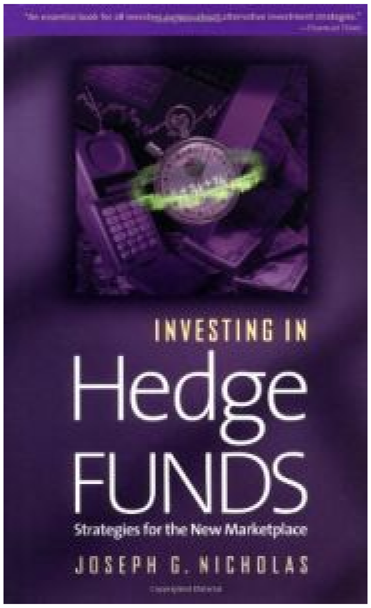

Book Investing in Hedge Funds

Strategies for the New Marketplace

Joseph G. Nicholas
Bloomberg Press, 1999

Recommendation

While this book is meant to serve as an introduction to the complex world of hedge funds, hedge fund managers and hedge fund investors (in short, the hedge fund dynamic), it is decidedly not of the For Dummies family that currently dominates the do-it-yourself investment section of the book store. This is a highly sophisticated look at what has become one of the most exciting sectors of the investment world. If you have some knowledge of finance and its terminology, and you want to know what a hedge fund is and what kinds of strategies most hedge fund managers use, *BooksInShort* recommends this highly specific book to you. On the other hand, if you just want to gain some insights into the investment world, you'd be better off picking up the financial section of the newspaper. Hedge funds are serious and so is Joseph G. Nicholas' book. (Editor's note: Despite the 1999 copyright date, the book makes no reference to Long-Term Capital Management, the hedge fund that collapsed in 1998, nearly bringing about a global financial crisis.)

Take-Aways

- The hedge fund industry's assets have skyrocketed over the past decade - Where was your money?
- Hedge fund managers go where mutual fund managers fear to tread.
- Hedge fund managers turn market uncertainties into financial opportunities.
- Technology plus favorable markets equals hedge fund glory.
- Hedge funds will continue to grow because they've done extremely well.
- Hedge fund managers rely on investment structures not investment approaches.
- Hedge fund managers work for incentive-based fees.
- Approach hedge funds as you would any other investment - wisely.
- When choosing a hedge fund manager look at his or her numbers.
- When choosing a hedge fund manager don't just look at the numbers, read between the lines.

Summary

The Big Guns of Finance

John Meriwether, Jeff Vinik and Jon Jacobson are some of the top minds in finance - but that's not all they have in common. They all left great jobs to get involved with hedge funds. Meriwether was the vice chairman of Salomon Inc. Vinik traded Magellan. Jacobson, meanwhile, handled part of Harvard's endowment. Leaving these institutions, you can bet, was no small step for these men; you can also bet, however, that they knew exactly what they were doing.

> "Money managers who distinguish themselves do so not by acting on where profit was generated in the past, but by where profit will be generated in the future."

Hedge funds allow you to exercise unprecedented control over your investments. They also allow you to use many more financial tools than you can in traditional markets. But if these slightly vague assertions wouldn't convince you to follow in Meriwether's, Vinik's and Jacobson's footsteps, then maybe some numbers will. In the past 10 years, the hedge fund industry's assets reached $400 billion. During the same period of time, the number of hedge funds rocketed from 200 to more than 3,000.

What Is a Hedge Fund, Anyway?

A hedge fund is not an investment approach - it's an investment structure. It allows you to manage a private unregistered investment pool through a fund manager who takes a percentage of the profits. Hedge funds are private (and therefore exempt from securities registration), so there is a limit on the number of investors and the types of investments they can make. The investor is usually either an institution or a person who has reached "accredited status." To be counted as an "accredited investor" you have to make a lot of money ($200,000 per year for at least two years) and be positioned to continue doing so.

> "By providing exposures that investors may not already have, hedge funds allow these investors to further diversify their investment portfolios, protect against risks inherent in traditional stock market approaches and realize excess returns."

The theory behind hedge funds is really quite simple. Rather than looking at where profit has been generated in the past, hedge fund managers act on where profit will be found in the future. Traditional stock and bond investments are all well and good, but they represent the present, and in turn, the past. Regulations and traditions limit the individuals and firms that invest in these stocks and bonds. They simply can't explore certain avenues. These avenues belong to hedge funds and their managers.

The Growth of Hedge Funds

Even though hedge funds are becoming more and more prevalent in the world of finance and investment, they are still wrapped in a shroud of mystery. People aren't really sure where they come from or where they're going. Of course, it's not possible to predict the future of hedge funds, but it's also not possible to ignore their track record to date. Hedge funds have reached their current status because of several verifiable factors.

- Opportunity - The world of finance is changing rapidly. The advent of new technologies, new instruments and new markets injects a whole new array of uncertainties into traditional long-term investment strategies. Hedge fund managers see these uncertainties as profit opportunities. They know that the real value of an asset is always going to be different from its market value. Once they estimate that real value through the use of specialized informational or statistical tools, they invest in assets whose market values don't match their estimates. By hedging their risk and waiting until the market catches up to their estimates, these investors reap great returns.
- Tools and support services - Everyone knows about the technology explosion, but not everybody knows how to use its products and services. Hedge fund managers have been using them for years and thus contributing to the rapid growth of their piece of the finance pie. Investment information is available more quickly than ever. The systems for analyzing this information are also quicker and more thorough. On top of this, much of the new technology and service is becoming less and less expensive.
- Talent and expertise - Hedge fund managers have thrived in the do-it-yourself climate created by the technological innovations of the past decade. Large-scale investment divisions have gone the way of the dinosaurs. A savvy investor with a good

personal computer can access all the information resources and analytic power necessary to capitalize on market opportunities. Hedge funds have thrived in this environment because they require specialists rather than large-scale organizations.
- Favorable markets - The 90's was a good decade for all investments, so there's a lot of wealth floating around, and that is just what hedge fund managers need to get started. Also, many hedge funds have become self-perpetuating. Because they were able to obtain a rather large sum of initial investment capital, many hedge fund managers could generate enough early profit to keep their hedge funds going. This would not have been possible if the market hadn't performed so well in the first place. More wealth means more wealthy people - and that means more private investment and more hedge funds.
- Performance - Performance is the factor that contributed most to hedge funds' growth. These funds wouldn't have grown so rapidly unless they were doing pretty darn well.

Hedge Fund Strategies

The basic differences between hedge fund strategies and the strategies used by investors with traditional portfolios are simple. Hedge fund investors use informational and strategic advantages to create a degree of leverage. They are not exclusively interested in the long, slow, traditional approach of selecting stocks and bonds they think will do well over time.

> "The typical hedge fund manager is an entrepreneur who organizes a money management company and investment fund to pool the manager's assets (often a substantial portion of his or her net worth) with those of family, friends and other investors."

Hedge fund investors do invest long, but they also invest short, or with some combination of the two approaches. By bringing together several instruments to create one position, hedge fund managers can avoid the plight of more traditional investment engines - that is, they are able to avoid losing money when the market declines. Instead, they hedge their bets. If a deal goes bad, they always have another one to cover its loses. Although all hedge fund managers have their own style (remember, one of the key elements of hedge fund investing is the human element), they use a similar assortment of tools, instruments and approaches to create a winning strategy. As you will see, many of these approaches are very similar to those used in traditional investment strategies. The difference, of course, is in the way that the individual hedge fund manager uses them.

- Leverage - When investors use leverage, they use money they don't have to build on money they do have. They borrow money to add to an investment they currently hold. Of course they expect this particular investment to perform well - certainly, well enough to exceed the cost of the funds they borrowed. This is a high-risk maneuver, one that skilled investors will use only in low-risk situations.
- Short selling - Short selling requires that managers have a certain degree of collateral. They need this collateral because to short sell they need to borrow a security from an insurance company, a bank or a brokerage firm. They borrow this security with the intention of moving it, immediately, into the open market. They hope that the security will decline in value, allowing them to buy it back for less than they originally sold it. This is also a dangerous device since there is always the possibility that a security will actually increase in value.
- Hedging - Market conditions cannot be predicted absolutely. Hedging allows managers to create a somewhat stable gain anyway. Hedging, then, is a tool that allows managers to cover the market's ups and downs. By investing in two positions at once, one primary and one secondary, the manager can create a relatively balanced situation.
- Arbitrage - This is an approach by which a manager notices that a certain security has been undervalued, and promptly buys it and sells it simultaneously.
- Investment instruments - These are the assets, such as stocks and bonds, that are bought and sold in financial markets by traditional and hedge fund investors. Additionally, most hedge fund investors will deal with investment instruments that traditional investors won't touch - such as futures, options or asset-backed securities.

The Hedge Fund Dynamic

Hedge fund managers are an interesting breed. They often come from more traditional financial venues and they often invest large sums of their own money in the "money management" companies they develop to organize funds into a hedge fund strategy. This information should tip you off to two points about hedge fund managers: First, they bring their own experiences and their own specialization to the table. Second, because they are investing their own funds, they are highly motivated to make money. With leaders at this level of commitment, no wonder hedge funds are attaining such unbelievable returns.

> “The alternative investment strategies that hedge fund managers use produce returns by leveraging some kind of informational and strategic advantage.”

Hedge fund investors are a little easier to qualify than the managers who serve them. In the past, hedge fund investors were mostly high net-worth individuals from outside the U.S. Recently, though, many Americans and many institutional investors - pension funds, banks, endowments - have started to get interested and to get in on the hedge fund action.

> “An investor can access a hedge fund manager in one of two ways: (1) by investing in an existing investment vehicle or (2) by placing assets in a separate managed account and hiring a hedge fund manager to invest them.”

These investors, whether institutional or individual, contribute to the hedge fund dynamic, which benefits everyone involved. Once investors are paired with managers, the managers gain access to the investors’ expertise and benefit from these investors’ non-traditional approaches to the market. Investors, of course, aren’t the only ones who benefit. By gaining access to a large amount of funds, managers can pool a healthy flow of assets, implement and develop their strategies, and collect incentive-based fees.

Investing in Hedge Funds

Don’t be mistaken. Investing in hedge funds is not a panacea for the anxieties of traditional investing. If you don’t use your head, if you don’t invest wisely and if you don’t exhibit prudence when prudence is called for, you’ll waste a lot of time, money and energy. If you’re thinking of investing in hedge funds, keep a few things in mind.

- Set your goals - You need to know what you hope to achieve by entering a hedge fund, and you also need to know how you’re going to achieve it. Learn the products and services available in the hedge fund market. Understand exactly what structure will best suit the type of investment you want to make. Granted, some are more risky than others.
- Calculate your risk and set investment parameters - As you set up, calculate the risk you are willing to endure. Like all other portfolios, a hedge fund portfolio should include investment parameters. You can impose parameters on each and every section of your portfolio, including the individual manager. You can also diversify with different managers or strategies.
- Minimize risk - Use the skills you have acquired in all your previous investment ventures. Be certain to protect yourself from potential fraud, manager incompetence, governmental regulations and the general condition of the market in which you’re trading.

> “A broad range of strategies are operated under the hedge fund structure. This spectrum includes non-leveraged hedged styles and highly leveraged directional approaches.”

Work from the outside to the inside - When selecting a manager, figure out which strategy you want to use and decide what parameters you want to set. This will eliminate many likely candidates before you even begin searching. Once you’ve narrowed down the list of managerial candidates, look very closely at each one. Begin quantitatively. How have they done in the past? Be warned, though. The past is not always a great indicator of the future, especially in hedge funds. Once you’ve tested your candidates quantitatively, look at them qualitatively. Is the manager systematic? Has the manager always dealt with a consistent base of assets? The answers to these questions can only be found between the lines of a more quantitative analysis.

About the Author

Joseph G. Nicholas is chairman of Hedge Fund Research, L.L.C., a research and investment firm that specializes in alternative investments.