Weltwirtschaft, Ökologie & Entwicklung
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WEED fact sheet

Hedge Funds

The incarnation of ›predatory capitalism‹

»Capitalism isn't something you can find in a museum, it is a red-hot issue.«
Franz Müntefering

The German government has placed the topic of Hedge Funds on the agenda of this year's G8 summit in Heiligendamm. This is a reaction to the ongoing ›locusts‹ debate that was kicked off by Franz Müntefering before the general election for the Bundestag of 2005:

»Some financial investors don't waste any time thinking about the people whose jobs they are destroying—they remain anonymous, have no faces, invade companies like locust swarms, graze them, and then move on. It is this form of capitalism that we are fighting.«

The former leader of the SPD und current Minister of Labour and Social Affairs did not get very far with his advance. At the meeting of the Ministers of Finance in Potsdam in May 2007, the only achievement was a recommendation that Hedge Funds should develop a code of conduct for more transparency. The USA and Great Britain had made clear that they would not agree to any further regulation in this area. A third class funeral for the German government's initiative that was.

What is a Hedge Fund?

A Hedge Fund is a sort of cash collection point, to which each investor contributes a minimum capital—usually starting at one million US Dollars. It is a closed fund, which means that the number of shareholders is limited. The funds are only open to wealthy private investors, as well as other institutional investors.

Hedge Funds are controlled very little or not at all. They are usually based in offshore financial centres and tax paradises like the Bahamas, Liechtenstein, British Jersey, or the US-state of Delaware.

At the heart of their operations lie leveraged takeover bids. Leveraged means that in addition to their own capital stock, their equity, a multiple of it, the external capital, is available. Example: If I have 100 million Dollars of equity, and then take up 900 million Dollars of external finance, I have one billion Dollars at my disposal. In these dimensions, speculating on a currency fluctuation by just one cent leads to a profit of 10 million.

Hedge Funds also perform other transactions that are not permitted to other investment funds, such as bear raids.

How does a bear raid work?

On 10 September I buy a warrant (this is the basic variant of a *derivative, a future*) for the disposition of a parcel of shares from *American Airlines* two days later at the price of 100 million US Dollars. However, I do not yet own the shares on 10 September. The next day, the price of *American Airlines* shares drops by 40%. I now purchase the parcel of shares—either with equity, or through a credit—that now costs only 60 million US Dollars. And the following day I present my *future* and receive the 100 million US Dollars warranted, making a gross profit of 40 million Dollars. Of course, such high profits in a single deal are the exception. But even in case of smaller margins, profits remain remarkable if the vested amounts are high and the operations are repeatedly performed.

The ›haut école‹ of bear raiding is to produce a drop in the stock price by massively selling one's own shares or bonds.

Lately, Hedge Funds have increasingly been buying companies, only to re-sell them after a short period of time with a large profit margin. This business model is in fact characteristic for Private Equity Funds. The differences between these two types of funds tend to blur.

What makes Hedge Funds so dangerous?

The risk potential of Hedge Funds was revealed by the near-bankruptcy of the Long-Term Capital Management (LTCM) Fund in 1998. LTCM had managed, with a net equity of 4.8 billion US Dollars, to acquire an external financing amounting to 125 billion US Dollars. That is an outside financing ratio of 1:25.

At one point, when some of the loan creditors wanted the repayment of their credits due to their own troubles, in fact a rather trivial and quite frequent situation to occur, the result was an impending chain reaction, threatening to trigger a worldwide crash. In a spectacular last ditch effort, the Clinton administration organised a salvation package of 3.7 billion US Dollars.

During the course of all this it became obvious that LTCM's operations were absolutely inscrutable. On the one hand, it remained unclear how high the total indebtedness and the risk deposits were. On the other hand, the complexity and the scope of the operations of the Hedge Fund created great intransparency.

Locusts advancing

Since 2006, Hedge Funds have managed to increase their deposits by almost a third. The total deposits are an estimated 2,097 trillion US Dollars. Bearing in mind the leverage effect of outside capital, it becomes clear what incredible economic power is in effect here.

All in all, there are about 10,000 of such funds. However, business is rather concentrated. The ten biggest funds alone have at their disposal about 250 billion US Dollars in equity.

A new type of capitalism

The stability risk is just one side of the problem. Just as worrying is the fsact that Hedge Fonds represent a way of doing business in which quick profits represent the overarching objective. A new type of capitalism, dominated by the financial markets, is emerging. The interest in profits of the investors is rigorously enforced without considering employment, social welfare, environment, or even innovation and long-term competitiveness.

In this regard, some people, such as the former German Chancellor Helmut Schmidt, speak of ›*Predatory Capitalism*‹, others of ›*Shareholder Capitalism*‹ or ›*Turbo Capitalism*‹.

Whatever it may be titled, the point is that this development stands in harsh contrast to a socially just, ecologically sustainable, and democratic development.

As long as the international regulation of Hedge Funds is prevented by the resistance of the USA and Great Britain, they should at least be denied access to the German market.

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