

PART

# One

## Evolution of the Hedge Fund Industry and Investing

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## CHAPTER 1

# The Truth about Hedge Funds

## From Misunderstood Investment Vehicle to Household Word

If you read the business press, watched television, or eavesdropped on a congressional finance committee hearing at almost any point since 1999, but especially in 2008, you might define hedge funds in several ways:

- Mysterious, secretive, risky pools of capital managed by swashbuckling, cowboy investment managers.
- Lying, thieving, Ponzi-scheming criminals.
- The cause of the whole breakdown of the financial system.

Alexander Ineichen, a leading research analyst and author, has said, “The reputation of hedge funds is not particularly good. The term ‘hedge fund’ suffers from a similar fate as ‘derivatives’ due to a mixture of myth, misrepresentation, negative press, and high-profile casualties.”<sup>1</sup>

Ineichen made a similar observation in another publication: “There is still a lot of mythology with respect to hedge funds. Much of it is built on anecdotal evidence, oversimplification, myopia, or simply a misrepresentation of facts.”

But in that instance, he asserted a hedge fund definition that is simpler and more germane to serious, sophisticated investors: “Hedge fund managers are simply asset managers utilising other strategies than those used by relative return long-only managers.”<sup>2</sup>

While the term *hedge fund* is used broadly, it is often used to describe a vehicle with a 1 and 20 fee structure. In our book *Foundation and Endowment Investing*, we summarized hedge funds as follows:

*Hedge funds are private investment vehicles structured as limited partnerships with the investment manager as the general partner*

*and the investors as limited partners. "Hedge funds" is not a traditional asset class but rather an amalgam of investment managers and traders who are compensated by a performance fee, have an opportunity to invest in any number of strategies across various asset classes, and use return-enhancing tools such as leverage, derivatives, and short sales. The defining characteristic of hedge funds is their goal: to generate an absolute return over time with little systematic or public equity market exposure.<sup>3</sup>*

This chapter will further define and describe hedge funds, provide historical context behind their rise to prominence, and discuss issues facing the industry and investors in the future.

## **HEDGE FUNDS IN THE SPOTLIGHT**

Hedge funds have become part of the collective consciousness not just because the media can easily exploit misinformation, but also because they have grown as an investment allocation in institutional portfolios. They now comprise a larger percentage of portfolio asset allocations and investment industry assets under management and influence most market trading activity.

### **Institutions Spur Hedge Fund Growth**

Foundations and endowments led institutions into investing in hedge funds in the mid to late 1990s. At the end of 1999 total hedge fund assets under management were estimated at \$450 billion.<sup>4</sup>

Writing *Foundation and Endowment Investing* in mid-2007, we said,

*The main reason hedge funds have received so much attention in recent years is their performance during the equity market downturn of 2000–02. At that point, ten-year average returns ending December 2006 beat both the US Public Equity (Russell 3000) and Bonds (Lehman Aggregate), by 200 and over 400 bps per annum, respectively.<sup>5</sup>*

Observing the success foundations and endowments experienced in hedge funds and the ability hedge funds had to perform in adverse market conditions, pension plans began allocating to hedge funds in greater numbers. Broader acceptance of hedge funds among institutions representing much larger pools of capital fueled the growth of hedge funds.

Greenwich Associates reported that by 2007 45 percent of all U.S. institutional investors had invested in hedge funds, accounting for 2.6 percent of total institutional assets and close to double the number reported two years earlier. European and Japanese institutions had embraced hedge funds even sooner than those in the United States, with U.K. and Canadian institutions lagging.

The velocity and size of the growth in assets meant that by mid-2008, \$2 trillion was estimated to be invested in over 10,000 hedge funds. At the end of 2008 hedge fund assets under management stood at approximately \$1.8 trillion.<sup>6</sup>

### **Hedge Funds Are Here to Stay**

In *Foundation and Endowment Investing*, we wrote, “Although many individual funds have underperformed, as a whole they (hedge funds) truly have provided an absolute return due to a neutral exposure to the equity market.”<sup>7</sup>

Despite the extreme market upheavals and hedge fund losses since then, that statement still largely captures the reasons why hedge funds have become so important and why investors want to understand them and learn how to invest in them.

More investors need to know about hedge funds, because more investors have either invested in them in some way—even if only through a company pension plan—or will decide to invest in them. Since hedge funds play such a large role in the markets, investors that have not or will not become hedge fund investors need to know how hedge funds impact their existing portfolio.

### **WHAT IS A HEDGE FUND?**

Hedge funds are almost easier to define by what they are not, rather than by what they are. Put another way, they are best defined at every level—from philosophy to legal structure—by what they are relative to traditional long-only investment strategies.

### **Philosophy**

Hedge funds differ from long-only strategies at the philosophical level in terms of their investment objective, manager’s skill, and approach to risk.

**Return Objectives** One way to compare long-only investment strategies to hedge funds is by their investment objective. Ironically, long-only strategies seek relative returns. They aim to perform better *relative to a benchmark*, usually within their own asset class. In a very simple example, a long-only strategy investing in U.S. equities is managed to perform better than the S&P 500. As a result, a long-only fund can lose money, but if it loses less money than the benchmark, then it still is considered to have outperformed. In that same example, if the S&P 500 drops 40 percent in one year, as it did in 2008, a long-only strategy that falls 38 percent in that same period has done well.

Hedge funds seek *absolute returns*. They aim to make money regardless of market conditions and to beat the risk-free rate.<sup>8</sup> Hedge funds balance profit seeking with loss avoiding by identifying and exploiting investment opportunities while managing risk to protect against the loss of principal.

**Manager Mindset** Hedge funds are considered skill-based strategies, meaning they depend on the skill of the individual manager to earn returns.<sup>9</sup> Because the managers tend to invest a significant amount of their own money in their funds, they have incentives to make profits and thus approach risk management much differently.

Investment professionals describe the differences in terms of alpha and beta. Beta is the return generated from the allocation to an asset class or exposure to a risk factor, which could be implemented passively, such as in an index. Beta is the return from the market. If the S&P 500 is up 10 percent in a year, an investment fund benchmarked against the S&P 500 that has returned 10 percent has delivered market beta. Alpha is the excess return generated by active investment managers above what could have been generated by investing in a passive exposure to a particular asset class.<sup>10</sup> Using the same example, if the investment fund had been up 12 percent when the S&P 500 had been up 10 percent, the 2 percent of excess return is considered alpha. Hedge fund managers focus on reducing beta and increasing alpha.

**Risk Management Approach** The difference in risk management philosophy between long-only and hedge fund strategies is, at the core, the purest definition of hedge funds. As stated previously, in trying to achieve absolute returns, hedge funds manage their portfolio to profit both when market conditions are good and when they are poor. They do not try to lose less money than everyone else during a downturn; they try not to lose money at all. They employ *hedging techniques*, typically pairing long and short positions against each other, in order to manage the risk in their portfolio. Hedge funds hedge.

Hedge fund managers care about total risk, or as described by Ineichen, “the probability of losing everything and being forced to work for a large organization again.” Long-only managers look at risk relative to their benchmark. An S&P 500 index fund is seen as without risk; taking action that deviates from the benchmark portfolio construction is seen as adding risk.

In an extreme example, if the S&P 500 somehow dropped to \$0.50, a long-only fund would not be taking risk if it continued to replicate the index portfolio construction. It would be taking active risk if it deviated from the benchmark construction, even if that action resulted in losing less money. If such calamitous conditions actually were occurring, a hedge fund manager would be actively buying, selling, and hedging the securities in the portfolio in an attempt to preserve capital if not earn a profit. In their approach to risk and its impact on performance, hedge fund managers hate to lose money, period, and focus on protecting the portfolio from downside risk. A long-only manager does not like or want to lose money, but if the fund loses less money than the benchmark, it has managed risk well.<sup>11</sup>

The approach to managing volatility, represented by the standard deviation of returns, is another important distinction between long-only and hedge fund risk management philosophies. Hedge funds focus on achieving risk-adjusted returns or getting the best performance possible relative to the amount of capital at risk. The Sharpe ratio measures risk-adjusted return.

$$\text{Sharpe Ratio} = \frac{\text{Performance} - \text{Risk Free Rate}}{\text{Standard Deviation}}$$

Managers strive to achieve a Sharpe ratio of 1 or better.

To give a very simple example, a long-only fund benchmarked against the S&P 500 will have the same level of volatility. If the volatility of the S&P 500 is 25 percent, so is the volatility of the fund. If that fund returns 15 percent on 25 percent volatility it will have a Sharpe ratio of 0.6. An equity long/short manager with the target return of 15 percent would use hedging techniques to attempt to limit the volatility of the portfolio to 12 to 15 percent for a Sharpe ratio between 1 and 1.25. In that scenario, the long-only fund has taken double the risk to get the same return. The hedge fund would have to return less than 7.2 percent to match the risk-adjusted return of the long-only fund. Over the long run the total compounded return is much better when risk-adjusted return is factored into portfolio performance.<sup>12</sup>

One of the great ironies of hedge funds versus long-only funds is that they are perceived as risky, yet hedge funds manage and control risk and deliver a less risky investment to their investors.

### Investment Structure and Techniques

The main area of difference between hedge funds and long-only funds is the structure of the investment vehicle and the types of investment techniques that hedge funds are allowed to employ within that structure

Almost any description of a hedge fund starts with the phrase “Hedge funds are an investment vehicle that. . . .” This description has more to do with the hedge fund legal structure than its investment techniques. A long-only fund is described as “a long-only fund.” Hedge funds and long-only funds are both investment vehicles. The hedge fund vehicle lacks constraints and gives the hedge fund manager more freedom.

Hedge fund managers can employ various specific, individual investment techniques that are more risky on their own. When employed incorrectly by less sophisticated investors, these techniques can be catastrophic to a portfolio. The ability to use these techniques is probably the source of the belief that hedge funds are extremely risky investments. The paradox is that some of these “risky” techniques allow hedge fund managers to reduce the risk in their portfolios.

The following list shows the key investment characteristics and specific investment techniques employed by hedge funds.

**Broad Mandate:** Hedge funds offer investors access to a wide variety of investment strategies and risk exposures not typically available through traditional investment classes and investment vehicles.

**Multiple Asset Classes:** Historically, hedge funds have focused on long and short investments in equities, fixed income securities, currencies, commodities, and their derivatives.

**Limited Risk Exposure:** Hedge funds are generally managed to limit exposure to broad market risk, unlike traditional funds, which typically are fully exposed to general movements in underlying stock or bond markets.

**Leverage:** Hedge funds are typically leveraged in that the value of the long positions may exceed, in certain circumstances substantially, the investor’s capital in the fund.

**Shorting:** Hedge funds have the ability to short securities, mainly stocks, in order to combine with long positions to hedge risk and to earn return.

**Uncorrelated:** While not an investment technique itself, by utilizing these various tactics, hedge fund returns are largely uncorrelated to other markets.

## **Regulation and Ownership**

Hedge funds are structured as private investment partnerships due to their regulatory and ownership statuses. Compared to long-only funds, particularly mutual funds companies, hedge funds are lightly regulated as it pertains to their investment mandates. The regulations imposed on hedge funds apply mostly to protect investors, such as minimum net worth requirements and forbidden marketing practices. The following lists important regulatory characteristics of hedge funds.

### **Regulatory-Related Characteristics**

- Funds are offered privately and not sold or available to the general public.
- Investors must be qualified:
  - High net worth individuals and institutions.
- Funds are not required to register as an investment company under relevant Investment Company Act laws.
- Funds can be domiciled offshore.

Hedge funds have an ownership and performance incentive structure rarely seen in other investment vehicles, even though investors find it to be one of the most important and appealing characteristics of hedge funds. They appreciate the structure and incentive culture, because it aligns the manager's financial interests with theirs. The most common ownership and fee structure characteristics<sup>13</sup> are highlighted in the following list.

### **Ownership Characteristics**

- Firms are professional investment management firms.
- Funds are structured as private partnerships.
- Managers typically own a large stake in the firm and serve as the fund's general partner.
- Fund managers and personnel invest a significant or meaningful portion of their liquid net worth in their own funds.
- Hedge funds receive a share of the fund's profits based on its investment performance.
- Funds give investors periodic, but usually restricted or somewhat limited rights to redeem.

The performance-based fee structure drives the ownership and incentive compensation practices of hedge funds. A long-only fund usually charges a straight management fee, typically a percentage of the underlying assets. Hedge fund managers impose a management fee and a performance fee, typically percentages known affectionately by the industry as "2 and 20."

In other words, hedge funds will charge a fee ranging from 1 percent to 2 percent for the assets under management and will then take 20 percent of the profits from the fund's return. Performance fees are usually paid on the amount of performance that has accrued in the one-year period following the investment. They are usually calculated against a "high-water mark," meaning that a manager must earn back any losses before it can take the performance payment. The sizeable performance fees make owning a hedge fund and sharing in its profits particularly lucrative. Unfortunately the challenge of earning back losses over a high-water mark frequently leads a manager to close shop and leave the investors high and dry instead.<sup>14</sup>

### **Asset Class or Investment Style?**

Investment professionals debate whether hedge funds are asset classes or not. The President's Working Group on Financial Markets (PWG) says no:

*Hedge funds are investment vehicles that allow investors to gain exposure to a wide range of investment strategies. They do not represent a single asset class but rather a type of investment vehicle.*<sup>15</sup>

On the other hand, Ineichen makes the case for classifying hedge funds as a separate asset class:

*Return, volatility, and correlation characteristics differ from those of other asset classes such as equities, bonds, commodities and natural resources, real estate, and private equity. In addition, it allows separation between liquid asset classes (e.g., equities and bonds) and less liquid asset classes (e.g., real estate, private equity).*

His strongest argument for treating hedge funds as a separate asset class is that doing so helps to calculate and demonstrate that adding hedge funds to a portfolio can increase its efficiency.<sup>16</sup>

At the same time, he says that it makes sense why some view hedge funds as simply a style of asset management.

*Absolute return managers are asset managers who define return and risk objectives differently but manage money by investing in traditional asset classes—equities, bonds, currencies, commodities, or derivatives thereof. They recruit staff from the same pool of talent as do other money managers and offer their products to the same client base.*<sup>17</sup>

Over time, this debate will most likely subside as institutions have begun to evolve their asset allocation approach toward treating hedge funds as an asset management style, not an asset class.<sup>18</sup>

### **Misunderstood No More**

Some individual hedge fund strategies are risky, mysterious, and complicated. Unfortunately, over the years that reputation has overshadowed all hedge funds and led qualified investors to miss out on the portfolio diversification and return enhancement benefits.

Simply, hedge funds are investment vehicles that seek to achieve absolute returns. The funds are managed by entrepreneurial investment professionals motivated by ownership of their firm and a share in lucrative performance fees. These managers rely on their investment and risk management skills and the broad investment mandate and tools of the hedge fund structure to create investment strategies that capitalize on opportunities in various markets while protecting capital. If done correctly, the hedge fund approach should result in positive performance, lower volatility, and little correlation to the markets. The broad investment mandate and the level of risk inherent in certain hedge fund investment techniques has caused regulators to restrict the pool of potential investors to wealthy individuals and institutions, because they are seen as being able to handle the risks. They invest in hedge funds because the ownership structure and 2 and 20 performance fee incentives align their interests with those of the manager. The risk-adjusted return profile and low correlation of hedge funds make them function in an investor's overall portfolio as a diversifying asset class.

Neichen claims that the hedged style of investing has been around since Joseph tried to buy his wife Rachel in biblical times. The relative return style of investing most investors know through long-only funds is a somewhat recent phenomenon that may be (or deserves to be) short-lived.<sup>19</sup>

In modern times the earliest hedge fund managers weren't so much mysterious as they were obscure. Alfred W. Jones gets most of the credit for creating the first modern hedge fund and for establishing the structures that remain in use today. He would probably be quite surprised at the reputation, size, and impact of the industry segment he originated. The next section chronicles the recent history of the hedge fund industry—dating back to Mr. Jones, not Joseph—to determine how and why the industry got where it is today.

### **ORIGINS AND HISTORY OF HEDGE FUNDS**

Most hedge fund experts trace the origins of the modern hedge fund to Alfred Winslow Jones (1900–1989) and the equity investment partnership he started in 1949. Using techniques such as leverage and short selling, Jones sought to maximize returns while minimizing market exposure by

taking both long and short positions in securities. He referred to it as a “hedged fund.”

An American born in Australia in 1900, Jones had an eclectic background. He graduated from Harvard in 1923, became a diplomat as Hitler rose to power in Berlin in the 1930s, and earned a doctorate in sociology from Columbia University in 1941, before becoming a journalist writing on nonfinancial topics for *Fortune* and *Time* magazines.

His experience researching and writing an article on stock market technical analysis entitled “Fashions in Forecasting” for the March 1949 issue of *Fortune* inspired him to become a professional investor. That year he formed the A. W. Jones & Co. general partnership with four friends. Jones contributed \$40,000 of the firm’s initial \$100,000 and saw his investment gain 17.3 percent in its first year.

Jones used leverage, to enhance return, and short selling, often in tandem. Believing stock selection drives return, he used short selling to capitalize on price drops in overvalued stocks and to control risks in the portfolio. Jones would tell other investors that questioned the use of short selling that he used “speculative techniques for conservative ends.”

Jones invested all of his own money in the partnership, because he thought investors should not be taking risks with their capital that he would not be willing to take, and thus aligned his capital and interests with those of his investors. When he converted the general partnership to a limited partnership in 1952, he added a 20 percent performance fee.

The first investment manager to combine the use of short selling and leverage in a portfolio, Jones also pioneered the concepts of aligning his interests with investors and sharing in profits from performance. He tended to leverage the portfolio 1.5 to 1 (\$1.5 invested for every \$1 in capital) and ran 110 percent in long positions and 40 percent in short positions. The equity long/short hedge funds of today barely deviate from that model.

In the early stages of their investment careers two investors with household names today, Warren Buffett and Barton Biggs, managed money using the Jones model. His investment style remained obscure, however, until *Fortune* magazine reappeared in his life, and made Jones the subject rather than the reporter of an article. In 1966, Carol Loomis (still a reporter for *Fortune* in 2009) wrote “The Jones Nobody Keeps Up With” for the April issue. In the article, she introduced Jones and what she called his “hedge fund” to the investment world. At the time Jones was outperforming the best performing mutual funds over a 5-year period by 44 percent and over a 10-year period by 87 percent, *after the 20 percent in fees was taken*. Readers did not care what the investment style was called; the spectacular performance inspired investment managers to launch hedge funds and by 1968, about 200 were operating.

Market downturns in 1969–1970 and 1973–1974 took a toll and most hedge funds failed. An estimated 30 funds with a total of \$300 million in capital existed by 1971. Managers began starting hedge funds again after 1974. Most were small private firms running equity long/short funds, what hedge fund investors today would probably call “two guys in a garage with a Bloomberg terminal.” By the end of the 1970s, approximately 100 hedge funds toiled in obscurity relative to the rest of the investment industry, but had numerous opportunities to exploit market inefficiencies.

During the 1980s the next wave of hedge funds came to the forefront, led by managers considered legends today, including Julian Robertson, George Soros, Michael Steinhardt, and Jack Nash. They made money in bull and bear markets, capturing the attention and assets of European investors. Another article about an individual hedge fund manager raised the industry’s profile again when Julie Rohrer profiled Julian Robertson for the May 1986 issue of *Institutional Investor*.

The bull market of the 1990s gave newly wealthy money managers and traders the impetus to leave larger firms to start their own hedge funds. Simultaneously, managers began starting hedge funds using new types of portfolio construction techniques or investing in markets that had not been used by hedge funds before. The type of hedge fund available became more diverse; previously about 90 percent of hedge funds were macro or equity long/short styles. With more types of strategies available, hedge funds became less correlated with each other, making it feasible for investors to combine individually risky hedge funds to create more risk-controlled portfolios.

Endowments and foundations then began investing in hedge funds even though they were still perceived as an unconventional investment. Hedge funds of funds began forming and growing, setting the stage for the influx of institutional investors that have made hedge funds the most prominent and influential form of investing today.<sup>20</sup>

Hedge funds have become a household word.

## **CONCLUSION**

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Investing in hedge fund strategies is no longer unconventional and is no longer the province of the superrich. Large pension plans invest in hedge funds, while absolute return mutual funds have come to market. Although hedge funds have grown in prominence and popularity with investors, hedge fund misinformation and misunderstanding has grown too.

The growth of hedge funds has created a more challenging investment environment for hedge fund investors and managers. This proved

particularly true in the market crises of 2008. But thinking about hedge funds over the long term, we stand by this statement in *Foundation and Endowment Investing*,

*Providing talented managers with a larger supply of capital helps make all markets more efficient, creating fewer security mispricings and arbitrage opportunities. Accordingly, future returns will likely be lower than they have been in the past.<sup>21</sup>*

Similarly, Ineichen says, “As the hedge fund industry matures, becomes institutionalized and mainstream, and eventually converges with the traditional asset management industry, this rent (return) will be gone.”<sup>22</sup>

Even so, hedge funds are a household word because they are here to stay. They became popular because absolute return investments can provide excellent, risk-adjusted return with low correlations to the markets and other funds. While the returns may be less attractive in the future, the role they play in diversifying investment portfolios will remain important. Investors will benefit from learning more about hedge funds and from getting insights and advice from accomplished hedge fund investors.

This chapter gave an overview of hedge funds, what they are, and how and why they have become important. The next chapter outlines the standard best practices for investing in hedge funds and will provide context for the advice from the subjects in Part Two.