Easuring investment performance. international investments. hedge funds and the m...

Finance

Finance and Accounting ID Number: of School Word Count 173 of Submission: August 21, 2011 Finance and Accounting Introduction The global financial market is in great turmoil today, as shown by the wild swings in the major stock markets during the past few days and weeks. There is a lot happening today that can be confusing to some people and investing has become a high-risk game for most investors. This paper tries to explain some of the wild gyrations in stock prices which has left people wondering if their monies can ever be safe, even with the “ secure idea” of a diversified portfolio. Measuring Investment Performance – the traditional view that a portfolio manager is to be measured over an entire market cycle is because most people leave their funds to be managed and do not worry too much about market fluctuations. These ordinary investors expect that their monies placed with portfolio managers will grow over time despite the ups and downs of market movements or gyrations. In short, these people expect their capital will grow accordingly and are in safe hands because they believe they had hired the portfolio managers precisely for this type of risk management. They think the cyclical nature of markets will protect their investments no matter what happens, because they believe markets will eventually recover in the long run. This type of thinking or mentality does not take into account the existence of other investing methods such as short-selling, leveraging (buying stock on margins), hedge fund investing and other kinds of esoteric investment instruments such as puts, call, options or other derivative instruments that can typically yield them higher returns without necessarily increasing the investment risks. Their kind of investing mentality is the “ buy-and-hold” strategy; hold a particular stock for an enough period of time

and the returns (dividends and stock price appreciation) will come naturally. This “ plain vanilla” type of investing strategy measures a portfolio manager in terms of performance based on his stock selection (which equities he had bought, how big is the firm, the dividend history of the company, etc.) and how well he allocated the funds accordingly based on asset-type allocations (Lawton and Jankowski, 2009, p. 731). This type of an investment strategy mirrors the performance of the economy and if the economy recovers, then the portfolio's worth should recover accordingly too. However, hedge funds adopt a different investing style and this style contradicts the conventional wisdom of the traditional investing strategy mentioned above. For one, hedge funds, if managed exceedingly well, can outperform the markets in either up or down conditions. These funds seem to defy the market dynamics by giving a decent return in all market situations; a well-managed hedge fund is that by billionaire George Soros. (360 words) Diversified International Investments – this is perhaps one of the most persistent myths in the investing and financial services industry today. With a number of esoteric and derivative instruments available today for the sophisticated investor, the belief is that holding a diversified portfolio insulates the investments from financial risks. However, recent market developments in a way had nullified this myth, with some investors losing out in a spectacular way because they made the wrong decisions. In short, these investors who tried diversification failed because of the extreme complexity in today's markets with a good number of extraneous factors which cannot be foreseen altogether, no matter how good the investment management is. Several factors which are often unpredictable to a certain extent are currency exchange rate

fluctuations, political risks of a country, price of oil, prices of commodities and futures markets. There are many instances in which even the most sophisticated investing techniques have floundered like LTCM. A good example here would be the Long-Term Capital Management (LTCM) that had collapsed out of the wrong presumptions in its forecasting methods. Its very spectacular collapse caused the chairman of the Federal Reserve at that time, Mr. Alan Greenspan, to cobble together a rescue package for it as he considered its failure to be so potentially harmful (Auerbach, 2008, p. 177) and that it posed systemic risks to the entire global financial market. It lost, for starters, a mere $4. 6 billion in just four months, making the wrong bets and it was over-leveraged to a tune of $100 billion. It employed a couple of Nobel prize winners in economics and also sophisticated computer-aided mathematical modeling methods designed to eliminate virtually any type of risks by its simultaneous trades in a variety of markets (Lowenstein, 2000, p. 155). A hedge fund like LTCM is by its very nature a diversified fund and yet it failed because of one variable which it had failed to take into account – the default of the Russian financial market back in 1998. With today's globalization, financial markets are closely intertwined and react very fast due to the use of instant communications and any diversification efforts will not provide the protection. If there is any benefit in diversification, it will derive from making the right choices, such as whether to put more weight in emerging markets or in detecting financial “ bubbles” early enough. (396). Bernard Madoff and his Ponzi Scheme – Madoff was able to pull off his swindle despite several doubts from his investors because of a number of things which perpetuated his scheme. A good number of “ red flags” or

warning signs were ignored by both the regulators and investors. The most flagrant or obvious sign that his investment fund was a scam was its consistent profits or return on investments (ROI) even during the worst kind of market downturns. In other words, his fund out-performed even the best-managed hedge funds and set some people wondering. The U. S. Securities and Exchange Commission ignored a warning letter by a financial fraud investigator named Harry Markopolos that enumerated 29 red flags that Madoff's firm was engaged in a Ponzi scheme. The various investment firms which also funneled large amounts of money to the Bernard L. Madoff Investment Securities L. L. C. (or a limited liability company) had not questioned how he got consistently above-average returns on their investments, which in retrospect they could easily have asked a few inquiries (Barkan and Bryjack, 2009, p. 109). The various investment firms such as Tremont Group Holdings, Inc. (Reuters, 2011, p. 1) funneled a lot of money from its individual investors into Madoff's fund. The scale of Madoff's scam is unprecedented due to its sheer size and that only a single person was essentially involved in the Ponzi scheme. However, many reputable big banks that are still being brought to the courts today include marquee names like JP Morgan Chase (some $20 billion), Hongkong and Shanghai Banking Corporation or HSBC ($10 billion), the UniCredit ($60 billion) and a host of other smaller banks (Henning, 2011, p. 1) but also includes another banking giant which is the Union Bank of Switzerland or UBS for $2 billion (Kaplan, 2010, p. 1) and all those supposedly careful and conservative banks and investment firms failed to react or even question the sheer volume of monies that Madoff deposited with them without raising the red flags or

warning signs of money laundering too. Madoff himself admitted these banks were also complicit in his crime for the sheer length of time he had been dealing with them. He claims these banks knew what he was doing and ignored it despite the red flags (Rushe, 2011, p. 1). The original whistle-blower Mr. Harry Markopolos thinks it is impossible for the banks not to know; both the U. S. and the U. K. governments also failed in their jobs of monitoring laundering. (417) Reference List Auerbach, R. D. (2008). Deception and abuse at the Fed: Henry B. Gonzales battles Alan Greenspan's bank. Austin, TX, USA: University of Texas Press. Barkan, S. E. & Bryjack, G. J. (2011). Fundamentals of criminal justice: a sociological view. Sudbury, MA, USA: Jones and Bartlett Learning, LLC. Henning, P. J. (2011, July 5). In shift to new court, risks for Madoff trustee's case. The New York Times. Retrieved from http://dealbook. nytimes. com/2011/07/05/in-shift-to-new-court-risks-for-madoff-trustees-case/? scp= 5&sq= Madoff,%20red%20flags,%20warning %20signs&st= cse Kaplan, T. (2010, November 24). Madoff trustee sues UBS to recover $2 billion. The New York Times. Retrieved from http://dealbook. nytimes. com/2010/11/24/madoff-trustee-sues-ubs/? scp= 8&sq= Madoff, %20red%20flags,%20warning%20signs&st= cse Lawton, P. & Jankowski, T. (2009). Investment performance measurement: evaluating and presenting results. Hoboken, NJ, USA: John Wiley & Sons, Inc. Lowenstein, R. (2000). When genius failed: the rise and fall of Long-Term Capital Management. Random House. Reuters. (2011, July 28). Settlement of more than $1 billion from Madoff-related funds. The New York Times. Retrieved from http://www. nytimes. com/2011/07/29/business/1-billion-settlement-from-madoff-related-funds. html? scp= 2&sq= Madoff,%20red%20flags,%20warning

%20signs&st= cse Rushe, D. (2011, February 16). Bernard Madoff says banks were “ complicit' in $90 billion fraud. The Guardian. Retrieved from http://www. guardian. co. uk/business/2011/feb/16/bernard-madoff-says-banks-complicit-in-fraud