GUIDE TO HEDGE FUNDS

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GUIDE TO HEDGE FUNDS

What they are, what they do, their risks, their advantages

Philip Coggan

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To Robin Coggan (1918–88), who taught me that there was always more to learn

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Philip Coggan
May 2010

Introduction

In a small room on the banks of the River Thames, on the site of an old dock, Meg Ryan and Jamie Lee Curtis stand in air-conditioned splendour. All day long, they calculate and analyse and send orders to some 17–18 traders sitting outside. No, the American actors have not taken up a second career. Meg and Jamie are the names of two of the computer servers in the headquarters of AHL, part of Man Group, one of the largest hedge fund groups in the world. AHL runs billions of dollars on the back of what those computers decide to do.

In his 1980s novel, *The Bonfire of the Vanities*, Tom Wolfe said the investment bankers were the "masters of the universe". That description is now out of date, as Wolfe himself admits. Hedge fund managers have assumed the mantle.

Those men (there are relatively few women) who run the funds have the power to bring down currencies, unseat company executives, send markets into meltdown and, in the process, accumulate vast amounts of wealth. A survey by *Alpha*, an industry magazine, found that the world's top ten managers earned almost $10 billion between them in 2008, with the top four taking home – or in their case, several homes – more than $1 billion each.[1] Some of the leading managers have become patrons of the art market, helping drive prices of contemporary artists to new highs.

But with this power has come immense controversy. During the credit crunch of 2007 and 2008, hedge funds were accused of exploiting the crisis, driving down the shares of banks and increasing the risk of financial panic. Their high earnings were seen as unjustified, their activities as mere speculation, and their continued existence as a threat to the financial system. European Union officials and parliamentarians vied to create the toughest set of regulations for the industry.

Meanwhile, the industry suffered a liquidity crisis as banks cut their lending to hedge fund managers. This coincided with poor investment performance (by the industry's standards), causing clients to demand their money back, and the fraud of Bernie Madoff (who did not strictly speaking run a hedge fund) increased the rush for the exit. The industry suffered the loss of around one-third of its assets.

This was a big change for a sector where the best fund managers were so sought after that they could afford to turn investor money away; being on their client list was a badge of honour akin to joining the more exclusive gentlemen's clubs. Madoff (who managed money on behalf of some hedge funds) was adept at using exclusivity as a lure to clients; initially, they would be turned away, only for Madoff to find some "capacity" after a short interval. Indeed, some would say that investors should be suspicious of any manager who is willing to take their money – the equivalent of Groucho Marx's famous saying: "I wouldn't want to belong to any club that would have me as a member."

Hedge funds have virtually set up an alternative financial system, replacing banks as lenders to risky companies, acting as providers of liquidity to markets and insurers of last resort for risks such as hurricanes, and replacing pension and mutual funds as the most significant investors in many companies. Some, such as Eddie Lampert, have even bought companies outright, notably the retailing groups Kmart and Sears; when Daimler sold its Chrysler arm in 2007, the buyer was not another auto giant but a hedge fund/private equity group, Cerberus. They are like wasps at a summer picnic, buzzing round any situation where a tasty feast might be available. If an asset price rises or falls sharply, hedge funds are often to blame. And even when they are not responsible, they will be blamed anyway.

The new managers also have a different style. Unlike traditional bankers, they prefer more casual forms of dress – open-necked shirts and chinos are more common than tailored suits. They run their businesses from different places – Greenwich, Connecticut and Mayfair rather than Manhattan and the City of London. And they have different aims, often rejoicing when prices fall as much as when they rise.

This book sets out to explain who the hedge fund managers are and what they do. Most people have probably heard of the term "hedge fund" but have little idea of what it means. That is hardly surprising, since there is no simple, three-word explanation; a survey of international financial regulators in 2006 found that no country had adopted a formal, legal definition of the term. But it is a subject that is hugely important, given the influence of hedge funds.

Working in the shadows

Although the term hedge fund is often bandied about in the press, there are few individuals or firms that could rank as household names. Public perceptions of the industry are behind the times. In Britain, the best-known example of a hedge fund manager is still George Soros, dubbed "the man who broke the Bank of England" for his role in forcing the pound out of Europe's exchange rate system in 1992; in America, the best-known fund is probably Long-Term Capital Management (LTCM), the fund backed by Nobel Prize winners that speculated and lost in 1998, prompting the Federal Reserve (the American central bank) to organise a rescue. But LTCM no longer exists and Soros is better known as a philanthropist and political activist than a fund manager these days.

Most hedge fund managers would rather stay out of the headlines. They do not want the political hassle that comes with bringing down exchange rates, nor do they want the details of their very large salaries bandied around in the press. (Eddie Lampert was kidnapped in 2003, although in "master of the universe" style, he talked his way free.) A survey of fund managers found that almost three-quarters believe their wealth makes them a target for criminals.[2]

Few hedge funds want to make the size of bets that nearly brought down LTCM. They simply want to make money for themselves and their clients, in an atmosphere devoid of the bureaucracy and stuffiness that often rule at the big financial firms. And they have been pretty successful, certainly in attracting clients.

The managers operate in a world that is bedevilled by jargon (which is why there is a glossary at the end of the book). It is a world that is ever-changing; indeed, one argument of this book is that the divide between hedge funds and traditional investors is steadily disappearing. In ten years' time, hedge funds may no longer be a separate category of institution.

But let us start with the basics. What is a hedge fund? It is a bit like describing a monster; no single characteristic is sufficient but you still know one when you see one. A report from the Securities and Exchange Commission (SEC), America's financial regulator, on the industry says "the term has no precise legal or universally accepted definition". But we can say that hedge funds have some, or all, of the following characteristics:

- They are generally (but not always) private pools of capital; in other words, they are not quoted on any stock exchange. Investors give the managers money and then share in any rise in value of the fund.
- They are not liquid investments. Investors may only be able to sell their holdings every quarter, and will often need to give advance notice of their intention to do so. Restrictions are even tighter at the start of a hedge fund's life when a lock-up period (which can be two years or more) is imposed. This allows the managers to take risks and buy illiquid assets, without being forced to sell their positions at short notice.
- They have been (until now) lightly regulated and taxed. Often, they will be registered in some offshore centre such as the Cayman Islands. In return for these privileges, regulators normally try to ensure that only very wealthy people and institutions (such as pension funds) can invest in them. Rules currently going through the American Congress and the European Parliament may tighten the regulatory net.
- They have great flexibility in their ability to invest. They can bet on falling prices ("going short" in the jargon) as well as rising ones. This means they aim to make money even when stockmarkets are plunging, an approach that is known as an absolute return focus.
- They have the ability to borrow money in order to enhance returns.
- The managers are rewarded in terms of performance, often taking one-fifth of all the returns earned by the fund. Together with an annual charge, this means they carry much higher fees than most other types of fund. Their supporters claim these fees are justified by the skills of the managers involved.

The hedge part of their name springs from the term "hedge your bets". It is generally agreed that an ex-journalist, Alfred Winslow Jones, set up the first hedge fund in the late 1940s. He fancied his ability to pick stocks; in other words, to find those shares that were most likely to rise in price and to avoid those he felt might fall. But he did not want to worry about the overall level of the stockmarket, which might be hit by a rise in interest rates or some political news.

So he tried to hedge his portfolio, buying some shares he felt would rise in price and offsetting them by having short positions in those he felt would fall. Provided his stock picks were correct, he would hope to make money regardless of how the market performed. He was also confident enough in his skills to use borrowed money in an attempt to enhance his returns.

Some modern hedge funds, known as market neutral funds, eliminate market risk completely. But most are not quite so pure. They take directional bets of one kind or another, hoping that a class of shares or bonds or oil or some other asset price will rise. Of course, they may get that bet wrong. That is one of a number of risks that hedge fund investors face. The others include the following:

- To the extent that hedge funds use borrowed money, their losses, as well as their gains, can be magnified. For example, if a hedge fund raises £100m, then borrows a further £300m to invest, a 25% fall in the value of its portfolio could wipe out all its capital. One of the earliest indicators of the credit crunch was the losses incurred by two Bear Stearns hedge funds in 2007, after they bet on bonds linked to the American mortgage market. One fund, supposedly the safer of the two, was eventually worth just 9 cents on the dollar; the other became worthless.
- Because the funds are lightly regulated, there is a greater chance of fraud. This is especially true because hedge funds are not transparent; investors do not know exactly what is in their portfolios (a particular problem for those hedge funds linked to Madoff). Hedge funds desire this opacity so that other investors do not know what positions they hold, and thus cannot copy their strategies or even bet against them. But in some cases, it has transpired that hedge fund managers have been able to lie about the profits they have made, or the places where they have invested.
- The illiquidity of hedge funds means that, even if investors realise that the manager has run into trouble, it could be months before they get their money back. Even then, arrangements called "gates" may restrict the proportion of an investor's holding that can be redeemed.

- The higher fees charged by hedge funds could absorb a large proportion of an investor's returns. Indeed, they could more than offset any skill the manager might possess.
- The combination of high borrowings and lack of transparency could lead to hedge funds taking large positions in some markets. In some cases, they may find it impossible to get out of those positions without taking huge losses. Some blamed this process for the sharp losses suffered by financial markets in late 2008.

Hedge funds: Darwin in action

So why do investors choose to back hedge funds at all? One reason is that they believe they are giving money to the best and the brightest; the smartest moneymen in the world.

The managers believe that too. They see themselves embroiled in a daily Darwinian struggle with the markets; they have to make money or perish. Andrew Lo of the Massachusetts Institute of Technology says:[3]

> *Hedge funds are the Galapagos Islands of finance. The rate of innovation, evolution, competition, adaptation, births and deaths, the whole range of evolutionary phenomena, occurs at an extraordinarily rapid clip.*

In 2008, for example, 659 new hedge funds were launched, but 1,471 folded; academic studies suggest that almost half of hedge funds fail to last five years. The financial crisis in 2007 and 2008 caused the industry to shrink by almost one-third; as assets fell in price, clients withdrew their money and some managers were forced to close their funds.

A brilliant reputation is no guarantee of success. Industry pioneers like Michael Steinhardt and Julian Robertson were eventually forced to close their funds because of poor results.

Think of the hedge fund manager as a batsman in cricket, or a batter in baseball, dependent on his skill. Some will succeed by taking wild swings and hitting the ball into the crowd; others will score through carefully placed singles. But if they miss the ball too often, they will be out. Most funds fail not because they lose all, or even a significant part, of investors' money; they simply do not earn a sufficient return to keep investors interested or achieve a decent performance fee. As the fund shrinks in size, it becomes uneconomic to carry on.

Nevertheless, it can still be argued, from society's point of view, that there is something bizarre about people becoming so rich from shuffling bits of paper, or manipulating numbers on a computer screen. No doubt the world would be a better place if our greatest minds were working on a cure for cancer or a solution to global warming than trying to bet on the next move in the Japanese yen.

But it is clear that many people are attracted by the buzz of testing themselves in the markets. As a manager, your "score" is known every day (at least to you) as your portfolio rises and falls in value. Luck clearly plays a part, but at the end of a year your performance numbers will tell the world whether you have done a good job. There is no need for career reviews, 360-degree feedback or any management jargon.

Managers work hard. Take a typical day of Nathaniel Orr-Depner, who trades in currencies and commodities for Lionhart, a US group. He gets up at 5am, checks the Bloomberg screens for the Asia closes and is in the office at 6am so he can talk to the firm's Asia office in Singapore. He then talks to the firm's traders in their Wimbledon office in south-west London. This is the best moment of the day for trading since all three major centres are open. But trading continues to be fairly busy through the New York morning when Europe is open. He will then go home, eat some dinner, then at night talk to the Asian traders as their markets open, so he may not finish till 9pm or 10pm. The weekends are more his own, at least from around 4.30pm on Friday to 8.30pm on Sunday, when Asia opens again. With a schedule like that, if you don't enjoy your job, you will not last long.

This frenetic activity has an enormous effect on financial markets. A 2009 survey by Greenwich Associates found that hedge funds made up 90% of trading volume in distressed debt, almost 60% of trades in high-yield credit derivatives and of trades 55–60% in leverage loans.

Diversification

Another reason investors are willing to give money to hedge funds is that they believe they are getting something different. As already explained, they have the ability to make money from falling as well as rising prices.

This absolute return means they aim to make a positive return each year. By and large, they have succeeded. The Hedge Fund Research index[4] shows that, since 1990, there have been only two negative years for the average hedge fund. The first was 2002 (a terrible year for markets in general), when investors lost 1.5%. The second was 2008, when hedge funds had their worst year, losing 19%. But even that was better than the 40–50% declines suffered by stockmarkets.

In contrast, traditional fund managers deliver a "relative return", based on some index or benchmark. They consider they have done well if they beat the index by three percentage points. But in a year like 2008, that could still mean the clients losing 40% of their money.

Modern financial markets are incredibly sophisticated. Investors can take a whole series of views on a wide range of assets. For example, they can bet on whether an individual company will default on its debt, without worrying about whether interest rates are rising or falling. They can bet on whether bonds that will mature in five years' time will perform better than those that will mature in 30 years. They can take a view on whether markets will become more volatile. They can even speculate on the weather.

As these new instruments emerge, hedge funds often have the brains and the computer power to take advantage of them. Traditional investors, such as pension funds and insurance companies, can be slow on the uptake. So for a while, the hedge funds may be able to make some easy profits before the rest of the world catches up.

The strongest claim from hedge funds, and one that is open to considerable dispute, is that their returns are "uncorrelated" with traditional assets such as shares and bonds. What this means is that hedge funds do not always move up and down in line with other assets.

Lack of correlation is an attractive characteristic in financial markets. It means that portfolios of uncorrelated assets can deliver the same return, with a lower level of risk, or a higher return, with the same level of risk.

Short orders

Another argument is that the extra tools hedge funds can use (going short, using borrowed money) give them advantages over traditional managers. To use another sporting analogy, they have a full set of golf clubs, whereas most managers are given only a driver and a putter.

However, the ability to go short is probably the hedge fund characteristic that causes the most controversy. Short-selling is a long-established practice, with its own little rhyme: "He that sells what isn't his'n, must buy it back or go to prison." It has never been popular. Many people see something underhand in betting on a falling price; it is rather like wishing bad luck on a neighbour. Generally, everyone prospers to some degree when the stockmarket rises, either directly (through shares they own outright or in a pension or insurance fund) or indirectly (as rising wealth leads to higher employment). Stockmarket crashes are usually associated with economic problems.

Companies do not like short-sellers. By driving down the price, they are perceived to be undermining the executives, who are partly motivated by share options. Politicians do not like short-sellers, often because they do not understand the role they play in markets. When a market falls sharply, you can usually find one party hack who will grumble about the manipulation of prices; it even happened after the attacks on New York and Washington in September 2001.

Regulators stepped in to restrict the short-selling of shares in banks in the wake of the credit crunch. The fear was that depositors and creditors would see falling share prices as a signal of a bank's poor health. Thus a determined short-selling campaign could be a self-fulfilling prophecy, forcing more banks to the wall.

Such regulations made it seem as if short-selling was a quick, easy (and dirty) way of making money. In fact, it is a difficult business. It costs money to borrow shares; short-sellers pay the equivalent of interest. In some markets, such as the United States, there are restrictions on when short sales can be made. Other investors can indulge in "short squeezes", trying to drive prices higher so the short-seller has to cut his position. Whereas there is no limit on how far a share price can rise, a short-seller's gains are restricted; the price can only fall to zero. If you buy a share and the price falls, it gradually becomes a smaller and smaller part of your portfolio; if you short a share and it rises, the position becomes larger and larger. Finally, over the long run, short-selling is a bad bet, since share prices generally rise.

But short-sellers still play a useful role in markets. Bubbles do occur, for example during the dotcom boom when companies with no profits and little in the way of sales were worth billions of pounds. Prices can develop momentum effects; as they rise, more investors want to get involved, and that pushes prices up even further. This can drive share prices a long way from fair value. It can lead to the misallocation of capital, a fancy way of saying that bad businesses get funded and good ones fail for lack of interest. Short-sellers, by taking aim at overvalued shares, can bring prices back in line.

Gradually, traditional investors are getting the powers to go short as well, or at least to bet on falling prices. Complex instruments called derivatives allow investors to bet on a host of different factors from currencies, through changes in short-term interest rates to the riskiness (volatility) of the market itself. In Europe, a set of regulations known as UCITS III allows fund managers to use hedge fund techniques. Many big asset management companies, such as Gartmore and Goldman Sachs, have hedge fund arms of their own; some of the big hedge fund groups are launching traditional-style funds.

A growing industry

This convergence reflects the extraordinary growth of the hedge fund business. Everyone wants to get in on the act. In 1990, according to Hedge Fund Research, hedge funds managed some $39 billion of assets, tiny in global terms; by the end of 2007, that figure had grown to almost $1.9 trillion (or $1,900 billion). By the first quarter of 2009, the number had dropped to $1.33 trillion, but a recovery took the figure to $1.54 trillion by the end of the third quarter. The number of funds increased from 610 in 1990 to 10,096 by the end of 2007, before dropping to just under 9,000 by the autumn of 2009.

America is still the global centre of the industry but Europe, led by London, is catching up. A Financial Stability Forum report in May 2007 found that Europe's share of total hedge fund assets had doubled from 12% in 2002 to 24% in 2006, while Asia's proportion had risen from 5% to 8% over the same period.

That is an awful lot of money and it generates an awful lot of fees. One estimate put total hedge fund fees in 2005 at $65 billion. This explains why hedge fund managers are able to buy up swanky apartments in Manhattan and commandeer the best restaurant tables in Mayfair.

Nevertheless, the hedge fund sector is still small in terms of the rest of