

[Book Review]

‘Edging Your Bets: Markets and the Management of Risk

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Sebastian Mallaby. 2010. *More Money Than God: Hedge Funds and the Making of a New Elite*. New York, The Penguin Press. Pp. 482. ISBN 978 1 59420 255 1 (hardback).

Anyone seeking a comprehensive account of the hedge fund industry from its inception down to the present will derive profit, but only limited profit, from Sebastian Mallaby’s latest book. The same holds true for those in search of a discussion of the economic significance of hedge funds completely uncontaminated by polemic. For *More Money Than God*, as the hyperbole of its title indicates, is a work of high-quality financial journalism, one that has the weaknesses as well as the strengths of a quasi-insider’s view. Mallaby’s extensive experience as a reporter for *The Economist* and *The Washington Post*, and his current position at a leading Washington think-tank, the Council on Foreign Relations, mean that he has had a ringside seat from which to observe the key economic events of the past two decades. At the same time, intimate involvement with his subject makes detached and systematic reflection difficult; Mallaby genuinely tries to remain objective, but he is a self-acknowledged hedge fund partisan and it is difficult to avoid concluding that his affection for them is rooted not least in the entertainment value they provide. The rather breathless tone of the book suggests an overmastering urgency at work; there is a compelling story to tell, one that Mallaby has no wish to see cut short by regulatory interference. A defense of hedge funds must be mounted, and time is pressing.

The story-telling first. The structure of the book is broadly chronological, with each of the first six chapters devoted to describing one of the formative hedge funds, its creator(s) and offspring. Thereafter the approach becomes more episodic, a journey through the crises in which hedge funds have figured prominently during the past twenty years. Mallaby breaks off to describe some of the companies which led the hedge fund renaissance of the new millennium, before returning to bring his narrative to a close with an account of the lead-up to the Great Recession of 2008 and the cataclysm itself.

What shape is there, if any, to this story? There are the obvious themes of the vast

expansion in the size and influence of hedge funds, and the increasingly diverse nature of their activities. But this immediately provokes the reader to ask whether their nature has not changed so radically over time as to render the term 'hedge fund' itself virtually meaningless. Mallaby rightly attempts to deal with the problem of defining his central concept at the outset, but his success is partial at best. He argues that the vehicle created by Alfred Winslow Jones, the founding father of the industry, had four essential features that nearly all its successors were to replicate: a (very large) performance fee; the avoidance of official regulation insofar as that was possible; a balance between being 'long' in some stocks and 'short' in others; and the 'leveraging' of bets on the performance of stocks with borrowed money (p. 2). It is only the third of these features, of course, which seems indispensable to the management of risk and so would make a hedge fund seem appealing to even the most cautious of investors. Yet it was 'casually discarded' by George Soros, the most famous/notorious hedge fund manager of them all (p. 91) — nor was he by any means single in this.

The 'hedging' element appears to be largely fictional in any case. Its essential premise and promise, that whether the market rises or falls the fund will return a profit, is far too grandiose a claim to be widely credible; it implies that risk can, in fact, be eliminated. If this seems too good to be true, the facts adduced here prove that this is indeed the case, even accepting that the information Mallaby provides is incomplete because too great a focus on failure might disenchant the reader. Clearly, from the very outset, hedge funds have never proved themselves immune to downturns in the market; as an economic life-form, they seem by their nature prone to periodic mass extinctions. Mallaby's allusions to the culs of 1968–74 (pp. 40–41), 1994 (pp. 182, 191) and 2000 (pp. 262–264), and his rather more detailed account of some of the casualties of the turmoil of 2008, point to the irresistible conclusion that hedge funds in general have failed to foresee and ride out crises — even though, as late as 2009, investors continued to believe that they should and would (p. 371). Yet if they have not in fact abolished risk, or even managed it with consistent success, what have they been doing with their time and energy?

The answer is, in some cases at least, making vast sums of money in astonishingly short order. A. W. Jones christened his brainchild a '*hedged* fund' and vehemently but unavailingly objected to the removal of the final 'd' when the term was popularized; Mallaby acknowledges that he himself has gone one step further by dropping the initial 'h' as well (p. 5). What truly fascinate him are 'edge' funds, the ones that have seemed able, for a while at least, to beat the market in spectacular fashion. The relatively few individuals who have acquired sudden and dizzying wealth thereby dominate swathes of the book (they constitute the 'new elite' of its subtitle). Mallaby is not, in fact, particularly concerned with the generality of hedge funds — which is perhaps the severest limitation of his study. In pursuit of good 'copy', his spotlight falls repeatedly on men who have seemed able to generate immense profits year after year, and he cannot refrain from the inevitable question, 'how did they do it?' (pp. 109–111). Is there some formula for success that has characterized these 'high performance clusters'?

Mallaby wisely refrains from trying to provide a single, simple answer to this question. None of the ‘titans’ of the industry was blessed with exact foreknowledge of events; at best they were all, in their own different ways, much quicker to acquire information or sense opportunity than their peers. Furthermore, limited as their individual talents may have been, these were well adapted to their times and circumstances – up to a point. Some, like Julian Robertson of Tiger Management, were adept and ultra-confident stock-pickers, or in the case of A. W. Jones himself, managers of stock pickers. They were able, for a time anyway, to incentivize and infuse their subordinates with an *esprit de corps* that made them seem invincible. Others, like Michael Steinhardt and Paul Tudor Jones II, were successful students of market psychology, taking advantage of their insights to identify market ‘waves’ and adopt strategies to exploit them, based either on contrarianism or on a feeling for how other market players would react in a given situation. Being first in the field also gave some hedge funds a temporary institutional ‘edge’ – part of Steinhardt’s profits, for example, came from block trading, i. e. providing liquidity where others had not yet seen the opportunity. Sometimes this shaded into illegality; A. W. Jones flirted with insider dealing on occasion, while Steinhardt almost certainly engaged in substantial collusive trading - claims of a type that continue to be made against hedge funds today (e. g. Lattman and Ahmed, 2011). Luck, too, played its part (e. g. pp. 38, 47–48, 92, 120), but Mallaby is right to insist that it cannot provide anything like a complete explanation. More important, he argues, was the ability to spot and exploit market inefficiencies that allowed for the laying of huge asymmetrical bets, most notoriously on currencies. These were especially lucrative since the counterparties were central banks and governments whose understanding of the market was often woeful; the victory of Soros and Druckenmiller over the Bank of England and Norman Lamont on 16 September, 1992, ‘Black Wednesday’, remains the perfect specimen of the type.

Mallaby has much less time for the generality of hedge fund managers. But these mere mortals can take comfort from the fact that none of the ‘titans’ proved able to master the market or the art of risk-taking completely or indefinitely, and a large part of the interest of studying elite hedge funds lies in seeking to understand their limitations. Mallaby’s book is of considerable help in cataloging these. It is clear from his case studies that all hedge fund gurus, each in their own different way, have fallen victim to their own success; this is partly a matter of hubris that betrays them into folly, partly the simple loss of ‘edge’ as their protégés defect (taking with them the proprietary formula for success and setting up for themselves), and partly burnout. Thus Julian Hart Robinson was seduced into diversifying from U. S. equities, where he had considerable expertise and where his long-term approach had made him a fortune in the 1980s, into macro-trading (of currencies in particular) where this approach invited disaster in the 1990s (pp. 122–127, 248–252). Mallaby seems right to argue that Robertson threw caution to the winds primarily out of the desire to best Soros, just as Soros himself lost heavily in Indonesia and Russia in pursuit of an unrealizable ambition to be recognized as a ‘statesman-philanthropist’ (pp. 207–209, 212–219). Generational change is another force that eats away at the foundations of a successful hedge fund. Young and

ambitious juniors, becoming increasingly frustrated, decide to strike out on their own, and their mentors are powerless to restrain them, as A. W. Jones discovered early on (pp. 35-36) - the only partially successful strategy for circumventing this rule seems to be teamwork culture of Renaissance Technologies (pp. 303-306). But often the founding father is not unhappy to see his disciples go, because running a hedge fund is ultimately debilitating; the landscape is littered with extinct volcanoes. Even the greatest eventually burn out and retire, often disenchanting, the life sucked out of them: the roster here includes A. W. Jones (p. 35), Steinhardt (pp. 190-191), Robertson (p. 262), and Druckenmiller (p. 264). Even Soros, the ultimate prizefighter, could not sustain the punishment indefinitely, and took extended periods of leave from the ring (pp. 87, 149-50, 264).

Stories of the excess and chastisement of the powerful are, of course, the stuff of journalism, but Mallaby, in his concluding chapter, seeks to shift the focus from individuals to the making of policy. On the merits and demerits of hedge funds in general and on one of the burning issues of the moment, how and how far they should be regulated, his argument is that, the very largest of them aside, lightness of touch is the wisest policy. On balance, he claims, these funds do more economic good than harm. He absolves 'genuine', i. e. independent, hedge funds of most of the responsibility for the ongoing Great Recession. For him, it was the funds located inside banks (and especially the great merchant banks) who were the true villains of the piece (together with AIG, which took ineptitude to an entirely new plane). These internal funds, he argues, bore the stamp of bank culture rather than hedge-fund culture; they lacked the independence from regulatory and ratings agencies, the exclusive focus on their business, and the paranoia about margin calls that, Mallaby believes, preserved real hedge funds from the suicidal risk-taking that brought down Bear Stearns, Lehman Brothers and others.

The latter do not, admittedly, constitute a very high bar, and Mallaby can seem at times to engage in special pleading in favor of the independent hedge fund. Yet his basic reading of the crisis of 2007-2009 aligns with those of Andrew Ross Sorkin and Michael Lewis. They too see its major institutional casualties as largely the authors of their own demise. Sorkin has little sympathy with those like Dick Fuld, CEO of Lehman Brothers, who tried to portray their companies as hedge fund victims (Sorkin, pp. 96-105). Lewis is even more scathing in detailing how, to take perhaps the most egregious example, Howie Hubler's adventure into the brave new world of the CDS cost his employer, Morgan Stanley, an estimated \$9 billion (Lewis, pp. 200-215). It is worth noting in passing that Lewis adds a moral dimension to the tale of fund operators like Steve Eisner and Michael Burry (neither of whom figures in Mallaby's book) who worked to unmask the folly of Hubler and his employers. Lewis takes the defense of such funds one step further by asserting that the behavior of Bear Stearns, Lehman, Morgan Stanley and others of their ilk in the bond market was not merely incompetent but essentially corrupt, and that in dragging this into the light of day (and, in the process, profiting very handsomely) funds like Cornwall Capital were doing the work of justice (Lewis, pp. 233-234, 242-251). Mallaby also has little time for the view that the 'shorts' need regulating because they somehow unfairly

conspired to bring down Lehman and others; he, too, believes that their role as the shock troops of the free market considerably outweighs any shortcomings they might have. But his principal argument for leaving them alone is that far from being too big to fail, they are too small to warrant much regulation. The claim that they are simply not at present systemically important places Mallaby firmly in alignment with other hedge fund apologists like Richard Baker, president of the Managed Funds Association, for example (Ahmed, 2011). The evidence of the past, even of the collapse of the inappropriately-named Long Term Capital Management in 1998, Mallaby argues, shows that hedge funds can be allowed to fail without the cost being passed on to the taxpayer. That being so, as the standard bearers and, on occasion, the saviors of modern capitalism (pp. 317–322, 363–371), they are worth two cheers at least.

All of which sounds reassuring. And yet, if we are to believe Nouriel Roubini and Stephen Mihm, it will still not prove sufficient next time; future disasters there will be, for ‘far from being the exception, crises are the norm’ (*Crisis Economics*, 4). On this view regulators, charged with both creating a framework of rules and taking the lead in responding to crises, face a seemingly impossible task, and Mallaby’s book offers one obvious reason why; the clear and simple fact that the future will not resemble the past, a fact this is more than usually true of hedge funds. But, whatever limitations regulators may face, a full appreciation of the protean nature of hedge funds can only help those charged with supervising them. These funds have changed, and their changing has been rapid and constant. That will continue. Which means that regulators need to ask themselves; what will such funds look like in five years time? Or ten? Or twenty? This is effectively asking how one should try to regulate the unknown, it is true, but it is still a very worthwhile question. For Mallaby shows beyond fear of contradiction that hedge funds have metamorphosed with such alarming rapidity over the past sixty years that regulators have always been playing catch-up, not least because of the culture of secrecy that seems to be part of the hedge fund DNA. Regulators, it seems, like generals fighting the last war, have failed to equip themselves to meet the enemy effectively because they have only the haziest understanding of what they are facing. Symbolic of this ignorance is the figure of Eddie George, deputy governor of the Bank of England, assuring an interlocutor on the morning of ‘Black Wednesday’ that “We have got it all under control” (p. 164) - this, at the very moment when Soros and Druckenmiller were selling the life out of sterling.

One can, of course, hope that not all regulators are as utterly complacent and blindly conservative as ‘Steady Eddie’, and Mallaby’s book will certainly help to educate any of them that wish to learn from the errors of the past; he may even succeed in persuading them to leave hedge funds largely alone in the present. But his book will serve its most important purpose if it stimulates them anew to ask where they should look in the present for clues to the future. Was the ‘quant quake’ of August 2007 really a public policy non-event, as Mallaby tends to suggest (pp. 345–347)? In a financial era increasingly dominated by ‘fly-by-wire’ technology, symbolized by the magic algorithms of Renaissance Technologies, will the human pilots of the system have either the time or the skill to intervene to prevent the next crash? It is the central virtue of

Mallaby's study of the past that one is led to ask questions of this kind about the future.

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