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Hedge funds

A Resource for Investors

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and
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In every phase of the market cycle
even the most difficult
when everything is about to crash
when pessimism pervades all
and of opportunities, there appear to be none

but opportunities do exist
and space for development
of new financial services
which enable us
to conquer new frontiers

there is always
a product
for each moment
now is the time
of hedge funds

thanks to visionaries
who through genius and courage
transform these opportunities
into concrete advantages
for the market and for the public

About the Authors

SIMONE BORLA is Managing Director of JD Farrods Securities Ltd., a company that has developed a global network for the distribution of innovative financial products and services to institutions. In Italy he created the distribution network of Lombard International Assurance and launched the first Unit Linked product on the market. In the past he worked for companies like Lombard International Assurance, JP Morgan and Philip Morris.

DENIS MASETTI has been working in the financial services industry for over twenty years with companies such as Dival, ING, Flemings and more recently GIA JD Farrods, a company specialising in the distribution of alternative investments. In 1995 Masetti founded Bluerating.com, a company providing rating to investment products and in 2001 Bluehedge.com, a website offering state-of-the-art information on hedge funds. He is the Editor of Hedge, the first Italian magazine on alternative investments.

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Denis Masetti and Simon Borla

Introduction

Finding a universally accepted definition of what a hedge fund is has proved somewhat difficult over the years. Lore has it that the first hedge fund was created in 1949 by Alfred Jones. Some 20 years later George Soros launched his Quantum Fund and the first fund of hedge funds, Leveraged Capital Holdings, was launched at roughly the same time. What is a hedge fund? The original definition, utilised *inter alia* by Alfred Jones, is of a fund that by taking both long and short positions in a given sector or market neutralises the market risk and effectively "bets" only on the spread between one security, sector or market vis-à-vis the other. While this investment technique is still utilised today by many hedge funds, it does not apply to all of them. The unique characteristic exhibited by substantially all hedge funds is the propensity, or at least the ability, to "go short".

The ability to go short is one of the constraints that mutual fund managers have to contend with, and according to a recently published essay by Clarke *et al.*,[1] portfolio constraints may reduce by up to one-half expected portfolio returns. Just like anything in life, it seems that performance is affected by the imposition of constraints. While it is beyond the scope of this introduction to go into technical explanations, we hold that the inability to go short is a fundamental constraint imposed on the mutual fund manager, both at a macro and at a micro level.

Over the last two years, probably with the assistance of a pervasive bear market in equities, investors world-wide are beginning to realise that the question is not, "should I invest in hedge funds?" but rather, "can I afford not to invest in hedge funds?". Especially in difficult markets, investors look to their portfolio managers for expertise that will help to protect the portfolio from excessive market fluctuations. Judging from the relative performance during the bear market of 2000–2001, hedge fund managers seem to have achieved this result. And, as the saying goes, investors are voting with their feet. Investment in hedge funds is at a historic high.

We maintain that this trend is not a temporary phenomenon but the beginning of a sustained historical move to hedge fund investments that will grow from the current roughly 5% of the global mutual fund net aggregated capital to a proportion in the middle teens. The effect of this shift to hedge funds is twofold. To the extent that investing in securities is a zero sum game, most analysts are forecasting a general flattening out of hedge fund returns. Hedge funds are outperforming mutual funds by being many times on the other side of the trade. As hedge fund assets grow, and as the proportion hedge fund to mutual fund grows, it follows that the scope

[1] R. Clarke, H. DeSilva and S. Thorley, 2001, "Portfolio constraints and the fundamental law of active management".

to take advantage of this phenomenon will decrease. In addition, certain hedge fund strategies are scarce. This is due to the fact that, unlike long-only investing (and long/short investing), certain hedge fund strategies (such as for example merger arbitrage and market neutral) have limited capacities. If there are no IPOs it is simply not possible to put on merger arbitrage trades!

The seasoned investor can and must take advantage of the outperformance of hedge funds even though this outperformance may in future years be less dramatic than in the present circumstances. When investing in hedge funds, diversification across strategies and single funds is very important. Funds of hedge funds are investment vehicles that typically invest in a broad portfolio of hedge funds aiming to enhance risk-adjusted returns by diversification. By investing in a selection of strategies and funds, a well managed fund of hedge funds can enhance Sharpe ratios and reduce risk, while "tailor-making" expected risk/return profiles that suit the particular target investor of that fund. In practical terms this means that, for example, investors with a low risk appetite can invest in funds of hedge funds that can lower volatility, and for a certain measure of volatility, maximise the return. On the other hand, a common critique of funds of hedge funds is that they add another layer of cost for the investor. Judging from the near explosive growth that these particular hedge funds have enjoyed, investors seem to be more interested in what risk-adjusted returns they get, rather than on the load factors. Nevertheless, one of the likely results of the spread of hedge fund investing will be the lowering of the fees paid to hedge fund managers.

Just as it took many years to convince stock market regulators in the United States that selling covered calls against equity portfolios was a conservative investment strategy, it may take time for regulators to understand that investing in a properly managed portfolio of hedge funds offers a lower risk profile than investing in an average equity mutual fund. There are signs that this change in perception is beginning to happen, perhaps catalysed by the poor performance of the world's equity market indices in the recent period. The authors of this book describe the current trends and key recent events in this shift to alternative investments from a European viewpoint.

Emanuel Arbib
CEO, Integrated Asset Management plc

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1 Hedge Funds and Alternative Investments in Europe

In recent years, hedge funds have once again returned to the limelight and are becoming increasingly popular with both private and institutional investors. Whilst the alternative investment industry has already existed for more than 50 years, this form of investment has never been the preserve of the wider investing public. Investors as a whole have always associated hedge funds with the spectacular raids made by certain individuals. Perhaps the most famous of these was George Soros's attack on sterling in 1992 and the collapse of Long Term Capital Management (LTCM) in 1998.

The objective of this chapter is to explain hedge funds simply and clearly, to find common characteristics amongst these particularly versatile instruments, to explain the different investment strategies that hedge fund managers pursue and to highlight advantages, risks and opportunities linked to different hedge funds.

Firstly, it is important to make the distinction between the investment structure and the investment method. The term hedge fund indicates that the investment structure is in the form of a limited partnership. The legal structure of the fund allows the manager to receive and therefore invest capital, whilst subject to certain conditions. The investment structure defines the number and type of investors, the method of remuneration for the manager, the rights and responsibilities of the underlying investors relating to returns, rebates, taxes and finally legal responsibilities relating to third parties. The investment strategy refers to the investment method chosen by the manager, the definition of the markets in which the fund is active, the instruments to be used and the fund objectives in terms of returns and volatility.

Above all, the objective of this chapter is to present hedge funds as an asset class (i.e. an investment instrument) different from the conventional categories to which investors are more used. In perceiving hedge funds as instruments with their own particular characteristics, we can evaluate the benefits that hedge funds offer when inserted in traditional portfolios. Indeed, when inserted in a portfolio made up of equity and bond investments, hedge funds can improve overall returns while at the same time reducing the level of risk in that portfolio.

Many investors are of the opinion (not unfounded) that hedge funds are imprecise products, which come to the fore on the back of a few spectacular trades, or when they register performance figures far in excess of those achieved by other financial instruments. Others consider these products to be excessively risky, to be explored only by a knowledgeable and elite private client base. Whilst all envy the returns achieved during negative market conditions, many feel such returns are unsustainable over time. These are some of the criticisms most often directed at hedge funds.

The next section, on the history of hedge funds, is not intended as a defence of the alternative investment industry but rather to bring a little clarity to hedge funds, explain why they came into being as well as how they have evolved and adapted to financial markets. It is our intention to go beyond labelling an industry with a name, and instead provide the reader with a greater understanding of the subject and its implications today.

1.1 THE BIRTH OF HEDGE FUNDS

It is generally acknowledged that hedge funds came into being on 1st January 1949, when Alfred Winlow Jones established his fund. This fund was conceived as a portfolio benefiting from maximum flexibility in terms of the range of sectors in which it could invest and of the trading approaches it adopted. The company formed by Alfred Jones and four partners was named A. W. Jones & Co. and was a partnership with limited liability. The fund's capital initially totalled $100,000, $40,000 of which was contributed by Mr. Jones. The innovative idea which characterised the fund consisted of the fund's capital being both hedged and leveraged. They took advantage of leverage in order to make acquisitions with the minimum margin deposited whilst they would short sell to hedge the portfolio's long positions.

An important aspect of the investment philosophy which henceforth gave its name to this type of fund was demonstrated by the fact that the fund always took short positions with the view of protecting the portfolio from market risk.

In general, a portfolio runs a long position on any given security when the manager, through his own analysis, purchases the security estimating that the security's price will rise in the future. A position is defined as being short when the manager makes an uncovered sale of a given security, estimating that the security will fall in price. If the manager's calculations prove to be correct, the security can be bought at a lower price and therefore deliver a profit on this price differential.

From 1949 and for almost 15 years, Alfred managed his fund outside of the limelight. His activities only became widely known in 1966 following an article which appeared in *Fortune* under the heading "The Jones nobody keeps up with", written by Carol J. Loomis. The article eulogised this unknown money manager who had beaten all the most famous managers of the era. The article cited the extraordinary performance that the fund had achieved in the five years from 1960 to 1965. Indeed, during this period, the fund had registered a 325% gain whilst The Fidelity Trend fund, which had the best performance of any mutual fund at the time, had only managed 225% growth. In the 10 years from 1955 to 1965, Mr. Jones's fund had achieved 670% whilst the best of the mutual funds was the Dreyfuss fund which had managed 358%. Following this article, Alfred Jones joined the ranks of legendary Wall Street figures. The second effect of this article was the proliferation of managers seeking to copy the investment style of Alfred Jones. The Jones model was conceived so that the performance of the fund depended almost exclusively on stock picking, i.e. the activity of stock selection, whilst relying little on the direction taken by the market.

During the moments in which the market was experiencing growth, good stock selection (and by extension, investment) results in much higher returns than the market average, whilst good stock selection in terms of short selling will most likely result in returns lower than the market average. In negative market conditions, a portfolio with well-selected long positions will in theory fall less than the market and the short positions will ideally fall further than is average for the market. In this way, the Jones model succeeded in obtaining returns in all market conditions, whether bull or bear. The Jones fund became the model to imitate by the emerging hedge fund industry. The success of hedge funds following the publication of the article was notable. Indeed in 1968, the number of hedge funds reached 200. Among these new hedge fund managers, the names of George Soros and Michael Steinhardt appear for the first time.

The sixties were a bullish time for the market and many hedge fund managers took advantage of this rising trend, obtaining excellent results. However, the euphoria surrounding these new hedge funds disappeared when the long period of favourable market conditions ended at the start of the seventies. The market contractions of 1969–1970 and 1973–1974 caught many managers unprepared to deal adequately with the market's fall. In the early years, the bull market led hedge fund managers to use financial leverage to increase their returns, paying little attention to the short constituent of their portfolio. But the innovation of the Jones model resided in the fact that both leverage and hedging were used to manage the portfolio. The Jones hedge fund demonstrated its superiority in relation to mutual fund investments, precisely during falling markets, thanks to uncovered selling of securities. Jones was able to profit notwithstanding the negative market trend.

Following the exit from the market of many managers, hedge funds returned to obscurity, far from the attention of the press. In the eighties, only a modest number of hedge funds were launched. In 1984, according to Tremont data, only 68 funds existed and investors were almost exclusively high net worth individuals. The relationship between the manager and the investor was personal and through word of mouth, the assets controlled by these funds rose.

In general, however, it was still difficult to establish the exact number of hedge funds in operation. The majority of managers traded on international financial markets and as such, were not registered under the SEC (Securities and Exchange Commission). In those years, the American authorities forbade managers to advertise, limited the number of investors to 99, and this forced managers to demand elevated minimum investments. These factors resulted in hedge fund managers basing their operations in offshore markets where such restrictions did not exist. For this reason, it was difficult to establish the extent of the hedge phenomenon.

In the United States, the financial community is bound by three separate pieces of legislation.

1. Legislation intended to protect the novice investor who does not fully understand the transactions, strategies and instruments used by the hedge fund manager, be that because of the individual's limitations, or because of the limited information available on these instruments.
2. Legislation intended to protect the integrity of the market in such a way that prices are formed correctly, in accordance with the principle of competition. This principle aims to guarantee absolute transparency relating to transactions, thereby preventing any form of collusion, price and information manipulation (insider trading and any form of market rigging).
3. Legislation relating to risk: representing legislation relating to financial markets within different countries (capital requirements, margins and limits on open positions) in order to ensure the robustness of the markets, rendering them more immune from speculation and arbitrage. This legislation affects all financial activities conducted by traders based in the USA, such as mutual funds, pension funds, insurance funds, etc. To escape the confines of such legislation, to avoid the strict supervision of the SEC, the hedge fund industry devised a system based on two distinct types of company, the "Limited Partnership" for companies based in the USA and the "Offshore Investment Corporation" for those companies headquartered in offshore locations. In 1986, a new article entitled "The Red Hot World of Julian Robertson" once again brought hedge funds back into the limelight. The article presented Julian Robertson's Tiger Fund which, in its first six years, had achieved 43% growth (net of commissions) contrasting with the 18.7% registered by the S&P 500 index. In this article, Robertson explained that he had adopted "a new working method". The innovation gave rise to a new type of hedge fund called *global macro* or simply *macro*. The name global macro derived from the investment philosophy of the fund: a global macro fund is characterised by its high risk/return profile, global approach and

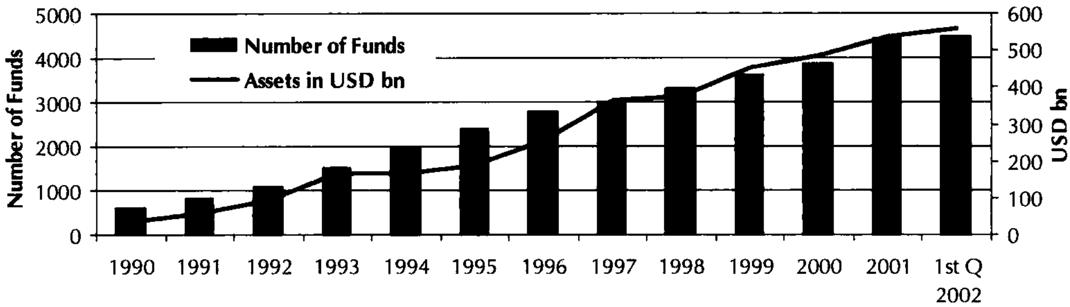

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Figure 1.1 Growth of the number of hedge funds 1988–2000

absence of limits in terms of investment instruments and sector diversity. Financial leverage was used aggressively and the fund's assets reached $20–30 billion which, compared with the average levels of other hedge funds ($60–100 million), was extremely high. The hedge fund industry became dominated by global macro funds, which had captured the wider press's imagination during this period. The managers leading this trend were Julian Robertson, George Soros and Michael Steinhardt, personalities who became known even to the man in the street. Their funds achieved returns during this period of around 40% per year. In 1990 for example, George Soros's Quantum Fund gained 30%, Julian Robertson's Jaguar Fund registered +20% whilst the S&P 500 had contracted by 3%. In the same year, the MSCI World index lost a staggering 16%. The sudden clamour awoke the interest of European investors, attracted by the advantages offered by this new breed of manager, both in terms of returns and the beneficial tax regimes of the offshore centres in which they were domiciled.

As demonstrated in Figure 1.1, the second half of the nineties saw a rapid increase in the numbers of hedge funds. Where hedge funds had in the past been rare exceptions, it is certainly true that the cult of major hedge players such as Robertson, Soros and Steinhardt had contributed to the exceptional growth of this industry.

During the early nineties, two interesting phenomena emerged: the first was that many money managers working for major institutions were suddenly tempted to defect to the world of hedge funds. This phenomenon began around 1994 but the role of the hedge fund manager was to be transformed. Whilst obtaining high returns was obviously important, the real objective was definable more in terms of the pursuit of this new "ostentatious" lifestyle. This is important in that the managers contributed a large proportion of their own assets to their funds' capital. Whilst this tendency could be described as a return to the Jones model, the second phenomenon was completely new. The second factor refers to the fact that a growing number of money managers introduced limits to the growth of their funds' capital. They defined a threshold beyond which new client monies and increases in the stakes of existing clients would not be accepted.

With the possibility that the fund manager would close the fund, the size of hedge funds fell, thereby imitating the Alfred Jones model. The guiding philosophy was that the manager should find a niche, where his ability and discipline would result in absolute returns whilst at the same time limiting portfolio risk. In 1992, as you can see in Figure 1.2 based on TASS data, global macro hedge funds were responsible for 74% of assets within the hedge fund industry.