

## *Act II*

# **LaRasmussteinmontians in Yellowstone Park**

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*Once upon a time, not so long ago, there was a bear named Winnie-the-Bear who lived in the Trillion Acre Wood. On some level, he was a silly old bear. Nevertheless, he was wondering what the fuss about hedge funds was all about. He invited his two best friends, George Jones, the famous hedge fund manager, and Ben Put, the famous academic and central banker since the 1980s, to the Trillion Acre Wood for a further chat on hedge funds.<sup>1</sup>*

Winnie-the-Bear                      Thanks for joining me again. With all the fuss about hedge funds they clearly are going to face tough regulatory headwinds going forward, no? I find the topic of hedge fund regulation difficult to grasp, actually quite weird, to be honest. I wonder; *if 'pro' is the opposite of 'con' what is the opposite of 'progress'?*

George Jones                         Yes, hedge fund regulation is weird. Regulators regulate banks. Banks screw up. There's a run on the banks. Banks cut credit lines to hedge funds. Hedge funds pull the cash from the banks. System breaks. Politicians save the banks and then go on and blame hedge funds. If it weren't so sad it would be comical.

Winnie-the-Bear                      It seems to me that *politics is the art of looking for trouble, finding it everywhere, diagnosing it incorrectly and applying the wrong remedies*. I find hedge fund regulation in Europe is particularly weird. You know,

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<sup>1</sup> *A Green Pig Down Wall Street, Act I, October 2009*

putting hedge fund regulation on top of the agenda at a G8 summit in 2007 and then—after the banking system collapsed in 2008—carrying on emphasizing hedge fund regulation in 2009, seems odd.

Ben Put   It *is* odd. You would have thought that the political energy was better spent elsewhere, wouldn't you? The reason is that financial regulation in Europe is conducted by a species from a different planet.

Winnie-the-Bear                                 Extraterrestrials? What, Martians, Klingons, Vogoons, the Borg?

Ben Put   No; the LaRasmussteinmontians.

Winnie-the-Bear                                 Why do the LaRasmussteinmontians feel the urge to regulate hedge funds?

Ben Put   Extraterrestrials go through mid-life too.

George Jones                                    Ben is pulling your leg Winnie. He's a funny guy. Ben uses extraterrestrials as a placeholder for Continental European politicians.

Winnie-the-Bear                                 Why?

George Jones                                    Mainly because their lines of reasoning are—to him—so far off from common as well as economic sense that it is sometimes difficult to acknowledge that they inhabit the same planet as we do.

Winnie-the-Bear                                 I see. *Politics is supposed to be the second oldest profession. I have come to realize that it bears a very close resemblance to the first.*

George Jones                                    Napoleon was probably on to something when he said: *In politics, stupidity is not a handicap.* However, as fun as it is to lament about politicians, they might actually not be as daft as the intelligentsia regularly likes to portray them. Ideologically, Continental European politicians just have read different books than their Anglo-Saxon peers.

Ben Put   Don't tell me you're an Austrian?

Winnie-the-Bear                                 Vienna is said to be quite nice this time of the year.

George Jones                                    Ben is referring to the *Austrian school of economics* that argues for greater economic freedom, small government and the abolition of central banks. It was tried in the 1930s and failed miserably, wiping out nearly one third of the Western world's GDP with a quarter of the labor force

thrown onto the streets. Authorities and central banks are currently doing everything to prevent a repeat. They have succeeded; so far.

Winnie-the-Bear

Do Austrians blame central banks for the crisis?

George Jones

Yes, they do. They argue it is central bankers' cheap money policies and emergency credit enhancing that fuelled the credit bubble. I'm glad that someone blames central bankers for the financial crisis; most other people blame hedge funds.

Winnie-the-Bear

Austrian economics sounds like 19<sup>th</sup> century laissez-faire to me.

George Jones

It is. However, the Austrians have some arguments speaking for them. One is that they hold that the complexity of human behavior makes mathematical modeling of the evolving market impossible. Second, they argue it is credit that matters, not money, when explaining business cycles. In other words, they can better explain bubbles and bursts. This is something the rational-man and efficient market theory disciples struggle with to this day, including our central banker friend. Thirdly, Austrians believe that the ever-evolving economic world is too complex, dynamic, and multi-faceted to be hampered with by political animals and bureaucrats. They also stress that economic failure is quite natural and healthy.

Winnie-the-Bear

Failure is painful. How can that be a good thing?

George Jones

All living species experience pain. It is the pain that tells you: stop doing what you're doing and don't do it again! It's a primordial but very effective part of learning and elementary to progress.

Winnie-the-Bear

I think I can relate to this. *Good judgment comes from experience, and often experience comes from bad judgment.*

George Jones

Yes, I like to call it *learning by doing*. Economic failure allows weak hands to hand over their capital—or what is left of it—to strong hands.

Ben Put

The market fundamentalists say that the only thing we did right was allowing Lehman to fail. I hope you don't agree; do you?

George Jones

I wouldn't go as far as that. I do admit though that the market fundamentalist Austrians at least have a point. Failures should be allowed to collapse and be replaced by creative new forces rather than being

propped up as zombies. Financial institutions have been failing for centuries and the world has survived.

Winnie-the-Bear

Is that true?

George Jones

Yes. On average we can track a financial crisis every 10 to 15 years back to the Middle Ages. The market fundamentalists argue that had the central bank allowed the failure of LTCM to run its course in 1998, Lehman, Bear Stearns, et al would still be here. Everyone would have lost so much capital that the madness of serial bubbles—dotcoms, housing, consumption etc—would never have occurred. Consider the alternative had they propped up the bankrupt Lehman. There would be even more of the same insanity in our central banks and governments than we have now. The idea that a problem of too much debt and too much consumption can be solved by more gigantic debt and consumption is—again according to this line of thinking—ludicrous.

Winnie-the-Bear

Am not sure I get that.

George Jones

Ever been to the Yellowstone Park, Winnie?

Winnie-the-Bear

Sure. Love it.

George Jones

As you remember, the big fire from 1988 destroyed 1.5 million acres. Lightning sparks several hundred fires within the park every year. Most burn less than an acre, or maybe a few acres before dying out. As of 1988, even the largest fire ever recorded had burned only twenty-five thousand acres. So when a lightning bolt sparked a small fire near Yellowstone's southern boundary in June of 1988, no one was unduly alarmed.

Winnie-the-Bear

Big events having small beginnings... We talked about this the last time.

George Jones

Exactly. What makes this case special is that the authorities from 1890 onward had a zero tolerance policy, even for forest fires sparked by natural causes. They intervened. One of the unintended effects of this intervention was that the forests began aging. Old trees were not replaced by younger trees. The natural evolution of the forest changed. The trouble is that fires are an indispensable component of the natural dynamics that keep forests in a more or less stable state.

- Winnie-the-Bear                    It doesn't take too much imagination to apply this *Yellowstone effect* to the financial system, does it?
- George Jones                        No it doesn't. By suppressing the natural dynamics of the forest, the authorities had driven the forests into an unstable state with a high density of burnable material everywhere. So the conclusion is that the forest is best left alone as it can take care of itself by regularly replacing the old and weak with the new and strong. The Austrians argue that the same is true for our economic systems. The intervention can be well intended. However, the long-term consequences could be much worse than non-intervention.
- Winnie-the-Bear                    *A common mistake that people make when trying to design something completely foolproof is to underestimate the ingenuity of complete fools.* Got that. What's *your* view on central bank intervention in the 2008 financial crisis?
- George Jones                        Given the hand dealt to the central bankers I think they did well. They met head-on with the worst economic crisis since the Great Depression and did what central banks are supposed to do in that situation: they flooded the market with liquidity. *Yes, there may be unknown long-term implications from these interventions, and yes in a perfectly free market and libertarian world it might have been better for the market to clear in the short-term.* However, you need to survive the short-term to experience the long-term. The central banks made certain that the short-term needs of the banking system were met, putting short-term necessities ahead of long-term niceties.
- Ben Put                                Thank you. What did you mean by the LaRasmussteinmontians having read different books?
- George Jones                        They've got something they call *Ordnungspolitik*.
- Winnie-the-Bear                    Uuh, sounds very strict. Sounds like *more stick* and *less carrot*.
- Ben Put                                Sounds more like a *whip* to me, rather than a stick, but never mind.
- Winnie-the-Bear                    Thank's for the mental image, Ben.
- George Jones                        You can call it what you want, but yes, Continental Europeans are more interventionist than Anglo-Saxons when dealing with economic affairs. *Ordnungspolitik* is influenced by the *German school of economics*.
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Winnie-the-Bear                    Another school? Please, can't you people just merge the different schools and be done with it?

George Jones                    The *German historical school of economics* held that history was the key source of knowledge about human actions and economic matters. The school rejected the universal validity of economic theorems. They saw economics as resulting from careful empirical and historical analysis instead of from logic and mathematics. The School also preferred the *real world* in terms of history, politics, and socio-economics, rather than abstract mathematical modeling in a *model world*.

Winnie-the-Bear                    Boring!

George Jones                    Most members of the school were concerned with social reform and improved conditions for the common man. They viewed government intervention in the economy as a positive and necessary force. The German school lead to the *Freiburg School* which builds on the political philosophy of *Ordoliberalism*.

Winnie-the-Bear                    Thought there might be another school. This is really getting boring.

George Jones                    I know. But bear with me. These ideas are experiencing quite a renaissance post the financial crisis. Ordoliberals are for competition and against extensive welfare as much as the next chap. However, it is the responsibility for human rights, moral conduct, and social norms and values that they suggest are better not left to the market place. One of its proponents, Wilhelm Röpke, sought to allow the maximum economic freedom and self-determination for each citizen. However, he also saw that the boundaries of this autonomy must exclude actions that weaken the social order and undermine the civic foundations of the market system.

Winnie-the-Bear                    Why am I not familiar with these ideas?

George Jones                    These ideas were written up in German mainly in the first half of the 20<sup>th</sup> Century and, as you can imagine, speaking German in the first half of the 20<sup>th</sup> Century didn't exactly allow you to climb too high up the global popularity totem pole, did it? By the time these ideas had gotten translated into English, mainstream economics spent most of the time debating whether Keynesianism or Monetarism was the better idea.

- Ben Put                                    This is only partially true George. We could argue ...
- Winnie-the-Bear                        Boring! What's the bottom line George?
- George Jones                            In a football tournament where different international teams compete you need an agreed set of rules, an event organizer as well as referees who understand the game and have both a yellow and a red card in their pocket. Then let the game commence with the football players playing the game, not the event organizers and referees.
- Winnie-the-Bear                        Got that. I heard that *the inherent vice of capitalism is the unequal sharing of blessings; the inherent virtue of socialism is the equal sharing of miseries*. Is that true?
- Ben Put                                    Winston was spot on, Winnie! Capitalism has created the highest standard of living ever known on earth. The evidence is incontrovertible. Capitalism is based on entrepreneurialism, full stop. Entrepreneurialism works best when the sticky fingers are held off.
- George Jones                            Look who's talking. Still carrying around an Ayn Rand photo in your wallet, Mr. Putoption?
- Ben Put                                    There is a saying that *socialists do not have children because if they did, they wouldn't be socialists*.
- George Jones                            There is no such saying. You just made this up.
- Ben Put                                    Yes I did actually. However, someone could have said it before. It means that problems are not solved but band-aided and transferred in to the future for our children to solve. They know quite well that children cannot vote.
- George Jones                            Look who's talking. Capitalism on the upside and socialism on the downside is indeed an interesting experiment. I'm not sure what will be the bigger surprise for our kids in adulthood when they learn that they share a common ancestor with monkeys or when they realize that they owe their parents and the world a lot of money. They might even suspect there is causality between the two.
- Winnie-the-Bear                        Reaping short-term profits while creating a long-term mess... Where did I hear that before?

George Jones                    The funny thing is, Ben, socialists nowadays know too that free enterprise and competition are the only sustainable welfare-enhancers. Isn't it interesting to observe how the capitalist nations are drifting to the left while the former socialists and communists are moving to the right as we speak? There is the possibility that the European ordoliberalists actually *do* understand that hedge funds are an attractive business for an economy. After all, it creates ridiculously remunerated jobs which most people today agree is a good thing. They also realize the supportive role providers of risk capital and liquidity can play to the wheel-bearings of capital markets. In addition, if business moves from oversized banks to hedge funds, that's another positive from a *systemic risk* point of view.

Winnie-the-Bear                Why's that?

George Jones                    The 'too big to fail' issue has not yet been solved. The hedge fund industry is very heterogeneous whereas banking is very homogeneous. Business moving from big banks to the much smaller hedge funds and other much smaller financial firms creates a better balance which reduces the risk to the overall system. In addition, the not-too-big-to-fail institutions are not amused. Most of the not-too-big-to-fail fraternity operated diligently, survived the storm without governmental help and now face unfair competition from zombies on governmental life support.

Ben Put                            I've never thought about it like that.

George Jones                    I know. There are additional considerations. Continental Europeans aspire to get 'their' financial hub back. Today, the financial hub in Europe is London. However, at one stage Paris was the center for finance and trade and before that it was Amsterdam and before that it was Venice and so on. The way it works, Winnie, is that money and business goes where it wants to go. It goes where it is welcome, where it is not stigmatized or unduly taxed. It likes the presence of a rule of law and dislikes legal uncertainty and laws coming into force with retrospective effect. Winnie, when you build a dam across a streamlet, what happens after a while?

Winnie-the-Bear                The water flows beside the dam.

George Jones                    Exactly. The same happens with capital. There is a natural flow. You can only control these flows intermittently. Capital—like water—seeks the



way of least resistance. If London screws up, business will go to Switzerland. If the Swiss screw up, business will go to Singapore or wherever else it wants to go. The *LaRasmussteinmontians* know that too.

Ben Put Doesn't look like it. When they introduced the Euro some ten years ago, they also thought that Continental Europe could take market share away from London. It didn't happen. London didn't wobble. London even gained business due to business-unfriendly interventionist behavior in the US. There is a saying that London is a great place to do business *because* of its regulation, and New York is a great place to do business *despite* its regulation.

Winnie-the-Bear You made that up again?

George Jones No, there actually *was* a saying along those lines a couple of years ago. The saying feels dated though.

Winnie-the-Bear So you think that the Europeans might be in the process of having another go at London?

George Jones Yes. It could be that they envisage that the *new normal* is a tightly regulated market place.

Ben Put The Italian PM will be wearing a chastity belt before *that* happens. One, Europeans cannot agree where the New London is supposed to be; Paris or Frankfurt. Brussels anyone? Second, it wasn't a *lack* of regulation that helped cause this mess. It was a combination of anti-market regulation and the lack of supervision that caused this mess. Third, the suggested regulation comes in form of a hidden trade barrier. Local suppliers are favored while keeping foreign suppliers out. *If hedge funds were cheese then the Continental European political will wants EU cheese-eaters to only consume EU cheese from EU cheese-makers using EU milk from EU cows fed in the EU munching EU grass.*

Winnie-the-Bear *It's impossible to rule a country that makes 250 kinds of cheese.*

Ben Put Yes. I must admit though, my analogy has its limitations. Europe has cheese. However, given that the Eurozone has no hedge fund industry to speak of, Continental Europe could continue to have exactly that: no hedge fund industry to speak of.

- Winnie-the-Bear                    Very funny, although *it's easy being a humorist when you've got the whole government working for you.*
- George Jones                    I wouldn't be so sure Ben. If there ever was a time for a more regulated market place, it is now. Governments around the world are—rightly or wrongly—taking power back from free markets, particularly financial markets, under the pretext that they have failed. Many investors are tired of a misbehaving financial sector and utterly disgusted by the Wall Street-Washington link. Trust needs to be rebuilt. The fear-and-greed gauge jumped to fear in 2008 and only gradually will move back the other way.
- Winnie-the-Bear                    But you think *greed is good* shall return? As in *the past may not repeat itself, but it sure does rhyme?*
- George Jones                    Yes, of course. Faster than anyone could have imagined only eight months ago it seems. Makes you wonder...
- Winnie-the-Bear                    Ben, you mentioned trade barriers. Wasn't there a G20 meeting in London recently where all the leaders sang along to free trade?
- Ben Put                            Yes. That was rhetorical mastery, generally referred to as *lip service*. By not allowing the market to clear, many governments are effectively putting up trade barriers. Banks for example in Spain, Canada, Brazil and Australia did relatively well. Had the market cleared, banks from those countries could have been the strong hands that take the remaining capital off the weak hands. However, by saving the weak local banks, governments in those countries not only have created zombies but also kept foreigners out. Same for cars. So everyone who is intervening in the market place is indirectly putting up barriers for foreign capital.
- Winnie-the-Bear                    You're not claiming that these countries had better regulation, are you?
- Ben Put                            They may or may not have had better regulation. What is undisputable from today's perspective is that they had better *implementation*. They withheld the pressure from big business.
- George Jones                    In essence, Winnie, your Ronald Reagan quote on the second oldest profession from before was spot on.

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- Winnie-the-Bear                      Thank you. Let's move on. Let me ask you something I always wanted to know: are hedge fund managers really *that* smart?
- George Jones                         Depends on how you look at it. Who do you think is smarter, Albert Einstein or David Beckham?
- Winnie-the-Bear                      You can't look good in knickers and be smart, so I'd say Albert Einstein. Wasn't he the guy who invented the theory of reflexivity?
- George Jones                         It's the theory of relativity, but never mind. The question is actually not as stupid as it initially sounds. We typically associate intelligence with *IQ*. We became accustomed to measuring the power of the human brain with the *IQ test*. However, when David scores through a free kick from miles away it is actually his brain that visualizes the situation, analyses the distances and movements of all elements, and orders the foot to hit the ball a certain way to give it the right curvature it typically has. Analysis, decision making, and execution are all done within the split of a second in David's brain. We just do not measure that kind of brain activity with the IQ test. It is debatable whether it is easier to turn a good football player into a good physicist or a good physicist into a good football player.
- Winnie-the-Bear                      I know that *the difference between genius and stupidity is that genius has limits* but I'm not sure I know where you're going with this.
- George Jones                         Don't you think it's fascinating how many intelligent and seemingly well educated people fail in life?
- Winnie-the-Bear                      Sort of. *The trouble with the rat race is that even if you win, you're still a rat.*
- George Jones                         The reason is that intelligence, as in IQ test, only matters up to a certain point. From there other factors determine success. IQ is overrated.
- Winnie-the-Bear                      Why are you telling me this?
- George Jones                         You wanted to know whether hedge fund managers were smart. We need to be clear what exactly we mean with *smart*.
- Ben Put                                 Hedge funds are a *compensation scheme masquerading as an asset class*. They're not smart, they're shrewd.

Winnie-the-Bear                    That's not nice Ben. Recently I saw an Ichneumon wasp lay her eggs in a live caterpillar after paralyzing it to provide fresh meat for the growing wasp larva feeding inside. The larva ate the internal organs in a judicious order, taking out the fat bodies and digestive organs first, leaving the vital heart and nervous system till last to keep the caterpillar alive as long as possible. Ben, you might not know this, but it's a jungle out there. It ain't all pretty. The weak *are* indeed sometimes eaten alive. Under competition you need to be shrewd like a fox just to survive. Although, that said, I'd say the shrewdness of the fox is often overrated because it is also credited with the stupidity of the chicken. Whether this analogy is applicable to investment management is, I guess, in the eye of the beholder.

George Jones                    *Shrewd* has a somewhat negative connotation when you use it Ben. In investment management we often use terms such as *savvy* or *street-smart* to describe an attribute other than *IQ* or *book-smartness*.

Winnie-the-Bear                    Now I remember. *There are no secrets to investing that only some select priesthood knows. Successful investing requires a quality of temperament, not a high IQ. You need an IQ of 125, tops—anything more than that is wasted. But you do need a certain temperament, and must be able to think for yourself. Then constantly look for opportunities. You can learn every day. You can't act every day, but you can learn every day.*

George Jones                    Absolutely. Commitment and high creativity are important contributing factors—next to opportunity and hard work—to success and are often unrelated to IQ or the number of books in your library.  
Let me test your imagination. Both of you write down what comes to your mind with *using a blanket*. You've got 30 seconds.

*30 seconds later...*

George Jones                    Ben, what have you written?

Ben Put                    *Keeping warm, smothering fire, tying to trees as a hammock, improvised stretcher.*

George Jones                    Winnie, what have you written?

- Winnie-the-Bear *To use on a bed. As a tent. To make smoke signals with. As a sail for a boat, cart or sled. As a substitute for a towel. As a target for shooting practice for short-sighted people. As a thing to catch people jumping out of burning buildings. As a cover for illicit sex in the woods...*
- George Jones ... Thank you, I think that's enough. Ben, you probably have the highest IQ from all of us and potentially have the most extensive library at home, but you do not have what it takes to succeed as an investor. Winnie has. He has imagination. He's got many ideas for using a blanket; he's intellectually versatile. Winnie's mind can leap from violent imagery to sex to people jumping out of buildings without missing a beat; your mind can't.
- Winnie-the-Bear *Imagination is more important than knowledge. Knowledge is limited.*
- George Jones Exactly. Or as Will Rogers put it: *There is nothing so stupid as the educated man if you get him off the thing he was educated in.* Successful investors are savvy which is not measured by conventional means. Imagination and creativity are key determinants for success, not a high IQ; although it helps.
- Winnie-the-Bear *You can't do well in investments unless you think independently. And the truth is, you're neither right nor wrong because people agree with you. You're right because your facts and your reasoning are right. In the end that's all that counts.*
- George Jones Yes, as Ludwig Von Mises put it: *Reason is the main resource of man in his struggle for survival.*
- Winnie-the-Bear I think I understand. *It is not enough to have a good mind. The main thing is to use it well.* But smart people can overestimate their smartness, can't they?
- George Jones Yes they can, it's human nature. Overconfidence has to do with the belief that we are the smartest species on the planet. We're not.
- Ben Put What?
- George Jones The dolphins are. As Douglas Adams put it: *Man had always assumed that he was more intelligent than dolphins because he had achieved so much... the wheel, New York, wars, and so on, whilst all the dolphins had ever done was muck about in the water having a good time. But*

*conversely the dolphins believed themselves to be more intelligent than man for precisely the same reasons.*

Winnie-the-Bear

I think I know where you're going with this. Rephrased you're saying: *Scholars in finance and consultants had always assumed that they were smarter than absolute return investors because they had achieved so much... benchmarks, tracking errors, performance attribution analysis, and so on, whilst all the absolute return investors had ever done was muck about making money and having a good time. But conversely the absolute return investors believed themselves to be smarter than scholars in finance and consultants for precisely the same reasons.*

George Jones

Exactly. That pretty much sums it up.

Winnie-the-Bear

*It is not clear that intelligence has any long-term survival value. You need to think on your own and be savvy too. I think I've got that. So it's the most savvy who survive the storms, right?*

George Jones

Let me ask you, was Ayrton Senna the best or worst racing driver of all times?

Winnie-the-Bear

The best, of course. He was a true champion. Why should he be considered as the worst?

George Jones

Because he drove into a concrete wall at 135 mph and died. Most other racing drivers don't do that and go on and enjoy the groupies happily ever after.

Winnie-the-Bear

Am not sure I know where you're going with this.

George Jones

Two points. First, we can argue he was the best because he achieved so much. But we can also argue he was the worst because he didn't survive whereas most other racing drivers of his time did. As so often, it's a matter of perspective. Second, we could argue that the reason he was the best was not because he was the most talented but because he took the most risk. All the years he might have been picking up Nickels in front of a steamroller. The more competitive and testosterone-prone an endeavor, the closer you need to go to the limit to win. As Mario Andretti put it: *If everything is under control, you're driving too slow.*

Winnie-the-Bear

I think I understand. *There're old pilots and there're bold pilots; but there're no old bold pilots.*

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George Jones                      Exactly. It doesn't take too much imagination to apply this to the investment world, does it?

Winnie-the-Bear                  No, it doesn't. Let's move on. I heard that some hedge funds are fraudulent. Is that true?

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George Jones                      Absolutely. When a tanned gentlemen drives his 1980s Corvette in front of a Florida retirement home, enters, tells the inhabitants that he runs a hedge fund, and then walks out with 100 million, then, yes, people typically go on an refer to this as a hedge fund fraud.

Ben Put                              Isn't hedge fund fraud more serious than that?

George Jones                      Yes it is. However, if we were able to *accurately* aggregate all financial fraud conducted over the past 10, 20, 30, or 40 years and then measure the proportion of hedge funds, I'm quite certain we would find that the 'market share' of hedge funds is either smaller or much smaller than the market share of hedge funds on the overall financial industry would suggest. I wonder whether the Bonnie and Clyde of financial accounting—Fannie and Freddie—could confirm this.

Winnie-the-Bear                  Why is hedge fund fraud small by comparison? After all, hedge funds are not as tightly regulated as other financial entities.

George Jones                      That's the point, they are not as tightly regulated. Regulation protects the investor—whatever that means—but not his money. History has shown that again and again and again. Regulation gives a false sense of security. When a business person walks into a hedge fund, he knows that he is on his own. He needs to be careful. He knows—as you put it Winnie—it's a jungle out there. However, when a business person walks into, say, a big bank, up until quite recently, due diligence didn't cross the business persons' mind. This is wrong. A heavily regulated environment implies that someone else is responsible; it's a disincentive to be diligent. Ever heard of the *swimming pool effect* Winnie?

Winnie-the-Bear                  No, economics freaks me out.

George Jones                      Many children drown in swimming pools every year. When a kid plays at the pool and there is *one* grownup watching, nothing happens normally. The reason is that the grownup *knows* that it is he or she who is

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responsible. However, there are various occasions where a kid had drowned while a number of grownups were at the pool. The reason for this is that when many grownups are around the pool, no one feels responsible. They all think someone else is taking care of the risks, that is, watching the kids. Regulation has the same effect. It encourages complacency. It encourages behavior where you believe someone else is responsible for the dangers, rather than yourself. Responsibility is the key issue. Hedge fund investors know that they're alone. It keeps their senses alert. That's a good thing.

Winnie-the-Bear

Am not sure I'm convinced; will need to think about this a bit. I still like your *caveat emptor* attitude but the world is clearly moving the other way. Wasn't there a huge hedge fund fraud in 2008?

George Jones

There was a fraud by a guy called Arnie Awfullymad. He was caught and sentenced to 500 years in prison.

Winnie-the-Bear

Isn't that rather harsh?

George Jones

Yes. Had he shot his investors instead of defrauding them, he would be a free man within ten years. The Awfullymad case is often portrayed as a hedge fund fraud but it wasn't. The organization that was controlled by Arnie Awfullymad had the status of a broker/dealer, not a hedge fund. His company was regulated. The general and limited partners of hedge funds were the victims, not the fraudsters. Not only was the broker/dealer regulated, the regulatory authorities were warned over many years that there was something fishy.

Winnie-the-Bear

Sounds awfully mad to me. Where the regulators sleeping at the wheel?

George Jones

One could make an argument along those lines, yes. Elliot Spitzer recently put it as follows: *Regulators get to the point of their incompetence and create the crisis because they fail to regulate, and then use the crisis as the argument for more power, and so now you have the Council of Regulators made up by the very same people who created the crisis in the first place.*

Winnie-the-Bear

The regulators are all very nice people though.

George Jones

Yes, they are. That's probably why it is typically them who run for public office. The bottom line is, Winnie, that the Awfullymad case was the



greatest Ponzi scheme in the history of mankind and you do not detect these things with understaffed and underfunded bureaucratic entities that operate in a poorly organized regulatory framework. Regulation is a good thing in theory though.

Winnie-the-Bear                      What's a Ponzi scheme?

George Jones                        The term is used for a scam that pays early investors returns from the investments of later investors. The scheme falls apart when more investors want their money than there are investors paying in.

Winnie-the-Bear                      Where did he get the idea for such a scheme?

George Jones                        Social security; functions on the same basis.

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Winnie-the-Bear                      So, George, how do we improve the system? It's a complex problem. This probably requires a complex solution, doesn't it?

George Jones                        Not necessarily. Do you know Alexander?

Winnie-the-Bear                      Which one? The Swiss analyst or the Mesopotamian conqueror?

George Jones                        I think it was the latter who, according to legend, solved a seemingly intractable problem in a rather unorthodox fashion while wintering in Gordium. A similar unorthodox act is required today.

Winnie-the-Bear                      Must have been the latter. The former is *a dreamer, a thinker, a speculative philosopher... or, as his wife would have it, an idiot.*

Ben Put                                So, George; how can we fix the system?

George Jones                        The solution can be put in one word.

Winnie-the-Bear                      *In character, in manners, in style, in all things, the supreme excellence is simplicity.* One word, I like that. What's the word? Gimme the word.

George Jones                        It starts with an "I".

Winnie-the-Bear                      Locusts, lunacy, liquidity, lost in space? Gimme the word.

George Jones                        Leverage.

Winnie-the-Bear                      *The obvious is always least understood.* Please elaborate.

- George Jones                    *Money matters, but credit counts.* Households, companies, governments cannot spend forever without balancing the budget once in a while. The ways we came to believe that a leverage of 20:1 or more is ok under certain circumstances is wrong...
- Winnie-the-Bear                Because circumstances always change, right?
- George Jones                    Right. The theories and assumptions which allowed us to be comfortable with banks leverage at 20, 30, 40, 50, 60 or 70 are wrong. The theories and assumptions of households leveraging up 10:1 or higher are wrong. The theories and assumptions behind the current corporate governance practices which allows the agents to lever up and the principals having no clue are wrong. The theories and assumptions on which regulatory capital requirements are determined are wrong. Fix this, and we're done. Although, that said, the market is already taking care of this. The tectonic plates are moving. Throughout history, the center of the world has shifted to where the capital is, where the assets are. You don't see any period in history where things are shifting to where the debt is. Those living off their social capital of their past need rebuild trust fast or die. It doesn't happen often that a treasurer from a *big debtor nation* is laughed out of the room by students of a *big creditor nation*, but it *does* happen.
- Winnie-the-Bear                So the debtors' currency is going to continue to devalue.
- George Jones                    Of course. The belief in currency devaluation is based on the idea that a slow devaluation shall give way to increased employment opportunities. However, I don't think there ever has been a case in history where a country could devalue itself to prosperity.
- Winnie-the-Bear                Hm, why am I thinking of a tasty BBQ at a gaucho ranch in Patagonia? ... Well, never mind. With 'we're done' you meant we're done until the next financial crisis?
- George Jones                    Yes, of course. I wish all long-only investors good luck.
- Winnie-the-Bear                Thought you might say that. *The only thing we learn from history is that we learn nothing from history.* What do you mean with the *tectonic plates are moving*?
- George Jones                    We have a tendency to focus on short-term volatility and thereby missing the bigger picture, that is, long-term change; trends that unfold slowly. In

1910, the market capitalization of Swiss stocks for example was smaller than that of UK stocks by the factor of 22.5 and smaller than Austria-Hungary by the factor of 3.8. By the end of 2008, Swiss market capitalization was still smaller than that of UK stocks. However, the factor was only 2.1, while Swiss market capitalization was 9.3 times the market cap of Austria and Hungary combined; both in currency neutral terms. *Lacking* the ambition to build an empire might be dull and might or might not rob its citizens of a sound sense of humor. However, *failed* empires are quite a prosperity killer.

Winnie-the-Bear

*Dull is good.* Wonder which empire is next in line to fail.

George Jones

Will Durant said that *every form of government tends to perish by excess of its basic principle*. Clement Attlee remarked that *democracy means government by discussion, but it is only effective if you can stop people talking*. Adding these two ideas might give you a hint Winnie.

Winnie-the-Bear

Got the hint. *Civilizations die from suicide, not by murder.*

Ben Put

George, you're not suggesting banks should be split up, are you?

George Jones

Whatever it takes. It doesn't matter that much *how* leverage is brought down. Many people find it rather odd that what used to be a bank a couple of decades ago, today is essentially a bank plus a hedge fund. A bank is supposed to raise money and lend it to sectors that need it. If you were to separate the bank bit from the hedge fund bit you would—in one go—make the system safer *as well as* more transparent. It's the Gordian Knot...

Looks as if Messrs Glass and Steagall were on to something after all.

Winnie-the-Bear

Hold on. If a bank is a bank plus a hedge fund then subsidizing banks essentially means taking tax payers money and handing it over to hedge funds.

George Jones

Essentially, yes. The funny thing is that people think hedge funds charge high fees. However, hedge funds take 20% of the gross profits, do not take a performance cut when there is no performance, are not subsidized by the tax payer and do not participate on loss-recovery-profits. Too-big-to-fail banks on the other hand take roughly 60% of gross profits for their employees, pay bonuses irrespective whether there is a profit for shareholders or not, are subsidized by the tax payer and currently are only

making a lot of money because the authorities manufactured, and are artificially maintaining, a positively sloped yield curve which incentivizes risk taking behavior and results in liquidity-driven asset inflation.

Ben Put I've never thought about it like that.

George Jones I know.

Winnie-the-Bear But the banks are doing God's work, George, are they not?

George Jones That remark turned out to be a joke Winnie. Otherwise the sky would quite literally be the limit, wouldn't it?

Winnie-the-Bear A joke. Yes; am sure it was.

Ben Put You're too negative on banks George. After all it was no one other than René Descartes who said hundreds of years ago: *I think, therefore I am entitled to a bonus.*

George Jones With the benefit of hindsight I believe it should be reasonably obvious to everyone that the bank-plus-hedge-fund combo isn't necessarily the pinnacle of socio-economic wisdom. Ever been in Reykjavik Ben?

Ben Put I think your line of thinking is too simplistic.

George Jones This is a conversation between three fictional characters one of which is a talking bear. What did you expect?

Winnie-the-Bear What about higher capital requirements for larger institutions and shouldn't these large institutions be regulated internationally?

George Jones Asymmetric capital requirements is certainly an idea worth thinking about as it addresses the negative externalities that are now obvious. International regulation is also a good idea in theory. Local regulation looks already challenging enough to me though...

Winnie-the-Bear What about liquidity? Seems important too.

George Jones Liquidity is a derivative of leverage. If your house is paid off, Winnie, you don't care that much if prices wobble a little, do you? And if you call your financial advisor to inquire how much your assets are worth and he doesn't pick up the phone because he's currently standing on a chair throwing a lasso over the ceiling's crossbar, you don't care. You can wait.

- Winnie-the-Bear                    Hold on. What this means is that if banks and households were overleveraged—as they both had much more leverage than hedge funds—it was actually hedge funds that were the most sensible when dealing with leverage...
- George Jones                        Yes, funny isn't it? Quite the opposite from public perception. Even at the peak in 2007, the *entire* hedge fund industry had less money under management than some of the banks that spiraled out of control. All the hedge fund losses in 2008 were smaller than all the other losses by a factor of between 100 and 150.
- Winnie-the-Bear                    Hedge funds as a beacon of humility? Well, well, I will need some time to digest that one... Whatever the case might be it certainly makes you wonder what all the fuss about hedge funds is all about. So why did hedge funds get smacked too?
- George Jones                        Bad luck. Unfortunate circumstances really. Their relationship with banks is symbiotic. It's the industry's Achilles' heel. When banks went down it was difficult to entangle fast enough. The nightmare of any risk manager is not when markets *fall* but when markets *fail*.
- Winnie-the-Bear                    So one direct consequence of this crisis is that hedge funds will try to improve their financing and funding.
- George Jones                        Yes; it is in their best interest. It's being done as we speak. However, hedge funds will remain part of the system. If the system fails the *Britney effect* applies.
- Winnie-the-Bear                    What's the Britney effect?
- George Jones                        It's financial jargon for an effect that states *if you think things cannot get any worse they actually can*.

*George and Ben had to run. Winnie thanked his friends for their patience and left some open questions for another day.*

