FUNDAMENTALS of HEDGE FUND INVESTING

A Professional Investor's Guide

William J. Crerend

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PREFACE

This book is written for investors wishing to gain a basic understanding of a world very often hidden from view. Too little has been written and, as a result, too little understood about an area that holds potential as a component of sophisticated, diversified investment programs. Although the subject of hedge funds may hold specific interest for experienced individual and institutional investors, anyone supervising the investment of assets should be intrigued. The book attempts to demystify hedge funds enough so that people retain a healthy respect for them but lose some of their fears as well.

To come away from this book smitten by a world "beyond understanding," or to conclude that the subject is too frightening to contemplate, is to miss the point completely. Hedge funds are a class of investment that attracts many extraordinary professionals. Some have indeed become "legends" but not all fit that stereotype, and by the way, some traditional equity managers can similarly be described.

Hedge funds hide few real mysteries if you are willing to devote the time and diligence to study the players, their strategies, and the investment itself. Merit drives investment decisions and keeps open the mind of a great analyst.

Most of the topics in this book are covered generically and without specific reference to Evaluation Associates (EAI) and Evaluation Associates Capital Markets (EACM), the consulting firm and fund of funds operation, respectively, that the author works for and whose very businesses are investment services for large institutional funds and high-net-worth individuals. The exhibits and data representing the various

hedge fund strategies are based on EACM's manager universes, which incorporate more than 400 series of manager returns, some with as much as 10 years history.

I also wish to acknowledge the help of my associates Anna Meena, Jody Grasty, Tony Minopoli, and Sally Marcus in the preparation of this book. I extend particular thanks to my partner and friend Tracey Hayes for her insight and advice, and to Janet Kalwat for critiquing and editing the manuscript.

My special thanks to my friend and partner Bob Jaeger for his help from start to finish. We had planned to co-author this book, but his business travel and responsibilities more neatly eased him into the role of chief advisor. It is a better effort because of him.

We would like to add a special, but anonymous, thanks to those hedge fund managers who helped me reach back through the years and who also gave me a glimpse into their souls. I knew and respected them as professionals in the field, and now I know them better as human beings.

William J. Crerend

INTRODUCTION

Depending on whom you talk to, hedge funds seem to have their roots in the 1930s, but they probably formally broke ground with A. W. Jones in the late 1940s. Growth was slow but steady going through the 1950s, and only in the mid-1960s did the bones of the business begin to gain some flesh. The late 1960s and early 1970s, with their treacherous markets, were more than a little troublesome, and it was not until the 1980s that the fledgling business regained its stride and experienced real growth.

Concurrent with those early days, some Wall Street trading desks were following a similar, albeit different, evolutionary path. Because they operated with proprietary capital, strategies and results had no formal structure, much less publicity. Even when firm capital gave way to block desk positioning, and investment banking and outside clients designated funds for management, limited communications surrounded the strategies offered, and meaningful explanations of results in terms of performance attribution basically did not exist.

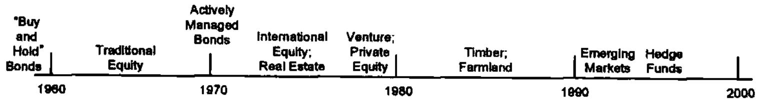
As such, when people left "the Street" to start what we now call hedge funds, limited disclosure defined the culture of this emergent style of investment management. The fact that hedge fund managers were not registered with regulatory bodies, and accordingly could not advertise or offer their services publicly, only intensified the limited disclosure element, not to mention the proprietary nature of the strategies themselves.

Such was, and is, fertile ground for the rugged individualist. But to believe that current-day hedge fund managers are superhuman beings, as conventional wisdom might suggest, is to fail to understand the business. Though some are "gunslingers" and others "professors," most simply have great faith in themselves and their abilities, demand control of the investment process, and are intense and passionate about delivering performance results. Many hedge fund managers, in fact, represent a natural evolution from traditional asset management, having taken advantage of opportunities afforded by a long-lasting bull market to test their skills in new investment frontiers.

In the past, hedge fund investing has been the province of high net worth individuals. We believe we are on the edge of an institutional awakening to this area and, as such, to a huge change in its dynamics. With the exception of manager names, finding and evaluating hedge funds is difficult at best and often outside the experience of even the most practiced professional consultants, fund sponsors, and high net worth investors. But if return and diversification are common investor goals, and if hedge funds are the right place, how does the investor connect the relatively unknown world of hedge funds with the all too public world of institutional asset management? That is the subject of this text, but with an important caveat. Hedge funds are a wonderful, albeit small, part of the investment business, but they are not for everyone.

The progression of asset classes along the path of institutional acceptability is a subject unto itself. We diverge here, not to give a definitive view on the matter, but to offer some perspective on hedge funds versus other types of investments and their future role in institutional portfolios.

The following time line demonstrates the expansion across types of assets that institutional total portfolios have generally experienced over recent decades:



For reasons related to the market environment or inherent in the investment itself, asset classes have met various levels of success or degrees of integration into an institutional portfolio. International equity has grown so rapidly in acceptance—a function of the globalization of world markets—that it is rare to find an institutional portfolio today without significant foreign stock market exposure. Venture capital, on the other hand, has generally gained acceptance as an asset class but appears only as a small component of relatively few institutional funds. Farmland, at the other extreme, emerged and faltered as a viable investment area for institutions.

Asset class strategies typically (but not necessarily) move in sequence from nontraditional, to alternative, and finally to traditional status. An institutional portfolio usually contains representative strategies from each, as well as some in a "nowhere" category that includes collectibles, physical ownership of commodities, and direct ownership and operation of plant and equipment. (To infer that strategies in the latter group are unimportant is wrong, however, since they may have wide acceptance elsewhere.)

Nontraditional refers to investments other than time-honored assets such as stocks, bonds, and cash and often is the category where most asset classes start. Because of their historical conservative image, bonds probably never were nontraditional investments, whereas stocks and money markets warranted the designation to the extent that fiduciary funds did not invest in stocks, and money market funds did not exist. Believe it or not, U.S. stocks were a "nowhere" category for institutions in the 1950s in that such investors generally regarded stocks as too risky for fiduciary funds. Current examples of investments some might consider nontraditional are emerging markets debt, oil and gas, and various hedge fund strategies. Most important, some asset classes may never gain enough acceptance from institutions to move out of nontraditional status.

Alternative strategies are those that have gained more acceptance than nontraditional but may never make it to traditional status, for some or all of the following reasons:

1. *Size (liquidity).* An inherent inability to absorb significant assets may prohibit the asset class from constituting a substantial portion of an institutional fund. A number of hedge fund strategies are restrictive in this sense.

2. *Seasoning.* Some asset classes passing through to traditional status need considerable time for fund sponsors to develop a sense of understanding and confidence. Emerging markets equity, for example, currently is in a transitional stage as improving research, data availability, and custody arrangements lessen some of the risks associated with this asset class.

3. *Legal/regulatory.* Dating back to the concepts of "legal lists" and "basket provisions," some otherwise attractive and accepted asset classes are relegated to junior varsity status by charter or applicable rules. Given the need to "lock up" funds for as much as 15 years, private equity is one such restricted investment that may, in fact, remain "alternative" indefinitely.

4. *Volatility.* Return volatility or even the perception of a relatively low success ratio within the individual investments of the asset class itself may commit the strategy to "alternative" status. Venture capital partnerships may fall into this category as a potentially good investment but with a limited hit ratio of substantial successes therein.

5. *"By Nature."* Some asset classes, while attractive, are simply too esoteric to be a major part of a total fund. As Keynes observed, "It is better to fail conventionally than to succeed unconventionally." Again, many of the hedge fund strategies fall into this category.

Traditional status imparts the idea of main-line, liquid, and understandable performance, which together characterize the dominant parts of an institutional total fund. Membership in this club is not preordained: almost any asset class that meets the requisite tests (or overcomes the prohibitive factors outlined above) can join the big leagues.

Our time line indicates that hedge funds are in the early stages of recognition and acceptance by institutions. Though hedge funds have been in existence for some 50 years, institutions historically have abhorred the shorting and use of leverage and derivatives that typically accompany such strategies. As institutions expanded their use of asset classes, they more often sought out other alternative strategies (such as international or emerging markets equity) that were more natural extensions of their current investment strategies and that also were better able to accommodate large institutional assets. Given that a growing number of institutions are just now becoming more comfortable with hedge funds, it is too early to predict how these large investors will ultimately accept and use this asset class. One of the defining characteristics of hedge funds is their lack of homogeneity. That is, over time, some hedge fund strategies will be more capable of absorbing large assets than others and some will prove more "acceptable" than others in different ways. To add to the complexity, hedge fund strategies use many of the other categories of investments, be they nontraditional, alternative, or traditional.

Keep in mind that the terms *nontraditional* and *alternative* are somewhat arbitrary. The less the acceptance of the asset class, regardless of terminology, the greater the inefficiencies or price imperfections in the marketplace that buyers or sellers can use to their advantage as a result of greater insight or information, or some other edge. To maximize the potential for superior returns, it is thus best to evaluate asset classes as early in the progression path toward traditional status as possible.

We have already warned that hedge funds are not for the faint of heart. From the start, note that unlike traditional managers, hedge funds can lose more than 100% in a day. This book is thus written for the sole purpose of conveying information about the area, not to tout it. With that said, some of us enjoy and respect the inherent potential in such an entrepreneurial business. Our enthusiasm can be contagious, so keep your guard up and your skepticism in full bloom.

ABOUT THE AUTHOR

William J. Crerend is one of the pioneers in investment consulting to U.S. institutions and high net worth individuals, with a career spanning over 40 years. Crerend was a cofounder and is currently Chairman Emeritus of Evaluation Associates, one of the preeminent firms in the field. He holds a degree in economics from Niagara University and an honorary Doctor of Commercial Science from the same institution.

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CHAPTER 1

What Are Hedge Funds? Why Invest in Them?

WHAT ARE HEDGE FUNDS?

In the past, the term *hedge fund* typically referred to an unregistered investment adviser—that is, one not registered with the Securities and Exchange Commission and therefore not subject to its regulations. The term was also associated with the practice of buying and selling U.S. stocks and bonds on a leveraged basis and with holding both long positions (buying and selling securities you own) and short positions (selling securities you borrow with the expectation of replacing them at lower prices). In general, hedge funds derived their name from the fact that they were often long and short, thus "hedged" or protected to some degree against market uncertainties.

Today, hedge funds encompass not just long, short, and levered securities but also futures (contracts for commodities or more often financial instruments bought or sold for delivery at a future date), forwards (similar to futures but not exchange traded), options (the right to buy or sell something else), and even physicals (tangible assets such as wheat, oil, copper, and gold). However expansive the term, hedge