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Book Guide

More Money Than God

In this book, CFR Senior Fellow Sebastian Mallaby gives an insider's view on the origin and evolution of hedge funds in the broader context of the history of modern finance through extensive research and numerous case studies. Teaching notes by the author.

Summary

Hedge funds have been secretive, exotic, and frequently misunderstood ever since they first developed nearly sixty years ago. *More Money Than God: Hedge Funds and the Making of a New Elite* provides the first comprehensive account of how hedge funds rose to prominence in global finance, explaining how they discovered inefficiencies in capital markets, delivering attractive returns to individual and institutional clients. Beginning with Alfred Winslow Jones in the 1950s, hedge fund managers have pioneered many innovations that characterize contemporary practice—performance-based compensation, the hedging out of market exposure by selling securities short, the use of leverage, the development of computerized trading programs, and statistical risk-management. This book reviews the evolution of these techniques in the broader context of the history of modern finance, supplementing the account with compelling portraits of the principals based on extensive original interviews. A rich collection of case studies highlights the impact of hedge funds at key moments in the past half century, including the 1987 Wall Street crash, the 1992 collapse of Europe's exchange-rate mechanism, the emerging crisis of 1997–98, the dot-com bubble, and finally the global deleveraging of 2007–2008.

Though it is not a "crisis book," *More Money Than God* adds an important perspective to the discussion of 2007–2008. Hedge funds are frequently berated for causing financial instability, yet they managed risks successfully through the turmoil. Superior incentives in hedge funds appear to explain this strong performance. Because hedge fund managers have no expectation of a government safety net, and because they typically have personal savings in their funds, they manage risks more vigilantly than large too-big-to-fail institutions beset with internal agency problems. Because they mark portfolios to market and because their borrowing is generally collateralized, hedge funds that get into trouble are rapidly wound up, avoiding losses for creditors and taxpayers. *More Money Than God* concludes that, contrary to conventional wisdom, sound policy should encourage hedge funds' proliferation. The best antidote to too-big-to-fail institutions may be small-enough-to-fail hedge funds.

This book, along with the teaching notes, discussion questions, and suggestions for further projects, is ideal for courses on introduction to financial markets, history of capitalism from Bretton Woods to the present, investment management, capital markets and political economy, and financial crises.

Discussion and Essay Questions

Courses on Introduction to Financial Markets

1. How does capital flow from savings to investment?
2. How are assets valued? Are these subjective or objective judgments? Can prices reach "equilibrium"?
3. What are the central claims of the efficient market hypothesis? How far does the success of hedge funds call these claims into question?
4. How do institutional characteristics affect the behavior of financial-market participants? How do these factors create opportunities for hedge funds?
5. To what extent does the history of hedge funds support or negate the thesis that there are "limits to arbitrage" in financial markets?

Courses on the History of Capitalism from Bretton Woods to the Present

1. How did the hedge fund sector develop? What were some of the first funds? What sorts of opportunities did they seek to exploit? How did they help transform capital markets?
2. How did financial markets change after the collapse of Bretton Woods in 1971? What new opportunities emerged? Who exploited them? Did these changes improve the stability and health of the financial system or increase its riskiness?
3. How did George Soros "break" the Bank of England in 1992? What were the consequences, both economic and geopolitical?
4. Were hedge funds fairly blamed for the Asian financial crisis of 1997?
5. Contrast the failure of Long-Term Capital Management (LTCM) in 1998, Amaranth in 2006, and the "Quant Quake" in 2007. What conclusions do you draw for hedge funds' contribution to systemic risk?
6. Considering periods of financial stability as well as crises, do hedge funds increase or reduce financial stability?

Courses on Investment Management

1. How should an investor evaluate the returns generated by an investment manager? What are alpha and beta? How should an investor price alpha?
2. What are some of the key characteristics of a hedge fund? How are hedge funds different from investment bank trading desks, private equity firms, and mutual funds?
3. What are the risks and opportunities of a hedge fund investment compared to other active investments? What are the risks and opportunities of a hedge fund investment compared to passive long-only investments? What are some historical examples of both?
4. Describe the major styles and strategies of hedge funds. Who are some of the pioneers of each style?
5. Consider the impact of college endowment investments in hedge funds. How might the investment management industry evolve in the wake of the financial crisis? What changes would most benefit investors?

Courses on Capital Markets and Political Economy

1. How do governments interact with capital markets? What role do hedge funds play in these interactions?
2. What is a currency peg? Why would a country establish one? What causes pegs to break? Why have some pegs remained in place? What are some examples?
3. Should governments fear hedge funds? Consider the effects of hedge funds on sovereign borrowing, currencies, and national ownership of strategic assets.
4. What does "too big to fail" mean? What are the characteristics of too-big-to-fail institutions? How have governments treated these institutions during financial crises? How should they be treated? Are hedge funds too big to fail?
5. How has capital market regulation changed? What are some of the pros and cons of these changes? How have hedge funds historically approached financial regulation? How should hedge fund regulations be changed, if at all?
6. How have government attitudes to consumer protection affected the financial industry?

Courses on Financial Crises

1. What is a financial crisis? What causes it? How does it end?
2. How have hedge funds participated in, ameliorated, or exacerbated bubbles and crises in the past fifty years? On balance, do they stabilize or destabilize the financial system?
3. Might trend-following hedge funds inflate bubbles? To what extent can contrarian hedge funds deflate them?
4. What sort of government actions could have prevented the most recent crisis by tempering the prior bubble? How should government proceed in the future to prevent such crises? What role might hedge funds play?
5. Describe the incentives that led investment banks and long-only investors to buy into the bubble.
6. Are hedge funds the answer to too big to fail, or are they growing to such an extent that they are also too big to fail?

Supplementary Materials

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Lewis, Michael, *The Big Short: Inside the Doomsday Machine*, 2010 (W. W. Norton & Company, Inc.).

Lowenstein, Roger, *When Genius Failed: The Rise and Fall of Long-Term Capital Management*, 2000 (Random House).

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