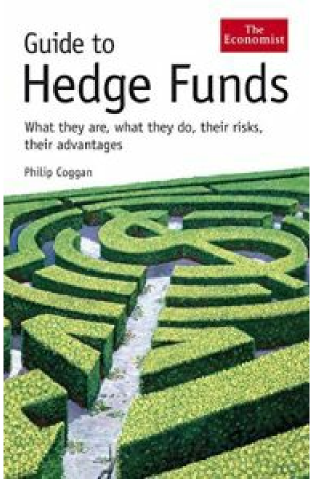

Book Guide to Hedge Funds

Philip Coggan
Profile Books, 2008
Listen now

- play
- pause

00:00
00:00

Recommendation

This brief handbook offers a concise, highly readable introduction to the controversial subject of hedge funds. Philip Coggan demystifies these complex, generally unregulated investment vehicles. He identifies the major hedge-fund investment styles, lists some of the most important hedge funds and explains how they work. He elucidates some of the darker corners of the hedge-fund world, providing one of the most comprehensible accounts yet written of its risks and regulatory challenges. *BooksInShort* recommends this book to readers who have a basic acquaintance with the language and concepts of finance and investment, and who seek an unbiased, objective introduction to hedge funds.

Take-Aways

- Hedge-fund managers have become a focus of fascination and even horror.
- The label "hedge fund" covers many investment styles and is difficult to define.
- Hedge funds share some characteristics: extraordinarily high compensation for managers, very high risk, greater than expected leverage and a focus on absolute return.
- Hedge-fund regulation and supervision have been rather lax in the United States.
- Continental Europeans, especially Germans, have called for tighter regulation of hedge funds, but Britain and the U.S. have preferred a *laissez-faire* approach.
- Studies suggest that hedge-fund managers do produce returns even in bad markets, but investors may not get what they pay for, since managers keep so much of the earnings.
- Activist investors buy corporate equity and push management changes to increase value.
- The hedge-fund industry is changing as it matures. Some managers are seeking permanent capital; others have diversified into tamer financial activities.
- The devastating consequences of the subprime mortgage crisis suggest that hedge funds' future growth may not be as impressive as their past growth.
- Clearly, the hedge-fund industry has serious work to do on risk control.

Summary

The Hedge-Fund World

Hedge-fund managers are Wall Street's new public paradigm: the money manipulators who take home the big profits. Mostly male, the managers of hedge funds have proven their power to change the value of currencies, rattle company managers, crash markets and make enormous amounts of money while doing so. Twenty-five hedge-fund managers shared $14 billion in total compensation in 2006, and the three most highly compensated earned $1 billion or more apiece. Moreover, they make that much even though they turn away investment money. The best hedge-fund managers are quite selective about whose money they manage. Indeed, having money with one of the funds at that level is a status symbol that confers bragging rights.

> "Those...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."

Hedge funds have grown more important in the financial system while they have taken on functions that used to belong exclusively to banks, insurance companies, pension funds, mutual funds and so forth. Yet, most hedge-fund managers have a casual, sartorial style that seems out of keeping with their eminence, and that is much more laid-back than the power-suited bankers of the 1980s. Unlike the old "Masters of the Universe" about whom novelist Tom Wolfe wrote in *Bonfire of the Vanities*, the new breed shuns the heart of Manhattan and prefers to situate its offices in such tranquil suburbs as Greenwich, Connecticut.

> "The industry is gradually becoming mainstream. But this is still a weird and wonderful world, with lots of different creatures being dubbed hedge funds, even though they have strikingly different characteristics."

In the public mind, at least in Great Britain, the face of hedge funds is George Soros, who "broke the Bank of England" in 1992. In the United States, the public may be more apt to recognize the name of Long-Term Capital Management, the fund whose roster of Nobel laureates was unable to prevent it from nearly crashing the entire global financial system in the late 1990s. However, few people outside of the financial industry know much about hedge funds, and even fewer know who manages them. This is partly by design. Most hedge-fund managers shy away from publicity for good reason: in 2003, kidnappers nabbed one of them.

Hedge-Fund Basics

Hedge funds are difficult to define. The category has a startling variety of investment styles, instruments, strategies, fee schemes and other characteristics. Yet, these generalities apply:

- Hedge funds tend to be private, that is, shares do not trade publicly.
- They tend to be illiquid – investors are not free to take out capital at will.
- They tend to be exempt from many of the regulations and taxes imposed on other investment vehicles.
- They tend to be flexible and to speculate in a wide variety of instruments.
- They tend to use leverage, that is, to borrow in order to boost returns.
- Their managers tend to be extremely well paid. They reap sometimes outlandish amounts, even when they don't succeed. These fees are quite controversial.

> "Hedge fund techniques are here for good, even if the industry itself changes out of all recognition – and 2007's bad publicity will probably slow its growth."

Hedge funds are riskier than many other investments. Among the risks:

- Leverage magnifies gains but it also multiplies losses. Some hedge funds were virtually wiped out in 2007, that is, their investors lost most or all of the capital they invested because of speculation in mortgage-backed securities.
- Exemption from regulation means that fraud may be easier to perpetrate in hedge funds. In fact, some hedge-fund managers have lied, or misrepresented profits or investments.
- Illiquidity ties investors to the fund, meaning that getting money out in bad times can be difficult.
- Hedge-fund managers charge high fees, sometimes more than high enough to absorb any excess return an investor may have expected; you may not get what you pay for in some cases.
- Hedge funds are not transparent, and their opacity makes it difficult for investors to know where funds are invested. And again, leverage makes this opacity even riskier.

> "Hedge fund fees are high enough to raise questions about whether they make more money for themselves than for their clients."

One scholar referred to hedge funds as "the Galapagos Islands of finance," meaning that intense competition among managers leads to rapid, multifaceted evolution and an astonishing proliferation of innovation. Investors flock to hedge-fund managers who have good reputations, but *caveat emptor* – a sterling reputation gives no real assurance that the manager will succeed.

> "Traditionally, activists were seen as a force in the American market, but they have been moving their attention to Europe. This helps explain why they have been the subject of controversy; in continental Europe, shareholders have traditionally been seen

Some investors may seek hedge funds to diversify their portfolios. Because hedges can make money whether the market is rising or falling, they have generally logged good records. However, unlike conventional money managers, hedge-fund managers do not define success in terms of beating a market index. If an index falls, and the conventional managers' customers do not lose as much as the index did, they may call that a success. However, the investors still lost money. By contrast, hedge-fund managers look to absolute returns. Losing money is failure – period!

> "The danger for funds-of-funds may lie in excessive risk aversion."

Hedge-fund managers make money in falling markets by selling short. Their ability to sell short easily is important to their success, but it is also fuel for controversy. Corporate managers detest it when investors sell their stocks short because that is, in effect, a vote against their management. The short seller bets that a stock's price is going to fall, borrows shares and sells them now, planning to buy them back later at the lower price and return them to the lender. Short selling serves a valuable economic function. For instance, it helps deflate bubbles and manias. Short selling whispers words of skeptical reason into a market's euphoric ears. So, hedge funds' short selling is not shady or immoral, but it is risky – as are many hedge-fund investment strategies.

How Hedge Funds Make Money

In 1990, only 600 hedge funds were active; in 2000, that rose to some 10,000. Hedge funds took in about $65 billion in fees in 2005, and likely more in subsequent years. Traditionally, hedge investors have been rich, but in recent years, even pension funds have bought hedge investments.

> "It certainly seems hard to claim, at first sight, that hedge funds earn rewards commensurate with their contribution to society."

Hedge funds break into four broad categories, each with numerous subcategories:

1. Equity or Stock Market Funds

These funds include:

- **Long-short** – Long-short managers buy some stocks and sell others short, hoping to make money when their long positions go up and their short positions go down.
- **Market neutral** – This is a subgenre of long-short investing in which the manager attempts to neutralize the portfolio against the market's up-or-down moves, and make money on the relationship between securities instead of on their directional moves.
- **Short selling** – Short funds do not take long positions; they rely only on short selling.

2. Arbitrage Funds

These funds attempt to profit from mispriced securities. Generally, the managers bet on a theoretical relationship between prices. When a price moves out of the theoretically correct alignment, they invest expecting it to move back. The main types of arbitrage investing are:

- **Convertible** – Some bond covenants allow investors to exchange the debt for equity at a certain price. Hedge fund managers analyze these convertible securities as a combination of a bond and an option, and speculate on the underlying price relationships.
- **Statistical arbitrage** – Statistical arbitrageurs, who are practitioners of an intensely quantitative discipline, look for patterns in security prices.
- **Fixed-income arbitrage** – These investors try to profit from inefficiencies in bond pricing. This was the strategy of the Long-Term Capital Management (LTCM) hedge fund, which failed due to flawed models and insufficient capital.

3. Directional Funds

These types of funds invest in trends:

- **Global macro** – Global macro investing has faded in popularity in recent years, partly because it takes a great deal of investors' faith that a hedge-fund manager will predict the future correctly. George Soros, Julian Robertson and Michael Steinhardt were famous in the early 1990s for their success with this strategy. George Soros, for example, became notorious for allegedly forcing the British pound out of the European exchange rate mechanism in 1992.
- **Managed futures and commodity trading advisors** – As the names imply, these funds invest in futures and commodities. Although not, strictly speaking, hedge funds, they do take enormous risks and earn enormous returns. Moreover, some of the best-known hedge-fund managers started out in this sector.

4. Event-driven funds

These funds invest in specific situations. For example:

- **Distressed debt** – These funds buy the debts of entities that have fallen on hard times, betting that in the rush to get out of these situations, the owners of that debt are willing to sell at lower prices than the entities' true prospects justify.
- **Merger arbitrage** – Investors bet on the results of acquisitions and mergers.
- **Activist investors** – Investors push management changes that increase value.

Hedge Funds: the Good, the Bad and the Future

Hedge-fund regulation has been a contentious subject. Generally speaking, the British and the Americans have favored a free-market approach while continental Europeans, especially the Germans, have called for binding rules. Until recently, the relative absence of hedge-fund scandals in Britain and the U.S. has given strong support to the case for self-regulation. However, recent events in the mortgage market, especially the chaos involving investments in subprime mortgages, may have changed that.

> "Academic studies come thick and fast but they seem to agree on one conclusion: Hedge funds do produce alpha [earnings in a down market]. The question is how much of that alpha is kept by the managers."

To many it seems that hedge fund managers are paid disproportionately to their value to society. It is difficult, they say, to argue that the task of managing a hedge fund is more socially valuable than that of teaching children or healing the sick. Moreover, hedge funds seem remarkably risky. Although champions of hedge funds point to the sophisticated risk-control policies of at least some funds, the subprime market crisis led many to believe that hedge-fund investing has had a deleterious effect on the financial system. These issues came to the fore:

- **Flawed models** – Hedge-fund managers tend to have studied at similar schools, so they look at the same data and draw similar conclusions. Because they have the same ideas about what it takes to build a good financial model, instances have occurred in which all their models failed in similar ways simultaneously, leading to the kind of coordinated movement that destabilizes markets.
- **Structured investments** – Hedge-fund managers invested heavily in mortgage-backed securities and other sophisticated security structures under the illusion that they had thoroughly analyzed this strategy and understood what they were doing. Events left little doubt that they had, in fact, misunderstood the risks.
- **Carry trade** – Managers borrowed in low-interest-rate currencies and invested in high-interest-rate currencies. Over the long term, the carry trade should be

unworkable. Indeed hedge-fund managers tend to be on the same side of the same trades, raising the question of just what customer they could sell to in the event of problems.

> "Hedge funds are not so much an industry, or an asset class, as a structure."

Two things are clear about hedge funds: They do seem to generate above-market returns and managers keep a disproportionate share of those returns. However, hedge-fund returns are not dispersed in a normal distribution. They are, according to some research, somewhat skewed to losses and somewhat more than normally vulnerable to extreme events.

> "At the risk of being pretentious, you could almost say that hedge funds are a state of mind."

That said, hedge funds have been remarkably popular among investors in recent years. Some of the more successful American hedge funds have evolved into diversified financial-services holding companies. Predicting what hedge funds will become in the future is difficult. Some evidence indicates that the industry may be consolidating and perhaps growing tamer. Some fund managers are striving to reduce risk and increase transparency. Hedge-fund managers have also been seeking permanent capital so they can insulate themselves against market instability and short-term turbulence. However, an industry notorious for high fees may have difficulty justifying those fees if it is not bearing risk.

About the Author

Philip Coggan writes the "Buttonwood" column for *The Economist*, where he is also capital-markets editor.