Financialization: The Role of Private Equity and Hedge Funds

Paper prepared for the meeting of the DFG Research Network "Die Politische Ökonomie der globalen Finanzialisierungsprozesse", May 2011 in Marburg, Germany

Jan Fichtner
Ph.D. Candidate
Department of Political Sciences
Goethe University Frankfurt
Email: fichtner@soz.uni-frankfurt.de

First draft – please do not quote!
Comments are very welcome.

I. Introduction

Research on financialization is still in its early stage and the interdisciplinary discussion has not yet resulted in a common agreement about the definition of the term, and even less about its significance (Epstein 2007). Many authors that did pioneering work on financialization tended to employ a structural, or 'macro' perspective on the phenomenon.

Epstein (2001) defines financialization broadly as 'the increasing importance of financial markets, financial motives, financial institutions, and financial elites in the operation of the economy and its governing institutions, both at the national and international level'. Krippner (2005) also employs a macro perspective and defines the phenomenon as 'a pattern of accumulation in which profits accrue primarily through financial channels, rather than through trade and commodity production'.

Hence, many attempts to define financialization are quite broad in nature and do not include *specific* causal mechanisms through which *specific* actors cause change in *specific* political economies. One partial exception is Palley (2007). He also defines financialization in a broad way as 'a process whereby financial markets, financial institutions, and financial elites gain greater influence over [economic policy and] economic outcomes'. However, he then further specifies the concept by identifying three different conduits through which financialization operates: changes in the structure and operation of financial markets; changes in the behavior of non-financial corporations, [and changes in economic policy].[1] Palley also notes the three principal impacts that financialization has: elevate the significance of the financial sector relative to the real sector; transfer income from the real sector to the financial sector; and increase income inequality and contribute to wage stagnation.

In contrast to many structural approaches in the emerging literature on financialization, this paper takes an actor-centered perspective on the phenomenon. Therefore, the focus is on two particular types of financial market actors, namely private equity and hedge funds (together known as alternative investment funds), and the particular causal mechanisms through which they advance financialization in particular parts of the contemporary global political economy. This paper uses the definition of financialization provided by Palley (2007) as its main point of reference. In particular, two of his three conduits through which financialization is said to work are used to analyze the role of private equity and hedge funds: First, changes in the behavior of non-financial corporations; Second, changes in the structure and operation of financial markets.

This paper is organized in four sections. Subsequent to this introduction, section two presents stylized facts about private equity and hedge funds. Section three identifies two central conduits through which hedge funds and private equity drive the trend of financialization: First, financialization of listed corporations; and second, predominance in certain financial markets. Finally, the concluding remarks dare to give a short outlook on the role that private equity and hedge funds are likely to play for the phenomenon of financialization in the future.

[1] Influence over economic policy and changes in economic policy are not the focus of this paper.

II. Stylized facts about private equity and hedge funds

Both private equity and hedge funds have been around in the US since the late 1940s, but only really began to take center stage in the 1980s and 1990s – subsequently they also expanded their activities internationally. During the 1950s, 1960s and 1970s alternative investors in the US were largely unknown to the general public and the assets private equity and hedge funds had under management amounted to only a tiny fraction of the overall financial markets. They were just too small to matter – for business and for academia.

This changed during the 1980s, as US private equity funds began to use the strategy of 'leveraged buyouts' (LBOs). Leveraged buyout means that the private equity fund acquires a whole company, a business unit or just some business assets from the current shareholders employing a large amount of borrowed funds. This financial leverage enables private equity funds to do much larger deals than they could by using only their capital under management. Thus, leverage allows private equity funds to generate much larger profits – but also entails much higher risk. The aim of LBOs is to restructure the target company and then to list it (again) on the stock market, to sell it to a strategic investor (that could be a listed or an unlisted company), or to sell it to another private equity fund. This latter model is known as a 'secondary buyout' and has only really emerged after the year 2000.[2]

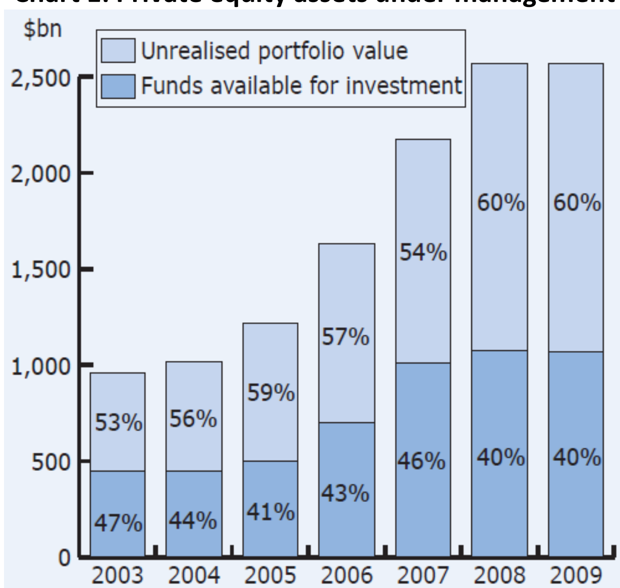
The managers of private equity funds (the 'general partners') invest some of their own capital in the fund in order to align their interest with that of the investors (the 'limited partners'). The general partners receive an annual management fee of around 2 per cent of the value of the fund. The second part of their financial reward is a share of the profits of the fund, which is usually set to about 20 per cent. This remuneration scheme is known as '2-and-20'. According to US regulations, only wealthy individuals and institutional investors are allowed in invest in private equity since it is considered a very risky type of investment. Hence, in 2009 the largest investors in private equity were pension funds (37 per cent),

[2] The private equity industry consists mainly of two strategies: LBOs and venture capital (VC). VC is providing finance to early-stage, high-potential, high risk, startup and growth companies. VC accounted for about one third of total private equity in 2008. VC is not analyzed here as its logic is diametrically opposed to LBOs.

wealthy individuals and family offices (19 per cent), insurance companies (10 per cent), endowments/foundations (9 per cent) and banks (8 per cent) (UBS 2010).

The global growth of private equity has been spectacular. Between 1985 and 2005, private equity funds experienced a compound annual growth of 18.5 per cent (Froud/Williams 2007). The global assets under management by the private equity industry ballooned from just under USD 1 trillion to over USD 2.5 trillion between 2003 and 2008 (see Chart 1).

Chart 1: Private equity assets under management



Source: *TheCityUK (2010)*

It is important to note, however, that private equity is by most accounts an industry that is dominated by only two countries – the US and the UK. Most of the capital that is invested in private equity comes from these two countries. The majority of private equity funds are managed in the US and the UK. In fact, the ten largest private equity funds that together raised about USD 370 billion of capital for direct private equity investment during the five years up to the end of 2009 are all based in these two countries – eight in the US and two in the UK (see Table 1 on next page). Of this fundraising from the end of 2004 until the end of 2009 over one half was done by private equity firms based in just two cities – New York with 36 per cent and London with 17 per cent (TheCityUK 2010).

Table 1: The largest private equity firms of the world

Firms ranked by amount of capital raised for direct private equity investment in 5 years up to end-2009		$bn
Goldman Sachs Principal Inv. Area	New York	54.6
The Carlyle Group	Washington DC	47.8
Kohlberg Kravis Roberts	New York	47.0
TPG	Fort Worth (Texas)	45.1
Apollo Global Management	New York	34.7
Bain Capital	London	34.2
CVC Capital Partners	New York	31.1
The Blackstone Group	Boston	29.2
Bain Capital	New York	23.0
Warburg Pincus	London	21.7

***Source**: TheCityUK (2010)*

This dominant position of the US and the UK holds also true for the hedge fund industry, which is in many ways comparable to the private equity industry. Hedge funds are structured in a similar way to private equity funds as limited partnerships. The limited partners just invest their capital in the fund. The general partners, the management, invest some of their own capital and they are rewarded in most cases according to the model of '2-and-20'.

The first '*hedged* fund' was set up by Alfred Winslow Jones during the late 1940s in the US. His idea was to create an investment fund whose performance (known as 'alpha') was protected (or hedged) against the general movement of the market (known as 'beta'). Basically what he did is to combine stock-picking, short-selling and leverage for the first time. He bought stocks (known as going 'long') that he thought would be undervalued and sold borrowed stocks that he deemed were overvalued (going 'short'). In this way his hedge(d) fund could profit in both bear and bull markets. In addition, Jones also used borrowing additional funds to enhance his returns (Lhabitant 2007).

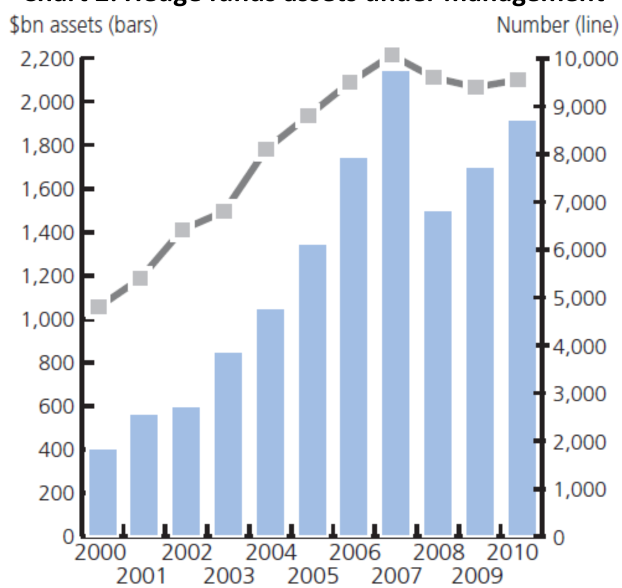
In contrast to private equity, most hedge funds do not acquire whole companies, but rather invest their capital in a very diverse fashion in nearly all parts of the international financial markets. Hedge funds speculate with bonds, currencies, commodities, derivatives and stocks – they invest in everything that is deemed profitable. An important subgroup are so called activist hedge funds that buy stakes in publicly listed companies and then pressure the management to take measures to increase 'shareholder value' in the short-term, i.e. special dividends, share buy-back programs or the sale of divisions.

No universally accepted or even legally valid definition of hedge funds exists. In general, a hedge fund is a private and for the most part unregulated investment vehicle, primarily for wealthy individuals and institutional investors which employs alternative investment strategies (Harmes 2002). In particular, hedge funds are able to follow whatever investment strategies they believe are profitable:

'They can buy and sell whatever assets or financial instruments they want to, trade any kind of derivatives instrument, engage in unrestricted short-selling, employ unlimited amounts of leverage, hold concentrated positions in any security without restriction, set redemption policies without restriction, and can employ any fee structure and management compensation structure that is acceptable to their investors. In addition, hedge funds have very limited disclosure and reporting obligations, to regulators, the public, and their own investors' (Edwards 2004, p. 34).

Since the early 1990s hedge funds have enjoyed phenomenal growth. In 1990 there were about 500 hedge funds with assets of close to USD 40 billion. By late 2007, this number had skyrocketed to a peak of about 10,000 funds managing over USD 2,000 billion.[3]

Chart 2: Hedge funds assets under management



***Source**: TheCityUK (2011)*

[3] One of the reasons for this spectacular growth was the fact that hedge funds on average had been able to generate 'alpha' during the dotcom-crash period of 2000-2002 when most other investments slumped.

Due to the rather secretive nature of most hedge funds, the data on the industry remain incomplete. Nevertheless, research indicates that in 2009 at least 60 per cent of hedge funds were legally registered in offshore financial centers (TheCityUK 2011). By far the most important offshore domiciles for hedge funds are the Cayman Islands, the British Virgin Islands and Bermuda. These three locations are all British Overseas Territories, which means they enjoy certain autonomy in domestic affairs, such as in tax legislation, but ultimately remain under the sovereignty of the UK.

The majority of hedge funds that are not registered in the Caribbean are located in Delaware – a *de facto* offshore financial center with lax regulation and low taxation. In 2009 more than 80 per cent of all operating hedge funds were legally registered in territories under the sovereignty of the USA or the UK (Fichtner 2011). Hence, these two countries play a paramount role as the primary legal domiciles of most hedge funds. The dominant role of the USA and the UK for the hedge fund industry is illustrated even more clearly by the fact that in 2009 almost 90 per cent of all hedge fund managers worldwide have worked in the USA (68 per cent) and the UK (20 per cent) (Ibid.). In late 2010 the ten largest hedge funds of the world all operated from these two countries (see Table 2). Finally, the capital that is invested in hedge funds originates predominantly from wealthy individuals – the so called 'high net-worth individuals' – and institutional investors based in the US and the UK.

Table 2: Largest hedge funds of the world

Largest hedge funds, December 2010, $bn	
Bridgewater Associates	60
JP Morgan Asset Management	41
Man Group	40
Brevan Howard Asset Management	32
Paulson & Co	32
Highbridge Capital Management	27
Soros Fund Management	27
Och-Ziff Capital Management	26
BlueCrest Capital Management	25
Cerberus Capital Management	24
Largest fund of funds, December 2010	
Blackstone Alternative Asset Management	33
HSBC Alternative Investments	28
UBS Global Asset Management A&Q	28
Grosvenor Capital Management	24
Goldman Sachs Asset Management	22
Permal Investment Management	22
BlackRock Alternative Advisors	19
Morgan Stanley	18
Pacific Alternative Asset Management Co	17
Lyxor Asset Management	16

Source*: TheCityUK (2011)*

The US and the UK prefer a 'light touch' regulation of alternative investment funds – private equity and hedge funds. This approach is also known as 'indirect' regulation by regulating not the funds themselves, but their main counterparties – the prime broker divisions of the largest investment banks, such as Goldman Sachs, Morgan Stanley and JP Morgan Chase. The first central argument that was typically brought forward for this paradigm was that both the private equity and the hedge fund industry were too small to impact the overall financial markets (Holmes 2009). The second argument was that no direct regulation was necessary as only affluent individuals and institutional investors were allowed to invest in these 'alternative' investments that needed no regulatory protection.

During the last twenty years Washington and London have argued strongly in favor of self-regulation of hedge funds. Robotti (2009) calls this approach 'regulatory self-capture': 'Facing a trade-off between the need to tackle publicly demonized issues and the difficulty of monitoring increasingly sophisticated and powerful private markets, regulators purposefully designed initiatives that were not meant to succeed, that is, they "self-captured" their own activity' (Ibid.). Even after the global financial crisis the only regulatory measure taken by the US was a mandatory registration of hedge funds that manage more than USD 150 million.

Private equity and hedge funds surely have not been the main culprits for the financial crisis, but hedge funds did exacerbate it by betting on the collapse of US real-estate prices and short-selling major international banks. Private equity has not been directly involved in the financial crisis itself, but rather in the economic downturn that was caused by the panic in the financial markets. However, hedge funds and private equity have helped to lay the foundation for the crisis by *financializing* important parts of the global political economy.

III. Two central conduits of private equity and hedge funds

There are two main conduits through which private equity and hedge funds drive financialization. First, they change the behavior of listed corporations. Second, they change the structure and operation of financial markets. In addition, alternative investment funds increase income inequality via the tremendous accumulation of wealth by its managers.

Financialization of corporations

Common to nearly all leveraged buyouts is that the private equity fund passes the debt that it used for the acquisition on to the target company by forcing it to pay special dividends to its owner – itself, the private equity fund. The result is that most companies that have been owned by private equity end up with a much higher debt load – especially in case of a secondary buyout. Clearly, private equity is also able to add value to the target company, either by bringing in new, superior management or by merging the company with strategically fitting assets also owned by the private equity fund. However, in a recession or during times of high volatility and uncertainty this financial engineering entails a much higher insolvency risk for private equity owned companies. Private equity funds have to refinance USD 814 billion of debt for their target companies until 2016 (FTD 2011). It remains to be seen, whether many of these highly leveraged companies will survive this tough test.

This behavior of private equity is what Froud and Williams (2007) have called 'value extraction'. They have argued that private equity is best characterized by an extraction of value from the target company to the partners of the private equity fund: 'The extraction of value is pure financial engineering because the operating business acquires liabilities in the form of debt equal to the sum of cash taken out. But the cash goes into the hands of elite private equity providers and fund managers while the liabilities are passed on with the business' (Ibid.). In this way the short-term financial interests of the company owners dominate over the medium and long-term interests of employees, management and other stakeholders.

Hedge funds assist private equity in their leveraged buyouts. The Financial Times (2007) has highlighted what it called the 'symbiotic' relationship between the two industries, noting that: 'Hedge fund investors are adding fuel to the buy-out fire as enthusiastic buyers of high-yield debt – helping to keep it cheap and plentiful. So far this year, hedge funds and similar investors have bought more than 20 per cent of leveraged loans' (Valdez/Molyneux 2010).

By increasing the debt load of virtually all the companies that have been the target of a leveraged buyout, private equity funds have made them much more vulnerable to economic downturns and they have depleted them of funds that could have been used for investments in the 'real' economy. Thus, private equity funds have clearly changed the behavior of their target corporations – thereby elevating the significance of the financial sector relative to that of the real sector and transferring income from the real sector to the financial sector. The result is what Stockhammer (2007) has identified as two key characteristics of the finance dominated accumulation regime – high volatility (excessive boom and bust cycles) and mediocre economic growth.

About three quarters of the capital that was invested in the global private equity industry during 2007 and 2008 were raised in the US and the UK. However, only about one half of the capital invested by private equity funds (in both venture capital and leveraged buyouts) went to the these two countries. This means that a considerable share of the private equity industry, which is dominated by the US and the UK, was used to financialize corporations based in other political economies – primarily France, Germany, India and Japan (Valdez/Molyneux 2010).

The financialization of corporations by hedge funds is different to that of private equity. Central in this regard is the sub-group of activist hedge funds, which makes up roughly about one tenth of the total hedge fund industry. An activist hedge fund typically acquires a stake of between five and ten per cent of the outstanding shares of a listed corporation. Then it calls for measures to increase short-term shareholder value: special dividends, share buy-back programs or the sale of divisions. Initially the hedge fund communicates its demands to the management of the target company in private. If the management is not willing to fulfill its demands, the activist hedge fund will typically launch a public campaign to build up pressure. In most cases they are able to attract like-minded investors (investment funds, banks or other hedge funds) that buy in on the target company stock in anticipation of a success of the hedge fund.[4] Quantitative studies by economists have indeed

[4] The CEO of a German listed company that was targeted by activist hedge funds told this author in an interview that German and Swiss private banks had sided with the hedge funds, whereas a public German *Landesbank* had sided with the target company.

found empirical evidence that the shares of corporations targeted by activist hedge funds perform better in the short term than those of companies that have not been targeted (Bessler et al 2008). In many cases activist hedge funds cooperate by forming a 'wolf pack' that has more financial clout to enforce its demands vis-à-vis the target company.

Activist hedge funds have done a few landmark deals in continental Europe. In 2005 a 'wolf pack' led by TCI (The Children's Investment Funds) and Atticus acquired nearly 30 per cent of the Deutsche Börse stocks and forced the German stock market operator to abandon the takeover of the London Stock Exchange. Instead Deutsche Börse had to pay a special dividend to its shareholders and initiate a share buy-back program. Watson (2005) called this pathbreaking deal 'the Deutsche Börse Affair'. TCI and Atticus also paved the way for the record-breaking takeover of Dutch banking giant ABN AMRO by Royal Bank of Scotland, Fortis and Banco Santander in 2009. Further deals in recent years have been the breaking up of the conglomerates Stork in the Netherlands and IWKA (today KUKA) in Germany.

Activist hedge funds have been among the most aggressive proponents of short-term shareholder value maximization.[5] The shareholder value model is a finance-based approach to corporate governance, whose aim is to provide investors with an enhanced comparability of potential returns of different investment opportunities. The capital flows inside the firm are to be made transparent and marketable in order to raise capital profitability and ultimately to increase the share price of the company (Beckmann 2006). In this way the external adjustment to the objectives of the capital markets (i.e. the interests of the shareholders) and the internal control of the company using concepts based on finance can be interpreted as the financialization of the firm (Froud 2000).

This financialization of the firm is comparable to what private equity funds do with their target companies as described above. Hence, the role of both private equity and activist hedge funds is to elevate the significance of the financial sector relative to the real sector, to transfer income from the real sector to the financial sector – thereby they are very likely to

[5] The CEO of a German listed company that was targeted by activist hedge funds told this author in an interview that a hedge fund manager had – during a meeting in his Manhattan office – taken an ancient rifle from the wall pointing it at his knee saying: 'CEOs that don't cooperate with us get shot in the knee!'

increase income inequality and to contribute to wage stagnation. These are the three principal impacts of financialization as identified by Palley (2007). This direct role of private equity and activist hedge funds in regards to financialization is relevant, but limited in scope due to the fact that both are still small to medium-sized players in the overall global financial markets. Their direct role is intricately linked to their indirect role, which is potentially far more important, as its scope is very much larger.

Disciplinary power

Private equity and activist hedge funds also play an indirect role for financialization, because they represent a credible threat to listed companies that do not adhere to the short-term shareholder value paradigm, which can be seen as an integral part of financialization. Hence, private equity and especially activist hedge funds wield 'disciplinary power' over potential target companies, as it is rational for them to fulfill the typical demands (special dividends, share buy-back programs or the sale of divisions) in order to avoid being identified by the financial investors as lucrative targets.

There is anecdotal evidence for this claim of 'disciplinary power'. In the last couple of years large German listed corporations, such as Siemens, Daimler and Munich Re have publicly voiced their concern that multiple hedge funds might have acquired stakes in them.[6] As a consequence most of them have initiated share buy-back programs, paid special dividends or sold divisions not deemed part of the 'core competence'.[7] The search for stable 'anchor investors' that many German listed companies have begun in recent years was in many instances motivated of a latent fear of aggressive investors such as activist hedge funds.

Predominance in financial markets

The rest of the hedge fund industry is markedly different to activist hedge funds. Hedge funds engage in a wide array of activities and predominate in several important markets.

---

[6] In Germany, investors only have to disclose their holdings if they exceed three per cent of the outstanding shares. Hence, a group of hedge funds acting 'in concert' can easily acquire a large stake in a listed company, but remain hidden, if each individual fund stays below the threshold of three per cent.

[7] Clearly, also other factors could be (partly) responsible for this behavior and much more research is needed on this 'disciplinary power' of private equity and hedge funds.

If leverage is included, hedge funds controlled an estimated USD 10,000 billion at their peak in 2008. Thus, total capital under management by hedge funds corresponded roughly to about one-fifth of the market value of the world's listed corporations – although much of it was invested in other assets, such as bonds or derivatives (Mackintosh 2009). In this regard, hedge funds still represent a small to medium part of the overall international financial markets. On the other hand, hedge funds constitute an extremely active class of investors that dominate several important market segments. For instance, hedge funds are pivotal players in the derivatives markets and they account for about 40 per cent of the turnover of major international stock markets (Noyer 2007). In addition, they are responsible for about one third of all foreign exchange trading (Valdez/Molyneux 2010).

A study by Greenwich Associates found that during the year April 2006/April 2007, hedge funds were responsible for nearly 30 per cent of all US fixed income (bonds) trading, 55 per cent of activity in all US investment-grade derivatives, 80 per cent for high-yield derivatives and 85 per cent of volume in distressed debt securities (Holmes 2009).

Harmes (2002) highlights the role of hedge funds as market leaders that stems from their ability to unilaterally influence asset prices. Hedge funds are able to do this because of their heavy use of leverage, their unique ability to concentrate capital in just a few investments and the fact that they cooperate for very large deals (they form so called 'wolf packs'). Furthermore, Harmes finds that hedge funds possess normative authority in the international financial markets which are increasingly characterized by the herd mentality of many mutual and pension fund managers that rely heavily on technical analysis, which induces trend-following rather than trend-creating behavior.

The term 'market' features prominently in many discussions about financialization, and this paper is no exception in this regard. However, the term is rarely, if at all, precisely defined. According to Rosenbaum (2010), a market is a voluntary and competitive exchange of specified goods and services that is taking place on a regular basis; it brings together demand (buyers) and supply (sellers). Markets have two fundamental functions that are closely related. First, markets serve as allocation mechanisms for scarce resources. Second, markets determine the relative prices of demand and supply (Ibid.). Hence, it could be argued that the intrinsic purpose of markets is to allocate scarce resources; it enables exchange between buyers (that have a real existing demand for goods or services) and sellers (that have a real existing supply in goods or services). Underlying this concept of markets is the view that the political economy is primarily driven by actors that want to exchange goods and services in order to satisfy their material needs.

Hedge funds use markets not for their intrinsic purpose, the exchange of goods and services in order to satisfy needs, but only for short-term financial speculation. This is clearly visible in the commodities markets. Hedge funds have entered important markets, such as oil and gold, but also more exotic markets, such as cocoa. The large amount of capital that they operate with allows them to create trends – regardless of the 'fundamentals'. Even though they might not be able to dominate these markets forever, because they are still a small to medium actor in the global financial markets, they are able to temporarily 'corner'[8] other market participants, thereby extracting capital from them. In mid-2010 the London-based hedge fund Armajaro bought more than 240,000 tons of cocoa, the largest single purchase since 1996, using derivatives in order to profit from rising prices (FTD 2011).

Hedge funds also played a major role for the dramatic spikes in the price of crude oil that happened between 2005 and 2011. Valdez/Molyneux (2010) note: 'Research by Goldman Sachs at the end of 2005 suggests that as much as 20 per cent of the huge oil price increase that year was a result of hedge fund buying.' Hedge funds are not omnipotent, however. In early May 2011 the largest commodity hedge fund Clive Capital lost more than USD 400 million in a few days due to the drop of the oil price (FT 2011). Back in 2006 the hedge fund Amaranth Advisor had even lost more than USD 6 billion within one week with futures on the price of natural gas.

Predominance in parts of the international financial markets is an important role that hedge funds play for the phenomenon of financialization. By predominating in certain market segments they transfer capital from the real sector, which uses these markets (e.g. airlines

[8] To 'corner' means the artificial reduction of demand in order to force the price up.

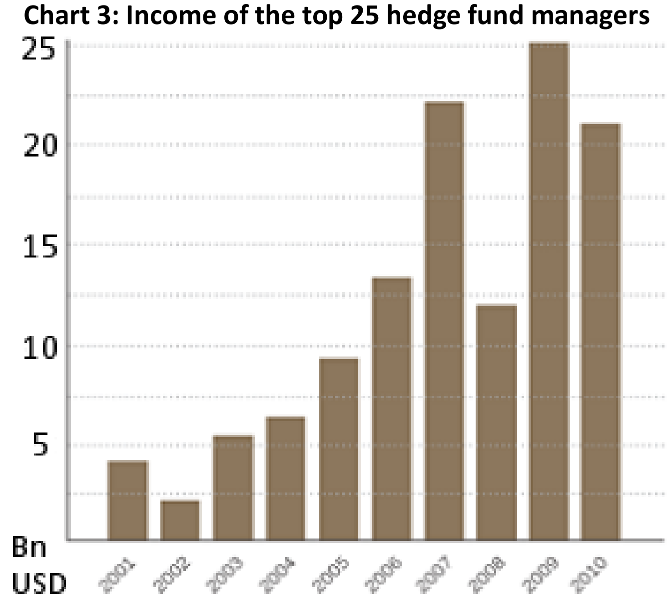
hedging their future jet fuel demand with derivatives or producers that buy commodities they need), to themselves – the financial sector.

Increasing income inequality

Hedge funds also contribute to an increase of income inequality, which is one of the three primary impacts of financialization according to Palley (2007). Chart 3 shows the income of the top 25 hedge fund managers of the world from 2001 to 2010. The cumulative income of the top 25 has risen from just under USD 5 billion in 2001 to well over USD 25 billion in 2009 – even in the catastrophic year 2008 the top 25 hedge fund managers earned about USD 12 billion. In total, the top 25 hedge fund managers earned close to USD 120 billion from 2001 to 2010 – an enormous concentration of wealth in the hands of very few people.

Managers of alternative investment funds (private equity and hedge funds) already account for at least 61 of the 400 richest Americans in 2010 (Forbes 2010). And their wealth is growing faster than that of most other people on the Forbes 400 list.

Chart 3: Income of the top 25 hedge fund managers



Source: Absolute Return+Alpha (2011)

IV. Conclusion

In contrast to many other studies, this paper has taken an actor-centered perspective on the phenomenon of financialization. One class of financial market actors has been the focus of this study – alternative investment funds (private equity and hedge funds). The main finding is that private equity and hedge funds are *agents of financialization*. Two central conduits through which hedge funds and private equity drive the trend of financialization have been identified: First, the financialization of listed corporations. Private equity firms financialize their target companies by forcing them to take on high debt, thus they transfer income from the real sector to the financial sector. Activist hedge funds financialize their target firms by forcing them to implement measures to create short-term shareholder value. The second conduit through which alternative investment funds advance financialization is their predominance in certain financial markets; they use markets not for their intrinsic purpose, but only for short-term financial speculation. Furthermore, alternative investment funds contribute to an increasing income inequality by enabling its managers to accumulate enormous amounts of capital.

Hence, hedge funds can be seen as the avant-garde of financialization – they are the embodiment of this powerful trend and at the same time one of its key driving forces. As the vanguard of this powerful development they wield a certain degree of normative authority over the mass of financial market actors that are often adhering to herd mentality. In addition, there are signs that they wield 'disciplinary power' over listed corporations.

Epstein (2007) has identified the central problem created by financialization: 'speculative and excessively liquid financial flows that create debt-laden balance sheets, overly short-term perspectives, volatility and mispricing of important asset prices, including exchange rates, and subsequent misallocation of resources and unstable economic growth'. As shown above, private equity and especially hedge funds are partially responsible for that.

This paper has identified the two countries that have been primarily responsible for the financialization through private equity and hedge funds – the US and the UK. Both countries have been among the chief beneficiaries of financialization. Thus, it is in the interest of both the US and the UK to keep private equity and hedge funds free from strict regulation. Hence, London (aided by Washington) has lobbied strongly during the recent discussion in the EU about the regulation of ‘alternative funds’. London Mayor Boris Johnson had even argued that proposals of EU regulation were ‘a blatant attack’ on London's position as a leading financial center (BBC 2010).

In the end, the UK (and hence the US) have been largely successful; pretty much the only thing that changes is that private equity and hedge funds that want to be active in the EU have to register with the regulatory body. Private equity funds will not be allowed to pursue ‘assets striping’ with their target companies in the first two years after the (leveragred) buy-out. However, there is a loophole which is of paramount importance and London lobbied very hard for it: Most of this regulation is only valid for funds that want to ‘actively’ market themselves to investors in the EU. Funds that restrict themselves to ‘passive’ marketing will not be bound to this regulation (Euractiv 2010).

One of the consequences of the financial crisis was the stricter regulation of banks, including the higher capital requirements under Basel III. As private equity and hedge funds will not be regulated much stricter than before, many industry insiders predict that much business will simply shift from the regulated banks to the ‘shadow banking system’ (Roubini/Mihm 2010) run by hedge funds and other minimally regulated financial actors. Indeed, hedge funds have already begun to offer so-called ‘capital relief trades’ to banks that need to fulfill stricter capital requirements, i.e. the hedge funds take on the most risky tranches of a whole bundle of credits and the banks pay a very high fee for this. On balance, it seems likely that the financialization through private equity and hedge funds – enabled and fostered primarily by the US and the UK – will grow in scale and scope in the next years.