

# [What is the role of hedge funds in the financial market](https://assignbuster.com/what-is-the-role-of-hedge-funds-in-the-financial-market/)

[Economics](https://assignbuster.com/essay-subjects/economics/)

There has been rapid growth in the number of edge funds and their assets under management, suggesting they provide economic value to investors that is not available in other investment instruments. Their main aim is to reduce risk and volatility whilst attempting to preserve capital and deliver positive returns under all market conditions. They used a range of aggressive methods to invest in a wide array of assets to generate returns which have a very low correlation with traditional asset classes, creating a diversifying effect on a portfolio.

This means they get a constant level of return, regardless of what the market does. Hedge funds tend to be illiquid as investors are limited in terms of when and how muchmoneythey are able to take out, therefore they are long term propositions. Originally, hedge funds were not subject to the public disclosure or regulatory reporting requirements that apply to other financial institutions, thus they had little or no regulatory oversight. But since the financial crisis, more regulations have been introduced, such as reporting under AIFMD; The Alternative Investment Funds Managers Directive.

Also, from February 2014, they will have to report under Emir. Policy director in the BBA's Capital Market and Infrastructure division, Andrew Rogan, recently said " If [funds] don't comply with Emir, there are real consequences to how a business can use derivatives to protect itself from risk... and you may even be shut out of the market completely. " The purpose of regulation is to protect investors. Although an element of secrecy between funds is kept in order to keep investment strategies to themselves, they can't do whatever they like with other peoples' money, so regulation had to be introduced.

Markets function best when investors use ifferent information and strategies to manage, or hedge against, risk. Private investment companies provide valuable liquidity to financial markets in normal market conditions. In " Hands Off Hedge Funds", Sebastian Mallaby states that " by buying irrationally cheap assets and selling irrationally expensive ones, they shift market prices until the irrationalities disappear, thus ultimately facilitating the efficient allocation of the world's capital. " (Mallaby, 2007). Consequently, hedge funds can be less volatile than individual stocks or mutual funds.

With the freedom to nvest wherever the managers believe they can perform better than the market, hedge funds broaden the use of investment strategies, increasing the number of investors, and enlarging the capital pools available and strengthening capital markets. Through flexibility, they are able to trade different securities in several markets at once, so opportunities for returns are maximised, improving risk management and encouraging innovation ot strategies, as well as financial products and services.

There is also a competitive advantage as hedge funds attract human nd financial capital, contributing to a stronger economy. They can act as an incentive for businesses and individuals to invest because they offer the chance for money to be invested in a range of products, free from fraud and over-regulation, and increases in investment can influence economic growth and stability. Hedge funds also improve the efficiency of capital markets by helping to price securities more accurately. This minimizes market distortions, which in turn leads to better allocation of capital, financing growth, innovation and Job creation.

Short selling, for example, may be a technique used by hedge funds and is sometimes seen as playing an essential part of the price discovery mechanism. Some researchers believe short interest is an indicator of poor stock performance, and that short sellers exploit market mistakes. Hedge funds have many different benefits such as diversification, flexibility and liquidity, but to the larger financial system they can provide innovation, reduction of mispricing, gains in both growth and employment, and the provision of capital for technological and economic development.