THE IRWIN
ASSET ALLOCATION SERIES
FOR INSTITUTIONAL
INVESTORS

# HEDGE FUNDS

## INVESTMENT AND PORTFOLIO STRATEGIES FOR THE INSTITUTIONAL INVESTOR

JESS LEDERMAN AND ROBERT A. KLEIN, EDITORS

INTRODUCTION BY TED CALDWELL
**President,** *Lookout Mountain Capital, Inc.*

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# *Author Biographies*

***Ted Caldwell***

Mr. Caldwell is president of Lookout Mountain Capital, Inc. (LMC), a registered investment advisor specializing in the evaluation, selection, and monitoring of hedge funds. LMC also publishes the *Lookout Mountain Hedge Fund Review* (see information at the back of this book), and advises several multimanager hedge fund pools. Mr. Caldwell began assessing hedge funds in 1980, and investing in them as a private party in 1984. In 1990, he began gathering extensive data on hedge funds for the purposes of diversifying his personal investments, and in 1993 he established LMC.

Mr. Caldwell received his MBA from the University of Denver.

***William J. Crerend***

Mr. Crerend is chairman and founder of Evaluation Associates, one of the nation's oldest and largest investment consulting firms. Prior to forming EAI, he was vice president, Paine Webber, Jackson & Curtis' Investment Manager Evaluation Services. Mr. Crerend has served as corporate controller for the March of Dimes Foundation, and earlier worked for the Equitable Life Assurance Society.

Mr. Crerend received a B.S. in economics from Niagara University, as well as an honorary doctorate of commercial science.

***Glen C. Dailey***

Mr. Dailey is an executive vice president of Montgomery Prime Brokerage Services. Montgomery Securities is a San Francisco–based institutional trading, research, and investment banking firm focusing on U.S. growth stocks.

Previously, he was a managing director of Furman Selz Incorporated, responsible for the operations and systems groups of their prime brokerage division. Mr. Dailey, a frequent speaker at hedge fund seminars, began his career at A.G. Becker after attending Bernard Baruch College.

***Michael E. Dunmire***

Mr. Dunmire is president of Paradigm Partners, Inc. Previously, he served as vice president at the Frank Russell Company, where he was responsible for the research and evaluation of unconventional money managers for Russell Private Investment clients. He also has been partner and director of research at Cable, Howse & Ragen; manager of strategic planning at Seafirst Holding Company; director of investment research at Seattle First National Bank; and vice president and senior security analyst at Bankers Trust Company.

Mr. Dunmire, a chartered financial analyst, has a B.S. degree from the University of Pennsylvania and an MBA from Columbia University.

***Martin J. Gross***

Martin Gross monitors hedge funds and advises four funds of funds from Livingston, New Jersey. Since 1983, Mr. Gross has tracked and evaluated the performance of investment managers and has conducted other investment banking activities. A member of the New Jersey and New York Bars, Mr. Gross has practiced tax and corporate law in New York City, and worked in the corporate finance department of L.F. Rothschild, Unterberg, Towbin. He has written for *Barron's* and other hedge fund newsletters and often lectures at industry conferences.

Mr. Gross received his B.A. summa cum laude from Brandeis University, an M.A. from Brasenose College, Oxford University, a J.D. from the University of Chicago Law School, and an LL.M. from New York University Law School.

***Bryan J. MacDonald***

Mr. MacDonald is president and managing director of Investment Strategies International, Inc., and chairman of the board of directors of Investment Strategies International, Ltd. of Hamilton, Bermuda. His firm provides investment banking and advisory services to alternative investment managers interested in expanding their client base on a global basis. Previously, he was a senior vice president of Tremont Advisors, Inc., responsible for all product development and marketing for the firm. Mr. MacDonald has also held positions as vice president and group head of market and product development for Bankers Trust Company, as client service manager for Frank Russell Company, and as product manager for The Vanguard Group of Investment Companies.

***Joseph G. Nicholas***

Mr. Nicholas is the president of Hedge Fund Research, Inc., a research and consulting firm that tracks hedge funds and alternative investment strategies and provides consulting and advisory services on hedge funds to institutional and high-net-worth investors. He is also editor of the *Hedge Fund Research Journal* and president of Nicholas Financial, Inc. and Nicholas Securities, Inc., a registered broker-dealer. Previously, Mr. Nicholas was president and managing director of Hart-Bornhoft Group, a registered investment advisor. Earlier, Mr. Nicholas served as an attorney with the law firm of Fishman & Merrick, P.C., specializing in commodities and securities law, and held positions in finance and consulting.

Mr. Nicholas received a B.S. in finance from DePaul University and a J.D. from Northwestern University School of Law.

***John P. Nicholas***

Mr. Nicholas is vice president of Hedge Fund Research, Inc., a research and consulting firm that tracks hedge funds and alternative investment strategies and provides consulting and advisory services on hedge funds to institutional and high-net-worth investors, and is managing editor of the *Hedge Fund Research Journal.* He is also vice president of Nicholas Financial, Inc. Previously, Mr. Nicholas was an attorney in the corporate department of McDermott, Will & Emery, practicing securities, commodities, and corporate law. Earlier, he served as legislative assistant for foreign policy and defense to Senator Joseph R. Biden, Jr.

Mr. Nicholas graduated magna cum laude from Harvard University and received his J.D. from Northwestern University School of Law.

***Lois Peltz***

Ms. Peltz is the managing editor of *MAR/Hedge,* a 32-page monthly newsletter devoted to hedge funds as well as *MAR,* a 32-page monthly newsletter focusing on funds and trading advisors in the futures and currency arena. In addition, she supervises the two databases in these respective areas. Previously, Ms. Peltz was vice president and manager of marketing services/CTA selection at ML Futures Investment Partners Inc., where she was responsible for advisor analysis, alternative fund structures, the review of all current funds, and marketing support for futures funds.

Ms. Peltz graduated Phi Beta Kappa from Vassar College and holds an M.A. in international affairs from Columbia University and an MBA from New York University.

***Joel Press***

Mr. Press is a senior partner with Ernst & Young LLP, where he also leads the Private Investment Partnerships practice and is a member of the steering committee. Among his many activities, he provides broker-dealers and investment companies with audit, tax, systems, and business advisory services; advises clients on regulatory matters; has structured buyouts and compensation arrangements for investment advisors; and has designed new operations systems and established internal audit departments for broker-dealers. Mr. Press is co-author of *Security Markets Around the World.* He is a frequent lecturer on the securities industries, and conducts seminars on hedge funds. Previously, Mr. Press was head of the international financial services group at Spicer and Oppenheim.

Mr. Press received his B.A. from Long Island University.

*M. Kelley Price*

Mr. Price is a principal of Price Meadows Capital Management Inc., located in Bellevue, Washington, and general partner of several investment partnerships that utilize short selling as a core investment technique. His firm invests with 15 outside money managers, including four dedicated short sellers. In addition, Mr. Price is a general partner of eight single-manager funds and his firm provides back-office support and consulting services to several independent hedge funds.

Mr. Price is a graduate of Stanford University.

*Paul N. Roth*

Mr. Roth is a senior partner with Schulte Roth & Zabel. His areas of expertise include investment partnerships; investment advisers and broker-dealers; securities regulation, mergers, and acquisitions; financial transactions; and cross-border acquisitions into the United States. Mr. Roth is a member of both the American Bar Association and the New York State Bar Association, and was chairman of the committee on securities regulation of the Association of the Bar of the City of New York.

Mr. Roth graduated magna cum laude and Phi Beta Kappa from Harvard College, and received his J.D. from Harvard Law School.

*Daniel S. Shapiro*

Mr. Shapiro is a senior partner with Schulte Roth & Zabel. His areas of expertise include partnership and securities transactions tax matters and corporate and real estate tax issues. Mr. Shapiro is a member of the New York State Bar Association and the American Bar Association, and is active in numerous civic and philanthropic groups. He has also been a frequent speaker at seminars, and has had articles published in the *Journal of Taxation, Taxes,* the *New York Law Journal,* and *Tax Notes.*

Mr. Shapiro received his A.B. and J.D. degrees from Columbia University.

*Mitchell A. Tanzman*

Mr. Tanzman is a managing director of Oppenheimer & Co., Inc., the securities and investment firm. He is co-head of Oppenheimer's investment partnership and offshore fund business, which acts as investment adviser to a family of hedge funds offered to U.S. and international clients. These funds manage in excess of $800 million in assets in a number of different strategies, all on an incentive basis.

Mr. Tanzman received a J.D. from the University of Chicago Law School and a B.A. from Emory University.

### *David A. White*

Mr. White is executive vice president with AIG International Asset Management Inc., responsible for marketing, product development, and investment analysis. Previously, Mr. White was treasurer and chief investment officer of The Rockefeller Foundation. Prior to that, he was staff vice president of capital management and trust investments at Unisys Corporation, where he implemented several investment firsts, including market neutral and currency as an asset class. He is a member of the Financial Executives Institute and a trustee of the Investment Fund for Foundations.

Mr. White received a B.A. in economics and mathematics and an MBA in finance and operations from the University of Michigan.

# *Preface*

Over the past several years, hedge funds have attracted more controversy, excitement, and misunderstanding than any other sector of the capital markets. Politicians have accused some of the larger hedge funds of manipulating the world financial markets; the press has suggested that some hedge fund managers are wildly overpaid; and rumors of spectacular hedge fund gains and losses are the subject of Wall Street gossip.

Meanwhile, savvy investors have realized that superior hedge funds offer an outstanding tradeoff between risk and return — perhaps the best of any available asset class. But what are hedge funds? How do they operate? And how can institutional investors and wealthy individuals best incorporate them into their asset mix?

The answers are presented in this breakthrough book, the first ever compiled on hedge funds. It is the result of a year of effort by sixteen of the brightest and most successful experts on this dynamic industry. *Investing in Hedge Funds* covers every facet of the business and clears the clouds of mystery that have long surrounded a critical market sector.

Many thinks much be given to each of the contributing authors for the time and energy they took from their hectic schedules. We are also grateful to the superb staff at Irwin Professional Publishing, who made the timely publication of this important book possible.

Jess Lederman
Robert A. Klein

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CHAPTER 1

# *Introduction: The Model for Superior Performance*

*Ted Caldwell, President*
*Lookout Mountain Capital, Inc.*

## Hedge Funds: Perception and Reality

How risky are hedge funds? Although broadly perceived by the investing public to be imprudent investments, in reality, most hedge funds are not. In order to gain useful insight into how many hedge funds provide superior returns with reasonable and controlled exposure to risk, let's begin with a better understanding of why they are *perceived* to be so risky.

Put an apple on a hedge fund manager's head and call it "the truth." Then step off fifty paces and hand a crossbow to a well-intentioned journalist with a steady hand and a mandate to "nail the truth!" As a courtesy, we will presume the hedge fund manager is blindfolded. If the journalist's best shot just barely misses, what happens? More often than not, the journalist's best shot ends up farther from the truth than the original fifty paces.

Over the past three decades, relatively few journalists have nailed the truth about hedge funds, while hundreds of misleading articles have been written by well-meaning journalists. The cumulative result is that "hedge fund managers—those flamboyant, dice-tossing speculators"[1] have an image problem.

There have been some glaring failures among hedge funds, and the media serves a useful purpose in disclosing as much as possible about them. But in general, the financial press grossly fails to convey how most hedge funds operate. Besides their focus on a small portion of hedge funds that are not typical of the industry, there are three primary reasons why the financial

[1] Riva Atlas and Dyan Machan, "George Soros, Meet A. W. Jones" *Forbes*, 17 January 1994, 42–44.

press so often misleads the public about the risk profiles of most hedge funds: A lack of good sources, an abundance of bad sources, and difficult risk management concepts. Let's consider each.

## *Sources of Information*

Most hedge funds are private limited partnerships, prohibited from advertising. For legal and proprietary reasons, hedge fund managers have, traditionally, been very reluctant to disclose specifics about their operation, even to investors. They have rarely spoken with the press until recent years, and now, they seldom reveal much.

As a last resort, financial journalists came to rely (decades ago) on others in the financial services industry for information on hedge funds. They failed to recognize several major problems with this arrangement: To begin with, industry sources can only speculate what a hedge fund manager is actually doing, even when a source has direct information on some aspect of a fund's activities. Of greater concern, sources have sometimes been slighted in their efforts to provide services to a hedge fund manager, and quite frequently, the sources compete directly with hedge funds. Finally, many sources fail to grasp the risk management systems that hedge funds use.

In the mid 1970s, *Institutional Investor*[2] summed up the relationship between hedge funds and the rest of the securities industry like this: "Today, they [hedge funds] are still targets for an uncanny number of unsavory market rumors, the victims of smear campaigns accusing them of just about everything short of pilfering the napery from the New York Stock Exchange dining room. . . . hedge funds are so often branded as villains by other sectors of the investment community."

Seventeen years later, an excellent overview of the industry by *Business Week*[3] characterized the pattern more pointedly. "Bankers, security industry professionals, mutual fund managers—all are beating the drum. . . . It's no secret that Wall Street hates hedge funds." But why? "It's not just jealousy or scapegoating that makes the hedge funds anathema to the powers on Wall Street. Fear is another possibility—fear that the public may demand incentive-based compensation for their funds as well."

The concept of performance-based compensation may well be unsettling to an industry that charges according to the volume of transactions made or the total assets under management, regardless of whether the customer profits.

[2] John Thackray, "Whatever Happened to the Hedge Funds?" *Institutional Investor*, May 1977, 71–74.

[3] Gary Weiss and Joseph Weber, "Fall Guys?" *Business Week*, 25 April 1994, 116–120.

The investment services industry is highly competitive, and although most professionals exercise restraint in disparaging the competition, many have made hedge funds the accepted target. Over the past few decades, hedge fund rumor that is fed to reporters one day has become front page news the next! As a result, millions of readers have developed strong misconceptions about the risk profiles of most hedge funds.

There is a biting irony in the fact that rumor is often generated about hedge funds on Wall Street, because the operations that most closely resemble hedge funds are the proprietary trading desks of big banks and brokerage houses. One main difference is that most hedge funds take on less risk than many of Wall Street's proprietary desks.

## Risk Management: Betting versus Gambling

The other reason why so many journalists have misled readers about the risks of hedge funds is that the concepts of risk management used by hedge funds can be difficult to understand. Many of the tools, and the lexicon applied to them, imply high risk to the average investor and to the journalists who write about their use.

Consider the word "bet," commonly used by hedge fund managers, but also by the entire investment community. Managers do not use the word "bet" to imply "gamble," but journalists often infer that is its meaning. Even though the inference of gambling is not correct, it is easily made when viewed in the context of tools like leverage, short selling, and financial derivatives. These are perceived by most investors as purely speculative tools, but many hedge funds successfully employ them to increase performance while actively managing risk.

Given some highly visible failures, it seems implausible, not just to journalists but to many good investors, that risk can be reasonably managed when using leverage, short sales, and financial derivatives. Yet it can! Let's approach some basic risk management concepts by personalizing them.

How much risk would you take with $1,000 of your hard-earned money, under the following coin-flipping scenarios?

1. Would you bet $1,000 on the flip of a coin?
2. Assume a win would pay you $1,200 against your loss of $1,000. Would you bet?
3. What if a win paid the same 1.2 to 1 ratio as in scenario #2, but you could bet in $10 increments and as many times as you wished? Would you bet, and if so, how often and how much?

4. What if you didn't have any cash to bet with, but you did have a bank CD you could borrow $1,000 against? Would you borrow against the CD to execute your bets from scenario #3?
5. Let's now assume the party you are betting against is a corporation with limited capital, making the same $10 bets and paying 1.2 to 1 to thousands of other people. You anticipate the company will go bankrupt long before you want to stop betting. Would you be willing to place an additional bet by selling short the shares of that corporation, in amounts equal to the winnings from your leveraged bets?

Scenario #1 is pure gambling, and if you answered yes, you are reckless with your money. Scenario #2 has an attractive payoff, but the downside risk is too great, at least for most people. Scenario #3 is appealing because your risk of loss on any single coin toss is acceptable, relative to your capital, and the odds heavily favor your making unlimited sums of money from a continuing series of coin tosses.

If you chose not to borrow against your CD nor to short the shares of the corporation under scenarios #4 and #5, you are not psychologically fit for investing in hedge funds. If you chose to bet under scenarios #4 and #5, congratulations; you are becoming an expert at utilizing leverage and short sales to increase performance, while prudently managing risk! Have you considered starting a hedge fund? (Affirmative answers to this question pose a problem that we will address later.)

Obviously, coin tosses that pay 1.2 to 1 do not entail any skills to come out a winner over time, so let's consider one more example.

When a "scratch" golfer makes a $2 bet on the flip of a coin, he is gambling. On the other hand, when he bets an eight handicapper "$2 Nassau, two down automatics, double the back and 18," he is *investing!* Never mind if you don't understand this bet. The point is, a scratch golfer fully understands the bet, and the odds are exceedingly high that he will collect a lot more than $2. Bets like this don't win many friends on the golf course (or on Wall Street).

Few financial journalists have taken the time to actually understand risk management as it is used by most hedge funds, relying instead on information fed to them by the competitors of hedge funds. Thus, most of their readers ("prudent men," many of whom acquired or held IBM at $170 in 1987) reject the suggestion that many hedge funds are very sound investments.

Given a better understanding why hedge funds are unduly perceived to be so risky, let's start over and develop a more legitimate awareness of hedge funds by reviewing their history and development.

## A Brief History of Hedge Funds

In the beginning, a defining characteristic of hedge funds was that they hedged against the prospect of a declining market. Hedging through private agreements is as old as commerce, but most instruments for hedging in a securities portfolio are quite recent; so let's briefly review the evolution of tools for hedging securities.

Hedging is the utilization of a defensive strategy to mitigate or eliminate risk, and it usually entails giving something up. The creation of most tools for hedging in a securities portfolio came through the commodity markets. In turn, the catalyst throughout the development of commodities markets, going back to rice warehouse receipts in 17th-century Japan, has been the common desire for producers, processors and merchants to hedge against adverse price changes.

Over the past century, commodity exchanges in the United States have become highly developed to meet these needs. Producers of numerous farm, forest, oil, and mineral products sell futures contracts to hedge against price declines. While protecting themselves against future price declines, they forfeit the right to additional profits if prices rise. Likewise, users of these products often purchase futures contracts to hedge against future price increases, but they forfeit the benefits of future price declines.

Standardization of futures contracts on exchanges made them easily transferable, inviting speculators into the futures markets. Speculators provide two critical services. They willingly take on price risk that the hedgers don't want, and they provide tremendous liquidity, making the exchange markets more efficient.

During the 1970s, the exchanges began to develop a number of financial futures for hedging interest rate and currency risk. These developments were followed by futures and options on various equity indexes and options on hundreds of specific stocks. The number of financial instruments for hedging, or speculating, has grown exponentially since 1980.

In addition to standardized financial futures and options, traded on major exchanges, some banks and brokerage houses create a multitude of customized, off-exchange instruments. Some of these contracts are relatively simple and easily transferable; others are exceedingly complex and have very limited markets. Unfortunately, the "D" word (derivatives) is applied equally, if not reasonably, to the entire range of financial instruments, from the most liquid and stable futures and options traded on the exchanges, to the most illiquid and volatile "toxic waste" traded over-the-counter. In spite of the prevailing public perception, most derivatives render far more benefits than harm and they are here to stay.