Statement of the Financial Economists Roundtable on

HEDGE FUNDS

November 3,2005

STANFORD, CA. - The Financial Economists Roundtable (FER) discussed hedge funds at its 2005 annual meeting and preparedthe following policy statement.

Executive Summary

Hedge funds have grown rapidly in recent years and are now about one-eighth the size of mutual funds. But these largely unregulated limited partnerships give rise toa number of concerns. Their management expenses are very high and their investment strategies are often risky with a small probability of very large losses. This and other risks are not understood by all investors. In response, the Financial Economists Roundtable recommends that fiduciaries for retail investors should limit their investments in hedge funds to a modest percent of assets under management, that regulators should not rescue troubled hedge funds, and that measures of performance and risk be standardized among funds. Caveat emptor should still apply, but more rational and informed investor behavior should result.

Introduction

Hedge funds typically are private, largely unregulated, limited partnerships with wealthy individuals and institutional investors as limited partners and the manager/investment advisor as the general partner. A hedge fund can employ leverage, thereby amplifying the variability of outcomes. It restricts redemptions so the investment is largely illiquid. Reportedly, the first hedge fund began in 1949, and it adopted a long/short equity strategy. Not until the mid 1980s did hedge funds swell in importance. By 1985, approximately 40 hedge funds existed. This number expanded to over 1,000 in 1995 and to some 8,000 in 2005. Currently, hedge funds manage about $1 trillion in assets, roughly one-eighth of the amount managed by mutual funds.

A. Observations and Concerns

1. Understanding returns, expenses, and risk. Some worry that investors in hedge funds do not fully understand the true returns nor the risks they bear. Expenses are high. The management fee to the general partner usually is 1 to 2 percent of assets, payable annually, and there often is an asymmetric performance fee in addition. This incentive, or carried interest, fee usually is 20 percent, and is often structured to be paid only if cumulative returns over time exceed a threshold return, known as the ?high-water mark.? When cumulative returns fall below this mark, the general partner can close the fund, then start a new one in order to establish a new base mark for generating performance fees. This exit risk is easily overlooked by new investors. The asymmetric fee structure creates an incentive for the general partner to adopt a high-risk investment strategy, since he/she stands to make a large return if the strategy is successful but not to suffer losses if the strategy fails. Offsetting this incentive to some extent is the fact that investors

generally insist on the general partners investing in the hedge fund. Nonetheless, the average life of a hedge fund is only about 3 years.

The returns on many hedge-fund strategies are not normally distributed, but have a distribution characterized by fat tails. Some refer to this risk as the ?peso problem.? That is, the Mexican government does not devalue the peso for a long period of time and then one day devalues it sharply so that peso holders lose a lot. Expressed differently, day by day there is a small probability of a large loss. Tail risk makes standard measures of return volatility and performance, such as the Sharpe ratio, inappropriate guides to investors. By its very nature, tail risk is difficult to measure. In addition, risk-adjusted average returns tend to be overstated, because of survivorship bias and other reporting and data problems, making it difficult to compare hedge-fund performance with competing alternatives. Another risk is the illiquidity associated with particular positions undertaken by hedge funds.

The investor, particularly the retail investor and his/her agents, should be wary; available performance data make it difficult to judge true hedge-fund returns and risk for this high-cost vehicle. While reputation may serve as a disciplinary device, it has not always been effective. Simply put, the investor needs to be extraordinarily careful.

2. Systemic risk. By systemic risk, we mean the risk that failure of one counterparty to a transaction will trigger failure of other counterparties: A cannot pay B, who then cannot pay C, and so on. The FER believes that systemic risk of a cascading nature that would jeopardize financial institutions is now small, but we recognize the inherent difficulty in drawing any firm conclusion in this regard. More recently, back-office delays in processing trades have made it difficult for hedge funds to know accurately their actual positions in real time. Outsiders cannot observe who the counterparties to transactions are and this uncertainty, together with the tail risk, is a concern for investors seeking to understand the risk of any cascading type of meltdown. The difficulty of assessing the potential exposure to systemic risk reinforces the need for caution in determining portfolio allocations to hedge funds. On occasion, liquidity in particular markets can be temporarily frozen as a result of hedge-fund activity. However, since the Long Term Capital Management (LTCM) episode in 1998, many hedge funds have become more cautious in their choice of counterparties and no single hedge fund is as large relative to the market as LTCM was at the time. Moreover, bank regulators now monitor the credit and counterparty exposure of financial institutions to hedge funds much more carefully.

3. Fund of Funds. Funds of (hedge) Funds can play useful information and disciplinary roles. A Fund of Funds allocates capital among a number of individual hedge funds, giving investors access to managers they might not otherwise know and giving them diversification as to style and as to the law of large numbers. For such services, a Fund of Funds will charge additional management and incentive fees, up to another 50 percent of the underlying funds? fees. This added cost must be evaluated relative to the information efficiency and discipline they bring to the process. Some of us suspect that the services provided by some Funds of Funds are worth the cost, and that they make the market for hedge funds more efficient Others of us believe that with some 8,000 hedge funds

playing against each other in many of their strategies, there surely will be losers ? particularly when the high costs are taken into consideration. All of us believe that Funds-of-Funds-of-Funds, F3s, which invest in Funds of Funds, do not have a favorable cost/benefit ratio.

B. Recommendations

1. Fiduciaries should carefully limit their investment in hedge funds. With the tail and exit risks involved, together with a lack of transparency, the FER has concerns about whether a large exposure to hedge funds is appropriate for pension funds and other fiduciary investors who make investments on behalf of others, particularly retail investors. The recent Bayou hedge fund fraud attests to what can go wrong. Money managers face incentive conflicts that might prevent them from adequately representing the interests of the beneficiaries whose funds were entrusted to them. The difficulties in assessing the full range of hedge-fund risks should dictate a limitation on investments in hedge funds to a modest proportion of the total assets under management. The FER fears that some fiduciary boards, particularly those composed largely of non professionals, do not adequately understand the true returns, risks and costs associated with investment in hedge funds.

2. Regulators should vow not to bail out hedge funds. The FER believes that banking regulators should not rescue hedge funds. No one or two hedge funds pose systemic risk, though an individual failure might temporarily disrupt the market. The prospect of free government ?bail-out? insurance creates adverse incentives for speculative behavior. Expressing a ?no bail-out? policy would reduce those incentives. While tail risk is a problem, we do not foresee likely scenarios in which the monetary authority would need to intervene in its capacity as lender of last resort.

3. Performance and risk measurement should be standardized. The FER recommends that institutions, such as the CFA Institute and the Chartered Alternative Investment Analyst Association, develop standards for measuring performance and risk for hedge funds as has happened for other investment vehicles. That is to say, there should be standardized measures pertaining to gross and net returns, expense ratios, leverage, volatility of returns, credit risk and liquidity. While some hedge funds are reputed to have developed good internal risk measures, they have not made them available to investors. With better measures of risk and return, more understanding and rational investing will be possible. Comparisons of hedge funds will be more uniform. Finally, the FER encourages research on the asymmetric fee structure and its effect on investment behavior by hedge funds.

The adoption of these recommendations should improve the climate for hedge funds, and result in a better understanding of performance, expenses and risks. We are hopeful the industry will provide more standardized information voluntarily. Caveat emptor will still apply, but more rational investment behavior should ensue.

FINANCIAL ECONOMISTS ROUNDTABLE

Members Signing Statement

Rashad Abdel-Khali
University of Illinois

Edward Altman
New York University

Harold Bierman
Cornell University

Marshall Blume
University of Pennsylvania

Willard Carleton
University of Arizona

Andrew Chen
Southern Methodist University

Tom Copeland
Monitor Group

Elroy Dimson
London Business School

Franklin Edwards
Columbia University

Robert Eisenbeis
Federal Reserve Bank of Atlanta

Wayne Ferson
Boston College

Charles Goodhart
London School of Economics

Richard Herring
University of Pennsylvania

Thomas Ho
Thomas Ho Company

Alan Kraus
University of British Columbia

Edward Kane
Boston College

George Kaufman
Loyola University Chicago

Dennis Logue
University of Oklahoma

Jay Ritter
University of Florida

Stephen Schaefer
London Business School

Eduardo S. Schwartz
University of California at Los Angeles

Kenneth Scott
Stanford University

Lemma W. Senbet
University of Maryland

William F. Sharpe
Stanford University

Jeremy Siegel
University of Pennsylvania

Seymour Smidt
Cornell University

Robert Stambaugh
University of Pennsylvania

Laura Starks
University of Texas

Hans Stoll
Vanderbilt University

James C. Van Horne
Stanford University

Randolph Westerfield
University of Southern California

J. Fred Weston
University of California at Los Angeles

FINANCIAL ECONOMISTS ROUNDTABLE

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The Financial Economists Roundtable (FER) is a group of senior financial economists, who have made significant contributions to the finance literature and seek to apply their knowledge to current policy debates. The Roundtable focuses on microeconomic issues in investments, corporate finance, and financial institutions and markets, both in the U.S. and internationally. Its major objective is to create a forum for intellectual interaction that promotes in-depth analyses of current policy issues in order to raise the level of public and private policy debate and improve the quality of policy decision.

FER was founded in 1993 and meets annually. Members attending a FER meeting discuss specific policy issues on which statements may be adopted. When a statement is issued, it reflects a consensus among the majority of the attending members and is signed by all members supporting it. The statements are intended to increase the awareness and understanding of public policy makers, the financial economics profession, the communications media, and the general public. FER statements are distributed to relevant policy makers and the media.

The following statement on ?Hedge Funds? is the result if a discussion at FER?s annual meeting on July 10-11, 2005 in Sonoma, California. A list of members approving the statement and their current or most recent affiliation is attached.

For further information contact:

Professor James Van Horne
Graduate School of Business
Stanford University
Stanford, CA 94305
(650) 723-2761
(650) 735-9932 (Fax)
e-mail: vanhorne_james@gsb.stanford.edu

Professor Kenneth E. Scott
Stanford Law School
Stanford University
Stanford, CA 94305-8610
(650) 723-3070
(650) 725-0253 (Fax)
e-mail: kenscott@stanford.edu

Professor Franklin R. Edwards
Graduate School of Business
Columbia University
New York, NY 10027-6902
(212) 854-4202
(212) 316-9219 (Fax)
e-mail: fre1@columbia.edu

Professor Robert Stambaugh
Wharton School
University of Pennsylvania
Philadelphia, PA 19104
(215) 898-5734
(215) 898-6200 (Fax)
e-mail: stambaugh@wharton.upenn.edu

FINANCIAL ECONOMISTS ROUNDTABLE
ADMINISTRATIVE OFFICE:

George G. Kaufman
Executive Director
Loyola University Chicago
820 North Michigan Ave.
Chicago, Illinois 60611
Tel: 312-915-7075
Fax: 312-915-8508
E-mail: gkaufma@luc.edu
Website: luc.edu/orgs/finroundtable