Senate Standing Committee on Economics

ANSWERS TO QUESTIONS ON NOTICE

Treasury Portfolio

Budget Estimates

1 June – 3 June 2010

QUESTION: BET 99

Topic: **Hedge Funds–IOSCO Principles**

Hansard Page: E33-34 (03/06/2010)

Senator CAMERON asked:

Senator CAMERON—Assistant Professor Baquero, who is part of the team on this report, says, 'Now is the time to discuss deep, substantial and effective regulation that will genuinely be of use to investors and protect our financial system for the future.' Do you agree with that proposition?

Ms Kljakovic—I would agree with that, yes.

Senator CAMERON—So what are we doing to deal with this deep, substantial—does somebody behind you want to say something? I saw a startled expression behind you.

Mr Miller—I think the question ignores in some ways what I was saying. We have a fairly strong system already.

Senator CAMERON—No, it is not ignoring. I was not satisfied with your response. Your response says, 'This is what we are doing.' What the professor says is that we need deep, substantial and effective regulation. I did not get the impression from what you said that the regulation is deep, substantial or effective. I am asking the question.

Ms Kljakovic—Certainly in relation to hedge funds as such, compared against the international principles we stack up very well and we are working to make sure that we stack up even better. I think for hedge funds we do have an external measure that we can say we are doing very well against the IOSCO principles.

Dr Kennedy—Senator, are your concerns more the global regulation of hedge funds or particularly the—

Senator CAMERON—Both. This is a global issue but it has got specific issues for Australia because APRA gave evidence to say that some funds have got up to four per cent of their investment in this type of investment instrument. If you take that across Australia, that is a significant amount of investment money going into what this report says is an opaque industry that requires deep, effective and substantial discussion. That is my concern. I just want to make sure that workers whose funds are being invested on their behalf across the industry can be confident that we are doing everything we possibly can to make sure that the concerns that have been raised by this report, the red flag, are being dealt with effectively.

Senator JOYCE—Dougie would know a lot about red flags.

Senator CAMERON—You seem to know a lot about all these houses that have taken Australia over, so give us a break, you dope.

Senator JOYCE—Go back to your red flags.

Senator CAMERON—No wonder the Libs gave you the flick. That is all I can say to you.

CHAIR—Can we get an answer to the question, please, from Senator Cameron, Mr Miller?

Mr Miller—The work that IOSCO are doing is in response to the problems that have been raised globally. The principles that they have come out with at the request of various international bodies are intended to give that deep regulatory response to those sorts of issues. What we are saying is we are meeting those six principles but maybe not to a hundred per cent. We want to make sure we are fully at a hundred per cent, and that is what we are doing—moving to that hundred per cent of all six principles. That is how we are going to get that deep. When I say 'going to get that deep', I think it already is deep but it could go deeper. That is what we are trying to do.

Senator CAMERON—Can you take on notice this report and provide a detailed response to the issues that this report raises as soon as possible?

Senator Sherry—We will certainly take that notice. The IOSCO meeting is next week. To summarise, there are direct regulatory and supervisory issues that go to this product. I accept your concern—there are direct regulatory and supervisory issues that go to the product. By taking your question on notice, I will ensure that—whatever occurs at IOSCO, for example, which is to meet very shortly and where this issue will be discussed amongst other things—you are able to get an update and response.

Answer:

The report to which the Senator refers is a working paper co-authored by academics from the European School of Management and Technology and the Rotterdam School of Management at Erasmus University, entitled 'Style Investing: Evidence from Hedge Fund Investors.'

Following a press release by the ESMT on 1 June 2010, various international media organisations published reports in which the preliminary results of the study were interpreted as presenting evidence that hedge funds pose serious risks to investors and the financial system.[1] Some reports used the study as a basis for calling for more regulation of hedge funds, including promoting the proposed Alternative Investments Directive currently being debated in Europe. These media reports appear to have been based solely on the ESMT press release, as the paper itself is not publicly available.

Treasury has obtained a copy of the original paper and has spoken directly to one of the paper's co-authors. Rather than investigating risks posed by hedge funds as such, the study's primary focus is about the determinants of money flows to hedge funds at the style level.

The research has so far shown that investors seem to follow the historical performance of hedge fund styles when making investment choices, even though this strategy is irrational and more often than not financially detrimental. It is postulated that this is due to investors failing to appreciate the fickle and capricious nature of financial markets, meaning there is no certainty that a hedge fund style that is in vogue and producing above-average returns one year will follow the same returns pattern the next. The paper argues that this is congruent with the Efficient Market Hypothesis,

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[1] For instance, see the International Business Times report on 1 June 2010, http://au.ibtimes.com/articles/25972/20100601/esmt-hedge-funds-pose-risk-to-investors.htm.

which predicts that opportunities for above-average returns should not persist over time in efficient markets.

The paper's findings imply a problem of 'asset allocation failure', in that there appears to be a myth among investors that some hedge fund styles are generically better than others, rather than any problem of an extraordinary risk posed by the funds themselves. If there is an argument for further intervention emanating from this study, it would be in relation to ensuring that investors in hedge funds have access to the appropriate information and a better financial understanding in order to make the right allocation choices. .

A more balanced review of the study, perhaps partly because it was published prior to the ESMT's press release, can be found in The Economist[2]. The article concentrates on the argument that hedge funds do not in fact produce the extraordinary returns with which they are often credited, but rather simply ride momentum and sell volatility. The article concludes that the perennial search for higher returns by following the past returns of various hedge fund styles is more likely to benefit hedge fund managers than their clients, but is still unlikely to pose a systemic risk of the sort seen with US sub-prime mortgages and the associated structured products.

While the ESMT study seems to confirm that hedge fund investors chase past returns, the same return-chasing behaviour is also seen in mutual fund and unit fund investments that are far larger in economic terms (particularly in Australia) and far more correlated than are hedge fund strategies. This is a view shared with Treasury by other leading hedge fund academics.

Australia has a comprehensive and robust investor protection regime contained within the *Corporations Act 2001*, including strict disclosure, reporting and advice obligations for fund managers. The Australian Securities and Investments Commission (ASIC) is responsible for the administration of the Corporations Act and consumer protection in relation to the financial sector. Australia's regulatory structure allows retail investors to invest in retail financial products and funds as they choose, in order to meet their risk and return needs – provided that such products are adequately and appropriately disclosed in accordance with these obligations. Australia's regime does not create specific financial product requirements for hedge funds.

Nonetheless, it is recognised that investors may make better informed decisions about investing in hedge funds and in complex and risky products if their level of financial literacy is improved. ASIC has taken on the national leadership role for advancing financial literacy in Australia. ASIC is currently progressing various initiatives to help build the capacity of Australians to make better decisions about their money and enhance their financial well-being. This includes launching a new *Investing between the flags* programme, that makes an analogy with the 'swimming between the flags' concept to highlight relative safety and risk reduction in investing. Initiatives such as these are designed to help retail investors make safer decisions and build financial security through long-term investment. While raising financial literacy is not specifically directed at retail investment in hedge funds, it is expected that the initiative will encourage investors to consider whether or not they should invest in such products and potentially lose a significant part of their capital.

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[2] See its 27 May 2001 article 'Who's the Patsy?', http://www.economist.com/node/16231444?story_id=16231444.

There may also be a question as to whether, in some circumstances, investors have been inappropriately advised to invest in hedge funds and various high risk products. On 26 April 2010, the Government announced the *Future of Financial Advice* reforms. It is proposed that the reforms will introduce a statutory fiduciary duty on Australian Financial Services Licensees and their authorised representatives which will require them to act in the best interests of their clients. The duty will also clarify that in no circumstances is it permissible for advisers to place their own interests ahead of their clients' interests.

As well as interventions addressing investor information, advice and financial literacy, the question of improving the regulation of hedge funds themselves is being considered internationally and nationally. In June 2009 the International Organisation of Securities Commissions (IOSCO) published six high-level principles on the regulation of hedge funds and hedge fund managers. Australia is already substantially compliant with all six of these principles. IOSCO's work on improving hedge fund regulation internationally continues. In September 2010 ASIC, and certain other securities regulators which are members of IOSCO, will participate in a survey collecting information from hedge funds managers using a common template. IOSCO will then finalise the methodology underlying the six IOSCO principles.

Treasury and ASIC are establishing a working group to discuss, among other things relating to hedge funds, the domestic implementation of the hedge fund recommendations put forward by IOSCO and the Joint Forum in order to ensure full compliance.

The ESMT study is still currently a working paper, but it is unlikely that the authors will modify their findings significantly. Furthermore, as the results of the paper come from a sample of hedge fund returns between 1994 and 2004, there is a strong possibility that the investor misconception that hedge funds always produce extraordinary returns may have been somewhat ameliorated by the poor performance of hedge funds during the global financial crisis. There is an argument that the crisis has enlightened the general public to the perils of irrational investment decisions based on myth or past returns.

Together with ASIC, APRA and the RBA, Treasury is continuing its work in ensuring that the Australian regulatory regime for hedge funds and other financial institutions remains at or above the international benchmark in these areas, and is consistent with best practice.