

## " 'Hedge funds' are a safety valve "

The Harvard professor defends the flexible regulation of the funds

ISABEL LAFONT  
NEGOCIOS - 15-01-2006

Robert Merton (New York, 1944) frowns when he talks about Long Term Capital Management (LTCM), the *hedge fund* he founded in 1994 with John Meriwether, the mythical vice chairman and super specialist in fixed income securities at Salomon Brothers, which in 1998 was dragged down by the Russian crisis. Its position in the financial markets entailed such risk that the Federal Reserve of NY organized with Wall Street's main firms a rescue of the fund to prevent its collapse.

"Crisis are unforeseeable", says Merton, whom from his cathedral at Harvard Business School continues with a brilliant academic career which started with his bachelor degree in Mathematics and Engineering from Columbia University. Thereafter it was completed with a master degree in Mathematics at the California Institute of Technology (Cal Tech) and a PhD in Economics at the Massachusetts Institute of Technology (MIT). In 1997, together with Myron Scholes, he received the Nobel Price in Economics for their work on stock options. Both winners, together with Fischer Black deceased in 1995, are the authors of the *Black-Scholes* formula on option pricing, the most utilized around the world.

**Question.** Now-a-days, is there more or less risk in the markets than in the past?

**Answer.** Our capacity to measure and manage risk has increased considerably, but this does not necessarily mean that we are more secure. We can use new instruments to increase the safety or to increase the returns. The ABS is a safety element in a car, but it has not reduced the accident rates. How are both things reconciled? The answer is that we can use this as a safety feature not to drive more safely, but to drive faster in bad weather. The markets need not be more secure either. All over the world there is a wider range of instruments in the financial markets. If there is a financial crisis we have more channels to carry on than in the past. Nevertheless, that does not mean there will be fewer crises.

**Q.** How is it explained that all the businesses, fixed income, variable income, raw materials, and currency have obtained record results?

**A.** One for the main engines, for example, in the market for raw materials has been China's expansion. But in general, it is something of a mystery that an extraordinarily high oil price has not had an impact yet in the economies, although we shall find it out in time. It cannot be explained either why variable income has performed as well as, for example in the US, the real state sector.

**Q.** What failed in Long Term Capital Management?

**A.** We would not have sufficient time to discuss it. Simply, I would say that errors were made and that unforeseeable things happen in financial markets. But the crisis was not precipitated by an error in the models or a mistake of this kind. Among the people that managed the fund, there were some of the most experienced traders in the world, who had been doing it for 15 years at a world-wide scale. They were not dreamers who thought the world was perfect; they had a lot of experience in crisis. I would not say there was something in particular, but a series of bets and a series of circumstances in the markets that precipitated the events.

**Q.** How did this experience affect you personally?

**A.** It was a very difficult experience. But, in a way, a financial crisis is something one cannot prepare for. Of course we had experience in financial crisis! But if history is analyzed some have arise from the strangest circumstances, so it is difficult to plan for them. They happen... you don't know where. But what I have concluded is that there were a series of mistakes that we made collectively.

**Q.** What kinds of mistakes?

**A.** Investments in some areas that should not have been as large as they were... But this happens frequently, there is no mystery in that sense. I am not saying it was not an important circumstance for me and for all of those implicated; what I mean is that there was nothing unusual. A bet was made and there were a series of circumstances. At the end it was resolved in a favourable way, without bankruptcies or suspension of payments, except for those involved directly, as myself, since I lost a lot of money.

**Q.** There is a heated debate on whether or up to what point *hedge funds* should be regulated.

**A.** In principle I am in favour of an intelligent regulation. I am not opposed to regulation. It is part of the financial system and it is necessary. But when regulating, it is important to understand well the function of what is going to be regulated. Overall, the *hedge funds* are subject to a light regulation, in comparison to banks and insurance companies. From the point of view of the financial system, their function is important because they act as intermediaries of intermediaries. In this global world, the financial systems of different countries are not at all coordinated; the most clear example is that there are different currencies, tax systems, accounting... there are institutional rigidities that impose restrictions on banks and insurance companies. The reduction of the impact of these rigidities has to come from someone who is not subject to them. There is a need for a different kind of institution on the other side that is not a bank. *Hedge funds* do that, they soften the effect of these rigidities. That is why we need to be flexible with regulating them. If they are subject to the same rules as, for example, banks they will not be able to fulfil their role.

**Q.** Do *hedge funds* represent a potential risk?

**A.** I don't think they do in an intrinsic way. This does not mean that they cannot collapse and then people lose money. But I view them as an improvement of our financial system, since they offer more financial channels, more cushions to confront shocks. We need an intelligent regulation that recognizes that role. But I don't think it is an adequate perspective to consider them as something outside the system that tries to circumvent the norms.

**Q.** What should be the reach of the regulation?

**A.** They should not be subject to strict rules, such as the solvency or transparency requirements in the case of banks, or the kinds of investments they can or cannot do in the case of insurance companies or investment funds. There is a need for a security valve in the system. If everyone is subject to the same regulation, it is tied. There is a certain preoccupation that some unsophisticated investors may end up investing in hedge funds. But, at least in the United States, there are also very few restrictions when purchasing common stock in regulated markets and people can put all their money in them, which is not too intelligent. I don't think the main worry should be that the small investor gets into hedge funds. I don't recommend he does, it can be costly, but there

are many other mistakes that can be made which are not prohibited for small investors, such as the purchase of risky small company shares, as happened with the dotcoms...

### Going back to 'stock options'

**Question.** The abusive use of *stock options* (options to purchase shares from the company one works for) has been proposed as the cause of recent business scandals such as Enron and others.

**Answer.** I don't think the *stock options* were responsible for the scandals. I have always believed they should be accounted for as an expense. Once it is exposed that they entail a cost, fewer businesses will use them, and this is a corrective mechanism. It was a good idea to adopt them 20 years ago in order to increase the link between management compensation and their own company shares. That, together with a favourable fiscal accounting treatment might have pushed their use beyond what could be desirable. I believe this is being corrected through the accounting mechanism, a way that will be more effective than anything else.

**Q.** It is possible to value objectively the *stock options*?

**A.** Surely to be comparable to other accounting valuations. To account for the useful economic life of an asset is a far more difficult task. Someone should tell me the accuracy in estimating the useful economic life of a computer, for example, that can last decades! When does it become economically obsolete? Isn't it there something subjective in this valuation? In the case of options, there are formulas which are used all over the world by investment banks and central banks that negotiate thousands of millions of actual investments in options. Why should options need to be valued to millimetre precision when other aspects of the balance sheet are lucky to be within meters? It is precisely in this area where the best valuation methods might be found. It is just enough to look at the balance sheet and analyze how many entries there involve subjectivity.



The 1997 Nobel Price Winner in Economics, Robert Merton, during the interview. (BERNARDO PÉREZ)

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