Invited Editorial

Growing role of hedge funds in the economy

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Majed R. Muhtaseb
is a professor of Finance at California State Polytechnic University, Pomona and former research director for Global Fund Analysis in London, UK. His primary research interest is in portfolio management, especially hedge funds performance, activism and fraud, and he has published many research articles in leading journals and run executive seminars and CFA review courses in major financial centers. He holds a PhD in Finance from the University of Tennessee, Knoxville. He is an CFA chartenholder and a CAIA member.

Correspondence: Majed R. Muhtaseb, Finance, Real Estate & Law, Cal Poly Pomona University, 3801 W Temple avenue, Pomona, CA 91768, USA
E-mail: mmuhtaseb@csupomona.edu

ABSTRACT **The objective of this article is to document the profound and growing role of hedge funds in the economy. It is accomplished through identification and analysis of numerous activities normally associated with hedge funds that have become an integral part of capital market activities. Examples include the phenomenal growth of exchange traded funds (ETFs) and mutual funds that follow hedge fund strategies. The number of mutual funds that hedge, short sell and use leverage is increasing. Hedge funds are key suppliers of liquidity in the stock and US Treasury bond markets. Commercial banks are investing the mortgages they originate as opposed to selling them in secondary markets. Hedge funds make commercial loans and modify residential mortgages. They underwrite reinsurance policies. Hedge funds significantly influence corporate governance by playing key roles in acquisitions and corporate reorganizations. NASDAQ OMX recently began listing the alpha index options intended to allow investors to trade options on the relative performance of a stock or ETF as compared with SPY. Hedge funds invest in sovereign debt, negotiate good terms and reap the rewards. They launch philanthropic organizations. The legal and competitive landscape is evolving in such a manner that fosters hedge funds investment strategies for many years to come.**

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INTRODUCTION

In spite of the negative publicity that hedge funds undeservedly earn, their role in the economy continues to grow unabated. The objective of this article is to demonstrate the significant and growing role of hedge funds on the economy. It is achieved through the identification and analysis of many activities normally associated with hedge funds. Many of the identified hedge fund activities have

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become common practices at other financial institutions.

The hedge fund industry is generally less regulated and multidimensional. It is very different from the traditional mutual fund industry, greatly index driven and excessively regulated. Regulations only limit but do not prohibit the use of derivatives, short selling and leverage by mutual funds. Hedge funds investment strategies are very different from those of mutual funds. Hedge funds are classified into the alternative assets category along with real estate, commodities and private equity. Unlike mutual funds, hedge funds enjoy many more degrees of freedom. Up until recently, hedge funds were generally not required to register with the SEC. The Dodd–Frank Act requires all hedge fund advisers with assets under management exceeding US$150 million to register with the SEC.

Depending on the investment strategy, a hedge fund can leverage, arbitrage, sell short a security, incorporate derivatives into investment strategy and risk management, concentrate the portfolio into a limited number of securities, control redemptions, link fund manager's compensation to that of the performance of the fund, pursue a neutral market exposure, invest in distressed securities and actively attempt to replace senior management in order to increase stockholders wealth. Through these activities, hedge funds bring about greater market efficiency, new market exposures unavailable through long-only investing, more effective corporate governance and enhanced market liquidity. The rewards for the savvy hedge fund managers have been huge. Consequently, for more than 10 years, the inevitable emigration of talent from the static long-only world into the flamboyant hedge fund industry has been taking place.

The investors in hedge funds include major US pension plans such as California Public Employees Retirement System Missouri State Employees Retirement System, Fire & Police Pension Association of Colorado; Foundations and University Endowments such as International Olympic Committee, Yale University and UCLA; golf courses such as Hillcrest Golf Course of St Paul, Minnesota and many wealthy individuals.

The most marked development is the evolving position of the SEC as stated in its 2003 report: 'Some commenters have asserted that retail investors could benefit from greater access to absolute return strategies and hedge fund investment techniques. The Commission should consider issuing a concept release requesting comment on this topic generally and focusing on issues such as whether: (1) current restrictions placed on registered funds' use of leverage and short selling should be relaxed; (2) an absolute return strategy, especially in connection with a performance fee tied to achieving an absolute return, has a positive effect on aligning the interests of hedge fund advisers and investors; and (3) additional investor education initiatives would be necessary to educate investors about absolute return strategies and risks'. Read carefully, SEC is directing mutual funds to follow on the footsteps of hedge funds. Yet in spite of this endorsement by the SEC, a critical analysis of the role of the hedge funds industry in the overall economy is absent from scholarly and professional periodicals.

Salisbury (2012) reports that recently, US Congress decided to make it easier for hedge funds to advertise, according to the 17 April 2012 Smart Money Report of the WSJ. President Barack Obama signed into law the Jumpstart Our Business Startups Act on 5 April 2012. Provisions in the act will allow hedge funds to advertise responsibly to

investors allowing fund mangers to present their strategies and performance through media channels available to mutual fund houses.

Major developments

Muhtaseb (2006) anticipated the progressive downsizing of the mutual funds as they have functioned before the introduction of exchange traded funds (ETFs). Traditional mutual funds are in their sunset years. ETFs will replace mutual funds for index such as investing and unique passive exposures. Hedge funds already and will continue to dominate in the active investment management arena. Hedge fund-like investing will continue to grow in the future. Hedge funds assets under management exceeded $2.0 trillion in 2012, according to HFR.

Hedge fund activities have helped investors and corporations. The developments are (1) investment products in the securities and mutual fund industries; (2) greater liquidity in the bond and stock market; (3) unique exposures offering high-risk adjusted returns; (4) Relative Value Strategies to Retail Investors Tool; (5) incentive-based compensation may work for loan originators; (6) hedge funds purchase and modify mortgages; (7) hedge funds are present when commercial banks are absent; (8) corporate governance; (9) mergers and acquisitions; (10) hedge funds are shareholders and managers friendly in corporate reorganizations; (11) hedge funds underwrite reinsurance policies; and (12) lenders of last resort to sovereign borrowers.

The next section discusses the developments affecting investors. Developments pertaining to corporations and sovereign borrowers are covered in the section after that. The subsequent section presents philanthropy of the hedge fund industry. The last section offers the conclusions.

DEVELOPMENTS AFFECTING INVESTORS

New investment products in the securities and mutual fund industries

The mutual fund industry has followed the trail left by the managers in the hedge fund industry. The growth of ETFs and exchange traded notes (ETNs) over the past 20 years has been phenomenal. There are many ETFs and ETNs that pursue a long-short and/or leveraged (bullish or bearish) exposures to a stock or bond market index or sector. Examples include the following:

1. ProShares Ultra Short MSCI Brazil ETF (BZQ).
2. ProShares Ultra Short QQQ ETF (SQQQ).
3. Direxion Daily Small Cap 3X Shares (TZA).
4. PowerShares DB Agricultural Double Long ETN (DAG).
5. KEYnotes First Trust Enhanced 130/30 Large Cap ETN (JFT).

Some of the companies sponsoring hedge fund-like ETFs are as follows:

1. Rydex Funds – Inverse NASDAQ-100® 2x Strategy and DOW 2X Strategy.
2. Aberdeen Asset Management – Aberdeen Equity Long Short,
3. NATIXIS Funds – Gateway Fund and Loomis Sayles Global Equity & Income Fund.
4. Diamond Hill Funds – Financial Long-short Fund and Research Opportunities Fund.

The analyst reading the prospectuses of the hedged mutual fund strategies would not think

that these are mutual funds. Their strategy descriptions are similar to those of hedge funds, but they are mutual funds because they are registered with the SEC, targeted at the retail investor. According to Mamudi (2010), investors allocated well over $10 billion to these funds in 2009.

In addition to ETFs, the first mutual funds focused on hedged and long-short strategies were set up in 1999. That is, some mutual funds companies started offering mutual funds that pursue investment strategies whose risk-return profiles are qualitatively different from those of traditional mutual fund strategies. Lake (2003) lists three types of these mutual funds:

1. Hedged Mutual Funds (discretionary regular hedging and short selling).
2. Leveraged or Inverse Index Funds.
3. Occasional Hedgers (hedging and short selling from time to time).

Recently, Fidelity Investments in collaboration with Arden Asset Management started offering access to hedge funds through a mutual fund that is essentially a fund of hedge funds. Chung (2012) reports that the fund opened in early December 2012 with $700 million. The fund of hedge funds provides a venue for individual (retail) investors to allocate part of their wealth to a diversified portfolio of hedge funds without the high fees and long lock-up periods, faced by investors who invest directly in hedge funds.

Greater liquidity in the bond and stock markets

Scholes (2004) argues that liquidity is the price of immediacy. Investors, other than hedge funds, are willing to pay for the liquidity that hedge funds provide. Several hedge funds strategies such as equity market neutral (long and short exposures with a zero net exposure to the stock market) can only be executed through continuously active trading. This trading is normally referred to as high frequency trading. In doing so, hedge funds provide tremendous liquidity on *a regular basis*. Aguilar (2009) comments that, although hedge funds control just 5 per cent of all US assets under management, they account for about 30 per cent of all US stock trading volume. On certain days, hedge funds can be responsible for as much as half of the daily trading volume on the New York Stock Exchange.

In addition, in the *Financial Times* Jones (2010) reports that hedge funds have significantly enhanced liquidity in the US Treasury bond market during 2010. In their pursuit of profiting from the elevated interest rate volatility, hedge funds accounted for nearly 20 per cent of the trading volume, much higher than the 3 per cent of the 2009 volume.

Analysts who actually crush and propel stock prices

Through a conference call on 1 May 2012, Herbalife met its destiny with David Einhorn of Greenlight Capital, report Chung *et al* (2012) of the *Wall Street Journal*. Upon concluding his remarks in the conference call, Herbalife stock price shed 8.8 per cent and bled another 12 per cent by the end of the day ($1.6 billion loss in market value). The market reacts decidedly to hedge fund manager's comments for at least two reasons. Hedge funds deploy their own money along with their clients and they conduct independent research. At an investor conference, Mr Einhorn blasted Green Mountain

and St Joe with 110 and 139 presentation slides, respectively. Both stocks nose-dived.
The authors reviewed the performance of 22 stocks that Mr Einhorn commented on.
In response to negative comments about nine companies, their stock prices declined by 13 per cent 30 days later. On the other hand, stock prices of 13 companies that received bullish comments from Mr Einhorn experienced an increase of 10 per cent 30 days later.

Unique exposures offering high-risk adjusted returns

Many hedge fund strategies create risk return tradeoffs that are impossible to construct through long-only investing. Examples of these strategies include equity market neutral, equity long-short, convertible bond arbitrage, event driven, merger arbitrage and global macro. These strategies tend to have no or low correlation with traditional benchmarks. Chincarini (2010) finds that quantitative and qualitative equity market neutral and global macro strategies enjoy low correlation with the stock market over the January 1994 – March 2009 period, presented in Table 1. These strategies offered higher Sharpe ratios than the market and delivered similar risk adjusted returns to those of the bond market.

Relative value strategies to retail investors too

The pride of the hedge fund industry is the relative value strategies. Relative value investment ideas have recently appeared in mainstream investing of individual investors also. NASDAQ OMX® recently introduced investment vehicles that enable retail investors to invest in company or ETF (the 'Target Component') outperformance or underperformance against the popular ETF, SPY (the 'Benchmark Component'), regardless of overall market movements. These vehicles are European-style, cash-settled index options whose value is derived from the relative performance of the stock (or ETF) against the SPY. These options are called Alpha index options. Alpha Index options are currently available for AAPL, INTC, GLD, F, EWJ and EEM among other stocks.

Hedge funds purchase and modify residential mortgages

The Associated Press in 2008 reported that Merrill Lynch sold the equivalent of $30.6 billion in residential mortgages to Lone Star Funds for $6.7 billion. Paradoxically, when banks have been slow and unprofessional in processing loan modification applications, hedge funds with staff that do not have any retail lending experience were more effective in restructuring delinquent residential mortgage loans. Undoubtedly, hedge funds are motivated by the profit opportunity. At the same time, homeowners have been offered not only a partial relief from a financial liability but one that is less taxing on their credit score. Biltmore Capital Group was buying up to $100 million in residential mortgages a year.

Other hedge funds that invested in distressed mortgages include G8 Capital, Marathon Asset Management and National Asset Direct. These hedge funds buy the mortgages at substantial discounts from the current investors that they can make special modification to the delinquent mortgage. Hedge Fund Alert (2012) reports that Bayview Asset Management recently raised $700 for its new fund, Bayview Opportunity Fund 3. This fund acquires non-performing and

Table 1: Equity market neutral and global macro hedge fund performance summary statistics

Group	*Mean*	*SD*	*Max.*	*Min.*	*P*	*Sharpe ratio*
Quantitative						
Equity Market Neutral	6.04	8.11	36.16	−30.45	0.11	0.39
Quant Directional	11.91	21.45	241.32	−90.78	0.46	0.42
Commodity Systematic	9.47	18.77	94.99	−38.56	0.09	0.37
Currency Syst	8.96	13.23	114.00	−32.59	0.04	0.28
Systematic Diversified	10.95	17.33	81.00	−54.50	0.02	0.43
Qualitative						
Equity Hedge: Fundamental Growth	9.45	21.15	172.20	−77.50	0.43	0.38
Equity Hedge: Fundamental Value	8.50	14.56	97.61	−60.80	0.39	0.45
Commodity Discretionary	11.83	13.48	67.27	−33.59	0.00	0.69
Currency Discretionary	9.83	10.08	63.23	−26.77	0.07	0.58
Discretionary Thematic	9.03	15.36	106.51	−86.60	0.21	0.42
S&P 500 Index	6.61	15.44	9.78	−16.79	1.00	0.19
Bond Index	7.03	7.40	9.02	−6.71	−0.06	0.45

Source: Chincarini (2010).

rehabilitated home loans among other mortgage-related securities. Since 1995, Bayview has purchased in excess of $20 billion of residential mortgages.

DEVELOPMENTS AFFECTING COMPANIES AND COUNTRIES

Incentive-based compensation may work for loan originators too

In addition to the management fee, hedge fund managers are compensated in two different ways. They can earn an incentive fee based on the performance of the fund. In addition, it is a common practice for a hedge fund manager to invest a substantial per cent of own wealth in the fund along with other investor's monies. Broxham (2011) suggested that mortgage originators (banks) retain a significant per cent of the mortgages that they originate on their books. That is, the bank should allocate some of the bank's own capital to these mortgages. This would serve as a bonding mechanism just like it does in the hedge fund industry. The banks will have an incentive to conduct a thorough evaluation of the creditworthiness of the borrowers. In essence, the partial commitment of the bank to the mortgages it originates mitigates the moral hazard problem.

Hedge funds are present when commercial banks are absent

Hedge funds have satisfied the needs of a certain commercial segment that 'traditional' commercial banks have forsaken. In 2005, just 3 years before the current economic crises

started, hedge funds loaned more than $500 billion to corporations. Der Hovanesian (2005) finds that hedge funds (along with other institutional investors) supplied more than 50 per cent of the $509 billion needed by riskier corporations. This represents a 250 per cent increase over their share of the market in 2000. Commercial banks tend to shy away from these loans. Once they fund the loans, hedge funds sell these loans in secondary markets. Demand for these loans was strong. Prices of these loans went up and loan yields declined. This sparked the recovery in the market for corporate loans. As of year-end 2007, these bank-like hedge funds had $12 billion in asset to lend. They normally charge as much as 3.2 per cent above current commercial bank rates (Story, 2008).

Corporate governance

Hedge funds activism in corporate governance leads to greater tax savings. Cheng *et al* (2010) find evidence that these improvements in a company's tax situation persist over the long term, subsequent to the involvement of the activist hedge funds. Furthermore, the greater tax savings accomplished by target companies are likely the result of more efficient tax planning rather than the use of tax sheltering, or earnings management. In addition, the change in tax avoidance produces an increase in firm value brought about by heightened presence of effective monitoring by institutional investors. Brav *et al* (2008) describe hedge fund activism as 'a new form of arbitrage'. In response to the announcement of hedge fund targeting a company, for a sample of US companies they find that stocks of these companies appreciate by an average abnormal return of 7 per cent.

Mergers & acquisitions

Kleinman (2010) reports that, on 28 August 2009, Kraft offered £10.2 billion to buy Cadbury's shares. The offer price was £7.45 per share, consisting of £3.00 cash plus 0.2589 Kraft shares. Wilson and Andrew (2009) wrote in the *The Telegraph*, that the majority of Cadbury's shareholders abruptly refused Kraft's £10.2 billion offer in September 2009. Hedge funds exemplified by Cedar Rock insisted on an all-cash offer. Quinn (2009) reports that Hershey and Ferrero made a competing bid to acquire Cadbury. The competing bid only firmed up Cadbury's share price and strengthened the position of the hedge fund managers. The news was welcomed by the hedge funds that bought the shares anticipating another bid at a higher price. Accordingly Jones and Dorfman (2010) reported on Reuters that the deal was concluded between Kraft and Cadbury at £8.50 per share; £11.9 billion in total, on 19 January 2010.

The terms were £5.00 cash (66.7 per cent increase in cash versus the earlier offer) and 0.1874 new Kraft shares, in line with what the hedge funds were demanding. Hedge funds prevailed, and through the 30 per cent stake that hedge funds owned in Cadbury, Cadbury's Chairman, Roger Carr, was pressured to negotiate for a successful deal with Kraft. Hedge funds made £0.51 billion (30 per cent of £1.7 billion increase in offer price) over a period of merely 5 months. The rate of return on the stock over the 5-month period was more than 14 per cent.

The vastly enhanced role of hedge funds into major corporate acquisitions brings about a new challenge to corporations and their corporate policies. Hedge funds were able to guide the direction and influence the outcome of an almost £12 billion (about $20 billion)

cross-Atlantic transaction. Companies whose shareholders list is hedge funds rich will be very careful when making major corporate strategic decisions.

Hedge funds are shareholders and managers friendly in corporate reorganizations

Aguilar (2009) asserts that hedge funds reportedly account for more than 85 per cent of the distressed debt market activity. According to Jiang *et al* (2012), hedge funds generally prefer to participate in complex corporate bankruptcy reorganizations that normally take longer time to resolve. They favor re-emergence of a company in financial distress over the other potentially terminal alternatives of liquidation or acquisition. Jiang *et al* report that hedge funds enhance the overall value of firms re-emerging through a 'Chapter 11' reorganization. This is accomplished through hedge fund attempts aimed at mitigating financial constraints, lessening the frequency of inefficient liquidation and resolving conflicts among different claims holders.

They find that hedge fund participation, in Chapter 11 reorganization, is positively associated with reduced leverage. Hedge funds' active participation is most favorable for decreasing financial constraints facing financially distressed companies. Such evidence is consistent with the widely held practitioners' view about hedge funds targeting companies with 'good fundamentals' but 'bad balance sheets'. In addition, interestingly, even though the participation of hedge funds is associated with high CEO turnover, hedge funds are very likely to retain key employees through key employee retention programs (KERP). In the case of the WorldCom, although the company's CEO (Bernard Ebbers) and CFO (Scott Sullivan) were both fired, a KERP was implemented for 329 key employees. Blue River Capital, Oaktree Capital Management, Angelo, Gordon & Company, Highland Capital Management and Cerberus Capital, among other hedge funds, were among the largest unsecured creditors who were also members of the unsecured creditor's committee. They played an instrumental role in hiring the new CEO of WorldCom and worked jointly with the company management to develop long-term strategic plans.

These findings point toward a favorable effect of hedge funds on financially distressed company value. Most notably, hedge funds' influence as creditors does not arise at the expenses of the distressed company shareholders. The fact that their presence greatly benefits the current shareholders is a strong indication that they successfully counteract the power of secured creditors, to the benefit of all junior claim holders.

Lim (2012) finds that hedge funds' involvements in distressed firms are associated with more flexible and faster corporate restructuring that brings about higher probabilities of successful reorganization. As a result of their activist involvement, distress-focused hedge funds outperform the S&P 500 index on an absolute basis as well as in terms of Sharpe ratios, over the January 1998–December 2009 period as shown in Table 2. Not to mention that the general CSFB Hedge Fund index also outperformed the S&P 500 index.

Hedge funds underwrite reinsurance policies

Twenty years ago, the catastrophe insurance market was too distant from hedge funds.

Over the past 10 years, hedge funds have been becoming increasingly active in this market. This business takes place predominantly in Bermuda. Hence, they establish offshore reinsurance units. Although hedge funds account for no more than 2 per cent of the total reinsurance market, Crombie (2005) states that they provide nearly 50 per cent of the capital available for unique forms of coverage, such as insurance against a single storm, earthquake or hurricane. Although a risky undertaking, the underwriting of reinsurance contracts by hedge funds represents a supply of capital outside the traditional insurance capital sources. Some of the active hedge funds in the reinsurance market include Nephila Capital, CIG Re (unit of Citadel Investment Group), Cooper Neff Advisers (a unit of BNP Paribas) and Max RE (a unit of Moore Capital).

Lenders of last resort to sovereign borrowers

Celarier (2012) published an article in *Fortune* magazine about Elliott Management, a $19 billion hedge fund run by Paul Singer. Elliott Management delivered an average annual return of 14 per cent net of fees over 35 years. Elliot Management invests in distressed debt including that of governments such as Argentina, Greece and Peru. In 1996, Elliot bought $11.4 million of Peru's defaulted debt and sued the government of Peru. In 2000, Elliot was awarded $58 million. Elliot was also a major investor in distressed debt of companies such as Chrysler, Delphi, Lehman Brothers and took activist equity stakes in companies such as Novell and Iron Mountain.

PHILANTHROPIC DEVELOPMENTS

Many may find it surprising to learn that hedge fund industry has a compassionate heart. Mr Christopher Hohn, founder of the Children's Investment Fund, London, United Kingdom, established the Children's Investment Fund Foundation whose officials come from institutions such as UNICEF and UNAIDS, according to Armistead (2008). The fund pays half of the management fee of 1 per cent to the foundation, which amounts to $3.5 million.

Table 2: Risk and return characteristics: Monthly Returns January 1998 – December 2009

	Distressed- funds in my sample	*CSFB Distressed Index*	*CSFB Hedge Fund Index*	*S&P 500*
Cumulative returns	151.19	184.17	132.39	41.47
Avg. ann. compounded returns	8.63	9.89	7.83	3.20
Avg. monthly returns	0.66	0.75	0.61	0.36
Annualized standard deviation	5.79	6.90	7.25	16.53
Annualized Sharpe ratio	2.99	3.05	2.10	0.27
Largest monthly loss	−6.58	−12.45	−7.55	−16.80
Largest monthly gain	4.11	4.15	8.53	9.78

Source: Lim (2012).

In 2008, he contributed £466 million to the foundation, which supports charitable projects in Africa and India. The donation is the largest ever bestowed by a Briton.

De la Merced (2007) finds that many hedge fund industry professionals have collaborated to start Hedge Funds Care, a not-for-profit organization that seeks to prevent and treat child abuse. It maintains several regional offices in the United States as well in few other countries. In a gala dinner held in London, United Kingdom, on 12 July, it raised £300 000.

CONCLUSIONS

In spite of the typically unfavorable publicity that hedge funds garner, hedge funds have played a constructive role in the overall economy and financial markets as detailed above. Their presence and influence span many different aspects of the securities markets, investment products, residential mortgage purchases and modifications, corporate finance including bankruptcy and reorganization and sovereign credit. Hedge funds create risk return tradeoffs unavailable otherwise. They enhance liquidity in the bond market and stock market. They have a presence in reinsurance market and commercial lending. Delinquent homeowners have also benefitted from hedge fund pursuit of profits. Hedge funds are the new liquidity providers, lenders, market moving analysts, corporate raiders and strategists, lead re-organizers in a bankruptcy process and paradoxically the profits guided yet kind-hearted residential mortgage loan modifiers. For additional excitement, NASDAQ OMX creates venues (option contracts) for individual (as well as institutional) investors to implement hedge fund-relative value strategies based on the performance of a stock or ETF to that of SPY. We are yet to see a mutual fund to initiate a lawsuit against an investee company, let alone the government of a country. In light of the dynamic legal, economic and competitive market state of affairs, going forward we expect to witness the widespread adoption of hedge fund-like as thinking, investing and (unsung) charitable giving.

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