CHAPTER 2

A Hedge Fund Is What?

Although this book is not intended to be a primer on hedge funds, one of the first tasks is for us to define the term *hedge fund*.

While there is no universally accepted definition, the term hedge fund generally refers to an investment vehicle that invests in a wide range of securities and other assets, and is not registered as an investment company under the Investment Act of 1940 (the 40 Act). As such, the hedge fund does not issue shares or units such as mutual funds to investors but instead offers limited partnership interests. Investments in hedge funds are not sold in a public offering like mutual funds, but through private placement offerings to investors that meet specific income and asset levels as defined by the 40 Act.

However, in light of the credit crisis of 2008 and the Madoff fraud, Congress is contemplating changing some of the requirements and guidelines mentioned previously and subsequently. At the time of publication, nothing had been made firm, and we don't know where things will end up. One thing is for sure: things will change sometime before the end of 2010. We don't know when it will come or what it will be, but we do know that things will change, maybe for the better, but quite possibly for the worse.

THE CREDIT CRISIS AND HEDGE FUNDS

It is important to understand the mechanics of hedge fund investing as they were in the early part of 2009.

Hedge funds are open to accredited investors and super-accredited investors that meet an income and asset test determined by the manager before he or she can accept the investor into its fund. As of this printing, the definition of accredited investors is individuals who have a net worth of $1,000,000 or more and an annual income greater than $200,000. Institutional investors must have a minimum of $5,000,000 in assets.

Hedge funds are prohibited from advertising under the Securities Act of 1933. Cold calling, advertising on TV, and using billboards or the Internet are prohibited.

Offerings can be made only by the private placement memorandum to accredited investors. In fact, all marketing material must include disclaimers and caveats regarding the risk associated with hedge fund and private placement investing such that any thinking persons who read the material completely would not be considered in their right mind if they invested in such a product. Think kitchen sink of risks and disclaimers and add about 10,000 words. If you would like to see examples of the disclaimer or have a question, send us an e-mail at dsrb@hedgeanswers.com.

While private placement memoranda vary from manager to manager because each is "individually" designed by the many different law firms around the globe that specialize in hedge funds, most private placement memoranda outline and state in broad terms the investment strategy practices of the manager, the pricing methods of securities in the portfolio, details of any conflicts between the investment manager and investors, and the risks and fees associated with the investment. The conflicts are usually few and far between and can include things like the manager places trades through an affiliated broker dealer instead of going to outside brokers. Other conflicts could be that he manages a number of funds that trade different strategies and one fund may take advantage of one thing that another cannot. Conflicts could also be employee related, and be a result of employees sitting on boards of directors or being involved in other businesses outside of the fund. The private placement memorandum also details whom the fund does business with and provides great detail on the manager and its organization. The section of the private placement memorandum that deals with fees is usually of great interest to investors. This section details how the managers make their money and how they are paid. As of this printing, the generally accepted fees for hedge funds consisted of a management fee of between 1 and 2 percent and an incentive fee of 20 percent. Fund of funds, for the most part, charge between a 1 and a 1.5 percent management fee with a 10 percent incentive fee.

HEDGE FUNDS ARE AN ASSET CLASS

Some critics of the hedge fund industry often state that hedge funds are not an asset class but merely a compensation scheme to reward managers. This is generally advanced by mutual fund managers who are deemed by most sophisticated investors as being not in the investment-management business but really in the asset-gathering business, given that they make fees only on assets under management and have little or no stake in the success of the fund's performance.

Hedge funds employ strategies to achieve an absolute rate of return by which the funds earn a positive return regardless of market environment. Hedge funds are not as concerned as traditional long investors in achieving a relative return through which the manager seeks to beat the benchmark index. A hedge fund manager is not content to state that "our fund outperformed the S&P 500 last year." Whereas a long-only manager would be content with results that are "only" down 5 percent while the index was down 10 percent, hedge funds seek to achieve positive results in all market environments. Remember alpha from Chapter 1?

Many hedge funds often use leverage to achieve higher returns while at the same time using sophisticated risk management tools to lower portfolio volatility. The most defining difference between hedge funds and long-only investing is the extensive use of shorting securities—stocks, bonds, commodities, and exchange-traded funds (ETFs)—to "hedge" long positions and to generate positive returns from the short positions. Shorting is accomplished by managers who sell securities short (stocks or bonds) that they don't actually own with an objective of buying them back at a lower price in the future with the stated intent of earning a positive return.

Many hedge funds use hedging as part of an arbitrage strategy, such as fixed-income and convertible arbitrage, to generate low-volatility returns that are consistent over a market cycle.

In addition to trading equities and bonds, hedge fund managers use strategies that utilize currencies, futures, ETFs, commodity contracts, derivatives, private placements, weather contracts, life insurance settlement contracts, asset-based lending, and trade claims. While the list could easily be expanded more comprehensively, the fundamental basis for hedge fund investing has been to exploit market inefficiencies and capitalize on gains that may be created in each respective market, all over the globe.

Unfortunately for hedge fund managers, globalization of the capital markets and the 24-hour trading day have improved the efficiency of the markets, forcing them to look under many more rocks than they needed to just a few short years ago in search of new and unique opportunities for undiscovered profit.

LIQUIDITY PRESENTS PROBLEMS

Certainly, the lower level of liquidity of hedge funds may present an additional obstacle for some investors. In a down market or period of market stress and dislocation, liquidity seizes up, the markets lock, and trade executions are stressed. Many hedge fund managers and investors experienced this in 2007, in 2008, and into 2009 as credit collapsed and everyone seemed to be hording cash, leading many to question what, if any, value hedge funds offer investors. On that issue the jury is still out; however, there are a number of issues that investors need to keep in mind above and beyond the recent events before an investment in a hedge fund is made:

- **Use of leverage.** As witnessed on several occasions during the past five years, hedge funds use leverage to "juice" returns in up markets, but that may cause the returns to be subject to downturns or large changes in standard deviation in the fixed-income and credit markets in a down market.
- **Underperformance.** While estimates of expected returns may not be achieved, some hedge funds may increase risk to increase return or recoup past losses.
- **Liquidity.** Investors must ask whether the liquidity terms and risk profile justify the investment.
- **Style drift.** Inflows of capital and generous compensation schedules for managers may not be enough to encourage managers to "stick to their knitting," or invest in strategies that compliment the managers' backgrounds. For example if they are long/short equity managers, they should not be trading fixed income securities.
- **Transparency.** It could result in economic damage to a manager if short positions were publicized or active buy programs were made public. Since all positions may not be known, investors with a lack of short positions must rely on incomplete portfolio modeling.

The strategies employed by hedge fund managers have considerable width and depth. Some of the most popular hedge fund strategies include:

Global macro

CTA/managed futures

Long/short equity

Sector-specific long/short equity

Risk arbitrage

Fixed-income arbitrage

Mortgage-backed arbitrage

Asset-backed arbitrage

Merger arbitrage

Statistical arbitrage
Convertible arbitrage
Regulation D exploitation
Credit arbitrage
Emerging markets
Multi-strategy
Event-driven
Distressed investing
Quantitative model
Asset-based lending
Short selling
Activist investing
Carbon emissions trading
Weather trading

Although most of these strategies have been around since the beginning of the hedge fund boom in the 1990s, spreads and returns have moderated as the capital markets have become more efficient, market participants have become much more sophisticated, and hedge managers continue to evolve and find ways to exploit market inefficiencies.

TECHNOLOGY HELPS THE INDUSTRY

One of the greatest contributors to leveling the playing field has been the growth, acceptance, and prevalence of the Bloomberg. This system has created a seemingly endless list of analytical tools for tracking and modeling most investment strategies and styles. As the Bloomberg moves from a box on a trader's desk to his home office, accessed through the Internet or BlackBerry, real-time around-the-clock, around-the-globe analytics became possible, thereby eliminating the edge that many money managers have used to extract profits from the markets.

Today, with a point and click of the mouse, you can literally get real-time prices and information about pretty much any security in the world. The proliferation of the Internet as a tool in the investment world has leveled the playing field between the haves and the have-nots in the money management world. Investors of all shapes and sizes believe that with the use of technology they can beat the markets. However, the data proves this to be untrue, and it has created an edge for managers or professionals to exploit.

As the markets continue to evolve, some conditions have caused various strategies to fall out of favor as opportunities wane and the ability to deliver returns vanishes. This has led Wall Street and others to develop and create new ways of skinning the proverbial cat.

Some Strategies Fail to Deliver

Take, for example, merger arbitrage, a stable and profitable strategy for much of the 1990s. However, as the deals dried up and merger and acquisition (M&A) activity during the technology bust of 2000–2003 all but disappeared, merger arbitrage returns declined and managers lost assets. Fewer deals meant narrower spreads and less profitability. Technology also played a part in the decline in merger arbitrage managers as modeling and new analytical tools and increased flow of information for announced merger deals came out in the open. Traders now can instantaneously price a new deal using Bloomberg, thereby reducing the advantage that old-school managers had with their ability to price deals before the evolution of the point-and-click trading turret.

The "new kids on the block" of hedge fund strategies in the post-technology blowup of the early part of the new millennium, along with those that have been successful despite the recent credit crisis, include credit arbitrage and activist investing. Investors seem to have moved away from the somewhat plain vanilla long/short equity and debt managers and good old-fashioned fundamental investing in favor of managers who use distressed and credit arbitrage strategies.

Investors believe that credit arbitrage managers take hedging to the next degree by buying or selling credit protection as a proxy for long or short positions in specific bond issues, or as a tool to increase leverage through the derivatives market. In the subprime meltdown, many victims—lenders, banks, and dozens of high-profile hedge funds—were wiped out, while numerous savvy managers who understood the subprime market, mortgage cash flows, and structure realized big rewards from big bets in short positions.

ACTIVISM IS A NEW BUZZ WORD

Activist investing has also become a more accepted strategy in the new millennium. Activist investing is fundamentally a long-only strategy that attempts to address the increasing institutional interest in corporate governance and to "enhance shareholder value" with substantial upside if the manager can be effective. Instead of just acquiring a large block of stock and trying to influence change within the company, many well-known managers/investors, including Nelson Peltz, William Ackman, Edward Lampert, Mario Gabelli, and Carl Icahn, have worked with management teams to ''achieve shareholder value''; but they become more hostile if the perceived necessary steps are not taken and an increase in stock price is not achieved. These managers go for the jugular; they believe—rightly so, we add—that it is their company and that shareholder value needs to be maximized.

The U.S. Congress whipped the nation into a frenzy over the executive compensation practices of AIG and the banking industry, but activist investors have been on the forefront of leveling the playing field for many years. Activists may advocate asset or whole division sales, corporate divestitures, or increased dividends and share buybacks—anything and everything to increase the share price. However, with exceptionally large positions, liquidity is lessened and partnership returns may be subject to large monthly swings. In some cases, the egos of the money managers seem to get in the way of actually producing increased overall shareholder value, which can hurt both the company and the fund.

Other new strategies that are less trafficked but growing nonetheless include catastrophe bonds, carbon emissions trading, weather derivatives, insurance premium finance, life settlement contracts, and asset-based lending. As a result, hedge funds are playing a greater role in the growth of assets by becoming more like private equity funds in some cases. Hedge funds have started to get involved in funding transactions and running businesses in a host of industries and sectors. One of the most famous examples of this is in the automotive area with the purchase of Chrysler by the hedge fund Cerberus and its purchase of a 51 percent stake of GMAC and ultimate divestiture in 2009. Edward Lampert of ESL Investments fame got into the game of operating companies with his purchase of old-time retailers Sears and K-Mart. The Chrysler purchase came to a head when on May 1, 2009, President Barak Obama forced the company into bankruptcy in order to complete a deal with Fiat.

PRIVATE EQUITY AND HEDGE FUNDS

Similarly, in recent years several large private equity firms have set up shop in hedge fund land, blurring the lines between the two groups. In the past, private equity firms provided leverage for multibillion-dollar financings while the hedge fund brethren traded and financed billion-dollar recapitalizations and turnarounds.

In the spring of 2002, the SEC undertook a fact-finding mission to conduct a study of the hedge fund industry that included service providers and the related investors. The 2003 Staff Report to the U.S. SEC, "Implications of the Growth of Hedge Funds," dated September 2003 stated "Hedge funds often provide markets and investors with substantial benefits. For example, based on our observations, many hedge funds take speculative, value-driven trading positions based on extensive research about the value of a security. These positions can enhance liquidity and contribute to market efficiency. In addition, hedge funds offer investors an important risk management tool by providing valuable portfolio diversification because hedge fund returns in many cases are not correlated to the broader debt and equity markets."[1]

In short, the SEC seems to have come to the conclusion that the capital markets need hedge funds. The question is, how good can this study by the SEC be in light of the recent news of the regulators' failure on so many issues? Nevertheless we like it!

The intent of the SEC's report was to recommend that hedge funds, hedge fund advisors, and hedge fund of funds register with the Commission as Registered Investment Advisors. The report considers a number of issues surrounding the hedge fund industry, including

- Valuation, suitability, and fee disclosures
- Monitoring capital introduction services by broker-dealers
- Permitting general solicitation of offerings by hedge funds
- Embracing a "best practices" policy

The SEC is not the only group looking into how hedge funds operate; that is a topic being considered by regulators around the globe. The UK Financial Services Authority (FSA) and the International Organization of Securities Commissions (IOSCO) have both been advocating change to the industry. The IOSCO released a report in 2007 looking at valuations for hedge funds, and the FSA called for greater transparency regarding fees and redemption policies. There is no doubt change will come to this industry; the question is, will it solve any of the so-called problems or just create more billable hours for attorneys and an increased bureaucracy?

HEDGE FUNDS AROUND THE WORLD

Hedge fund acceptance globally is still in the early stages as more hedge fund outposts are established in Asia, Australia, the Middle East, and Latin America. The U.S. media and elected officials are not the only ones always quick to blame hedge funds for market volatility or price collusion; hedge funds have had a challenging time in Europe and Asia as well. In Germany, one public official called hedge funds ''schabe'' (translated into English, ''cockroaches''). This comment illustrates the concern of the German government about hedge funds, causing regulators in that country and others in Europe to make it very challenging for hedge funds to raise assets and attract investors in this area of the free market.

In this case, Wall Street has done what it does best when faced with adverse working conditions; it comes up with a solution to get around the regulation or impediment. Accordingly, Wall Street created a series of structured products using bond-like investment characteristics, which in turn made it possible for many German and European institutional investors to gain access to hedge funds. Hedge fund wraps, including principal-protected notes and structures that resemble bonds, seemed to be acceptable as German investors look to capitalize on the returns of hedge funds and are not allowed to go direct by their government. This is just one example of Wall Street ingenuity finding ways to allow some institutional investors, including insurance companies and others who have restrictions on investments, to get around those restrictions and gain access to hedge funds.

ALTERNATIVE INVESTMENTS

Hedge funds are one type of investment vehicle included in what is now called the alternative investment universe. If we look at the maturity of the investment management industry and various investment buckets that assets are placed in along the investment curve, hedge funds should no longer be labeled ''alternatives'' in our opinion. Hedge funds had previously been called ''other'' by investment counselors and consultants; now, however, they are commonplace and not just accepted but expected as part of a diversified portfolio.

Alternative investments may be structured as limited partnerships, limited liability companies, trusts, or corporations. Included in alternatives in addition to hedge funds are private equity funds, real estate funds, leveraged buyout funds, venture capital funds, offshore fund vehicles, and of course fund of funds. Investors in these so-called alternatives include college and university endowments, foundations, pension plans, investment companies, family offices, high net worth investors, among others. The range of investment allocation to alternatives varies according to the risk profile of the underlying investor. Some investors may invest in a single hedge fund or a series of individual hedge funds, while many investors allocate to a specific range of hedge funds. The traditional fund of funds investor seeks portfolio diversification through the expertise of the fund of funds manager.

Many believe that hedge funds are still classed as alternatives, but probably they should not be. True alternatives are direct investments such as timberland, real estate, oil and gas, venture capital, and private equity. Investors seek hedge fund investments for absolute return with low correlation to the public markets or more traditional long-only investments.

Investors want and demand alpha! Unlike true alternatives, hedge funds can provide shorter liquidity, which generally ranges from monthly to annual, though in some cases, it may be as long as three to five years.

Even with skeptics characterizing hedge funds as lucrative compensation schemes for the manager to get rich (we believe the only people who complain about the fees are those who cannot charge them), the investor's mandate is to achieve a net of fee return and risk profile that meets the portfolio objective. Simply put, the manager and investor are in it to win it, together.

Hedge funds have been able to generate good returns for the investors and general partners with little direct regulatory oversight until recently. The subprime meltdown and the well-publicized extraordinary results of many hedge funds along with the sudden failure of the Bear Stearns external hedge fund in the spring of 2007 pushed hedge funds to front-page news. The collapse of Madoff's Ponzi scheme has kept them there. For the masses, the jury on the industry is clearly still out; however, managers continue to survive and thrive.

The use of structured products, illiquid private placements, and the ability of hedge funds to quickly react to borrowers' needs has led to new tools of financial innovation to provide higher levels of return for investors. Clearly, this is the new turf of market inefficiency, with only the most nimble being rewarded. From the perspective of a hedge fund or fund of funds investor, the higher noncorrelated returns and alpha produced are meeting investors' objectives, but a whole new set of due diligence and compliance requirements have arisen for all investors.