TA Tomorrow's Affairs

Analysis of today
Assessment of tomorrow

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Are hedge funds a bogeyman or an opportunity?

In this article, I wanted to offer an analysis of hedge funds – an issue that many people are curious about, that regulatory authorities often treat as a “bogeyman”, and that experienced investors tend to describe as a source of “market deepening” and “opportunity”.

Hedge funds are among the most discussed yet least understood players in capital markets. The reason is quite simple: they may look like ordinary investment funds, but their operating methods are far more flexible.

They can buy equities, invest in bonds, take positions in foreign exchange markets, use derivative instruments, engage in short selling, and employ leverage.

Therefore, to understand hedge funds, one must first recognise that they are not classic “buy and hold” funds; rather, they are structures that actively seek to benefit from market movements through more complex strategies.

Hedge funds in emerging markets

In emerging markets, hedge funds are generally offered only to individuals defined as “qualified investors”. The reason is that these funds may take higher risks in pursuit of higher returns.

As Fintables also emphasises in its explanation of hedge funds, these funds target absolute returns through advanced financial techniques such as leverage, short selling, and derivative use; in return, they also carry features such as lower transparency, higher risk, and limited access.

The first impact of hedge funds on capital markets is seen through liquidity. Liquidity, in simple terms, refers to the ability to buy an asset quickly and convert it into cash rapidly when sold.

> Hedge funds contribute to price discovery in normal periods

Naturally, when there are many buyers and sellers in a market, transactions take place in a healthier manner. Hedge funds can be said to provide liquidity to the market because they conduct large-volume transactions.

They contribute to price formation, especially in equity, bond, foreign exchange, and derivatives markets, through active trading. In this respect, they are beneficial.

Indeed, in a study published by the SEC on hedge fund liquidity management, it is stated that hedge funds contribute to price discovery in normal periods, while requiring such funds to hold higher liquidity creates a balancing problem.

A “waterfall decline”

What we call price discovery is the process through which an asset reaches a price close to its fair value in the market.

Since hedge funds trade continuously, monitor price differences across markets, and take advantage of mispricing, they contribute to this process. For instance, if a stock appears undervalued, they buy it; if it appears overpriced, they sell it.

In theory, this behaviour helps prices move towards more reasonable levels. In an international study I came across during my source review, it was also stated that hedge funds make meaningful contributions to market liquidity and permanent price changes under calm market conditions.

> Hedge funds provide liquidity to the market, but they may also contribute to liquidity drying up very quickly

However, the same study also draws attention

to the potential of these funds to amplify risk during periods of crisis, while acknowledging their role in improving market efficiency.

Hedge funds may deepen markets in good times, but they can also increase volatility in bad times. This is because many of these funds often operate with similar risk models.

When a shock hits the market, many funds may start selling the same assets at the same time. In such a situation, liquidity can disappear suddenly.

Assets that find buyers under normal conditions may become difficult to sell during a crisis. This accelerates price declines. In other words, hedge funds provide liquidity to the market, but they may also contribute to liquidity drying up very quickly. As a result, what we call a “waterfall decline” may occur.

The role of leverage

This is where leverage becomes extremely important. Leverage means that a fund takes a position larger than its own capital.

For example, it is possible to open a 300-lira position with 100 liras of capital. If things go well, gains increase. But if things go wrong, losses also increase.

Therefore, funds using leverage may be forced to close positions rapidly when the market moves against them. This increases selling pressure.

As the IMF frequently emphasises in its financial stability reports, the connection between highly leveraged financial institutions and the banking system creates an important vulnerability for macro-financial stability during periods of market turbulence.

> The impact of hedge funds must be handled more carefully in emerging capital markets such as Türkiye

Another impact of hedge funds is on market psychology. The positions of large funds are closely followed by the market. If investors believe that a hedge fund has taken a position in a particular stock or bond, other investors may move in the same direction.

Sometimes this supports prices; at other times, it may trigger panic. This effect is more pronounced, especially in emerging markets. Because if market depth is limited, the buying or selling of a large fund can create significant price movements.

For this reason, the impact of hedge funds must be handled more carefully in emerging capital markets such as Türkiye.

As the number and size of funds increase, liquidity enters the market; however, how permanent that liquidity is also matters. Short-term and highly leveraged money may look friendly to the market on good days, but on bad days it is often the first to head for the exit.

The greatest risk: lack of transparency

Of course, the positive aspects of hedge funds should not be underestimated. These funds bring professional investors into the market, improve pricing quality, evaluate arbitrage opportunities, and may make it easier for companies and governments to raise funds through capital markets.

They also offer investors portfolio diversification through different strategies. Academic studies in Türkiye also highlight the role of hedge funds in providing liquidity, contributing to price formation, and creating portfolio diversity.

However, their negative aspects are also quite clear. For example, the greatest risk is lack of transparency. In ordinary investment funds, investors can more easily see what the fund invests in.

In hedge funds, however, strategies may be more complex and less visible. Therefore, investors may be attracted by return expectations without fully understanding the risk they are taking.

This is also the main reason why hedge funds in Türkiye are offered only to qualified investors. These products are not suitable for everyone.

If a single hedge fund suffers losses, that concerns its own investors

Another risk is liquidity mismatch. A fund may offer investors the right to exit at certain periods, but the assets in which the fund invests may not always be easy to sell.

If investors want to exit at the same time during a crisis, the fund is forced to sell assets. If these sales occur in low-liquidity assets, prices may fall sharply.

This is why the emphasis placed by the Capital Markets Board of Türkiye on effective liquidity management and the definition of high-quality liquid assets in its studies on investment fund liquidity risk is meaningful.

The systemic risk dimension is broader. If a single hedge fund suffers losses, that concerns its own investors. But if very large funds carry similar positions at the same time, and if those positions are connected to banks, brokerage firms, and derivatives markets, the problem grows.

Let us give an example: in 1998, the positions held by Long-Term Capital Management were so large and so interconnected with the financial system that its collapse almost turned into a broader financial crisis.

It would not be wrong to say that this episode remains one of the main sources of the cautious approach towards hedge funds in academic literature and policy discussions.

Not simply good or bad

For this reason, it is not correct to define hedge funds as simply good or bad in a single sentence. In fact, they are somewhat like medicine for the market. In the right dose, they provide benefits; in the wrong dose, they create side effects.

Hedge funds bring speed to capital markets. But if the braking system is not strong enough, speed does not always mean safety - Emre Alkin

They bring liquidity to the market, but they may also increase volatility. They contribute to price discovery, but during panic periods they may push prices away from their fair values. They deepen capital markets, but because of leverage and lack of transparency, they may also create systemic risk.

In conclusion, hedge funds are natural and important players in capital markets. The problem is not their existence, but how they operate and how effectively they are supervised.

Well-regulated hedge funds, whose risks are monitored and whose investors are informed, add depth to the market. However, if leverage, liquidity risk, and transparency problems are ignored, these funds can make markets more fragile instead of strengthening them.

Simply put: hedge funds bring speed to capital markets. But if the braking system is not strong enough, speed does not always mean safety.

I wrote this article for the executives of SEC-like institutions and capital market regulators. While supporting steps taken to deepen the market, I wanted to present, for their consideration, a recommendation note cautioning against falling into the trap of "overregulation", or excessive regulation.