PRESS RELEASE

SOCIAL WATCH: HEDGE FUNDS MAY JEOPARDIZE WORKERS' SAVINGS

NEW YORK (Oct 23) - Individual and government investment of pension programme money in hedge funds could jeopardize workers' retirement savings and future well-being as senior citizens, warns the 2007 Social Watch Report launched here Tuesday in the context of the United Nations High-level Dialogue on Financing for Development.

"Hedge funds are high risk investments, and therefore not an appropriate place for workers' retirement money", said Social Watch coordinator Roberto Bissio. "And the way hedge funds currently operate creates volatility and instability, which erodes jobs and diverts money from social spending", he added.

An increasing proportion of citizens' retirement savings is being placed in hedge funds, which specialize in pursuing very complicated, high-risk investment strategies with the purpose of obtaining above average returns.

In France, such funds can be accessed by individuals with a minimum amount of EUR 10,000, while according to recent reports, German investors can buy into hedge funds through Deutsche Bank in units of less than EUR 125 and UK regulators are considering reducing restrictions on marketing hedge funds to individuals.

"When the funds that could be at risk are the retirement savings of ordinary people, the issue becomes one of social security regulation. The state jeopardizes its social security obligations when it invests in hedge funds and when it fails to properly regulate them", says author Aldo Caliari in one of the articles of the Social Watch annual report. Caliari is a researcher for the US-based Center of Concern.

A reassessment of the need for hedge fund regulation took place after the 1997-1998 East Asian financial crisis, when the operations of macro hedge funds, and to a lesser extent financial institutions' proprietary trading desks, were an important source of instability in the region's financial markets and contributed to the overshooting of exchange rates and other asset prices.

A second critical landmark for hedge funds was the failure and subsequent bailout of the Long Term Capital Management (LTCM) hedge fund in the late 1990s.

Other events that focused renewed attention on the regulation of hedge funds in 2006 were the USD 6 billion loss made by the Amaranth hedge fund and the 75% loss made by the Vega hedge fund's USD 13 billion fixed income trading.

In late 2006 the German government announced its intention to use its presidency of the G8 (in 2007) to include the subject of hedge funds in the Group's agenda. However the Heiligendamm Summit in June failed to take any meaningful action.

The greater returns obtained by hedge funds come at the cost of higher risk due to the use of leverage, often several layers of it. For example investors could raise money to invest in funds by borrowing from other funds that in turn use derivatives to leverage themselves.

Hedge funds can leverage themselves with very high multiples, either directly, by borrowing from prime brokers, or indirectly, through selling credit derivatives, making themselves especially vulnerable to a sudden decrease in market liquidity.

The main problem is posed by a lack of reporting requirements for hedge funds, which makes it very difficult to know, at any point in time, how leveraged hedge funds really are, especially through their derivatives exposure.

As analysts have repeatedly warned, the benign liquidity conditions prevailing in the market in which they have proliferated makes current hedge fund-related risks hard to even estimate with any degree of accuracy.

Additionally, in their search for financial performance, hedge funds have been known to employ strategies that have negative impacts on the “real economy” and workers. Routine activities pursued by hedge funds pose threats that cannot be ignored.

One such practice consists in influencing the direction of companies by taking activist positions in their shareholder assemblies. This activism promotes greater efficiency in corporations and generates value, but it can also disrupt companies’ economic activity through immediate return considerations.

Often hedge funds are especially damaging for employees of restructured companies in terms of job security erosion and loss of benefits.

The leveraged buyouts practiced by hedge funds for profit-making purposes are financed with debt, with the purchased firm becoming responsible for servicing those debts. The higher the leverage the higher the risk of subsequent company failure, with workers being the first casualties.

Moreover, workers can be double losers in this trend as, at the same time, in many jurisdictions high profits are facilitated by interest being offset against tax, which basically means that taxpayer’s money is subsidizing profit.

"The investors in pension funds are the middle classes and, in the more developed countries, the workers, and their future incomes should not be the result of the kind of market games played by equity private funds or hedge funds", says Fernando Cardim de Carvalho, professor at the Institute of Economics of the Federal University of Rio de Janeiro and a Social Watch consultant.

Originally, hedge funds were supposed to be very specialized investment vehicles with access to them severely restricted to a limited number of sophisticated investors, and for this reason they were not regulated. But the last few years have seen a considerable broadening of the investor class having access to hedge funds.

In addition, regulated institutions accessible to average investors, such as mutual funds and pension funds, are increasing their investments in hedge funds. This is mainly due to a relaxation of accreditation requirements.

The main reason behind such investments by both individuals and institutions, whether private or public, is the collapse of public social security systems and the transformation of systems based on intergenerational solidarity into systems based on personal savings – a shift from defined-benefit to defined-contribution – states the Social Watch report.

All over the world, public institutions responsible for providing retirement support are being either privatized, downsized or destabilized, and the pressure to finance their obligations causes governments to seek higher-than-average returns through strategies such as those offered by hedge funds.