CHAPTER 1

Hedge Fund History

"History doesn't repeat itself, but it does rhyme."

Mark Twain

I recently read an article printed in the financial press that questioned the viability of hedge funds as an asset class. Following the bear market decline and the corresponding volatile market environment, the article suggested that investors had begun to question whether or not hedge funds actually hedge and whether or not the asset class was doomed. Managers responded that it had become too hard to find profitable shorts, as all the best shorts quickly become crowded trades—which can lead to short squeezes.

The author of the article suggested that many hedge fund managers had become overconfident going into the market decline and had begun to invest outside of their core mandates and, even worse, did not do a good job of matching the liquidity of their fund's underlying investments with that of their underlying investors. As a result, some hedge fund investors are still waiting to receive redemption proceeds.

Additionally, the article highlighted that the SEC is tracking hedge funds more closely and that they are currently determining how to best regulate them.

What is most striking about the article (titled "Hard Times Come to the Hedge Funds") is that it was written by Carol Loomis and was published by *Fortune* magazine in June 1970.[1] The bear market referred to in the article occurred the previous year and had a disastrous impact on the hedge fund industry. Many hedge funds shut down and the asset class went into a dark period that lasted nearly two decades. I suggest that readers interested in hedge fund history read this article in its entirety because it provides perspective on hedge fund history and clearly shows that no matter how much things change and progress, history is likely to repeat itself (or at least rhyme).

SO WHO INVENTED THE HEDGE FUND?

The hedge fund industry is generally linked historically to Alfred Winslow Jones, who created the basic format for the hedge fund—which still exists to this day. However, a number of other early pioneers had invested with an absolute return methodology long before Jones entered the investment business.

THE SAMURAI

It has been suggested[2] that the world's first commodity trading advisor (CTA) or macro fund was created and managed to great success in the mid- to late 1700s in Japan. During the Tokugawa shogunate (1615 to 1867) Japan changed from many separate provinces to a single unified country. This had a positive impact on commerce and the nation's official marketplace for rice, which effectively was the currency in Japan, formed in Osaka due to its favorable location near the sea. The Dojima Rice Exchange was officially set up in the late 1600s and initially dealt only in the physical purchase and sale of rice. However, as rice became big business, more and more rice farmers and merchants began to sell "coupons" against the future delivery of rice. These coupons became actively traded because they provided buyers and sellers the ability to effectively go *long* or *short* various grades of rice at different delivery dates in the future. This market is generally considered to be the world's first futures exchange.

Munehisa Honma was born in 1724 into a wealthy merchant family in Sakata. He took over the family business in 1750, and his talent and skill as a trader has since become the stuff of legend. His first innovation was to study years' worth of price, weather, and crop data (it is rumored that he analyzed hundreds of years' worth of data) and to make forecasts of rice production and quality based on changes in weather and other seasonal effects. By reviewing the historical price movements and plotting them against other factors, he was able to anticipate when rice harvests would be strong and when they would be weak—and trade using that information. This combination of historical technical data combined with fundamental information gave him a genuine edge over his trading competition. This is a concept that we now take for granted, but back then no one else had thought to do it.

In addition, he devised a system of early price discovery. As most rice trading was done in Osaka and he was situated in Sakata (a considerable distance away), he developed an ingenious signaling system by positioning people on rooftops at regular intervals across the distance between the two cities. Once the official price was determined in Osaka, the first team member would signal the next team member using flags. This person would

then signal the next in line until the message was received back home; not quite real-time quotes, but this innovation allowed for quicker price discovery. With this information in hand long before other traders in Sakata had access to it, Honma was able to gain a significant advantage over his peers (what we would today refer to as "low latency" trading).

Honma did not run a hedge fund as we define them today, but he certainly embraced the spirit of absolute return investing. He looked to make money by investing both long and short and developed ingenious methods that gave him a clear edge over his competition.

He was so successful as a trader he eventually became a financial consultant to the Japanese government and later was given the honorary title of samurai. He authored a book colorfully titled *Fountain of Gold: The Three Monkey Record of Money*.[3] This work is credited with being one of the first investment books that focused on market and investor psychology. In his book, Honma posited that there was a clear link between supply and demand (in rice markets) but determined that investor perception and sentiment could cause temporary dislocations that an astute trader could take advantage of. He is also credited with developing many of the principles of what we now refer to as contrarian investing and reversion to the mean. In his book, he suggests that when markets are oversold there may exist a buying opportunity and vice versa. He also employed a more philosophical approach to investing, describing the rotation of the markets as yin (a bear market) and yang (a bull market).

Many of his technical and charting techniques became the basis for what is now referred to as Japanese candlestick charting, which is still used to this day (largely in Japan).

Monehisa Honma's Innovations:

- Using past price history to develop expectations for the future
- Employing charts and graphs to quickly and efficiently see potential opportunities—the precursor to candlestick charting techniques
- Realizing a method of early price discovery (flag communication system)
- Early work relating to behavioral finance

THE ACADEMIC

In 1931, Karl Karsten published a significant but largely unheralded work titled *Scientific Forecasting*.[4] While most people have never heard of this book, it contains some of the most important early work on absolute return investing ever documented.[5] The book details eight years of statistical analysis that his firm, the Karsten Statistical Laboratory, performed to develop an automated system designed to gauge the state of the economy and stock

market. Their objective was to determine if they could develop a systematic method of beating the market using publicly available information.

Karsten and his team reviewed a variety of "economic conditions," or what we would now refer to as economic/market indicators, to determine which data series had a statistically significant impact on the subsequent return of the equity market. He ultimately determined that thirteen indicators passed their tests. He broke the indicators into two main categories: (1) broad market and (2) industry specific.

Economic/Broad Market Indicators	Industry-Specific Indicators
The wholesale commodity price level	The building trades industry
The bond market	The automobile industry
The stock market	The petroleum industry
The short-term money rate	The iron and steel industry
The long-term money rate	The railroads
General business activity	The public utilities
	The chain stores

Not being financial experts themselves, Karsten and his team started the analytical process by holding conferences with experts in each field specified in the thirteen indicators and then tested a number of data series to determine their relative importance and the degree of influence that they had during the period studied. They looked at each time series over their respective histories but also recognized that recent history might be more relevant, so they reran the statistical work to look at the impact from recent periods as well as the overall time frame.

Some of the thirteen indicators were measured by a single factor or data series while others represented a combination of several. The complete list of underlying factors used to determine and track the indicators follows.

Data Series Used to Determine Barometers

Bank debits in New York City	Commercial paper rates
Bank debits outside of New York City	Bond price average
Gold movement	Stock price index
Freight car surplus or shortage	Wholesale price index
Unfilled steel orders	Farm products price index
Electrical power sales	Railroad gross earnings
Building contracts rewarded	Shares traded
Pig iron furnaces in blast	Gasoline consumption
Automobile production	Lubricating oil production
Call-loan interest rates	

Karsten divided these factors into three main categories:

1. Financial conditions
2. Speculative conditions
3. Business conditions

Some of these factors were thought to be leading and lagging indicators so they created various statistical combinations with different time leads and lags.

The results of their labor (remember that all of the regressions and correlation analyses were computed by hand) was the development of six "barometers" that Karsten believed would help to forecast stock price movements.

Karsten's Six Barometers:

1. Volume of trade
2. Building activity
3. Interest rates
4. Bond price level
5. Wholesale price level
6. Stock of leading industries (railroads, public utilities, steel, oil, automotive, and store stocks)

Karsten then tested his work by creating a paper portfolio. In creating the model for this portfolio, he foreshadowed several methods, techniques, and concepts that would not become commonplace on Wall Street for several decades. Among them, he wrote that diversification is the key to successful investing.

> *It would seem the part of caution to divide the risks as much as possible, not to stake everything upon any single operation or bet.*[6]

In addition, he also seemed to recognize that some stocks and groups of stocks exhibited greater returns than the market as a whole and, as such, it would be fruitful to buy the most attractive candidates and sell short an equal dollar amount of the stocks in the market (meaning go short the market index), as this would provide an opportunity to profit regardless of market gyrations and isolate the effectiveness of the underlying signals. He essentially formed the basis for market or dollar-neutral investing and the concept of alpha investing or absolute returns.

Ultimately, Karsten created a strategy that divided the equity market into six sectors (rails, utilities, steels, motors, stores, and oils) and applied each of the six barometers to each sector to create a single ranking for each sector from most attractive to least attractive. After a great deal of testing, they determined that buying a fixed dollar amount of the two most attractive sectors and simultaneously selling short an equal dollar amount of the least attractive two sectors would allow them to profit regardless of the direction of the market.

Their statistical work indicated that they did not have to buy all the stocks in each group; concluding that a basket of the largest stocks in each sector would effectively provide the same return as a basket consisting of all the underlying names in that group in the marketplace. The selected names were weighted according to their market capitalization. The holdings within each group are highlighted as follows:

Rails (basket represented 54 percent of the total market cap within the sector):

Company Name	% Held in Basket
Pennsylvania	24
New York Central	20
Atch. Top. & S. Fe	13
Union Pacific	12
Southern Pacific	10
Baltimore & Ohio	7
Chesapeake & Ohio	7
Norfolk & Western	7

Utilities (basket represented 70 percent of the sector's total market cap within the sector):

Company Name	% Held in Basket
Amer. Tel. & Tel.	37
Consolidated Gas	15
Columbia Gas & Electric	10
Electric Bond & Sh.	10
United Gas & Imp.	10
North American	8
Pacific Gas & Electric	5
United Corp.	5

Steels (basket represented 76 percent of the sector's total market cap within the sector):

Company Name	% Held in Basket
U.S. Steel	74
Bethlehem Steel	14
Amer. Roll. Mills	4
Inland Steel	4
Republic	4

Motors (basket represented 80 percent of the sector's total market cap within the sector):

Company Name	% Held in Basket
General Motors	81
Packard	9
Chrysler	6
Nash	4

Stores (basket represented 54 percent of the sector's total market cap within the sector):

Company Name	% Held in Basket
Woolworth	34
Sears Roebuck	19
Macy	10
Montgomery Ward	10
Kresge, S. S.	9
Penney, J. C.	8
First National Stores	5
Kroger Groc. & Bak. Co.	5

Oils (basket represented 85 percent of the sector's total market cap within the sector):

Company Name	% Held in Basket
Standard Oil of N. J.	29
Standard Oil of Ind.	16
Standard Oil of Cal.	15
Standard Oil of N.Y.	11
Gulf of Pa.	10
Texas Corp.	10
Vacuum Oil	9

The monthly results of the theoretical (paper) portfolio are shown in Tables 1.1 and 1.2. The cumulative performance is illustrated in Figure 1.1. According to his book, Karsten applied leverage equal to four times the actual value of the securities—200 percent gross exposure for the long book and 200 percent gross exposure for the short book to achieve these results.

TABLE 1.1 Karsten Paper Portfolio—Monthly Performance

	Monthly Return Paper Portfolio	Monthly Return DJIA	Out/Under Performance
3/1/1928	20.1%	8.7%	11.4%
4/1/1928	3.2%	2.8%	0.4%
5/1/1928	5.2%	0.9%	4.3%
6/1/1928	1.2%	−3.6%	4.8%
7/1/1928	1.6%	1.9%	−0.3%
8/1/1928	−2.9%	12.0%	−14.9%
9/1/1928	5.9%	−0.8%	6.7%
10/1/1928	8.0%	5.8%	2.2%
11/1/1928	2.2%	6.7%	−4.5%
12/1/1928	13.7%	12.9%	0.8%
1/1/1929	4.9%	0.0%	4.9%
2/1/1929	13.5%	2.6%	10.9%
3/1/1929	0.7%	−4.5%	5.2%
4/1/1929	−1.0%	8.7%	−9.7%
5/1/1929	23.6%	−6.7%	30.3%
6/1/1929	−0.9%	12.5%	−13.4%
7/1/1929	24.9%	7.6%	17.3%
8/1/1929	15.8%	3.5%	12.3%
9/1/1929	5.2%	−13.4%	18.6%
10/1/1929	16.1%	−21.8%	37.9%
11/1/1929	12.2%	−3.1%	15.3%
12/1/1929	10.6%	−1.2%	11.8%
1/1/1930	5.0%	8.1%	−3.1%
2/1/1930	15.9%	1.5%	14.4%
3/1/1930	4.5%	5.5%	−1.0%
4/1/1930	0.7%	−9.8%	10.5%
5/1/1930	0.7%	5.0%	−4.3%
6/1/1930	−0.6%	−18.1%	17.5%
7/1/1930	9.7%	7.2%	2.5%
8/1/1930	−4.4%	0.0%	−4.4%
9/1/1930	−2.0%	−10.1%	8.1%
10/1/1930	−3.9%	−13.6%	9.7%
11/1/1930	0.5%	−0.5%	1.0%
12/1/1930	16.8%	−6.5%	23.3%

TABLE 1.2 Karsten Paper Portfolio—Annual Performance

	Monthly Return Paper Portfolio	Monthly Return DJIA	Out/Under Performance
1928	73.0%	56.9%	16.1%
1929	218.7%	−19.3%	238.0%
1930	48.6%	−30.4%	79.0%

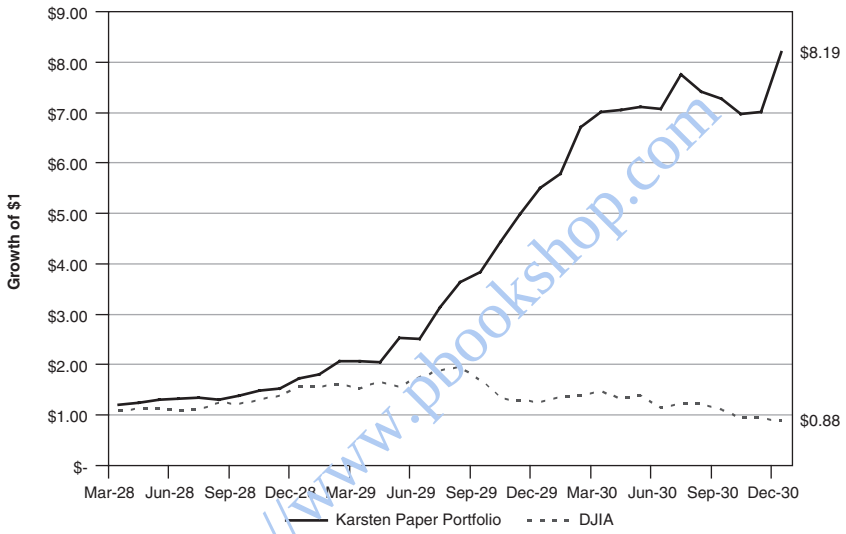

FIGURE 1.1 Karsten Paper Portfolio (Cumulative Performance from Mar-28 to Dec-30)

The paper portfolio declined in value in only seven of the 34 months under review while the Dow declined in 14 months over the same period. The two return streams had a low correlation to each other (0.06 over the period), and the end result of investing $100 in each on March 1, 1928, would have resulted in a gain of $719 for the paper portfolio against a loss of $12 for the Dow Jones Index.

While concluding that the paper portfolio was a clear success, Karsten recognized that a theoretical analysis would not be enough to convince the Wall Street crowd of his system's effectiveness. As a result, he determined that it would be necessary to manage real money in an actual brokerage account and record the results. So on December 17, 1930, his firm

established an account with a New York brokerage house and managed a "fund" using the aforementioned barometers and according to the specified guidelines. The results are presented in Table 1.3 and reflect the growth of a $100 investment made on December 17, 1930.

The performance data highlighted in Table 1.3 and Figure 1.2 indicate that Karsten's dollar neutral portfolio significantly outperformed the Dow Jones Industrial Average over the review period. Karsten's portfolio experienced a cumulative return of 78 percent while the Dow Jones fell 21 percent over the period. The Karsten portfolio declined in value in only four of the 24 weeks under review while the Dow declined in 10 of 24 weeks.

In a chapter titled "The Hedge Principle," Karsten educates readers about the necessity of hedging out market factors to focus on what he calls

TABLE 1.3 Karsten Portfolio—Weekly Performance

	Karsten Portfolio	DJIA
12/17/1930	$100	$100
12/24/1930	$105	$100
1/1/1931	$112	$103
1/7/1931	$115	$104
1/14/1931	$128	$ 98
1/21/1931	$133	$102
1/28/1931	$143	$101
2/4/1931	$131	$103
2/11/1931	$133	$110
2/18/1931	$133	$109
2/25/1931	$133	$115
3/4/1931	$138	$109
3/11/1931	$140	$110
3/18/1931	$143	$111
3/25/1931	$145	$111
4/1/1931	$140	$103
4/8/1931	$143	$102
4/15/1931	$152	$ 99
4/22/1931	$148	$ 99
4/29/1931	$152	$ 87
5/6/1931	$169	$ 90
5/13/1931	$186	$ 90
5/20/1931	$171	$ 83
5/27/1931	$171	$ 79
6/3/1931	$178	$ 79

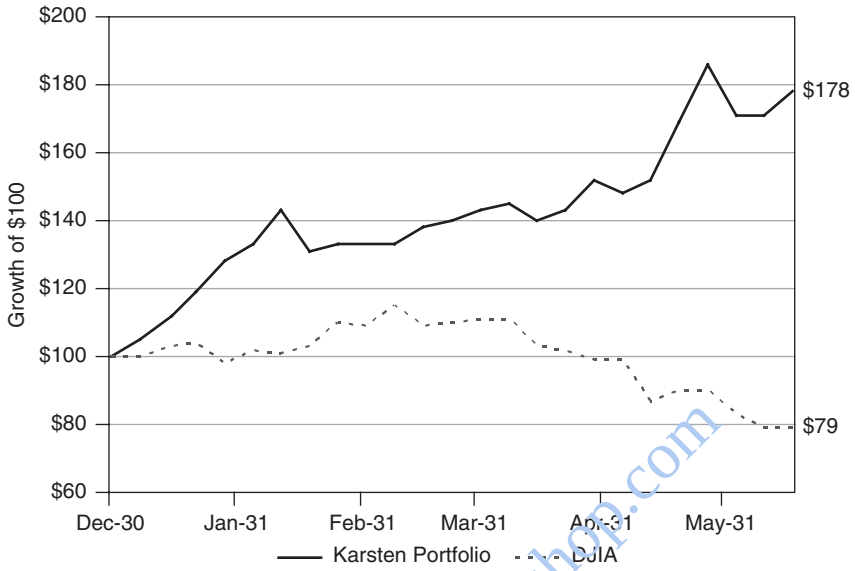

FIGURE 1.2 Karsten Portfolio (Cumulative Performance)

the sample portfolio's "out of line movement" (the concept of alpha, which had not yet been invented). The following quote summarizes the concept:

> *Our results will depend entirely upon the correctness of our prediction of the out of line movement. Stock market gyrations which affect all stocks, and which were not predicted in our forecast, would have no effect upon the results of our gamble. The speculation would be limited to the thing predicted.*[7]

Contrary to popular opinion, it was Karsten who first coined the term *hedge fund* (Chapter 12 in Karten's book is titled "The Hedge Funds on Paper"). In addition, in a rather mysterious passage in his book, Karsten states that while they were testing their strategy at the New York brokerage they were aware of another investment account being managed there that seemed to apply the same types of principles. The names of the brokerage house and the other investor are not mentioned in the book. Perhaps he could have been referring to the legendary investor highlighted in the following section.

Karl Karsten's Innovations:

- Created model for what we now call dollar neutral investing
- Quantitative (model driven) asset management
- Focus on alpha
- Coined the term "hedge fund"
- Emphasized diversification
- Use of baskets to represent investment opportunities (sector baskets)
- Weighted baskets by market capitalization (not a common practice at that time)
- Used lead and lag indicators in statistical models
- Predicted the use of mathematics and quantitative techniques in money management

THE LEGEND

Benjamin Graham is widely considered to be the father of value investing and one of the true innovators in the investment world. He is the co-author of the seminal book *Security Analysis*,[8] which is considered required reading by anyone in the investment business, as well as *The Intelligent Investor*, another classic tome. Over several decades of teaching at Columbia University, he motivated many other now legendary investors, including Warren Buffett (who also worked for Graham before branching off on his own and eventually creating what is now known as Berkshire Hathaway).

What is not well known in the investment community is that Graham may well be the first hedge fund manager as we have come to define them today. After all, he employed many of the concepts and strategies now embraced within the hedge fund community. He managed a market-neutral account, invested in distressed and other event-driven strategies, put on hedged merger trades, and employed a variety of other instruments and strategies to "hedge" portfolio risk and to take advantage of unique "arbitrage" opportunities. In addition, he also collected a base fee and an incentive fee. Sounds very much like a hedge fund to me.

Benjamin Graham started his career on Wall Street as an assistant in the bond department at Newberger, Henderson and Loab just prior to the start of World War I. In 1915, he made the first of many arbitrage trades when he determined that the breakup value of the Guggenheim Exploration Company was significantly greater than its actual value traded

in the marketplace. When Guggenheim management expressed interest in dissolving as a holding company to distribute the shares of its underlying holdings (which consisted of shares in four publicly traded copper and smelting companies), Graham calculated that the stock market value of the four underlying holding companies exceeded the value of Guggenheim by 10.7 percent (he estimated that the value of the underlying holdings amounted to $76.23 while Guggenheim shares were valued at $68.88). Assuming the simultaneous purchase of Guggenheim shares and the short sale of the four underlying copper/smelting companies, an arbitrage value of $7.35 per share of Guggenheim stock was possible. The obvious risk lay in the possibility that shareholders would not approve of the dissolution. Graham was able to establish this trade, and when the company eventually went through with the dissolution in January 1917, Graham's reputation grew right along with investment performance.

His first role as a portfolio manager came when a friend from Columbia University, Professor Algernon Tassin, gave him $10,000 to manage. The arrangement was for Graham to manage the money using his unique value-oriented methodology and to employ his skills as an arbitrageur. The profits were to be split evenly between the two. After some initial success, Graham made investments in some illiquid stocks that suffered greatly in the liquidity crunch brought on by World War I, and the account suffered margin calls. The account lost much of its value, and it took Graham several years to eventually build it back to its original value (what we would now refer to as a high water mark).

After the war, Graham continued his successful ways and was made partner at his firm. Following several years of successful trading for his clients, many of them began to open personalized accounts for Graham to manage on their behalf to take advantage of his expertise, and they contracted to pay him 25 percent of the resulting profits. He was so successful in this endeavor that a few investors eventually pooled their money and established a $250,000 account to be managed by Graham. For his services, he received a fixed salary ($10,000) and was contracted to keep 20 percent of the profits of the account. Graham created the Grahar Corporation ("Gra" came from his last name and "har" came from the last name of the cornerstone investor, Louis Harris) in 1923. One of Graham's most profitable trades while managing the Grahar Corporation was a trade involving DuPont and General Motors (GM). At that time, DuPont owned a significant number of GM shares and was trading at levels comparable to GM (so an investment in DuPont was akin to buying GM and getting the DuPont business for free). He believed that the market was overvaluing GM and undervaluing DuPont. As a result, he established a relative value trade

where he was long DuPont and short GM in the expectation that investors would eventually realize this inefficiency (which did eventually occur).

Graham managed this account until the end of 1925, when he proposed a new fee schedule to Louis Harris (one in which the performance fee would increase as portfolio returns increased). Harris rejected the new fee proposal, and the Grahar Corporation was dissolved.

In 1926 (at the ripe old age of 31), Graham created the Benjamin Graham Joint Account, which was funded with $450,000 at inception and eventually grew to roughly $2.5 million within a few years. The joint account did well from its inception through 1928. In 1929, when the markets started to decline, Graham covered many short positions at nice profits. He did not reestablish new short positions while maintaining his long exposure. He was reluctant to establish new short positions because he believed stocks were trading at such low valuations that they did not make attractive short candidates. This resulted in a more directionally long book at a time of extreme market weakness. The joint account declined −20 percent in 1929 versus a decline of −15 percent for the Dow, and it declined another −50 percent in 1930 versus a decline of −29 percent for the Dow. The joint account also declined in 1931 and 1932, but had significantly outperformed the Dow (falling −16 percent vs. −48 percent in 1931 and −3 percent vs. −17 percent in 1932). The joint account's total return over this four-year period was −70 percent versus −74 percent for the Dow.

Graham and his partner, Jerry Newman, went many years without receiving any profit share, and times were tough financially for Graham. Recognizing that it might take years to recover the account's value, the fee structure was changed from the "upward scaling" model originally agreed upon to a flat 20 percent of profits starting on January 1, 1934. In addition, responding to IRS questions regarding the joint account's status as a partnership or a corporation, Graham formed the Graham-Newman Corporation on January 1, 1936, to manage client assets.

In the Graham-Newman Corporation's annual report dated February 28, 1946, Graham and Newman started by stating their investment policy.

> *The current Prospectus of the Corporation states that its general investment policy is:*
>
> 1. *To purchase securities at prices less than their intrinsic value as determined by careful analysis, with particular emphasis on purchase of securities at less than their liquidating value.*
> 2. *To engage in arbitrage and hedging operations in the securities field.*

TABLE 1.4 Strategy Breakout for Graham-Newman Fund

Percentage Distribution of Portfolio by Type of Operations		
Type	**1/31/1943**	**1/31/1946**
Cash & Gov't Securities	3	11
Arbitrages, Reorganizations, Guaranteed Issues	17	36
Liquidations	12	12
Hedges & Convertible Issues	—	20
Financial Companies	9	13
General Portfolio	59	8
Total	100%	100%

The annual report goes on to document the account's broad asset allocation and the changes implemented by the portfolio managers between 1943 and 1946 (see Table 1.4).

The decrease in the general portfolio was due to Graham and Newman's assessment that the equity market had become fully valued over the period and reduced exposure to lock in profits and to reduce volatility. They recognized that a significant reduction in their long stock portfolio might cause periods of relative underperformance in bull markets but believed that action was true to their value-oriented roots.

The only real difference between the Graham-Newman Corporation and modern-day hedge funds is in the legal structuring. Modern hedge funds are set up as limited partnerships. The limited partnership structure was created and employed to great success by the investor in the next section.

Benjamin Graham's Innovations:

Distressed investing
Merger arbitrage
Base and performance fee combination
High water mark
Portfolio hedging
Volatility reduction methods

THE INNOVATOR

In 1966, Carol Loomis published an article in *Fortune* magazine titled "The Jones Nobody Keeps Up With,"[9] and the modern hedge fund industry was born.

In this article, Loomis introduced readers to Alfred Winslow Jones and informed us that he managed a "hedged fund" that had outperformed every mutual fund in the country for the previous 10 years by a wide margin. She stated that Jones's fund gained 670 percent for the 10 years ending in May 1965 versus a return of 358 percent for the Dreyfus fund, which was the best-performing mutual fund over the same period.

Figure 1.3 illustrates Jones's performance over the preceding five-year period compared to the best-performing mutual fund, the Fidelity Trend Fund managed by Gerald Tsai, as well as the Dow Jones Industrials Index. As in the 10-year review period, Jones outperformed his mutual fund peer by a considerable amount and more than doubled the return of the Dow.

Needless to say, these exceptional returns caught Wall Street's attention, and within a few years the number of hedged funds grew from a handful to roughly 140 according to some reports.

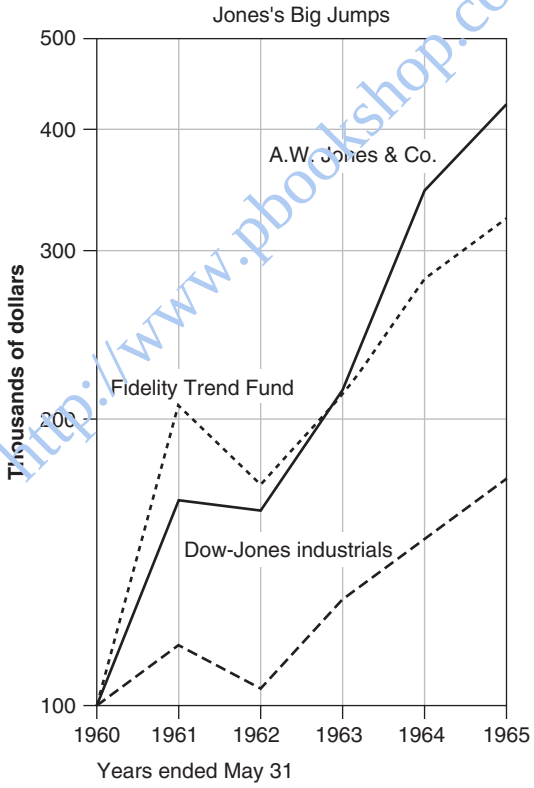

FIGURE 1.3 A. W. Jones's Hedge Fund Performance (from Loomis's Article)

By many accounts A. W. Jones was the least likely hedge fund manager you would ever encounter. Jones was born in 1900 and didn't begin his fund management career until 1949. He held many positions in fields far removed from Wall Street. He spent a year as a purser on a tramp steamer, worked as a statistician, and eventually joined the U.S. State Department, where he started as a vice commissioner in Germany in 1930.

After his time with the State Department, Jones worked under a pseudonym for the Leninist Organization and attended the Marxist Workers' School in Berlin. In the early 1930s he represented the Leninist Organization in Britain and attempted to persuade the Labour Party to take military action against Adolf Hitler, who was viewed as a burgeoning threat.

After returning to the United States in 1934, Jones pursued a degree in sociology at Columbia University, got married, and honeymooned at the front lines of war-torn Spain. It is rumored he ran with the likes of Dorothy Parker and Ernest Hemingway.

His time in Germany and Spain alerted Jones to the struggles of the working class. After returning home to the United States, he completed his PhD and published a doctoral thesis under the title "Life, Liberty and Property" in 1941. Jones began to write for *Fortune* magazine and in 1948 published an article that likely prompted his career as a hedge fund manager. The article was titled "Fashions in Forecasting,"[10] and it detailed for readers new technical methods of betting on the stock market.

In 1949, Jones along with four friends/partners launched a general partnership that many view as the first hedge fund as we now define them. They pooled their money and launched with $100,000 ($40,000 from Jones). He would remain a significant investor in his funds for the rest of his life. This concept of investing alongside clients is another trait that is indicative of the modern hedge fund. Having skin in the game helps keep the manager's and investor's interests properly aligned.

In 1952, Jones converted the general partnership to a limited partnership, and the rest is history. Jones built upon the techniques employed by Karsten and Graham to create an investment vehicle/strategy that has withstood the test of time.

His first innovation was to create the fund as a private partnership, as opposed to a public fund (like a mutual fund). This allowed him to fly under the Security and Exchange Commission's (SEC) radar screen and gave him the ability to employ leverage and apply short selling to create a specific risk/return profile.

In addition, he determined that the use of cash as a means of diversification and risk dampening was inefficient. Instead, his method relied upon creating a portfolio with two components: a long book and a short book. He asserted that a long book that employs leverage will give the portfolio

manager a better chance of capturing gains based on strong stock selection. The short book was used as a means of reducing overall market risk, but could also add value if their stock selection in this book was good.

As an example, Jones details in a 1960 annual letter to shareholders in his fund the following scenario. Two investors are each given $100,000 to invest. Both investors are bullish about the market's future opportunity and are equally skilled at selecting stocks. The first investor decided to invest $80,000 in a basket of stocks and $20,000 in what he determined to be safe bonds (as a means of dampening overall portfolio volatility).

The second investor employs leverage and increases the initial $100,000 to $200,000. He then takes $130,000 and invests it in a basket of securities he believes will outperform the market and takes the remaining $70,000 and sells short a basket of stocks he believes will underperform the market.

The first investor has $80,000 exposed to the market but the second investor only has $60,000 exposed to the market ($130,000 in the long book minus the $70,000 in the short book). In current terminology, we would say that the second investor has a gross (levered) exposure of 2x or 200 percent and a net exposure (the difference between the long and short books) of 60 percent. The first investor would have a gross exposure of 1x or 100 percent (equities plus bonds) and a net equity exposure of 80 percent.

Using two techniques previously attributed to riskier investing (leverage and shorting), Jones was able to build a better mousetrap—a fund with greater ability to make money when the market went up while reducing volatility when the market declined (by virtue of its lower net exposure).

In creating this new methodology, Jones recognized that he had no real stock-picking ability. So he devised another method of portfolio management that still exists today. He developed the multiple manager concept. He asked brokers to create paper portfolios for him with their best long and short ideas, and he used his statistics background to determine which brokers actually added value and which didn't by tracking the broker's "model" portfolios. He would then use this information to construct his portfolio. He also incentivized brokers to call him with their best ideas by paying them based on how well their stock picks performed. As simple as this sounds, it was something that others just hadn't thought to do. This gave him a significant advantage because brokers knew that they would be paid handsomely for providing successful trade ideas to Jones, and this performance incentive led them to call Jones ahead of his competition.

Eventually, Jones would use this model portfolio technique to hire individuals to work as in-house portfolio managers. This was an incredibly effective employment screen, as he was able to view a real history of their ideas and determine if they would add value to his fund as portfolio managers. This hiring practice is still in effect to this day. In fact, there

are several hedge funds that use Jones' method of tracking and analyzing sell-side research as a means of adding potential alpha.

A further illustration of just how far ahead of his time Jones was is an innovation he referred to as relative velocity. In Jones's 1961 shareholder report, he makes the following statement:

> *Different stocks habitually move up and down at different rates and hedging $1,000 of a stodgy stock against $1,000 of a fast mover would give no true balance of risk. We must therefore compute the velocity of all our stocks, both long and short, by their past performances, compared with the past performance of a good measure of the market as a whole.*[11]

He goes on to say that he and his team used the S&P 500 as a measure of the overall stock market and then measured the size and amplitude of each of their stocks relative to this index. Because these measures were all calculated manually, they performed the velocity calculations every two years on a universe of roughly 2,000 stocks.

He used two stocks to provide an example. He calculated that the average move in Sears was roughly 80 percent that of the S&P 500 while the average move in General Dynamics was 196 percent compared to the S&P 500. He asserted that it would be foolish to buy $1,000 worth of Sears and hedge it with $1,000 of General Dynamics because the relative velocity of each stock was not aligned. To effectively offset the heightened volatility in General Dynamics, one would need to buy nearly twice as much stock in Sears Roebuck.

Jones used the relative velocity measure to better manage what he perceived to be the true risks and exposures within his fund. Once he determined a desired net exposure for his fund, he would apply the relative velocity calculation to every stock he owned to ensure that he matched the targeted exposure and risk with the actual portfolio exposure and risk. In other words, Jones created the concept of market beta and put it in practice long before it would be formally introduced by William Sharpe in 1964.[12]

In addition, Jones also developed a method of evaluating the performance of his portfolio managers as well as the overall fund. Now that Jones had effectively developed a measure of stock and portfolio beta, he set his sights on determining how much of his fund's performance came from market moves and how much came from the investment decisions that they had made—what we now call alpha versus beta.

Using the earlier example of a $100,000 account levered to $200,000, with $130,000 in long positions and −$70,000 in short positions, we can

estimate how much of the account's return comes from superior stock selection versus market influences.

Assume that we are evaluating the account's performance over a one-month period using the following assumptions:

1. S&P 500 return of +1% over the period.
2. Long positions gained $2,500 in value over the period.
3. Short positions lost −$400 in value over the period.

So over the period in question, the account gained $2,100 in value (the sum of the $2,500 gained by the long positions and the −$400 lost by the short positions). This translates to a gain of 2.1 percent for the account based on the original $100,000 invested. To determine the market impact, Jones applied the following steps:

Determine amount gained and return for the long portfolio due to skill:

Step One

Gain in long portfolio—(market return × amount invested in long portfolio)
= $2,500 − (1% × $130,000)
= $2,500 − $1,300
= $1,200 $1,200/$100,000
= 1.2%

Step Two

Using the amount lost, determine return for the short portfolio:
= −$400 − (1% × −$70,000)
= −$400 − (−$700)
= $300
= 0.3% [$300/$100,000]

Step Three

Determine amount and return based on the market performance:
= Portfolio net exposure × market return
= $60,000 × 1%
= $600
= 0.6% [$600/$100,000]

— Return due to manager skill: 1.5% (1.2% from longs and 0.3% from shorts)
— Return due to market moves: 0.6%
— Total gain for the period: 2.1% (return from manager skill + return from the market)

As the 1960s came to an end, Jones took a less active role in the management of his hedge fund, and the portfolio managers left managing the fund began to question the merits of shorting or hedging the portfolio. After all, markets had been on a multiyear run and shorts were largely unprofitable; they were a drag on performance. As a result, the fund began to hedge less and its net exposure to the market rose significantly. When the market declined in 1969, Jones's hedge fund experienced its worst losses ever. This led Jones to come back to the fund to reinstitute his hedged principle and recoup losses.

As the Loomis article that we highlighted in the beginning of the chapter indicated, many other hedge fund managers had also lost their way. Funds hedged less and owned securities that were less liquid than expected. Hedge funds, which a few years earlier had been poised to take over the asset management industry, found themselves on life support. It would take nearly two decades before hedge funds returned to prominence.

A. W. Jones's Innovations:

LP structure
Invest alongside clients
Multiple portfolio manager structure
Pay brokers for best ideas
Use of leverage (to amplify returns as well as protect the portfolio)
Use of statistics to measure and evaluate portfolio managers
Portfolio attribution (stock selection versus market returns)
Concept of alpha and beta
Creation of an asset class

The hedge fund industry started with a $100,000 investment in A. W. Jones's fund in 1949 and has experienced some bumps along the way, but it has developed into a multitrillion-dollar industry. Figure 1.4 illustrates just how much things have changed over the years. Total assets in the hedge

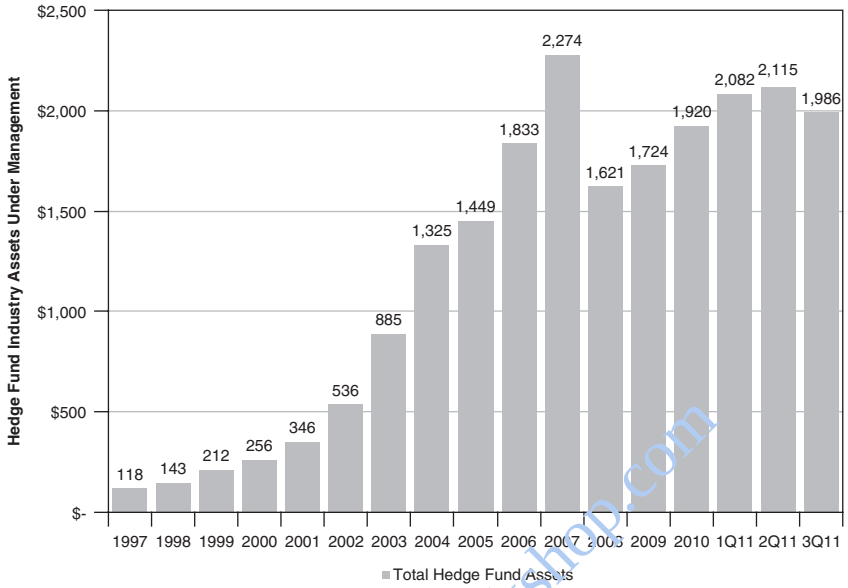

FIGURE 1.4 Growth in Hedge Fund Assets

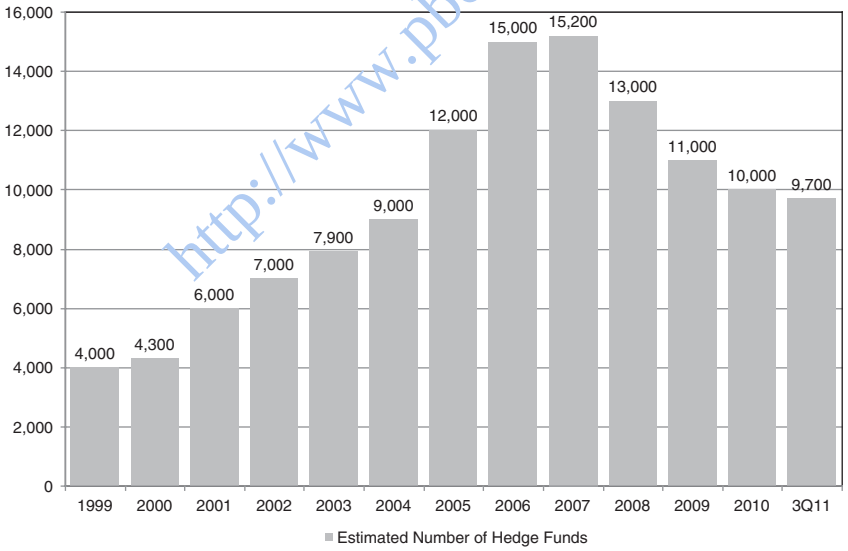

FIGURE 1.5 Growth in the Number of Hedge Funds

TABLE 1.5 Hedge Fund Industry's Life Cycle

Stage Years	Foundation 1925–1948	Birth 1949–1965	Emergence 1965–1969	Death 1970–1985	Reemergence 1985–1999	Explosion 2000–Present
Environment	Pioneers in this period all but forgotten to time but they forged a path for others to follow. Many concepts created would be used later by others.	Jones created a "better mousetrap" and managed money in relative obscurity.	*Fortune* article profiling A. W. Jones brings the "hedged fund" into the limelight and imitators followed.	In the late 1960s, hedge funds stopped hedging and were unprepared for the market decline in 1969. Performance suffered, assets left the industry, and only a few funds emerged.	Returns led by hedge fund titans (Steinhardt, Soros, and Robertson) in combination with a bull equity market reenergized the industry leading to an increase in the number of hedge funds and assets.	Institutions enter the market; bursting of the tech bubble highlights advantages of hedge funds versus traditional asset classes. Financial meltdown in 2008 leads to regulatory changes and heightened scrutiny.
Players	Karl Karsten Benjamin Graham	A. W. Jones	A. W. Jones Fairfield Partners Cerberus Associates	Michael Steinhardt George Soros	Steinhardt Soros Julian Robertson	Winton Renaissance Paulson S.A.C. Tudor Bridgewater Brevan Howard

TABLE 1.6 Hedge Fund Strategy Composition as of 3Q 2011

Hedge Fund Industry Strategy Composition ($Billions)		
	2011	**1997**
CTA	269	23
Multi Strategy	249	42
Emerging Markets	224	7
Fixed Income	193	23
Event Driven	179	12
Equity Long/Short	178	32
Equity Long Bias	164	19
Macro	119	17
Distressed	118	3
Sector Specific	104	9
Convertible Arbitrage	37	6
Equity Market Neutral	32	8
Other	28	6
Merger Arbitrage	16	3
Total Hedge Fund Assets	**$ 1,911**	**$ 210**

fund industry (as calculated by BarclayHedge) grew from $118 billion in 1997 to just under $2 trillion at the end of the third quarter of 2011.

In addition to the growth in assets, the number of hedge funds has grown as well. Using information provided by BarclayHedge, we can see that the number of hedge funds has grown from 4,000 in 1999 to 9,700 at the end of the third quarter of 2011.

The hedge fund industry has gone through several iterations over the last six decades. The industry's life cycle is highlighted in Table 1.5.

In addition to changes in the size and scope of the hedge fund industry over the last few decades, there has also been a dramatic change in the depth within the industry. Table 1.6 illustrates how the strategy composition of the industry has changed between 1997 and 2011. The total level of assets in the hedge fund industry grew 9.1x from $210 billion to $1.9 trillion.

NOTES

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