Chapter One

What Is a Hedge Fund?

The Traditional Long-Only Portfolio versus the Alternative Hedge Fund Portfolio

Hedge funds are generally perceived to be the investment of choice of the rich and the informed, and they are more interesting and fun to discuss than your Vanguard index fund.

—Cliff Asness, AQR Capital Management

THE YEAR WAS 1989. I had just started working at Goldman Sachs in the world of investment banking—the industry adored by many Ivy League students and business school graduates. A few floors up, legendary research director Lee Cooperman was asked by Goldman Sachs to create a mutual fund and lead the Asset Management Division. This long-only equity mutual fund was called GS Capital Growth.

Although Cooperman was extremely successful at picking stocks and examining company income statements and balance sheets, he was intrigued by the opportunity of starting a hedge fund, as he saw its potential to profit from smart stock picking even if the market seemed overvalued at times. And so, he approached the head honchos at Goldman, trying to convince them to start a fund. At the time, they passed as they were concerned over the consequences of shorting the stock of one of their investment clients. After all, no investment bank would want to put a sell recommendation in writing for fear of losing its relationship with the companies it covered . . . especially when there were advisory fees on the line. The thought of shorting a client company's stock back then was unthinkable. For Lee Cooperman, however, his passion was managing the money not managing the business.

Shortly thereafter, he started Omega Advisors. While his fund has experienced some ups and downs, he has had a spectacular career replete with great performance for his clients. The fund's ability to hedge risks through shorting, options, and derivatives has allowed his portfolio to have lower volatility and higher returns than he could have achieved in a classic mutual fund.

So, why am I telling you this story? Well, on a simplistic level, a *Little Book of Hedge Funds* just wouldn't be complete without a few big stories from big personalities who have become hedge fund legends. In fact, that is exactly what the hedge fund industry has become—big! Its managers' personalities. Its successes. Its failures. Its mystique. Its impact on the global market. Granted, it is a small, young industry that is still undergoing a maturation process, but this is an evergreen industry that has a big impact on the market and investors.

Right now we are witnessing an explosion in the hedge fund industry similar to the one the mutual fund business experienced more than 50 years ago. We are witnessing a transition of assets—and while there is competition from mutual funds, hedge funds will be a continued source of power in the world of money management.

So, back to my original question—why am I telling you all of this? In order for you to understand the hedge fund industry—its impact on the market and your investments—you need to first understand this alternative investing tool and how it differs from traditional asset classes such as mutual funds.

Although mutual funds are similar to hedge funds in that they are both pooled investment vehicles that invest in publicly traded securities in order to generate a positive return, there are a number of differences between these two fraternal twins. In this chapter, we will explore these differences. In doing so, we will gain a better understanding of the true meaning of a hedge fund so that you can better ascertain if it is an appropriate investment vehicle for your portfolio, while also helping you get a better sense of its impact on the overall market.

Comparing Apples to Oranges

Just ask any identical—or even fraternal—twin and they will tell you that their life has been full of constant comparisons and tradeoffs. Which twin is better looking? Smarter? More outgoing? More athletic? Better with numbers? Makes more money? Has the better education? You get the gist. Similarly, the financial world is riddled with unbalanced comparisons of financial products that render investors bewildered and uncertain. A frequent source of such comparison often involves mutual funds vs. hedge funds.

Mutual funds are the propeller plane, while hedge funds are the fighter jets. Mutual funds are the general practitioners in medicine, while hedge funds are the surgeons—generally the neuro kind. Mutual funds are the Breyer's Vanilla Bean, while hedge funds are Ben & Jerry's Cherry Garcia. Mutual funds are Guy Lombardo on New Year's Eve, while hedge funds are Mayor Mike Bloomberg dancing with (and kissing) Lady Gaga. Mutual funds are Rodney

Dangerfield, while hedge funds are Jon Stewart. Mutual funds are Berlin with the Wall, while hedge funds are Berlin with all the swank art galleries.

Have I satisfactorily crushed the mutual fund industry? I wasn't trying to. As your hedge fund muse, I was just trying to help you see that the mutual fund industry has matured and become prosaic, while the hedge fund industry has become cutting edge. But, let's base this comparison on facts not playful analogies. Let's start by comparing some definitions and performance, shall we?

According to the Securities and Exchange Commission, a mutual fund is a professionally managed investment company that invests clients' money in stocks, bonds, money market instruments, and cash. Although many brokerage houses would have an investor believe that this portfolio is composed of a wide set of subcategories including large-cap growth stocks, large-cap value stocks, municipal bonds, treasury bonds, and so on, most plain-old-vanilla portfolios are simply made up of stocks and bonds. And, as the old investment cliché goes, to figure out the exact allocation between these two birds, an investor should simply subtract his age from 100 to figure out what percentage he should allocate to stocks and then put the rest in bonds.

Now anyone who wasn't living under a rock during the fall of 2008 can certainly tell you how this long-only allocation can play out under adverse market conditions. While this blend of traditional assets may be a winning strategy during periods of steady and stable growth, it has been quite a disaster in the last decade. Consequently, it has caused many an investor to reevaluate his long-only cookie-cutter portfolio construction and rethink his portfolio mix.

That's where hedge funds—I mean the hedge fund comparison—come in. As we learned in the Introduction, a hedge fund is an alternative investment vehicle that seeks to produce absolute returns by utilizing a wide range of traditional and untraditional investment strategies that exploit market opportunities while protecting principal, preserving capital, and maximizing returns. These private investment pools are actively run by managers who typically invest their own money in the fund and receive a 20 percent performance fee. Although many hedge fund managers hold a diverse portfolio of stocks, bonds, and alternative investments, the typical allocation varies by manager and his investment strategy. In other words, hedge fund managers are less interested in a pie chart that divvies up a portfolio by offsetting slices; rather, they are interested in exploiting market anomalies and gaining an informational edge through a dizzying array of investment and trading strategies.

While I am not naïve enough to suggest that hedge funds performed well during the financial crisis, they did far less damage than a traditional stocks-and-bonds portfolio. In 2008, the hedge fund industry was down an average of 22 percent, which is much better than the market, which was down approximately 55 percent. Furthermore, according to Hedge Fund Research, an investor who put $1,000 in hedge funds at the beginning of 2001 would have $1,418.89 at the end of 2010 (inclusive of all fees and taxes). One who put $1,000 in the Standard & Poor's 500 in 2001 would have just $920.67 at the end of 2010.

As Ronald Reagan once said, "Facts are troubling things, they don't lie and are irrefutable." Hedge funds are products that, for the most part, have performed well in down or choppy markets. If you want to make money for yourself in the future and also find ways to potentially lose less money, then you need to spend the time to learn about the differences of hedge funds versus mutual funds.

Regulation . . . or Lack Thereof

According to the SEC report, "Hedging Your Bets: A Heads Up on Hedge Funds," the key difference between mutual funds and hedge funds relates to regulation—or lack thereof:

> Unlike mutual funds, hedge fund are not registered with the SEC. . . . In addition, many hedge

fund managers are not required to register with the SEC and therefore are not subject to regular SEC oversight. Because of this lack of regulatory oversight, hedge funds historically have been available to accredited investors and large institutions, and have limited investors through high investment minimums (e.g., $1 million).

Mutual funds are tightly regulated by the Investment Company Act of 1940, which requires them to invest in publicly traded securities according to their stated investment objectives. Some of the requirements imposed by regulators include releasing their holdings and performance to the general public, providing daily liquidity, valuing shares accurately and daily, and providing investors with a prospectus prior to investing.

Conversely, hedge funds are loosely regulated and currently do not have to register with the SEC or the Commodity Futures Trading Commission. And, let's face it, registration doesn't mean a hell of a lot these days considering that Bernard L. Madoff Investment Securities LLC was once registered with the SEC. (Allow me a quick soapbox moment: Although the media tag Madoff as a hedge fund guy, the irony was that he wasn't running a mutual fund or a hedge fund; he was running a separate account business that made tons of money and thousands of clients bucketed him in the world of alternatives. Regulation never stopped Madoff . . . the recession did.)

The regulations imposed upon hedge funds include the following:

- *Type of Investor*: As mentioned previously, hedge funds are only accessible to "accredited" individuals and institutions that meet specified criteria, which was updated in the summer of 2010. (We will discuss these criteria in Chapter 3.)
- *Number of Investors*: In addition, they are required to have no more than 500 limited partners invest in the fund.
- *Advertising*: No solicitation of clients through traditional forms of marketing and advertising. In taking a "fair and balanced" approach to any dissemination of information, a hedge fund must be certain to tread water carefully so as to get its message out while adhering to regulatory provisions.

At some point in the not-too-distant future regulators will find a way to more closely monitor the hedge fund space. In my opinion, this will not impair the ambidexterity of the industry or its respective investment process; rather, it will provide the necessary transparency and disclosures to protect investors.

Size: The Achilles' Heel

Hedge funds and mutual funds differ quite considerably in the amount of assets they manage. According to Daniel Stratchman, author of *Getting Started in Hedge Funds*, the largest hedge fund has more than $120 billion in assets under management, while the largest mutual fund complex has more than $2.7 trillion in assets under management. And yet, this is a quite misleading number as there are numerous hedge funds with less than $10 million in assets under management!

Hedge funds are not able to aggregate capital in the same way as some of the largest mutual funds. If anything, they will get bigger due to performance and organic growth, but they will never be able to remain true to total return objectives if they overscale as their growth depends on their ability to be nimble and dynamic.

What are the implications of this finding on the global market? As hedge funds are smaller than mutual funds and large banks, their investments have less of a direct impact on the overall move of the market. Moreover, as "small enough to fail" institutions, a hedge fund blowup generally does not require government intervention and taxpayer dollars, whereas "too big to fail" banks require such intervention.

That being said, the tremendous growth in the hedge fund industry—which has slowed down a bit since the

2007 to 2009 economic crisis—has often been described as the Achilles' heel for many funds and their bottom lines. Why? More funds equals an increasing amount of hedge fund dollars crowding similar trades and utilizing similar strategies, which equals diminished ability to execute trade and increase performance.

Think of it this way: Elephants don't fit in small bathtubs, but then again they don't get all of the extra pampering, either. Hedge fund managers need to be big enough to scale a disciplined and deep research and investment process but not so big that they deliver diluted returns.

Manager Fee: The Infamous Two-and-Twenty

Perhaps the most discussed difference between mutual funds and hedge funds is the fee and reward structure. Traditional investment funds—or those that generally invest in the stock and bond market—earn a fixed percentage of the assets they manage, passing along gains or losses to their investors. This investment management fee is equal to approximately 1 to 1.75 percent of assets under management.

Whereas mutual funds tend to only charge one fee that is based on assets under management, hedge funds demand two fees—an investment management fee of 1 to 2 percent of assets under management *plus* the performance fee of 20 percent of the profits earned. Often referred to as "two and twenty," a hedge fund manager's fee is directly correlated to his fund's performance. This linking of compensation to investment performance has both positive and negative effects on the industry—both in terms of its performance and perception.

On a positive note, performance-related incentive fees (as well as fixed fees) tend to attract more skilled, talented, and entrepreneurial professionals to the industry, which in turn, is said to be one of the main drivers of high returns. Makes sense to me. After all, it is not completely out of the realm to think that an incentivized fee structure with the opportunity for high rewards would attract top-level talent who have the self-confidence to make contrarian decisions. Just look at the New York Yankees!

On the other hand, critics argue that these asymmetrical and high fees harm investors in the long run. Once described as a "compensation scheme dressed up as an asset class," hedge funds do not usually require that managers give back a fee to the investor if the fund loses money. Conversely, mutual fund gains and losses must have a symmetrical effect, that is, the fee for the manager is the same regardless of the amount of over- or underperformance relative to a benchmark.

This incentivized fee structure has also caused quite a stir in the industry as critics claim it leads to excessive risk taking. And yet, the 2007 to 2009 economic crisis proved otherwise. As the reward structure of large banks is closely tied to the performance of the entire bank itself, critics of traditional investing claim that bankers may take unnecessary risk so as to achieve glamorous profits that will garner attention from upper-level management, which determines their bonuses. This compensation structure ultimately damages financial stability because it ties a shareholder's earnings to the performance of the entire bank.

In addition to the fee structure, hedge fund managers generally have their own capital in the fund, which theoretically aligns the manager's and investor's interests. According to Yale University endowment guru David Swensen, this arrangement puts greater emphasis on generating superior investment returns while protecting the risk of loss of principal. He says, "The idea that a fund manager believes strongly enough in the investment product to put a substantial personal stake in the fund suggests that the manager shares the investor's orientation."[1]

Although mutual funds and hedge funds are managed by professionals who make investment decisions on behalf of their clients, the fact that hedge fund managers often put their own money into their fund incentivizes them to protect their wealth as well as their income, which is riding on their performance. In having their skin in the game and in putting their money where their mouth is, they are further incentivized to ensure that their portfolios achieve positive returns.

As you can imagine, there are various pros and cons to this fee structure, which we will discuss further in Chapter 4.

Investment Strategies: The Long and the Short of It

As an alternative investment, hedge funds are able to operate in almost any type of market and use almost any type of investment strategy. Although the *New York Times* once referred to hedge funds' use of these instruments as "exotic and risky," it should be noted that most financial institutions use these "exotic" instruments . . . albeit in different capacities.

Short Selling

Generally, mutual fund managers are only able to hold "long" positions—in other words, they buy a security, such as a stock, bond, or any other money-market instrument, with the expectation that the asset will appreciate in value. They load up on "hot" stocks when the market is expected to go up and then sell these hot stocks when the market is expected to go down. Under this umbrella, investors usually shop a 60/40 portfolio—60 percent in stocks and 40 percent in bonds.

On the other hand, hedge fund managers are able to employ a diverse range of investing strategies that literally enable them to *hedge* their bets—hedging their investments to increase gains and offset losses. Similar to an insurance policy, these investment techniques are designed to prevent losses when another investment falls in price. (In 2008, however, what we learned is that despite past history most asset classes displayed high correlation. They all went down with few exceptions—cash and U.S. Treasuries.)

Although hedge fund managers also hold long positions in their portfolio, they are able to both **long** and **short** the market in order to generate positive performance and reduce risk.

Here's how this works: Managers split securities into two buckets—securities that they think will *rise* faster than the market and securities that they think will *fall* faster than the market. Then they take *long* positions in the first bucket (the risers) and *short* positions in the second bucket (the fallers). This enables hedge fund managers to neutralize market risk, take advantage of turbulent market conditions, and ensure that they'll make money whether the market goes up or down. Or, as hedge fund founder A.W. Jones says, "shorting enables you [to] buy more good stocks without taking as much risk as someone who merely bought."

Sounds simple . . . but it is quite the contrary. Playing the long/short game can be quite complicated. In order to short stocks or other securities managers need to be able to set up margin accounts. In other words, they must use **leverage**—that is, they must borrow money—to make more money and amplify the returns. Sound risky? It is . . . but we'll get to that in a minute. Right now, let's get back to the heart of the matter—shorting a stock. Here's how it works.

How to Short a Stock

Step 1: The hedge fund manager identifies a position that he thinks is overvalued in the marketplace—this finding is based upon a thorough analysis of the company's fundamentals and/or technical analysis. Alternatively, managers may get intel on the potential short position from their respective prime brokers.

Step 2: The manager borrows the stock from the prime broker and sells it into the market. (There used to be an uptick rule, meaning you could only short stock on a price uptick, but not any longer. Many people believe that this rule should be reinstated, but until it is, you can sell the stock right into the market.)

Step 3: If the manager is correct—as David Einhorn was about Lehman Brothers in 2008 and currently is with Green Mountain Roasters—that the fundamentals of the company are flawed and the stock is overvalued, there will be a steep drop in the value of the stock.

Step 4: The manager goes back into the market and buys back the stock at the lower price and returns the stock to the borrowing source.

Step 5: The manager pockets the profit, less the loan amount paid for the "borrow."

If the manager is incorrect and the stock rallies at some point, he will have to buy it back and he still pays the borrowing fee and loses money on the reversal. A massive buying panic is sometimes known as a "short squeeze." This occurs when there is positive news on a name that lots of hedgies are shorting; many of them will step into the market and buy the stock to effectively get out of the way.

How does this practice compare to the conventional mutual fund operating principles? Let's compare, shall we?

Imagine you are the Warren Buffett of stock picking—you are extremely gifted at selecting the best stocks and have a keen understanding of market conditions. And, as luck would have it, you were just given $100,000 to invest.

Let's say that you believe the price of GothamDay is overvalued at $100 a share (don't even bother looking up that fictitious stock—do you really think my compliance team would let me publish any actual stock advice?). In knowing that GothamDay has poor fundamentals you believe that the stock will fall. So, you borrow 100 shares of GothamDay from your prime broker and sell them for $10,000. A few months later, the price of the stock falls to $50. You buy the 100 shares back for $50 a share or $5,000, return them to your broker and pocket the difference—$5,000.

Sounds simple. Hardly. Shorting is hard. The fact is most managers don't do it well. It is a complicated mix of assessing fundamentals, understanding momentum and market psychology, being able to handle pressure, and having a sense of timing. It is almost like having to learn all of the fundamentals of investing by reading a textbook that you are holding up to a mirror—everything is backwards! Ever drive 65 miles an hour in reverse on a freeway? Didn't think so.

And, of course, this strategy only works if the manager is a skillful stock selector. What if your gamble didn't pay off? What if GothamDay produces a new product that rivals the iPhone and suddenly the stock rises to $250 a share? Ring ring—it's your broker calling and he wants his shares back . . . now! So, you have to buy the 100 shares you borrowed for $25,000, resulting in a $15,000 loss (plus broker fees). Ouch!

In sum, the ability to short gives hedge funds a sizable advantage over mutual funds as it enables a manager to potentially achieve higher returns while assuming less risk regardless of market conditions. In offsetting one's long positions through short positions (thinking = hedging), a manager decreases his net exposure to the market and consequently assumes less market risk. But, be careful, as shorting takes no prisoners.

Leverage

As you can see from the previous examples, a critical investing tool used among many hedge funds is leverage. According to the SEC, "many hedge funds seek to profit from all kinds of markets by pursuing leveraging and other speculative investment practices that may increase the risk of investment loss." Whereas a traditional mutual fund manager would only be able to invest with the endowment he receives, a hedge fund manager is able to use leverage to increase his endowment and increase or broaden his investments. Specifically, managers are able to borrow money from their prime brokers and use it to expand their portfolios so that their long positions and short positions are often augmented by borrowings. In other words, they are able to borrow money to make money (or lose money if they are wrong).

Again, let's say you were given $100,000 to invest. Here's how the scenario would work out with and without our good ole friend leverage:

- *Long-Only Investor*: As a traditional investor, you would put $60,000 in stocks and $40,000 in bonds. Cut-and-dried.
- *Short-Selling Investor*: In an effort to hedge your portfolio, you borrow $100,000 so that you increase your kitty to $200,000. This leverage enables the manager to buy $140,000 worth of good stocks while shorting $60,000 worth of bad stocks, thus giving him more money to play with so he can better diversify his portfolio. As a result, the hedge fund manager incurs less stock-selection risk and less market risk.

But, leverage can be a fickle bitch . . . just ask Long-Term Capital Management. As Warren Buffett says, "When you combine ignorance and leverage, you get some pretty interesting results." Leverage can be tricky as it bears various levels of risk—counter party risk and market risk. I compare this alternative investment tool to a very sharp knife coming out of the steering wheel of your sports car; it can point at your heart as you are traveling downhill on an icy mountain road. In other words, when you need leverage least, it can hurt you the most.

As a matter of policy, I disdain heavy leverage as it wipes out your ability to be anything less than certain. Any slight miscalculation or exogenous unpredictable market event can permanently impair the capital in your portfolio. It's sort of like the Wolf and the Three Little Pigs. No matter how brick house your conviction and analysis is, leverage can turn your portfolio into a straw house, and any slight wind can take that house down.

That being said, there are managers who know how to use leverage judiciously and with the right risk management and downside protection, the tool of leverage can be effective at enhancing returns.

Derivatives

Along the quest in the hedge fund crusade to mitigate risk and preserve capital, hedge funds also use fancy-pants derivatives, which are contracts between two or more parties where the price of the security is "derived" from one or more underlying assets. Derivatives make it possible to precisely target risk and reward. A stock option is an example of the classic derivative where one can enter into a contract with another based upon the price of a stock. A call option means that someone is betting that a stock is going up. A put option means someone is betting the stock is going down. Of course, their counter party is betting the opposite; this difference in opinion is what makes the market.

Some critics—including the Oracle of Omaha—have coined derivatives as weapons of mass destruction in the market . . . and for good reason. Back in 2008, AIG almost brought the world to its knees by not having enough capital on hand to make good on Lehman credit default swaps (CDSs), which are basically contracts that allow the buyer to buy insurance on a potential debt default. In other words, if I am worried that Lehman is going out of business I can buy CDSs on Lehman's debt. The contractor must then pay to make that debt whole in the event of a default. Guess what? AIG was selling this derivative but couldn't back it up in the event it ended up on the wrong side of the trade. AIG was like a bookie making a bet without having the dough on hand if the 60 to 1 long-shot came in and won. That would have been a financial market Armageddon had the government not stepped in and loaned AIG $85 billion to clear and make good on those contracts.

Liquidity: Swimming in Pools of Money

My grandfather used to say that "if you can't afford the price of the ticket, then don't go to the movies." The same can be said about liquidity, which is defined by Investopedia as the degree to which a security can be bought or sold in the market without affecting the security's price. This is where mutual funds have a significant advantage.

Mutual funds allow investors to place sell orders and remove funds on a daily basis. And when they say the check is in the mail . . . it literally is—within a week or less! They have a per-share price (called a net asset value) that is calculated each day, so you could sell your shares at any time. The reason for this high level of liquidity is attributed to the types of investments they hold. And, consequently, it defines the purpose of a mutual fund as a vehicle that generates asset inflows from investors rather than one that generates the highest level of performance possible.

As hedge funds seek to generate returns over a specific period of time they are typically not as liquid as mutual funds. (Ironically, hedge funds are able to engage in shorting because of their supply of liquidity or cash.) Critics of hedge funds argue that they use this slow-and-steady-wins-the-race mantra to justify "lockup periods"—which are periods of time during which investors cannot remove their money. They can be quarterly, biannual, or annual; they are rarely monthly and never daily. Although investors can withdraw their investments sooner, they can only do so at a price—a redemption fee.

Although certain hedge funds and funds of hedge funds—such as SkyBridge Capital—have developed products that have shorter lockup periods, many funds require long lockup periods. As such, people need to be careful about the percentage they allocate to hedge funds in their portfolio.

Over the course of my 25-plus-year career, one thing that I've learned is that a lot of people think they are long-term investors, until they have short-term losses. Know thy investing self. If you don't have a long-term investment plan, don't lock up your money.

So, Do They Actually Hedge?

Today the use of the word *hedge* when describing a hedge fund can be considered a misnomer. The reality is this: Many hedge funds do not hedge risk. If they did, there would be no return. Instead, hedge funds seek to hedge *certain* types of market risk while simultaneously exposing themselves to risk where they expect a reward from bearing the risk. As a result, their key priorities are to make consistent and stable returns over an established period of time.

The Proof Is in the Pudding

Mutual fund? Or hedge fund? What's an investor to do? Sure, he could just move to cash, but what's the satisfaction in that? It tastes sour; is less filling; and is less diverse.

Given the current state of the market, I recommend that all institutional, wealthy, and retail investors have hedge fund exposure. As evidenced by the preceding laundry list, the varying elements of hedge funds enable these investors to better diversify their portfolios so that over time they can better reduce risk, preserve capital, and reap healthy returns. Furthermore, the environment is ripe for an investment vehicle that has a well-rounded arsenal of tools, which pounce on market inefficiencies and give investors an edge in their portfolio construction. True, they may appear riskier than traditional vanilla mutual funds, but many of them are actually less risky and provide better returns.

That being said, hedge funds are not for everyone nor are they a substitute for other investment vehicles. For many people, mutual funds—with a swirl of alternative asset or hedge fund exposure—are probably the best option. It isn't a one-size-fits-all sort of approach; however, a portfolio of hedge fund portfolios can be sleeved into most investors' tactical asset allocation.

A word of warning: Before anyone invests in this industry, they must heed this surgeon general's warning—investing without proper due diligence or proper personal risk assessment can be bad for your mental and financial health. Do your homework. Be prepared. Have a proper screen. Research. Research. Research.

So, let's find out just who can invest in these enigmatic and stealth investment vehicles and how every dentist in the United States can get in the game.

In the Words of a Hedge Fund Legend . . .

Leon G. Cooperman, Chairman, Omega Advisors Inc.

1. **How would you define a hedge fund?**

   A hedge fund is defined by a few distinct characteristics:

   a. Fee Structure where Managers Receive a Percentage of the Profits plus a Management Fee
   b. Long and Short Investing Strategy
   c. Multi-Asset Class Portfolio Construction
   d. Large co-investment by general partner leading to a complete alignment of interest

2. **How or why did you get started in the industry?**

   I worked at Goldman Sachs for approximately 25 years starting in 1967 and was elected to the partnership at the end of 1976. My principal roles at the firm were Partner in Charge of Research, Chairman of the Investment Policy Committee and in 1989 I started Goldman Sachs Asset Management. I retired from the firm at the end of 1991 to start Omega Advisors. At that time Goldman Sachs was reluctant to have a hedge fund as part of its product line and, since this was my passion, I decided to retire from the firm to pursue a new career path. To this day

I have maintained a great relationship with my colleagues at Goldman and have an extremely high regard for the firm. I am proud to say Omega Advisors is an investment option for their employees' retirement funds.

3. **What hedge fund strategies do you use?**

   At Omega we try to make money for our clients in five ways:

   a. Stocks are high risk financial assets and short-term bonds and cash are low risk, so we spend a good amount of time at the firm trying to figure out stock market direction, (e.g., are stocks undervalued going up or overvalued going down?). Let's face it, a rising tide lifts all the ships and a receding tide lowers them. Our view of the investment outlook importantly dictates our risk asset exposure.

   b. All the studies I have read regarding portfolio returns indicate that in any one year, more important than individual stock selection, is being in the right asset class. So we spend a great deal of time studying and assessing indicated and expected returns for stocks compared to bonds and in various classes of bonds, (e.g., high yield, investment grade and government). We do this globally. In essence, we are looking for the straw hat in the winter. People don't buy straw hats in the winter when they tend to be on sale.

c. Our most important activity is seeking and finding undervalued equities, mainly in developed countries.

d. Shorting overvalued stocks again in developed countries.

e. An occasional macro trade which would include currency, bonds, commodities and the major equity indices away from the S&P 500.

4. **What do you see as the future of the industry?**

The hedge fund industry is a cyclical growth business. I would guess that in 1968 the aggregate assets of hedge fund managers were less than $1 billion, with the largest fund being A.W. Jones & Co. with modestly over $200 million. Today, assets in the hedge fund industry exceed $1 trillion and these assets are managed by approximately 10,000 hedge funds with the largest being over $100 billion. If that isn't growth then I don't know growth.

I believe this growth will continue and that the incentive fee structure will continue to attract top-caliber talent. As long as hedge funds continue to generate superior returns, they will continue to attract superior talent, cash, and attention. After all, money goes where money is treated best.