

Myths and realities of hedge fund investing

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Everybody's talking about hedge funds, but a lot of what they're saying doesn't make much sense. Some of the nonsense emanates from within the hedge fund community, where marketing people sometimes make exaggerated claims about the strategies and managers that they are selling. These exaggerations naturally arouse scepticism among thoughtful listeners, which leads in turn to an opposing set of negative exaggerations. The positive myth says that hedge funds can solve all your investment problems, while the negative myth says that hedge funds are the source of all your investment problems. The challenge is to steer a prudent course between the opposing myths.

1. THE TWO MYTHS

According to the positive myth, hedge funds are the smart money, the result of a massive brain drain that has driven all the investment talent from the long-only world, and the broker/dealer proprietary trading desks, into the hedge fund world. Hedge funds generate alpha by taking advantage of the long-only dinosaurs, exploiting market inefficiencies to generate return without taking on directional market risk. According to the negative myth, hedge fund managers are investment cowboys who make huge leveraged bets. Their primary objective is to game the incentive fee, which gives them all upside and no downside. If they can't make money by successful trading, then they make it the old-fashioned way, by fraud or theft. The positive myth has contributed to the remarkable growth of the hedge fund business, while the negative myth is a natural reaction to what looks to some like excessive growth. Our firm has been involved with hedge funds since the late 1970s, so we've been in the middle of the fray as hedge funds have moved from the fringes into the mainstream. According to the standard estimates, there is now about \$1 trillion invested across a universe of roughly 10,000 hedge funds. A good deal of that money is controlled by funds of funds, of which there are at least 1,000.

2. SUPPLY AND DEMAND

Hedge funds are not merely a fad. The growth of the business has been driven by powerful forces that have created both the demand for hedge funds and the corresponding supply. The demand story boils down to three words: *return, volatility, and correlation*. A well diversified hedge fund portfolio can deliver decent return, tolerable volatility, and low correlation with the standard stock and bond markets, especially when those markets are down. The return objective is typically expressed as a premium over the risk free rate, which is the return generated by a perfect hedge. Hedge fund managers strive to build "imperfect hedges" in which the long positions will outperform the short positions, thus delivering a premium over the risk free rate.

This approach creates the potential for returns that are not linked to rising markets. Low correlation became especially important after the end of the great bull market of the 1980s and 1990s, when investors finally realized that stocks sometimes go down.

The supply story boils down to two words: *freedom and fees*. Although traditional “long only” investment management can be challenging and lucrative, it can also be a bureaucratic nightmare, dominated by consultants who obsess about style boxes and tracking error. The hedge fund world is a “free form” world where managers use a broader range of tools in pursuit of their absolute return objective. Think Technicolor vs. black and white. In addition, the pay is better: “1 and 20” beats 50 basis points any day of the week.

3. THE BLOW-UP PROBLEM

Let’s dispose quickly of the negative myth so that we can focus more thoroughly on the problems with the positive myth. The negative myth begins by emphasizing “the blow up problem,” which usually involves one or more of the following elements: major trading losses resulting from overly aggressive positions; misrepresentation of historical and/or current performance; fraud and/or theft. Blow ups do occur, but they are the exception, not the rule.

There are certainly some very aggressive managers willing to make large leveraged bets, but most hedge fund managers have told their investors that they are devoted to consistency of return and to preservation of capital in down markets. Investors get unhappy when they see big negative numbers, which places definite limitations on the manager’s ability to be aggressive.

This point has implications for the standard incentive fee arrangement. Critics often complain that the incentive fee grants the manager a free call option on the trading profits, thus serving as an incentive to take extra risk. But the incentive fee can also serve the opposite function. Most hedge fund managers are long-term greedy, not short-term greedy. They want to build a business that will generate a handsome income stream over multiple years. The best way to do this is to produce a stream of attractive returns with manageable volatility. A 100 per cent gain in the first year will produce a bountiful incentive fee, but it will also scare away potential investors.

As for the problems of fraud and theft, they are no more common in the hedge fund business than in any other business. Moreover, the knowledgeable investor can often spot the problem cases. Sometimes the problem is an affiliated broker/dealer or a relatively unknown accounting firm. Sometimes the problem is that the basic story simply does not hang together. Over the years, our firm has had initial encounters with a number of hedge funds that wound up generating headlines later on due to some form of blow up. In each case, there were warning flags that would deter the careful investor. Of course, it’s easy to name the blow-ups that we all know about. The problem is the blow-ups that we don’t know about yet. Our tool for addressing this risk is not a *system* but an

attitude: a powerful blend of cynicism, scepticism, and paranoia, carefully refined over a thirty year period of seeing weird stuff happen. Our operating motto comes from Andy Grove, the Chairman of Intel: only the paranoid survive. Even so, every tool for addressing risk is fallible. The ultimate protection is diversification.

4. DO HEDGE FUNDS MAKE MONEY?

It is important to ask whether hedge funds, in aggregate, make money. After all, the central ingredient of the positive hedge fund myth is that hedge funds are “the smart money,” with a carefully-developed monopoly on the brain power available in the investment business. This is a pernicious distortion: there are lots of talented investors in the long-only world, and lots of people in the hedge fund world who are not nearly as talented as they think they are. The hedge fund business is ruthlessly competitive: the barriers to *entry* are low, but the barriers to *success* are high. This point applies even to those “celebrity managers” who are able to launch funds with billions of dollars in assets and multi-year lock-ups. The perfect resume is no guarantee of investment success. Hedge fund aficionados suggest that their business is a positive-sum game that extracts profits from less skilled investors who do not belong to The Club. We disagree. The investment community divides into various sub-communities: long-only managers, hedge fund managers, proprietary trading desks, and so forth.

Within each of these subcommunities there are many different levels of skill. It’s plausible to assume that skilled investors extract profits from the less skilled, but that doesn’t mean that hedge funds extract profits from other sectors of the investment community. Our working assumption is that the hedge fund business may well be a zero-sum game.

A working assumption is not the same as a definitive conclusion, since it is impossible to form definitive conclusions about the performance of *all* hedge funds. The information is simply not available. Moreover, the familiar databases are vulnerable to various biases. There are many hedge funds that do not report to the familiar databases. The nonreporters include some of the long-established funds with good records, plus a larger number of smaller/newer funds with unremarkable records. Managers with lackluster results do not clamor to have their results included in the databases, which produces an upward bias in the database figures.

If hedge fund investing is a zero-sum game, does that not remove the main argument for investing in hedge funds? Not at all. But it does mean that the reason for investing in hedge funds is not to capture some “average return,” but to earn a superior return by making intelligent decisions about strategies and managers. The situation here is analogous to private equity investing, where the *average* return across multiple vintage years is not nearly as mouth-watering as you might imagine. People who invest in private equity are not trying to capture an average return: they are trying to earn a superior return by making smart choices about industries and funds.

5. HOW DO HEDGE FUNDS MAKE MONEY?

Hedge funds do *not* make money by exploiting market inefficiencies. Although there are some funds that seek out inefficiencies, they tend to be small funds with limited capacity. Most hedge funds are not even looking for inefficiencies. Moreover, even if there are inefficiencies lurking in the corners of the capital markets, there aren't enough to support a \$1 trillion business. Finally, it is crucial to remember that the enterprise of exploiting market inefficiencies is not risk free. To paraphrase Keynes, prices can remain inefficient longer than you can remain solvent.

Hedge funds make money by taking risk. The prudent investor needs to understand what risks the manager is taking, and needs to diversify those risks within an intelligently designed portfolio. In principle, the risks can be divided into *beta* and *alpha*. Betas are market-related risks that can be implemented either totally passively or in some other simple and cheap mechanical fashion. The most familiar beta is long equity market exposure, but hedge fund investors also need to worry about "non-directional betas," or "alternative betas." For example, many equity hedge funds have a tendency to be long small cap stocks and short large cap stocks; in the fixed income markets, many managers have a tendency to favor carry trades, in which they are long higher-yielding instruments and short lower-yielding instruments. All of these tendencies can be implemented mechanically and cheaply. The manager who is charging "1 and 20" has to demonstrate that he can add value relative to a mechanical implementation of the underlying trading style. That's the alpha component of risk and return.

Many people have developed multi-factor models of hedge fund performance, linking returns to a variety of market-related factors: "cross-sector spreads" (small cap vs. large cap, value vs. growth, mortgages vs. Treasuries, etc.), levels of volatility and trend, and so forth. These models can be a useful analytical tool, but they do not show that all hedge fund returns can be totally explained via the relevant factors. Still, they can help separate the low alpha managers (for whom the underlying factors will offer a fairly complete explanation of returns) and the higher alpha managers (for whom the regression coefficients will be low and will vary with the choice of time periods.)

We divide the menu of hedge fund strategies into two main groups. The first group is the category of *opportunistic active management*, or what you might call *hyper-active management*. These managers use analytical tools very similar to those of a long-only manager, but they use those tools with more degrees of freedom, in order to seek out absolute return. This category includes most equity hedge funds (including the market neutral funds), the global macro funds, and even fixed income arbitrage. Second, there are the *specialist strategies* that do not emerge naturally from the world of long-only active management. The main examples here are risk arbitrage, convertible hedging, and distressed debt investing.

The specialist strategies tend to be rather *homogeneous*. Different practitioners are looking at the same universe of opportunities and analyzing those opportunities in very similar

ways. Moreover, these are the strategies where the various "alternative betas" play an especially prominent role. For example, risk arbitrage depends critically on deal flow and deal spreads; convertible hedging depends critically on volatility and on credit spreads (at least with some practitioners). The homogeneous strategies present the greatest risk of "crowded trades": too much money chasing too few opportunities. These are also the strategies where the capacity issue arises most acutely.

Strategies in the category of "hyper-active management" tend to be much more *heterogeneous*: the number of different styles and approaches is at least as great as in the long-only world. There's growth vs. value, momentum vs. contrarian, and all sorts of sector specialists and regional specialists. This makes for high dispersion of positions and high dispersion of returns. For example, as oil markets moved steadily upward in 2005, some of our managers were long, some were short, and many had no positions at all. The heterogeneous strategies are the portion of the hedge fund universe where it is especially dangerous to make glib generalizations about "what hedge funds are doing."

6. IS THERE A HEDGE FUND BUBBLE?

Many people argue that we are in the midst of a hedge fund bubble: too much money is chasing too few opportunities, thus dragging down returns. Barton Biggs started talking this way several years ago, before he launched his own hedge fund, and then wrote a book about his experiences. The current version of the argument goes like this: hedge funds need volatility in order to generate profits, but the proliferation of funds has drained volatility from the markets.

To place this question in perspective, it is essential to remember that hedge funds returns are cyclical. Although hedge fund managers aim for "absolute return" and for "consistency of return," the fact is that there are dry spells and then there are good periods. This point emerges clearly from Table 1, which shows the performance history of two "homogeneous strategies" (convertible arbitrage and merger arbitrage) as well as two "heterogeneous strategies" (equity hedge funds and macro hedge funds). Convertible arbitrage struggled in both 2004 and 2005, with 2005 an especially difficult year thanks partly to well-publicized problems provoked by the travails of General Motors Corporation. Merger arbitrage and macro hedge funds also struggled in those two years. Note, however, that equity hedge funds performed quite respectably in 2005, though not as robustly as in some prior years.

It is worth noting that 2006 has started out on a very strong note, with three of the four groups posting *unannualized* returns above 4 per cent in the first three months. The pattern here is typical: when all the commentators are proclaiming that "hedge funds are dead," that usually means that better times are right around the corner.

Disclaimers about the limitations of hedge fund databases, let us return to the broader point that hedge fund returns are cyclical. (To avoid misunderstanding, I should emphasize that "cyclical" does not mean "predictable.") Some of that

cyclicality is related to short term interest rates. Hedge fund investors are generally aiming for a spread over LIBOR. When short-term rates are unusually low, as they have been for much of the recent period, expected nominal returns from hedge funds are also low. But there are two other factors that contribute to cyclicality.

First, as noted above, hedge fund strategies respond to various non-directional market variables: intra-market spreads, changing levels of volatility and trend, and so forth. Second, hedge funds are vulnerable to major financial storms, as in 1994 (Fed tightening), 1998 (Russia/LTCM), and 2002 (Enron etc.).

The recent period has been relatively free of major crises, but at the same time the markets have offered very low volatility and very low dispersion of returns. Figure 1 shows volatility and dispersion within the US equity market. The first panel shows historical volatility, both at the index level and the level of individual stocks.

TABLE 1. RETURNS OF SELECTED HEDGE FUND STRATEGIES

Convertible Time Period	Merger Arbitrage Index	Equity Arbitrage Index	Hedge Index	Marco Index
1991	17.60	17.86	40.15	46.66
1992	16.35	7.90	21.32	27.17
1993	15.22	20.24	27.94	53.31
1994	-3.73	8.88	2.61	-4.30
1995	19.85	17.86	31.04	29.32
1996	14.56	16.61	21.75	9.32
1997	12.72	16.44	23.41	18.82
1998	7.77	7.23	15.98	6.19
1999	14.41	14.34	44.22	17.62
2000	14.50	18.02	9.09	1.97
2001	13.37	2.76	0.40	6.87
2002	9.05	-0.87	-4.71	7.44
2003	9.93	7.47	20.54	21.42
2004	1.18	4.08	7.68	4.63
2005	-1.86	6.25	10.60	6.79
Jan-Mar 2006	4.63	6.48	6.60	2.74

Source: Indices supplied by Hedge Fund Research, Inc.

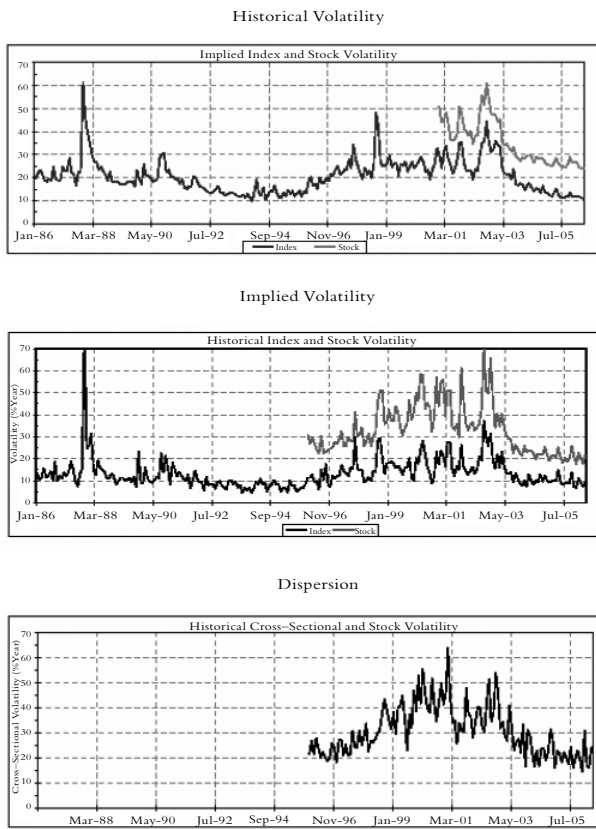
(The upper line is the average volatility of the 100 stocks in the OEX index. The lower line is the volatility of the index. The volatility of a portfolio is lower than the average volatility of the components of the portfolio.) The second panel shows implied volatility, again at two levels. The third panel shows dispersion of return, or cross-sectional volatility.

Hedge funds require price movements for trading profits, and they require cross-sectional volatility so that the long positions can outperform the short positions. The recent environment has been challenging on both fronts. The hedge fund cynics argue that hedge funds have brought this problem upon themselves: they are responsible for the lack of volatility and dispersion. This claim is not plausible. The trading strategies that draw volatility from the markets are contrarian, mean-reversion, buy low/sell high strategies. These strategies act as negative feedback loops so that small moves don't turn into big trends. Although many hedge funds fall into this camp, many have the opposite tendency: they are momentum-oriented investors who would rather buy on strength than on weakness. Hedge funds, in aggregate, are not a contrarian trading machine functioning as a negative feedback loop within the markets. Moreover, it is ironic to note that hedge funds have recently been blamed for *reducing* market volatility, whereas in earlier years they were blamed for *increasing* market volatility. You can't have it both ways, and you can't blame everything on hedge funds.

7. THE REGULATORY ENVIRONMENT

Most hedge fund managers are based in the US, which is generally regarded as the birthplace of the hedge fund business. But hedge fund communities have also taken root in London, Tokyo, and other major financial centers. In the UK, the Financial Services Authority has had jurisdiction over hedge funds for many years. In the US, on the other hand, hedge funds operated for many decades in a manner that enabled them to avoid regulation by the Securities and Exchange Commission. In the US there was a "regulatory compact" that went roughly as follows: if a money manager offered his/her services to the institutional market (pension funds, endowments, foundations, high net worth individuals, and so forth) and not the retail market (small individual investors), then the manager was not subject to SEC regulation. This regime changed in 2005, which meant that many hedge funds were obliged to register with the SEC by early 2006. During the long and controversial process leading up to the promulgation of the new regulations there was intense discussion about the impact of the new regulatory regime on the hedge fund business.

FIGURE 1. VOLATILITY AND DISPERSION



Source: Citigroup/Smith Barney and Chicago Board Options Exchanges

Our general sense is that the impact may well be less than expected. Many managers (including our firm) were already registered. Many others have decided to register, accepting the new rules as part of the cost of doing business. Some of the more established managers have taken advantage of a special feature of the new regulations, which provide an exemption for hedge fund managers who require that their investors lock up their capital for two years or more. (This exemption was created so that private equity funds would not be captured in the enlarged regulatory net.) Finally, the new rules may encourage some of the more marginal players to fold their tents. This would be a good thing: culling the herd strengthens the herd.

Even if the new regulations have only a minor impact on the hedge funds themselves, there is a totally separate question about the impact of the new regime on those who invest in hedge funds. The new rules raise an important moral hazard issue, since they may encourage the unwary investor to relax, taking comfort from the impression that “now the SEC has everything under control.” In fact, the powers of the SEC are thoroughly finite. SEC audits are a useful tool, and they may discourage certain forms of wrong-doing, but they are not a “magic bullet” that will eliminate fraud, theft, and other kinds of misbehavior. There will be a few bad apples among the firms that register with the SEC, and there will be highly professional firms that have their own reasons for preferring to avoid SEC registration. If a firm is registered with the SEC that is not an automatic “plus,” just as failure to register is not an automatic “minus.” Registration status is merely one small item on the long list that guides the in-depth due diligence process conducted by a knowledgeable investor who is thinking about putting real capital at risk.

