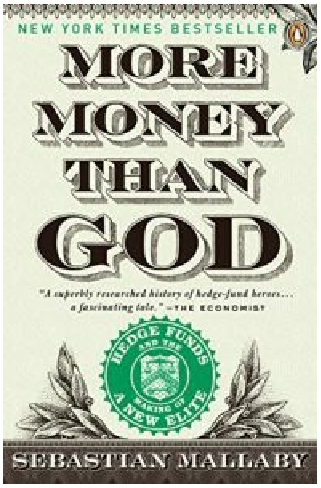

Book More Money Than God

Hedge Funds and the Making of a New Elite

Sebastian Mallaby
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Recommendation

As hedge funds increase in size, variety and number, they also exercise growing power over central banks and national governments, as well as companies and industries. Unfettered by a fixed investment philosophy, hedge fund managers bank on the flexibility to buy assets and sell them short as dynamic markets dictate. Some hedge funds have succeeded spectacularly and some have failed, such as those holding too many mortgage securities when the U.S. housing industry collapsed in 2007. But over its history, the hedge fund industry's performance has been remarkably good. Here, business journalist Sebastian Mallaby forcefully argues that hedge funds contribute to economic stability by chasing the true value of mispriced assets. His richly detailed book centers on the successes and occasional missteps of famous hedge fund managers, including such luminaries as Stanley Druckenmiller, Paul Tudor Jones II, Michael Steinhardt, Julian Robertson and George Soros. *BooksInShort* recommends this book as a vivid introduction to hedge funds for those who are unfamiliar with them, and as a valuable, often entertaining, reference for financial professionals. And if you want to know even more, read the illuminating footnotes.

Take-Aways

- Hedge funds take a more flexible approach to trading than other investment vehicles.
- To minimize risk, hedge funds often hold simultaneous long and short market positions.
- The majority of hedge funds are designed to profit from distorted prices for stocks and other assets.
- Hedge funds usually serve an economic purpose by discouraging irrational investment-pricing trends.
- The field's pioneering leaders include Alfred Winslow Jones, who created the first hedge fund in 1949 and became a pacesetting performer.
- George Soros achieved fortune and notoriety by betting against the British pound.
- Paul Tudor Jones II made huge profits by buying bonds when stocks crashed in 1987.
- The 1998 failure of the Long-Term Capital Management hedge fund threatened the financial system.
- Some hedge funds failed because of the mortgage industry slump that started in 2007, but none required a tax-funded bailout.
- Only the largest hedge funds require strict government regulation.

Summary

How Hedge Funds Got Started

The first hedge fund manager, Alfred Winslow Jones, was an unlikely leader in financial innovation. The son of a General Electric executive, he graduated from Harvard and embarked on a world tour as a purser on a freighter. After time as an export buyer and investment firm statistician, he joined the U.S. State Department, which assigned him to a post in Berlin in 1930. His short marriage to a "left-wing anti-Nazi activist" and their involvement in the Leninist Organization, forced his State Department resignation. He returned to America in 1934, but stayed abreast of the "German left" and possibly remained "involved in U.S. intelligence."

> "Hedge funds are vehicles for loners and contrarians, for individualists whose ambitions are too big to fit into established financial institutions."

Worried that a political hysteria like the Nazi movement could undo even his own nation, Jones authored an ode to American democracy. His 1941 book and doctoral thesis, *Life, Liberty and Property*, led him into journalism. After *Fortune* published an abridged version, Jones started writing articles for the national business magazine, including a notable essay criticizing investment strategies that remain intransigent and fixed in the face of changing market conditions.

> "The cataclysm has indeed shown that the financial system is broken, but it has not actually shown that hedge funds are the problem."

His focus gradually shifted to investing. In 1949, four friends placed a total of $60,000 with Jones, who added $40,000 of his own and started the first hedge fund. He called it a "hedged" fund because he managed risk by offsetting long positions on securities with short positions. In about 20 years, he earned a cumulative return on investment of nearly 5,000%, one of the best performance records in hedge fund history. His pioneering style undermined a broad assumption that investors earn bigger returns by taking bigger risks. Compared with traditional investment managers who never hedged bets, Jones actually reaped bigger returns by taking smaller risks.

What Makes Hedge Funds Different?

Hedge funds have more flexibility than other investment funds. Equity mutual funds typically buy stocks for long-term growth and mitigate risk with portfolio diversification. On the other hand, hedge funds often address risk by taking simultaneous long and short market positions. They take long positions by purchasing assets for appreciation, and they hedge against the risk of depreciation by conducting short sales, which profit when the price of the underlying asset falls. In a successful short sale, for example, an investor borrows a $10 stock from a securities broker, sells it, then buys it back when the price drops to $7, returning the stock to the broker and pocketing the $3 decline as profit.

> "Quickly, [Paul Tudor] Jones emerged as a prodigy with a distinctive style. He approached trading as a game of psychology and high-speed bluff."

Hedge funds apply the risk management technique of simultaneous long and short investment positions to other assets, from stocks and bonds to futures and options. Mutual funds, by contrast, often confine themselves to one type of asset, such as stocks or bonds. Leverage is another distinguishing characteristic of hedge funds: They try to maximize profits by investing with borrowed money. These traits give hedge funds structural advantages over other types of funds that neither hedge nor leverage their investments. Unlike other investment professionals, hedge fund managers tend to invest their own money, as well as their clients' money, in the funds they run. These managers aim for investment results that exceed the returns on broad market indicators such as Standard & Poor's index of 500 stocks. In the parlance of money managers, the investment return on the broad market is known as "beta." Hedge funds' main mission is to deliver returns in excess of beta, known as "alpha."

The Contrary Behavior of Hedge Fund Managers

Hedge fund managers tend to take investment positions that are contrary to mainstream financial thinking. Some critics deride short selling as destructive, but hedge fund manager Julian Robertson routinely doubted companies' stated values, leading him to make frequent short sales. He began his hedge fund business, Tiger Management, in 1980, and his mix of skepticism and stock-picking skill rewarded investors well. They earned an average annual return of 31.7%, after fees, during his remarkable run from 1980 to 1998.

> "To an extent that was generally not realized at the time, hedge funds were changing monetary policy."

The efficient-market theory says a stock price will change immediately, if at all, to reflect new information relevant to the stock. Many hedge fund managers contest this idea. Michael Steinhardt, who had only four losing years in 28 years as a hedge fund manager, based his investing less on securities' long-term growth than on large investors' short-term needs to buy or sell. In his view, the efficient-market theory works gradually, not quickly. Long-term prices settle at rational levels, but short-term prices can become distorted, presenting investment opportunities.

> "If ever irrational markets cried out for efficiency-enforcing arbitrage, the dot-com bubble surely was a clear example."

Indeed, hedge funds often display an internal contradiction. Managers can take directly different investment positions day to day, as conditions require, so they can quickly change their funds' makeup. Paul Tudor Jones II is legendary for making a fortune during the Black Monday stock market crash on Oct. 19, 1987, when the Dow Jones index plunged 22.6%. His firm, Tudor Investments, collected $80-$100 million in profit by selling stock futures short – that is, by betting, the week before equities collapsed, that the futures market would fall. Once the crash occurred, Jones bought bonds, which appreciated after the Federal Reserve eased monetary policy to calm investors, just as he'd predicted. Price momentum drove Jones' decisions to buy or sell, and how much. His fund management style reflected his experience in the mathematically intensive commodities trading profession. He apprenticed as a cotton trader in New Orleans before joining the New York Cotton Exchange. He left there to start Tudor Investments in 1983. His performance as a securities market "trend surfer" is one of the best.

Exploiting Price Anomalies

Of course, price momentum does not always move in a rational direction. In the short term, misled investors may push the market value of an asset away from its true worth. But normally, at some inflection point, an irrational price trend ends and a rational one begins. George Soros, a genius at identifying these pricing inflection points, became a hedge fund industry legend by pinpointing developments that foreshadow reversals of irrational price trends.

> "Hedge funds might have fallen less than the S&P 500, but customers expected them to be up in any kind of market, as though the magicians who ran them had abolished risk rather than merely managing it."

Little seemed rational in Soros' traumatic childhood. Born into a financially comfortable Jewish family in Budapest, Hungary, he survived the city's Nazi military occupation by adopting a Christian persona and hiding with the help of his father's acquaintances. Soros was only 17 when he moved, alone, to London in 1947. He graduated from the London School of Economics with unimpressive grades and relocated to New York, where he began his Wall Street career in 1956.

> "The new view emphasized that traders might attack currencies that were decently managed, and that the attacks might prove self-fulfilling. The spectacular collapse of sterling created a tipping point in this debate."

As a hedge fund manager, Soros got rich by identifying market misperceptions of asset values and betting on price corrections. His investments defied the efficient-market theory and its rational pricing mechanism. Soros bases his style largely on what he calls "reflexivity," or the propensity of confused investors to misprice assets.

In his view, investors lack a perfect understanding of reality and, therefore, distort it through their misguided actions. Soros himself has been misguided at times. His hedge fund had large losses – some $200 million – mostly on equity investments, due to the October 1987 crash. But a few weeks later, he made substantial profits for his investors with short sales of U.S. dollars, betting correctly that the dollar would depreciate against other currencies as U.S. monetary policy eased. His main investment vehicle, the Quantum Fund, finished 1987 with a 13% annual return on investment, a heroic feat given that the fund had recorded an annual loss for the year at the time of the October crash.

Breaking the British Pound

Another remarkable hedge fund manager, Stanley Druckenmiller, met Soros in October of 1987, just before the crash. Druckenmiller, who began his career as a bank's equity analyst, foresaw the downturn and reconstituted his portfolio in response, so he suffered fewer Black Monday losses than Soros. In 1988, Druckenmiller joined Soros Fund Management. He and Soros were practiced at the art of picking stocks to buy and sell; they were unimpressed with the small returns that this narrow investment style usually garnered. They shared a vision of profits from mispriced assets of all kinds, and their winning bets revealed that hedge funds could influence not just companies and industries but also national governments and central banks. "Soros was inclined to see markets as wild things, constantly at risk of boom and bust; constantly destabilizing."

> "Soros became known as the man who broke the Bank of England."

Their massive attack on the British pound in 1992 was one of their most notable victories. At this pre-euro time, European governments shared an exchange-rate mechanism that permitted currency rates to fluctuate within preset ranges. The pound shed value after the German central bank raised interest rates. That pressured the Bank of England to do the same. But as Soros and Druckenmiller accurately anticipated, the Bank of England refused to raise interest rates to defend the pound's value. Soros Fund Management profited by selling British pounds at prices within the official exchange-rate mechanism and buying German deutsche marks. Often, the entity buying Soros's pounds was the Bank of England itself, since it had an unlimited obligation to buy pounds offered by sellers. The selling pressure was intense. When the Bank of England announced that it had borrowed $14 billion to purchase pounds and prop up their value, Soros and Druckenmiller noted that this was about the same amount they wanted to sell, and they represented just one firm. Other hedge funds also made big bets against the pound. Britain's government ultimately surrendered by removing the pound from the European exchange-rate mechanism, and Soros's team pocketed more than $1 billion in profits.

Too Big to Fail?

A doomed hedge fund called Long-Term Capital Management had been considered a leader in quantifying risk. Started in 1994, LTCM hired professionals with advanced academic degrees and special expertise to take a mathematically intensive approach to identifying minor price distortions and capitalizing on them, while hedging with numerical precision against the risk of adverse price moves. With a steroidal boost from leverage, LTCM scored annual returns of 19.9% in the final 10 months of 1994, 42.8% in 1995 and 40.8% in 1996. Its impressive performance helped it attract more clients and amass more assets. By the time LTCM sank in 1998, it held assets valued at $120 billion. Monetary authorities saw its failure as a systemic risk, so a senior official at the New York Federal Reserve brokered a deal among 11 major financial institutions to contribute $3.65 billion to an orderly liquidation of LTCM, instead of allowing a sudden shutdown.

> "LTCM's failure had exposed the fallacy that diversification could reduce risk to virtually zero; but over the next decade investors repeated this miscalculation by buying bundles of supposedly diversified mortgage securities."

One reason for LTCM's collapse was its inability to liquidate assets fast enough to meet margin calls from brokers that had lent it money. Many copycat funds made the same investments LTCM made, creating a so-called "crowded trade," which complicated LTCM's efforts to liquidate its positions. The fund's managers quantified the risk of adverse price changes but failed to address liquidity risk fully enough, that is, to admit the possibility that no one would offer to buy certain classes of assets. LTCM's failure underscores the need for tightened regulation, but only of giant funds. More than any other hedge fund collapse, its breakdown threatened chaos throughout the global financial system. But not every hedge fund needs stricter regulation. Few are too big to fail or so crucial that providing government-funded bailouts would be better than letting them fold.

> "The critics of hedge funds continued to worry that these leveraged monsters could ignite systemic fires – after all, Long-Term Capital had done so."

Consider what happened to hedge funds when the mortgage securities industry imploded and foreclosures surged, triggering the U.S. recession that began in 2007. Some hedge fund managers had spectacular returns, such as John Paulson, a Harvard Business School graduate and former Bear Stearns mergers-and-acquisitions specialist. His fund bought a mountain of insurance on mortgage-backed securities and profited when the underlying mortgages went bad.

> "When hedge funds cease to be small enough to fail, regulation is warranted."

Although some poorly managed hedge funds disappeared during the mortgage market meltdown, not one hedge fund failure has consumed tax dollars, not even LTCM during its scary fall. Government-funded bailouts of major banks have encouraged excessive risk taking at these supposedly safer institutions. Allowing most hedge funds to operate freely may be the best check against further risky behavior in the banking industry.

About the Author

Sebastian Mallaby, a senior fellow at the Council on Foreign Relations, is a *Washington Post* columnist. He previously covered international finance for *The Economist* and was its bureau chief in Japan, Africa and Washington. He also wrote *The World's Banker* and *After Apartheid*.