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About those hedge funds [1]

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The Telegraph has a nice piece about the hedge funds [3] and Brad Delong comments upon it here [4]. All very interesting but still missing one vital point: that the current blowups amongst hedge funds are exactly the way this liberal capitalism, this market allocation of investment, is supposed to work.

Start at the beginning, decades ago: some bright sparks noted that excess returns (that is, above the risk adjusted normal profit rate) could be had by arbitraging in the markets. It might have been bonds against stocks, or debts of different maturities, or currencies and loans: doesn't matter. They thus invested in such arbitrage trades and in the process of making themselves a great deal of money they smoothed out these market inefficiencies.

Those excess returns were spotted by other investors, of course, and they acted as a signal that perhaps investing in the same business could bring more of those highly desirable profits. This is what we actually want to happen, that resources are applied to their highest known value usage: it's the very definition of wealth creation when an asset moves from a low to a higher value use.

At some point enough investors note these potential excess profits and thus they are competed away. There's enough, or more than enough (for markets do sadly tend to overshoot) capital now working in this sector and of course the returns to it fall.

We might thus end up with what we actually desire: the sector as a whole makes normal risk adjusted returns, clearly with some making good decisions and thus good profits, others less so. The whole economy has been made more efficient (and thus wealthier) by the elimination of those imperfections that led to the arbitrage opportunities and the bright sparks go off to look for another similar opportunity to allocate capital to its most productive use.

What's not to like about this?

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