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Are These Hedge Fund Results Real?
By FLOYD NORRIS
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NASHVILLE -- FOR those who favor open markets and open investment management, it may look like the best of times. But it may really be the worst -- and we may not learn just how bad it is until something horrible happens.

Never have American stock and bond markets been more transparent and subject to better regulation. New rules protect investors in companies and mutual funds by requiring better disclosures.

But more and more trading -- and more and more money -- now falls outside almost all regulation. Hedge funds trade with virtually no disclosure of what they are doing.

And both they and others trade -- without disclosure -- derivatives that had not been dreamed of when the regulatory structure was established more than half a century ago.

This has happened in the last two decades with little notice. Alan Greenspan, as Federal Reserve chairman, and the derivatives industry won the argument that regulation of new instruments would just drive them offshore.

In any case, they argued, the players in the derivatives markets -- the big banks and institutional investors -- were regulated, so why worry?

But now many of the traders are hedge funds. Many disclose only limited information to their investors about what they do, and they disclose almost nothing to regulators. Is a fund taking too many risks? The hope is that the banks that lend to it will police that. If not, good luck.

At a Vanderbilt University conference on conflicts of interest in financial markets, a paper was presented yesterday by Naveen D. Daniel of Purdue. Written with Vikas Agarwal of Georgia State and Narayan Y. Naik of the London Business School, it argued that hedge funds manage their results just as corporations did in the bad old days.

The paper, ''Why Is Santa So Kind to Hedge Funds?'' tries to figure out why hedge funds almost always do better in December than in any other month, and why performance often slumps in January.

Could it have something to do with the fact that hedge fund managers usually get a share of calendar-year profits? Is it interesting that the funds most likely to report a blow-out December are those whose managers most need such a result to collect their annual profit share?

''It looks like they could be faking'' some of the numbers, Mr. Daniel said. But the case is circumstantial because ''we have no clue what they are doing inside the funds.''

The similar, but smaller, end-of-year effect for mutual funds seems to come from managers' buying shares just before the Dec. 31 close, in that way pushing up the portfolio values they will report. But in hedge funds only monthly performance is released. No portfolios are available.

As hedge funds come closer and closer to being available to ordinary investors, that raises investor protection issues. But even if one assumes that hedge fund investors are sophisticated, questions remain.

The market in credit default swaps means that holders of General Motors bonds may not be in danger if that company defaults. But how much risk has been passed off in that market, and to whom? Has some of it landed with players who might not be able to meet their obligations?

The coming regulatory fights are shaping up to be over efforts to relax the Sarbanes-Oxley Act, and over whether mutual fund boards must have independent chairmen.

But months before Sarbanes-Oxley was passed, no one would have thought that such a law was possible. Then came Enron and WorldCom. Let us hope that no similar alarm and outrage come up when we do learn more about how -- and how safely -- hedge funds are secretly trading all those secret derivatives.

Graph shows the average monthly hedge fund returns for January-November and December, since 1998. (Source by Naveen Daniel)

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