Problem set 3
266: Fi. Markets and Institutions
Spring 2016
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Directions. You are to do this problem set alone.

Due Date/time. Your work is due by beginning of class (10:30am) April 28. You can hand the work in to me at the beginning of class. If you put the work under my office door or in my mailbox, it must be in before I leave for lecture at about 10:20 am.

Questions. If you have questions, email me or one of the TAs, raise them in class, or come to office hours.

Grading. All parts have equal value.

Note: Be sure to note the proper units (e.g., millions, billions, etc.) in the following answers.

1 Hedge funds.

1.1 The typical hedge fund charges investors a certain percentage of all assets managed (management fee) and then charges a certain percentage of any gains in value (performance fee). What have these two percentages been traditionally? (Some of these fees have fallen in recent years)

Management:

Performance:

1.2 Suppose that the hedge fund charges the fees noted in the previous part and then in a particular year simply matches the broad stock market outcome, with capital gains and interest bringing the total return to 5 percent. What is the return (after fees) earned by an investor who invests at the beginning of the year?

(Note: presume that the management fee is paid at the beginning of the year and is not part of any gains.)

1.3 Suppose that the broad market has a total return of 5% in a given year. What return will the hedge fund have to make in order for the customers to break even after fees?

1.4 You are advising a qualified investor who is considering investing in a hedge fund. Agreeing with the SEC's advice you say: 'Ask questions. You are entrusting your money to someone else.' The investor says, 'Tell me three very important questions to ask' (Assume that you both already know the fee structure.) Your three questions:

1.5 Based on the answers the investor receives from the hedge fund, the investor chooses to put money in the hedge fund for at least 1 year. At the end of the 1 year, the investor returns to you with the investment results and asks whether he or she should keep the money in the hedge fund. How does your advice differ from your initial advice?

Answer that same question if the investor comes back with 3 years of investment results.

2 Facts, myths, and yet to be determined.

2.1 The Fed is audited. True/false and explain.

2.2 The large-scale asset purchases have led to an unprecedented level of reserves in the banking system of the U.S. Some economists fear that this must inevitably lead to inflation. Historically, this would likely have been the case. Why does the traditional logic no longer necessarily apply?

2.3 The Fed's policies could nonetheless lead to inflation. Why is this so?

2.4 The purpose of quantitative easing was to flood the economy with liquidity in hopes that more money in the economy leads to more spending. True/false and explain.

2.5 According to the Fed, the main purpose of quantitative easing was for the Fed to push out the demand curve for longer-term securities, driving up their price and lowering their yield. True/false and explain.

2.6 Many mainstream economists believe that the Fed's QE purchases should have little or no effect on yields. True/false and explain.

2.7 When the Fed purchases longer-term government securities, so long as the yield on the securities exceeds the Fed pays on reserves, this saves money for the taxpayers. True/false and explain.

2.8 From 2012 through 2015 the Fed's ownership of securities saved or cost the taxpayers about how much per year? (Hint: google federal reserve remittances.)

2.9 Federal debt in the hands of the public as a share of GDP is over 70 percent. Historical precedent worldwide clearly shows that debt much higher than this is almost inevitably associated with sharply rising sovereign borrowing costs. True/False explain.

2.10 When a government borrows at negative interest rates, this inevitably puts an increased tax burden on future generations. True/false explain.