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Panel 2: Hedge Funds – How Far is it Necessary to Regulate?

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Hedge Funds: How Far is it Necessary to Regulate?

Presentation to the IOSCO Annual Meeting
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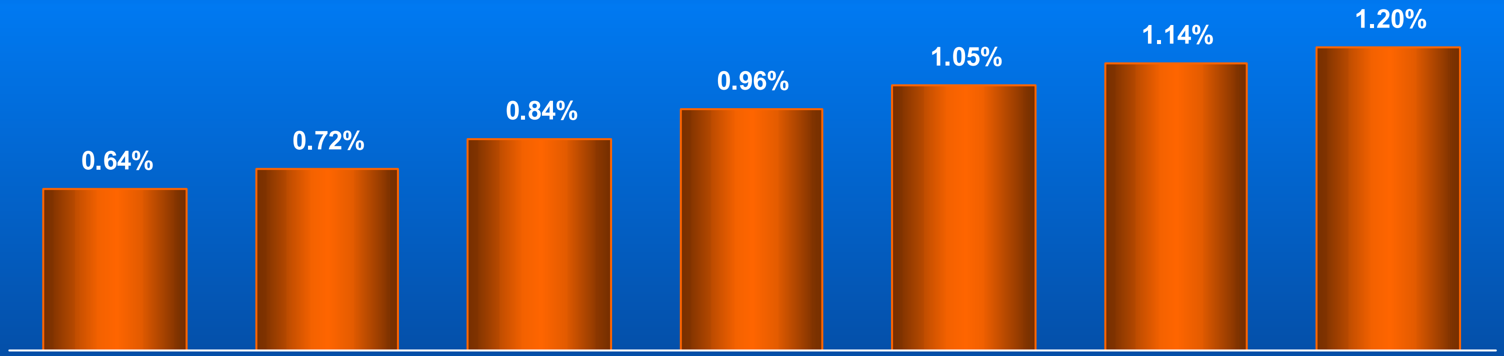
Chairman, Goldman Sachs Asia

Global Hedge Fund Universe

Fastest Growing Segment of Investment Management

- Hedge funds are the fastest growing segment of investment management business, attracting $338 bn in new capital since 2000[a]
- From 1998 to 2005, number of hedge funds increased 160% to over 8,600[b]

Hedge Fund AUM as % of Global Wealth Market[c]



	1999	2000	2001	2002	2003	2004	2005
HF AUM ($bn)	$456	$491	$539	$626	$820	$973	$1,105

(a) Source: Hedge Fund Research Industry Report, 4Q05.
(b) Source: AsiaHedge, EurekaHedge, Bloomberg, Goldman Sachs Prime Brokerage estimate. As of March 2006.
(c) Source: AUM HFR 4Q05 Industry Report, Boston Consulting Group (2005 report).

Hedge Funds have Outperformed

Hedge Fund Performance vs. S&P 500 (1994-2005)[a]					
	S&P500	Hedge Funds			
		Relative Value	Event Driven	Equity Long/Short	Macro Tactical Trading
Annualized Return	10.5%	8.7%	11.4%	11.9%	9.4%
Volatility	14.8%	3.0%	5.7%	10.3%	9.4%
Risk Adjusted Return (Sharpe Ratio)	**0.43**	**1.54**	**1.28**	**0.75**	**0.57**

(a) Source: Goldman Sachs internal fund database estimates.

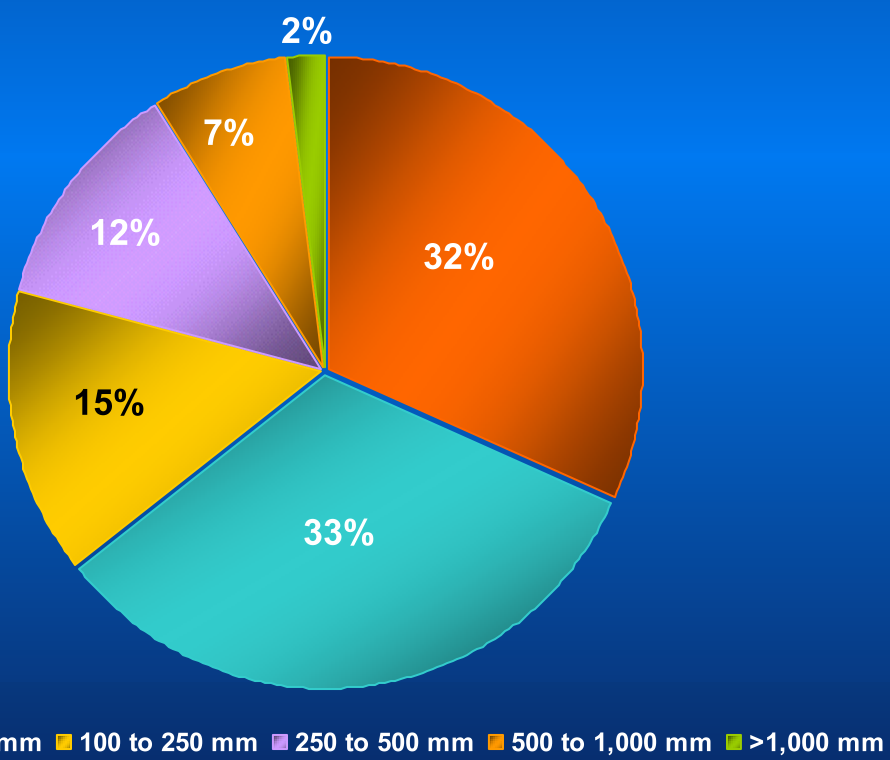
Hedge Funds bring Benefits to Markets

Estimated Hedge Fund Volume by Asset Class[a]	
Equity Securities – NYSE & LSE	40-50%
Exchange Traded Funds	70%
Convertible Bond Trading	70%
Credit Default Swaps	20-30%
High Yield Bond Trading	33%
Distressed Debt Trading	82%

(a) Source: Equity research reports and studies by Fitch, Standard and Poor's and Greenwich Associates.

Asia Hedge Fund Industry
Still Young and Small

- 50% of all Asia-focused hedge funds were launched within the last 2 years
- The typical Asia-focused hedge fund remains a small business - around 1/3 of these funds manage less than $25 mm[a]



(a) Source: AsiaHedge, EurekaHedge, Bloomberg, Goldman Sachs Prime Brokerage estimate. As of March 2006.

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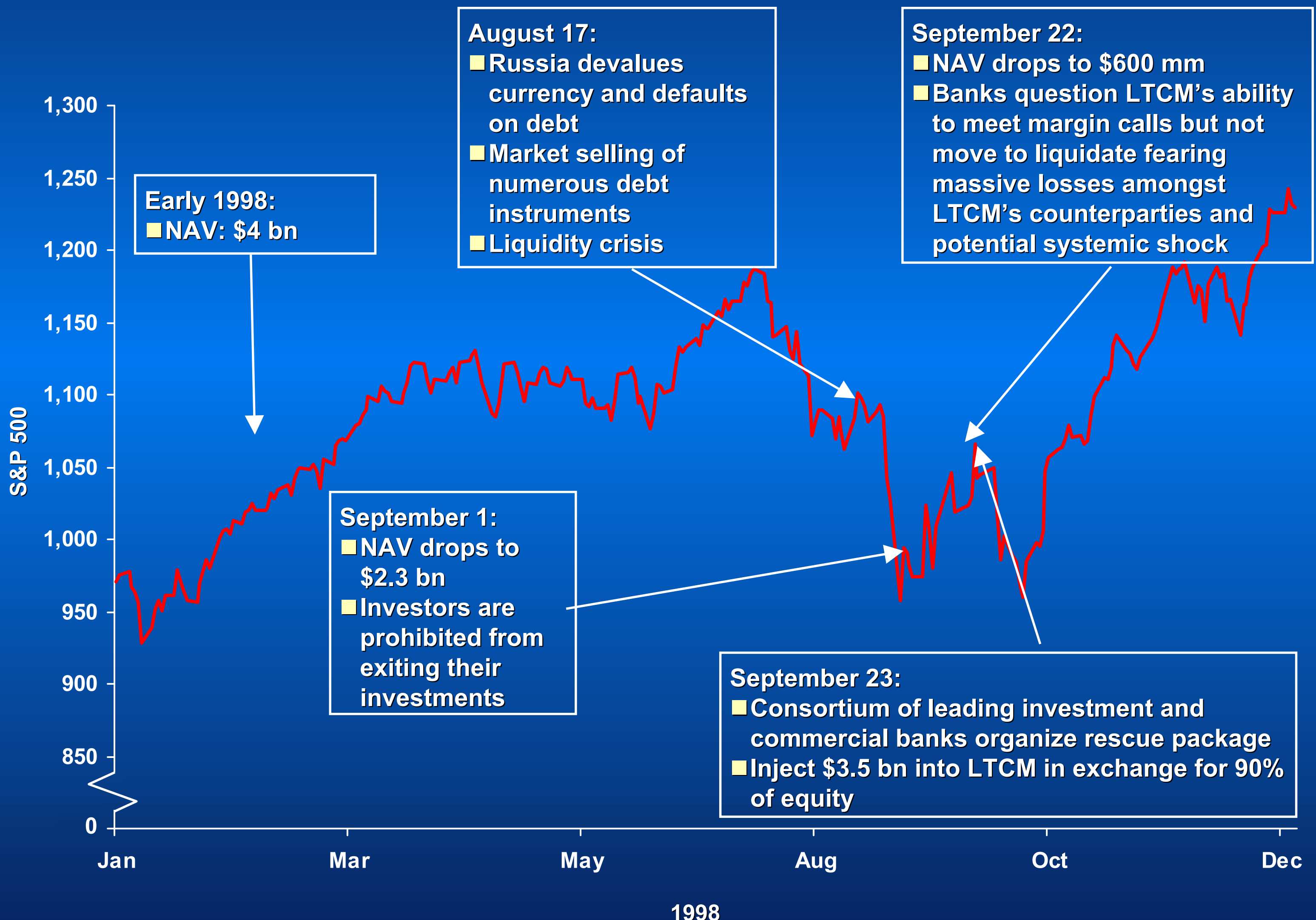
How Far is it Necessary to Regulate?

- Key justifications for regulation
  - Investor protection
  - Fair and healthy markets
  - Systemic risk
- Some regulation is now a reality
  - Registration in US and UK
  - Licensing in Hong Kong, Japan and Australia

LTCM
What Happened?



Private Sector Review
Counterparty Risk Management Group (CRMPG)

CRMPG I: January 1999

- Co-chaired by Jerry Corrigan and Stephen Thieke; members included representatives of 12 major commercial and investment banks
- Established in light of 1998 market disruptions (LTCM)
- Focus: promote enhanced strong practices in counterparty credit and market risk management

CRMPG II: July 2005

- Chaired by Jerry Corrigan; members included chief risk officers from six major banks and other industry experts from banks, fund managers and law firms
- Report: *"Toward Greater Financial Stability: A Private Sector Perspective"*

Could "LTCM" Happen Again?

Improvements since January 1999 – CRMPG II Conclusions

- Heightened resilience in the financial system
- Enhanced risk management and prudential supervisory practices
- Diversification of market and credit risk through innovation
- Greater liquidity in markets from size and number of hedge funds and private equity
- Improved infrastructure in major markets

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Could “LTCM” Happen Again?

Areas for Continued Improvement – CRMPG II Conclusions

- “Continuous vigilance" by market participants focused on funds (private equity, real estate and hedge funds)
- Fluctuations in asset bases
- Diligent risk management and other best practices essential, especially given high targeted returns
- *“A disturbance that threatens a group of smaller funds having similar investment strategies could achieve a critical mass that engenders broad-based market dangers"*

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Investor Protection

- Directed primarily to sophisticated investors
- Most strategies probably inappropriate for retail
- General market rules apply
  - Insider trading
  - Information distribution
  - Asset valuation

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