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Hong Kong

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

J. Michael Evans

Chairman
Goldman Sachs (Asia) LLC, Hong Kong
Hedge Funds: How Far is it Necessary to Regulate?

*Presentation to the IOSCO Annual Meeting*

*Hong Kong*

8 June, 2006

J. Michael Evans
Chairman, Goldman Sachs Asia
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\(^{(b)}\).

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(a) Source: Hedge Fund Research Industry Report, 4Q05.
(b) Source: AsiaHedge, EurekaHedge, Bloomberg, Goldman Sachs Prime Brokerage estimate. As of March 2006.
Hedge Funds have Outperformed

<table>
<thead>
<tr>
<th></th>
<th>S&amp;P500</th>
<th>Hedge Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Relative Value</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Annualized Return</td>
<td>10.5%</td>
<td>8.7%</td>
</tr>
<tr>
<td>Volatility</td>
<td>14.8%</td>
<td>3.0%</td>
</tr>
<tr>
<td><strong>Event Driven</strong></td>
<td></td>
<td></td>
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<tr>
<td>Annualized Return</td>
<td>11.4%</td>
<td>11.9%</td>
</tr>
<tr>
<td>Volatility</td>
<td>5.7%</td>
<td>10.3%</td>
</tr>
<tr>
<td><strong>Equity Long/Short</strong></td>
<td></td>
<td></td>
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<tr>
<td>Annualized Return</td>
<td></td>
<td>9.4%</td>
</tr>
<tr>
<td>Volatility</td>
<td></td>
<td>9.4%</td>
</tr>
<tr>
<td><strong>Macro Tactical Trading</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Annualized Return</td>
<td></td>
<td>0.4%</td>
</tr>
<tr>
<td>Volatility</td>
<td></td>
<td>1.54%</td>
</tr>
<tr>
<td><strong>Risk Adjusted Return (Sharpe Ratio)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>S&amp;P500</td>
<td>0.43</td>
<td>1.54</td>
</tr>
<tr>
<td>Event Driven</td>
<td>1.28</td>
<td>0.75</td>
</tr>
<tr>
<td>Equity Long/Short</td>
<td></td>
<td>0.57</td>
</tr>
<tr>
<td>Macro Tactical Trading</td>
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</tbody>
</table>

(a) Source: Goldman Sachs internal fund database estimates.
Hedge Funds bring Benefits to Markets

### Estimated Hedge Fund Volume by Asset Class

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity Securities – NYSE &amp; LSE</td>
<td>40-50%</td>
</tr>
<tr>
<td>Exchange Traded Funds</td>
<td>70%</td>
</tr>
<tr>
<td>Convertible Bond Trading</td>
<td>70%</td>
</tr>
<tr>
<td>Credit Default Swaps</td>
<td>20-30%</td>
</tr>
<tr>
<td>High Yield Bond Trading</td>
<td>33%</td>
</tr>
<tr>
<td>Distressed Debt Trading</td>
<td>82%</td>
</tr>
</tbody>
</table>

(a) Source: Equity research reports and studies by Fitch, Standard & 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.
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
Early 1998:
- NAV: $4 bn

August 17:
- Russia devalues currency and defaults on debt
- Market selling of numerous debt instruments
- Liquidity crisis

September 1:
- NAV drops to $2.3 bn
- Investors are prohibited from exiting their investments

September 22:
- NAV drops to $600 mm
- Banks question LTCM’s ability to meet margin calls but not move to liquidate fearing massive losses amongst LTCM’s counterparties and potential systemic shock

September 23:
- Consortium of leading investment and commercial banks organize rescue package
- Inject $3.5 bn into LTCM in exchange for 90% of equity
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
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
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"
Investor Protection

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