Congressional Testimony
Jeffrey L. Matthews
General Partner
Ram Partners, LP
March 13, 2007

Mr. Chairman and members of the committee, good morning and thank you for inviting me to speak.

My name is Jeff Matthews and I am General Partner of Ram Partners, LP—a hedge fund I formed in 1994, after working at another hedge fund for four years, and starting my career at Merrill Lynch in 1979.

My fund is small relative to the others here, and rather old-fashioned. We buy stocks for the long term, hedge against short-term fluctuations, and don't do any derivatives.

Nevertheless, 18 years in the hedge fund world does make me something of an old-timer, and I do have views on the issues you have raised.

To understand the growth in hedge funds you might ask yourself "Why do people start them in the first place?"

The answer is simple.

Hedge funds are <u>private partnerships</u> whose investors are wealthy individuals and large institutions. That private structure and more sophisticated investor base gives us flexibility to pursue alternative investments, take greater risks, and reap greater rewards than a more strictly regulated mutual fund.

Furthermore, as a private partnership, hedge fund managers can charge what their investors are willing to pay, including <u>a share of the profits the fund generates</u>. So a successful, multi-billion dollar hedge fund manager can literally earn hundreds of millions of dollars while her mutual fund counterpart cannot.

That's why people start hedge funds, and why this industry has exploded.

In fact, the single biggest change I've witnessed since I started is size. In 1994, the biggest hedge fund had about $6 billion in assets. $6 billion today wouldn't rank in the <u>top 50</u> U.S. hedge funds today—and the three largest now have over <u>$30 billion each</u>.

Along with that explosive growth has come diversity: hedge funds no longer focus mainly on stocks, bonds and currencies but have branched into sub-prime debt, distressed securities, real estate, uranium ore and even grain silos. In fact, there are hedge funds that do nothing but invest in other hedge funds.

The flood of money has also caused many so-called hedge funds to no longer actively hedge against market declines, because hedging has been a drag on returns during the bull market. It's like paying premiums for an insurance policy you never need.

However, the most significant change I have witnessed in 18 years is the increased use of leverage—meaning borrowed money—to start new hedge funds.

A $400 million hedge fund today, for example, might actually have only $100 million of true equity. The other $300 million might come from a bank that has sold a preferred class of equity which looks, acts, and smells like debt—yet is called equity.

That structure works fine if the value goes up—everyone makes money and the bank gets paid back. But if it goes down, the equity gets wiped out like a house bought with almost no money down.

What type of risks might this pose? Could the greater leverage cause another Long Term Capital-type hedge fund catastrophe that nearly brings down the markets?

Well, we had just such a catastrophe last year, and the outcome was quite instructive.

Amaranth, a $10 billion hedge fund with sophisticated investors run by intelligent managers using computerized trading systems collapsed in just twenty days owing to huge, complex bets on natural gas that went wrong.

What does this tell us?

1. Hedge fund managers can do stupid things, just like any money manager, only in much bigger size.

2. Even sophisticated hedge fund investors don't necessarily mind this kind of risk-taking unless and until it goes wrong, but when it does, they pull the plug quickly.

3. The more exotic the investments, the harder it is for any outsider to know what is going on inside a hedge fund. After all, if Amaranth's General Partner didn't realize his business was at risk, how would the Fed or the SEC have seen what was coming and act to stop it?

There is, however, a fourth, more positive lesson from Amaranth which was not foreseen by many observers at the time. It is this: a $10 billion fund could evaporate in a matter of months, yet aside from a couple of wild weeks in the natural gas pits, the system didn't even blink.

Unlike Long Capital in 1996, which had to be bailed out by the Fed, <u>other</u> hedge funds bought Amaranth's positions and the firm was liquidated without a problem.

It is true that Amaranth's investors, including public sector pension funds, lost a great deal of money. But those investors knew, or should have known, the risks, and they invested anyway.

As I said, I run a smaller, old-fashioned hedge fund. We do not do derivatives, so I am not defending my own business model here—these are simply my real-world observations. Nor am I acting as a cheerleader for all hedge funds: there will be failures again, and they could get ugly.

However, the presence today of so many large funds specializing in all aspects of the world's markets means in my view the systemic risk of broad failure is probably much lower, and certainly not higher, than I have seen it in the past 18 years.

I was there when Long Term Capital blew up, and I was there when Amaranth blew up. And I can tell you this: Amaranth turned out to be no Long Term Capital.

Thank you for inviting me to speak.

###