

Hedge funds slapped

In speech, Fed chairman Greenspan cautions against risky bets; low long rates still a conundrum.

June 6, 2005: 10:14 PM EDT

WASHINGTON (Reuters) - Federal Reserve Chairman Alan Greenspan on Monday warned that hedge funds had picked the "low-hanging fruit" of easy profits and may be set for a fall as they assume more risks in a quest for high returns.

He said, however, that the financial system should escape widespread damage from hedge fund woes as long as banks lending to them managed risks effectively.

"After its recent very rapid advance, the hedge fund industry could temporarily shrink, and many wealthy fund managers and investors could become less wealthy," the influential Fed chief cautioned in remarks prepared for delivery via satellite to a bankers conference in Beijing.

"Continuing efforts to seek above-average returns could create risks for which compensation is inadequate," Greenspan said. "Significant numbers of trading strategies are already destined to prove disappointing, a point that recent data on the distribution of hedge fund returns seem to be confirming."

Hedge funds are largely unregulated entities that cater to wealthy and institutional investors. Their assets are estimated to have doubled over the past five years to around \$1 trillion, although observers think funds suffered perhaps the heaviest redemptions in a decade in the second quarter of this year.

Still a conundrum

In his remarks, Greenspan tied the big risks hedge funds have taken on with the unusually low long-term interest rates prevailing around the globe.

As in February, when he termed the low level of long-term interest rates "a conundrum," the Fed chief wrestled with a number of potential explanations for the atypical environment -- but again found them all inadequate.

"One prominent hypothesis is that the markets are signaling economic weakness," he said. "This is certainly a credible notion. But periodic signs of buoyancy in some areas of the global economy have not arrested the fall in rates."

He said stepped-up demand by pension funds for long-term assets was likely no more than "a small part" of the cause.

Greenspan said while foreign central bank purchases of U.S. government debt may have lowered long-term borrowing costs in the United States, Fed staff estimates suggested only a modest impact. Further, he said this would fail to explain the lower long-term rates elsewhere around the globe.

He said the integration of low-cost producers like China and India into global markets likely had lowered the inflation compensation investors had previously demanded for holding long-term debt. But he said that more readily explained trends of the past decade, rather than of the past year.

The Fed has raised overnight borrowing costs by 2 percentage points since June 2004, taking the benchmark federal funds rate to 3 percent. Long-term rates, however, are lower now than when the Fed started

Although warning of hedge fund troubles ahead, Greenspan reiterated his view that the industry had helped increase the economy's resilience.

He said this was important, since economic policy-makers were not always able to head off brewing trouble in time. He urged countries not to become resistant to free trade because it would lessen their economic flexibility.

"In this regard, the recent emergence of protectionism and the continued structural rigidities in many parts of the world are truly worrisome," Greenspan said.