction

The worst financial crisis for 70 years, the credit crunch, sub-prime, recession: There has been so much coverage of events in the media but a lot of the terminology is confusing and I wanted to understand the situation for myself.

I am interested in working in the financial industry or becoming a day trader and wanted to know more about the various players and the kind of deals that they get involved with. I thought that this topic covered a lot of potentially interesting areas and would give me the opportunity to learn about them in more depth. As well as reviewing a plethora of media coverage as part of my research, I was able to read and consider the opinions of a highly respected politician, a leading business journalist, an award winning writer and an industry practitioner. The nature of the research material generated required an ability to interpret and understand technical information and to challenge the objectivity of sources. I have attempted to present a balanced argument having assimilated information and commentary from a wide range of resources including my local Library, the CISI workbook, newspapers and the internet.



We will look at Hedge funds and banks reviewing the kind of investments and practices they are involved with and whether they are to blame for the financial crisis, as well as considering a number of pertinent questions: What do Hedge funds and proprietary traders do, why are they getting the blame and what is to be done about it? Who regulates them and just who is a “traditional” investor.

What is a Hedge Fund?

Hedge funds are investment funds; they differ from more traditional funds because they undertake a wider range of investment and trading activities. This is because of the way they are set up and their ownership, where direct investment is normally restricted to very wealthy individuals or professional investors. Individual investors can gain access to Hedge funds by investing in funds of Hedge funds.

They invest in shares, derivatives, commodities and debt and are described by Investopedia as being “aggressively managed”

Although they are more common today, the first Hedge fund may have been created in 1949 by Alfred Jones who borrowed money to buy shares and did short selling, which was used as a method to reduce risk by effectively hedging his bets – far from the kind of practices that Hedge funds have made unpopular today.

The role of Hedge funds and the way they are regulated have been subject to debate with many commentators arguing for tighter regulation following the collapse of Lehman and the sub-prime problems. However, ‘Hedge funds’ is a collective term for a very diverse group of investment funds: Some do employ high risk strategies but others do not, as they seek to generate returns that do not rely on the underlying market going up or down: These ‘Absolute return’ funds carefully select different investments and may take either long or short positions.

Common aspects of Hedge funds

Structure

- Most hedge funds are unregulated as they are unauthorised collective investment schemes. This also means they cannot be marketed to private individuals.

Entry level

- Most require a minimum investment of over £50000; some over £1million.

Flexibility

- There unregulated status gives them the freedom to invest in a diverse range of assets and to go long or short.

Gearing

- Many can borrow funds and use derivatives to potentially enhance their returns

Prime Broker

- Hedge funds buy and sell investments from, borrow from and, often, entrust safekeeping of their assets to one main wholesale broker called their prime broker

Liquidity

- They usually have a 'lock-in-period of between one and three months before investors can sell their investments

Cost

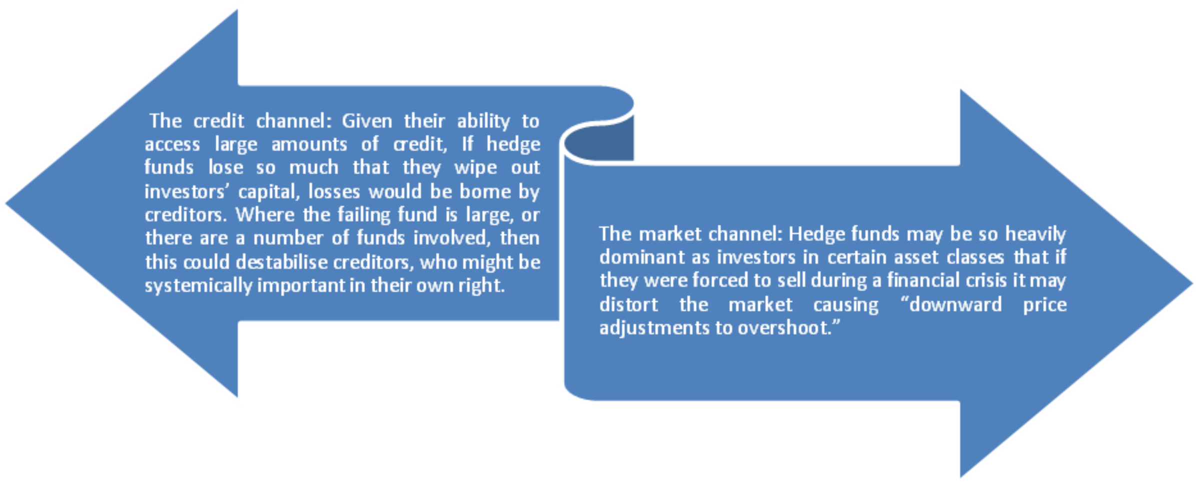
- Hedge funds typically levy performance-related fees, which the investor pays if performance levels are achieved. Fees can be substantial.

The case for regulation

The Financial Services Authority (FSA) is the regulator for the financial services industry in the UK. They have 4 statutory objectives:

Market confidence: maintaining confidence in the financial system
Public awareness: promoting public understanding of the financial system
Financial Stability: contributing to the protection and enhancement of the UK financial system
Consumer protection: securing the appropriate degree of protection for consumers
The reduction of financial crime: reducing the extent to which it is possible for a business to be used for a purpose connected with financial crime.

The role of the FSA and its relationship with the Bank of England and HM treasury have been the subject of much debate in the fall out of the financial crisis. In March 2009 the FSA published the “Turner review” designed to make recommendations for reforming the way banks are regulated. It recommends that banks have “...several times as much capital required to support risky trading activity...” and called for “…increased reporting requirements for unregulated financial institutions such as Hedge funds…”. Subsequently, in February 2010 the FSA published a report which stated Hedge funds may cause systemic risk through two main channels: The Credit and Market channels:



In March 2010 The Telegraph reported “a storm of controversy” with London-based Hedge funds concerned that their recovery might be hampered by the threat of “onerous regulations proposed by the European Union” in the form of the Alternative Investment Fund Managers (AIFM) directive with its proposed limits on leverage, marketing and a large increase in regulatory costs. (Armitstead, 2010)

As far back as October 2006 Sir John Gieve, Deputy Governor for Financial Stability at the Bank of England, discussed the impact of Hedge funds on the financial system and their risks to financial stability: Well in advance of the financial crisis, Gieve rather tellingly said “…Periods of rapid growth and innovation in financial markets have often led to difficulties and overshooting and we should not assume that this one will be different...” (Gieve, 2006).

Whilst the debate continues about how best to approach regulating the Hedge fund industry it appears that there is a common consensus forming that regulators must become more intrusive in how they police <u>all</u> institutions and markets.

Hedge funds as Heroes?

Robert Peston is the business editor of BBC News. In his Blog, "Hedge funds as Heroes", Peston explained why he believed that Hedge funds were not actually the cause of the worst global banking crisis since the 1930s. At the time Peston was considered to have particular insight into the matter having been responsible for a number of scoops relating to the crisis. He argues that the EU has a blinkered vision in their determination to regulate Hedge funds. Whilst greater transparency and limiting debt would be welcome, he states that the EU are missing two important points: Firstly it is the banks and financial markets providing Hedge funds with liquidity who should bear the brunt of new restrictions; secondly, in Peston's view, the fact that hundreds of Hedge funds went bust without the need for bailouts or government intervention is an argument for making the investment banking divisions of banks <u>more</u> like Hedge funds – subject to the direct scrutiny of their investors and creditors without the possibility of being bailed out.

(Peston, 2010) illustrates 4 kinds of “harm” attributed to Hedge funds, offering solutions he believes could be implemented without “…direct constraints on Hedge funds…”

Clearly the Banks have had a key role in the financial crisis, not least with their interaction with Hedge funds. In order to assess Peston’s assertion that Banks should bear the brunt of new restrictions one should consider their activities and how they are regulated.

The role of Banks

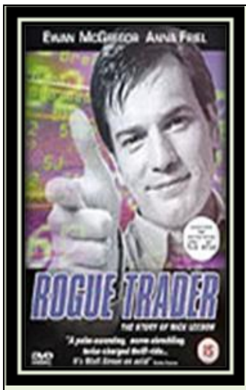
The main services provided by banks are illustrated here:

Corporate finance and advisory work, normally in connection with new issues of securities for raising finance, takeovers, mergers and acquisitions.
Banking, for governments, institutions and companies.
Treasury dealing for corporate clients in foreign currencies.
Investment management for sizeable investors such as corporate pension funds, charities, and private clients.
Securities trading in equities, bonds and derivatives and the provision of broking and distribution facilities.

Historically, these activities have been split between Retail (high street) banks and Investment banks. More recently, many banks business models have changed to incorporate both retail and investment banking activities. There has been a great deal of controversy of this blurring of the line with criticism focused on the proprietary trading activities of Banks and whether such practices should be limited or completely outlawed.

What is Proprietary trading?

Proprietary trading is the term used in banking to describe the activities firms undertake in trading for their own benefit rather than for its customers. These desks are often considered to be like internal Hedge funds within banks and can contribute significantly to their profitability. In June 2006 Hector Sants, Chief Executive of the FSA said “The more that investment banks make money from buying and selling securities for their own account rather than from traditional investment banking activities, the more potential there is for conflicts of interest to arise and possibly be abused”. Whilst attempting to research proprietary trading it became clear that a lot of problems have arisen and that there have been numerous incidences of traders behaving inappropriately, the most famous of all being Nick Leeson:



Case study: Nick Leeson – Rogue Trader

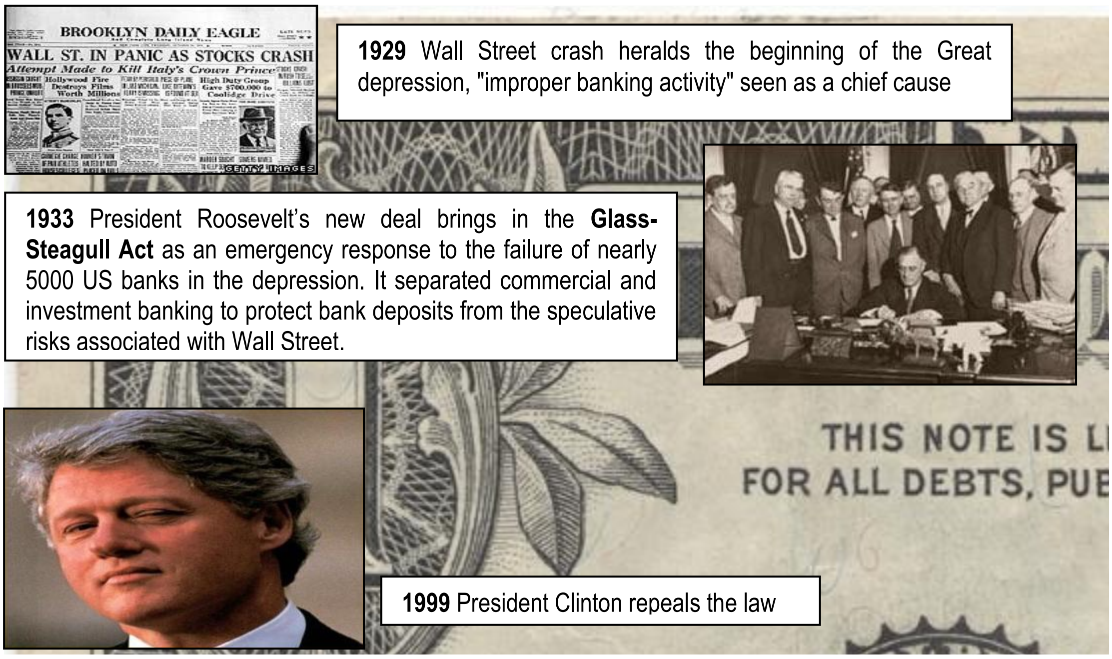
“In the early 1980s, Nick Leeson landed a job as a clerk with royal bank Coutts, followed by a string of jobs with other banks, ending up with Barings, where he quickly made an impression and was promoted to the trading floor. Before long, he was appointed manager of a new operation in futures markets on the Singapore Monetary Exchange (SIMEX) and was soon making millions for Barings by betting on the future direction of the Nikkei Index.” (Leeson, 2010)

In the case of Leeson, he was able to convince his employers, Barings bank, that he was trading on behalf of clients whilst he was actually investing the banks money. He was able to do this by putting loss making trades into error account 88888. The problem for Leeson, and Barings, was that he was losing money – he requested and was granted further funds. Over three months he bought more than 20,000 futures contracts worth about $180,000 in what he describes on his website as “a vain attempt to move the market”. Eventually Barings executives discovered the deception and were forced to inform the Bank of England that Barings was effectively bust – Leeson had incurred $1.3 billion dollars of liabilities which was more than the entire capital and reserves of the 233 year old bank.

Nick Leeson’s actions and the fall of Barings have been documented in both book and film, to understand why proprietary trading has been allowed to develop one must first take a look at history.

Regulatory timeline

The timeline below illustrates how the US authorities have chosen to adopt and then repeal regulation relating to the activities of banks:



The repeal in 1999 has been criticised in the wake of the financial crisis.

Jill Treanor, Deputy City Editor of the Guardian, stated that Citigroup, one of the banks bailed out by the U.S. taxpayer, would not have been able to even exist without the repeal.

There have been subsequent calls for its reinstatement and in the U.K. Vince Cable of the Liberal Democrats has also advocated the case for “narrow banking” where banks cannot perform both retail and investment banking.

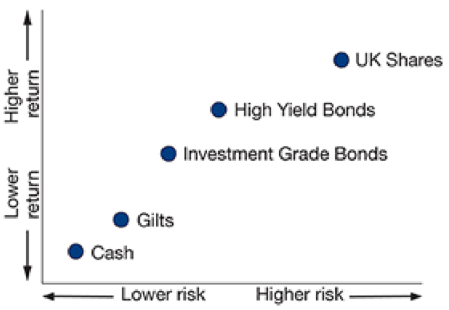
On January 21 2010 President Barack Obama proposed the largest regulatory overhaul of Wall Street since the Glass-Steagall Act. The "Volcker rule" originally called for a complete ban on proprietary trading by depository institutions but has since been revised and is the subject of ongoing international debate with some arguing that today’s Banks need to function in this way.

A further issue may be that, just like in the case of Hedge funds, no country wants to act unilaterally in clamping down on proprietary trading as it may drive these highly lucrative institutions to relocate. Aside from the role of financial institutions, a great deal of debate has been made about the kind of instruments involved and whether they are too complicated in contrast to traditional investments.

Traditional investments

Although there are many different types of investments, there are four main asset classes: Shares, Bonds, Property and Cash deposits.

It is generally acknowledged that risk and reward generally go hand in hand as illustrated below:



Source: IMA

***Cash** offers a low risk but also low return.*
*Then **Bonds**: firstly in the form of government ‘Gilts’ with a slightly higher risk and reward; secondly Corporate bonds.*
***UK shares** are said to have the highest ratio of risk and reward.*

On its website, the London Stock Exchange (LSE) state that “studies have proved time and again that shares are one of the best long-term investments in the financial market place. They tend to outperform government bonds, corporate bonds, property and many other types of asset” (London Stock Exchange Plc, 2010). Since the 1980’s more people have become active in investing in shares in the UK as a result of the privatisation of a number of, until then, nationally owned businesses under the Conservative government. This coincided with the “Big Bang” as the U.K. stock market was deregulated to make it more of a free market.

Table 1 summarises the main benefits of share ownership for individual investors.

Dividends	The return Investors get for providing risk capital for a business.
Capital gains	If the price of a share rises the owner has made a capital gain or profit.
Shareholder Perks	Some companies give special offers to their shareholders.
Right to subscribe for New Shares	Shareholders have pre-emptive rights meaning that they can buy new shares if there is a Rights issue and sometimes receive compensation if they decide not to.
Right to Vote	Ordinary Shareholders have the right to vote on matters presented to them at company meetings.

Table 1

The LSE point out that investors have different characteristics and objectives, just like companies: Some people buy shares because they want a regular income, others because they want to see their capital appreciate significantly. Whilst some investors are extremely cautious; others are willing to accept higher levels of risk.

Table 2 details the main risks associated with share ownership:

Price Risk	If the price falls investors could face a loss of capital
Liquidity Risk	In some circumstances it may be difficult to sell shares at a reasonable price. Smaller companies tend to be less actively traded than larger ones.
Issuer Risk	If the issuing company collapses its shares will become worthless

Table 2

Traditionally people have invested via pension contributions in professionally managed funds spread across a diverse range of assets such as equities, property and bonds. These ‘institutional investors’ have also come under scrutiny; Hector Sants of the FSA gave a speech to the National Association of Pension Funds in 2009 where he questioned the role of institutional shareholders, arguing that they contributed to the crisis by allowing institutions to participate in instruments that were not fully understood without being sufficiently challenged about the risks. In turn, this “intense search for yield” as he termed it, led institutions to innovate with “complex securitisation... ” by offering investors more combinations of risk and return more attractive than those available historically...” (Sants, 2009)

There are many who cite innovation and the use of derivatives as being a major factor in the crisis.

What are derivatives?

The Chartered Institute for Securities and Investment (CISI) Introduction to Investment workbook states that "A derivative is a financial instrument whose value is based on the price of an underlying asset. This could be a financial assed or a commodity. Examples include bonds, shares, stock market indices and interest rates for commodities they include oil, silver or wheat."

I have compiled a list of common types of derivatives; it is worth noting that all of them have been in use for a long time.

Futures
"A future is an agreement between a buyer and a seller: The buyer agrees to pay a pre-specified amount for the delivery of a particular quantity of an asset at a future date. The Seller agrees to deliver the asset at the future date, in exchange for the prespecified amount of money" (CISI 2009)
Futures have been around for hundreds of years: Farmer's used them to guide against price fluctuations in agricultural markets. They provide a mechanism by which the price of assets can be traded in the future at a price agreed today without the full value of this transaction being exchanged or settled at the outset.

Options
" An option gives the buyer the right, but not the obligation, to buy or sell a specified quantity of an underlying asset at a pre-agreed exercise price, on or before a prespecified future date or between two specified dates. The seller, in exchange for the payment of a premium, grants the option to the buyer" (CISI 2009) Options have also been in use for a long time and have been widely used since the development of an options pricing model by two US academics in 1973.

Swaps
"A Swap is an agreement to exchange one set of cash flows for another: They are most commonly used to switch financing from one currency to another or to replace floating interest with fixed interest." (CISI 2009)
Swaps can be used to Hedge certain risks such as interest rate risk, or to speculate on changes in the expected direction of underlying prices. Swaps have been in use for over 30 years.

Swaps have been criticised for being a cause of systemic risk, particularly in relation to the 2008 financial crisis where AIG and Lehman were counterparties in a very large number of credit default swaps (CDS). Vince Cable says “the derivatives markets ran way ahead of any rules” citing the $860 trillion CDS market as operating “without proper exchanges for settlement” (Cable, 2009).

Complex securitisation and the credit crunch

The roots of the financial crisis are often cited back to sub-prime lending, which began in the USA in October 1997. (Cohan, 2009) explains that changes to the Community Re-investment act effectively meant that US banks would be rated based on how much ‘Subprime’ lending they did. These mortgages were bundled together and sold to banks who entered into Credit default swaps. Economist Joseph Stiglitz suggested contributed to the systemic meltdown: "With this complicated intertwining of bets of great magnitude, no one could be sure of the financial position of anyone else-or even of one's own position (Stiglitz, 2009). Cohan goes on to illustrate how when “heavyweight” Hedge fund manager Kyle Bass testified to congress that “subprime credit has become the mad cow disease of structured finance. Nobody knows who consumed the infected product” it set about a chain of events that led to the demise of Bear Stearns, dubbed “Wall Street’s toughest investment bank”, effectively causing the credit crunch. In the UK, Northern Rock, the UK's fifth largest mortgage provider, had to seek emergency funding from the Bank of England as it could no longer rely on the credit market, and the government were ultimately forced to step in and take state ownership of a number of UK banks.

The fallout

The resultant uncertainty led to record stock market falls exacerbated as Hedge fund investors sought to redeem their investments, which in turn added to the severity of the collapse. Bank shares were particularly hit hard and allegations were made about the ethics of short selling, with Hedge funds and proprietary traders seeming to be the culprits. Figure 1 below depicts how short selling works. Given that short selling is the preserve of market professionals, perhaps this is a key area where the market is being ruined for the traditional investor. After all, short selling was also highlighted as a key reason for the 1929 Wall street crash and blamed for prolonging the depression. Not so, according to leading academic Paul Asquith who, on the basis of extensive research, concluded that “All the short sellers are going to do is make the market react faster…. The question is, Can the short seller take a firm down? The answer is no. Not by themselves. If there is nothing fundamentally wrong, all you need is a couple of smart people on the other side to show that they're wrong." (Saporito, 2008)

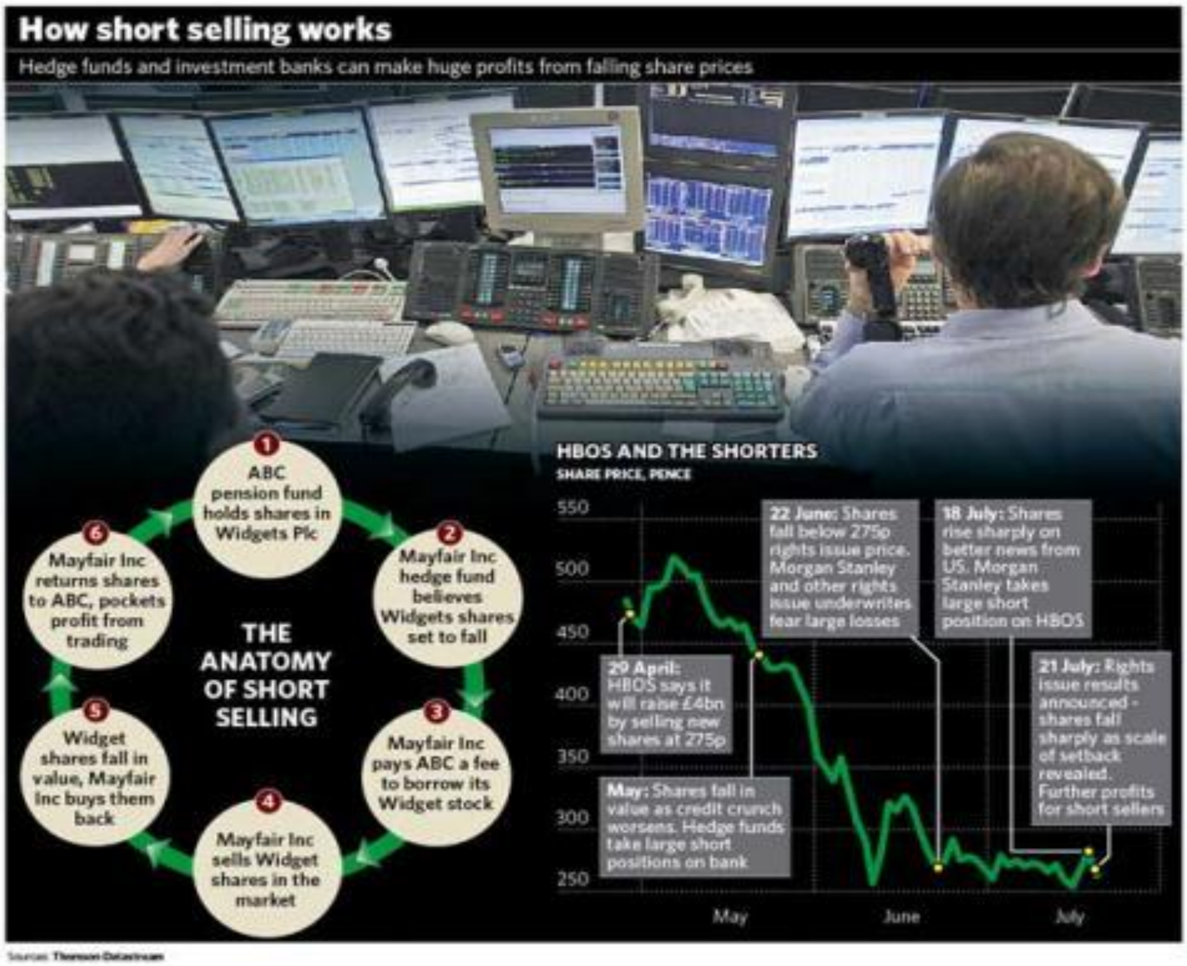


Figure 1 (Prosser, 2008)

Viewpoint: Derivatives alone don't wreck markets

Robert Reoch an investment manager writing for the BBC compared the financial crisis to a car crash suggesting that there may be many causes of the crash but to put the blame solely on the fault of the vehicle is a mistake, given that there are both good and bad drivers on the road. He argues that "...to banks and derivatives: as with so many things in life, accidents are mainly caused by the driver, not the vehicle". He goes on to explain how financial engineering and innovation in derivatives "spawned" simple everyday products such as mortgages that allow home owners to put an upper limit on their repayment rate or, for tourists buying foreign currency, the ability to sell back unused money at a fixed rate.

> "Anybody with a mortgage, car loan or un-cleared credit or store card balance contributed to a mountain of debt that was unsustainable" (Reoch, 2009)

In the same way that short selling alone cannot necessarily be held to blame for the collapse of share prices there are those who believe that it is not financial innovation and complex transactions that cause problems rather than how they are handled, or mishandled, as the case may be.

Conclusion

Having considered the issue from these different viewpoints, I tend to agree with the views expressed by Rioch that financial innovation, in itself, has not ruined the market. It really seems to me that what lies at the heart of the matter is how these instruments are used and how institutions, or in the case of Nick Leeson, individuals act. I think the reason that Sub Prime, MBS and CDS were so popular was because they offered radically unusual outcomes: Applicants with poor credit ratings were suddenly able to get mortgages and institutions were offered higher than traditional returns. At is at that point that innovation, which has resulted in many other positive products and outcomes, should have been checked and institutions and regulators given more scrutiny. As the FSA say on their website "If you see an investment promising a high return at little or no risk, be very wary. The old saying 'if it looks too good to be true, it probably is' almost always applies to investments" (Financial Services Authority, 2009). In my opinion Banks, Hedge funds, regulators, Politicians, credit rating agencies, institutional investors and consumers have all had a part to play in the crisis, but to single out one party, such as Hedge funds or proprietary traders, is wrong.

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