

BROOKINGS

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Why Transparency Matters

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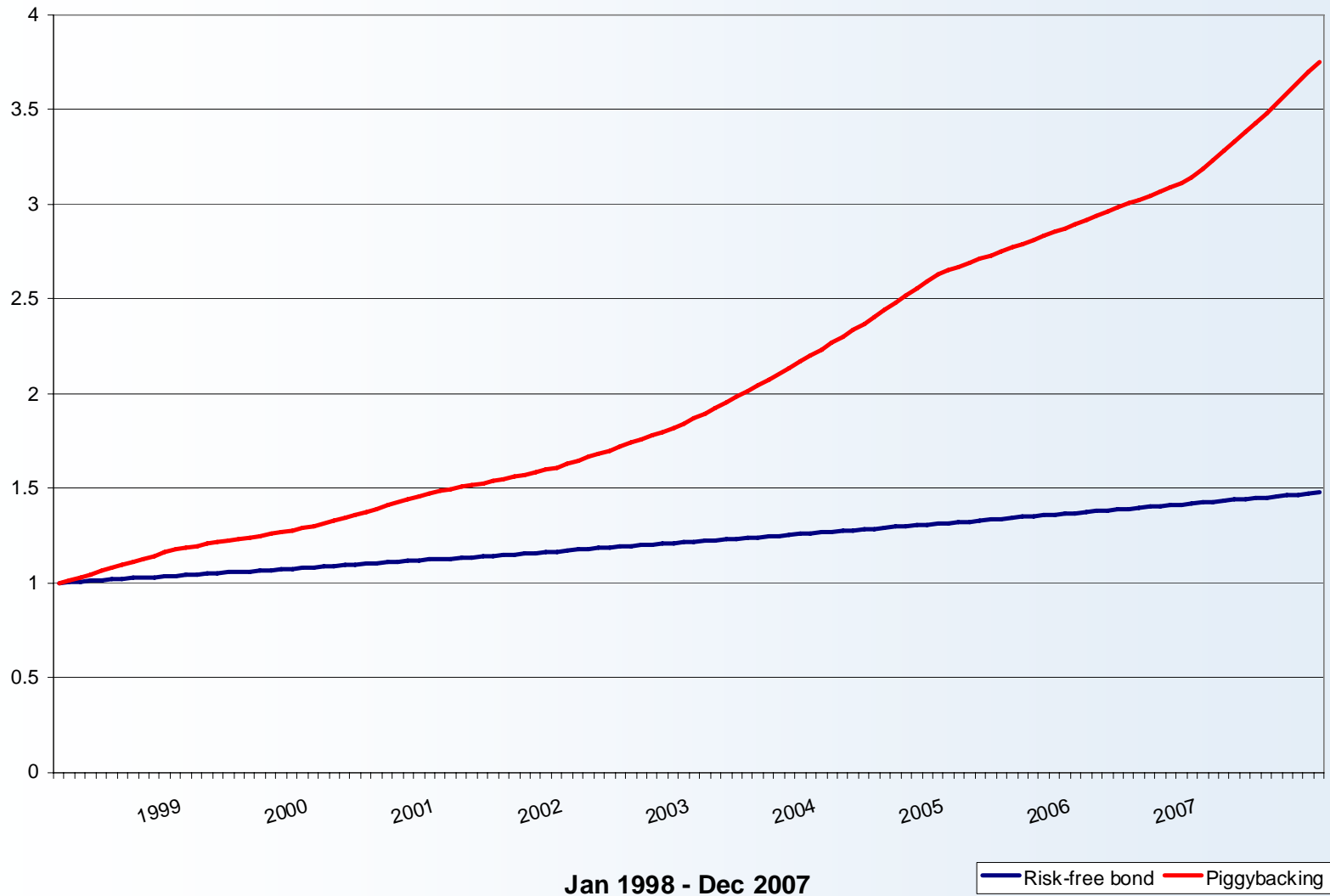
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Black-Box Investing

- Many hedge funds do not allow their investors to look “inside the box”
- The reason is to prevent copycats from stealing the fund’s proprietary methods
- Unfortunately this opacity opens the door to deception

- Using options-trading strategies, a fund manager can manipulate the distribution of returns to make it look **as if** he is generating above-average returns when in fact he is not
- This method of fluffing up returns is called **piggybacking**

Piggybacking on T-Bills

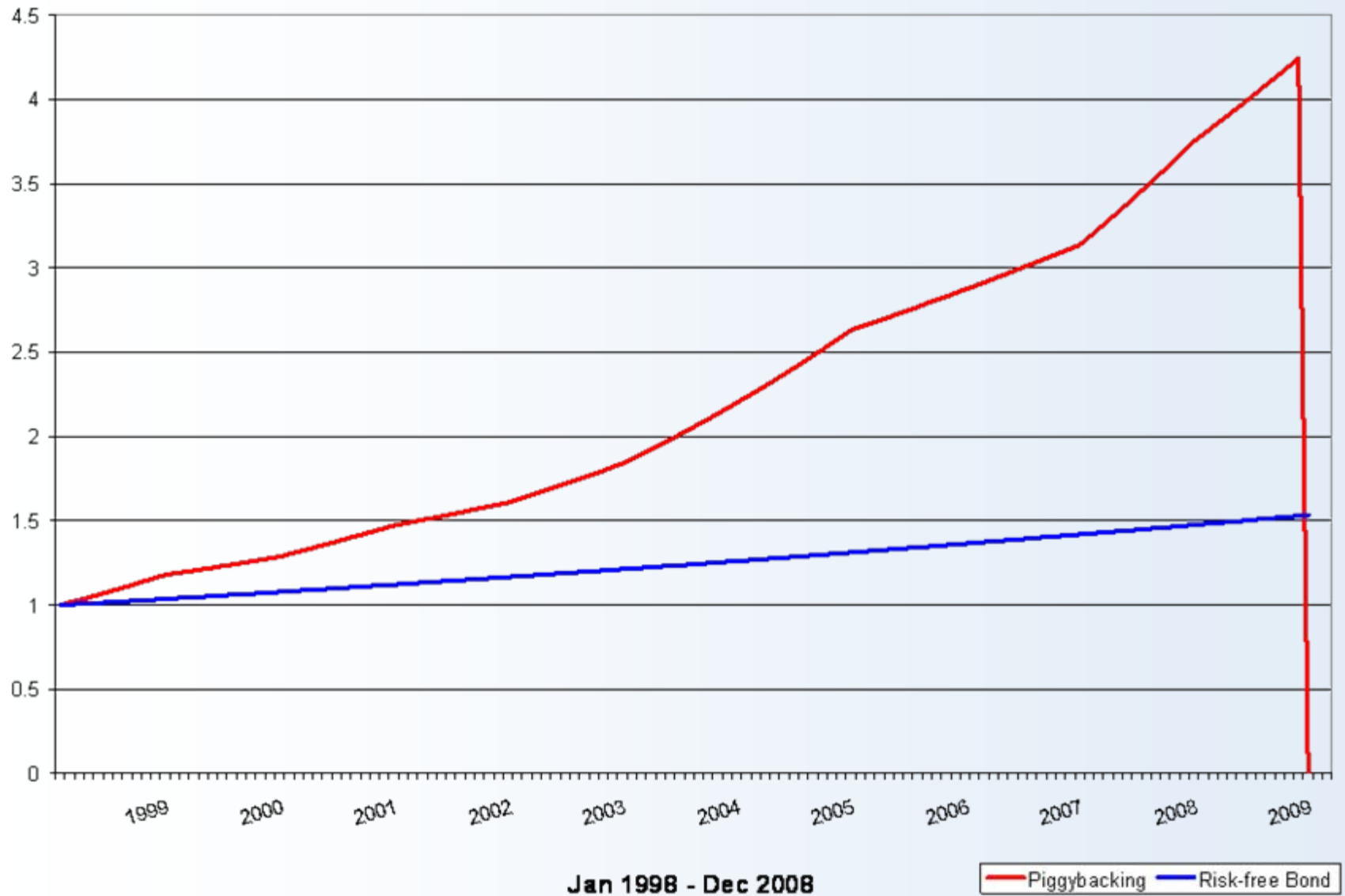


Piggybacking on the S&P 500



- Piggybacking is not fraudulent or illegal *unless* it contradicts what the fund's prospectus tells investors it is doing
- It is not a Ponzi scheme. Peter is not being robbed to pay Paul
- Positions are fully covered and paid for.

- But like a Ponzi scheme, the reported returns look better than they really are
- The trick is that there is a black swan hiding in the tail: the fund can go bust with small but positive probability
- The hidden black swan is driving the larger-than-normal returns that the investor sees



Such schemes can run for a long time

Suppose a manager pads the returns by $x\%$

Expected number of years y before going bust

x	y
5%	21
10%	11
15%	8

A potential “lemons” market

- When investors cannot tell the real McCoys from the fakes, confidence is undermined
- The entire industry can suffer a collapse
- The real McCoys have an interest in promoting greater transparency and some regulation as a way of maintaining confidence

Reforms with weak teeth

- Publishing value-at-risk measures (too easy to circumvent)
- Postponing managers' fees (still too tempting for the charlatans unless fees are postponed for a *really* long time)
- Assessing draconian penalties for bad performance (keeps the real McCoys out of the market also)

Some sensible first steps

- All hedge funds must register at inception
- The names of the fund's managers must be made public
- Returns must be audited frequently and publicly reported by an auditing firm with expertise in complex financial instruments
- When a fund closes, the final value paid to investors must be publicly disclosed