Letter: Hedge Funds Race to the Bottom

ANTHONY D'AMATO

Dear Editors:

An additional perverse incentive could be added to the hedge fund story: the "wizards" of the funds described by Foster and Young know in advance that their time will run out and the fund will collapse. Their best strategy therefore is to maximize annual return. Suppose they are buying bundled mortgages. Someday all the mortgages will collapse, but until they do the investor in the fund has no idea about the comparative risk between types of bundles. Thus the wizard will simply buy the bundles that come on the market with the highest interest rate of return. (If the choice is between bundle A that contains mainly prime mortgages and pays 10%, and bundle B that contains nothing but the riskiest sub-prime mortgages and pays 14%, the wizard need not engage in any qualitative calculations. He only needs to know that 14 is higher than 10.)

Thus there is a race to the bottom. The worst and riskiest bundles (of mortgages or any other debt instruments such as car loans or credit cards) will attract the most investor money, keeping the game alive and compounding it. Fortunately for the wizard, he pays himself annually. (He also takes bonuses, which often exceed his payments for managing the fund.)

Anthony D'Amato

Northwestern University

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REFERENCES AND FURTHER READING

Foster, Dean P. and H. Peyton Young (2008) "Hedge Fund Wizards," The Economists' Voice, 5(2): Art. 1. Available at: http://www.bepress.com/ev/vol5/iss2/art1.