

Chapter 1

What People Talk About When They Talk About Hedge Funds

In This Chapter

- ▶ Knowing the long and short of hedge funds
 - ▶ Discovering the history of hedge funds
 - ▶ Factoring a fund's position on alpha into your investment decision
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Is a hedge fund a surefire way to expand your wealth or a scam that will surely rip you off? Is it a newfangled mutual fund or a scheme for raiding corporations and ripping off hard-working employees? You see hedge funds in the news all the time, but it's hard to know exactly what they are. That's because, at its essence, a hedge fund is a bit of a mystery. A *hedge fund* is a lightly regulated investment partnership that invests in a range of securities in an attempt to increase expected return while reducing risk. And that can mean just about anything.

Some of the smartest money managers on Wall Street have started their own hedge funds, attracted by the freedom to manage money as they see fit while raking in good money for themselves and their investors in the process. Hedge fund managers today take on the roles of risk managers, investment bankers, venture capitalists, and currency speculators, and they affect discussions in boardrooms at brokerage firms, corporations, and central banks all over the world.

In this chapter, I cover the basic vocabulary and structure of hedge funds. Having this knowledge helps you understand hedge funds so that you can figure out what you need to know in order to make the best decisions with your money. Also, I clarify what a hedge fund is and what it isn't, which is important because you come across a lot of myth and misinformation out there. The information you find here serves as a springboard for the topics I introduce throughout the rest of the book, so get ready to dive in.

Defining Hedge Funds (Or Should I Say Explaining Hedge Funds?)

Here's the first thing you should know about hedge funds: They have no clear identity or definition. In the investment world, "I run a hedge fund" has the same meaning as "I'm a consultant" in the rest of the business world. The speaker may be managing money and making millions, or she may want a socially acceptable reason for not having a real job. The person who really manages money may go about her business in any number of ways, from highly conservative investing to wildly aggressive risk taking. She may be beating the market handily, or she may be barely squeaking by.



I'm not trying to say that the term "hedge fund" means nothing. Here's the short answer: A *hedge fund* is a lightly regulated investment partnership that uses a range of investment techniques and invests in a wide array of assets to generate a higher return for a given level of risk than what's expected of normal investments. In many cases, but hardly all, hedge funds are managed to generate a consistent level of return, regardless of what the market does. Before I get to the longer, more complicated explanation of hedge funds, however, it helps to know exactly what hedging is.

Hedging: The heart of the hedge-fund matter

Hedging means reducing risk, which is what many hedge funds are designed to do. Maybe you've hedged a risky bet with a friend before by making a conservative bet on the side. But a hedge fund manager doesn't reduce risk by investing in conservative assets. Although risk is usually a function of return (the higher the risk, the higher the return), a hedge fund manager has ways to reduce risk without cutting into investment income. She can look for ways to get rid of some risks while taking on others with an expected good return,

often by using sophisticated techniques. For example, a fund manager can take stock-market risk out of the fund's portfolio by selling stock index futures (see Chapter 5). Or she can increase her return from a relatively low-risk investment by borrowing money, known as *leveraging* (see Chapter 11). If you're interested in investing in hedge funds, you need to know how the fund managers are making money.

Risk remains, no matter the hedge-fund strategy, however. Some hedge funds generate extraordinary returns for their investors, but some don't. In 2005, the Credit Suisse/Tremont Hedge Fund Index — a leading measure of hedge-fund performance (www.hedgeindex.com/hedgeindex/en/default.aspx) — reported that the average hedge-fund return for the year was 7.61 percent. The NASDAQ Composite Index (www.nasdaq.com) returned only 1.37 percent for the same period, but the Morgan Stanley Capital International World Index (www.mscibarra.com) was up 10.02 percent. The amount of potential return makes hedge funds more than worthwhile in the minds of many accredited and qualified investors (see Chapter 2 for more on hedge-fund requirements).



In 2005, 9,000 hedge funds managed a total of \$1 trillion dollars, according to Hedge Fund Research, a firm that tracks the hedge-fund industry (www.hedgefundresearch.com). In 2005, therefore, the average fund had \$111 million in assets. Given the industry's standard fee structure, in which managers charge at least 1 or 2 percent of assets (see Chapter 2), the typical fund generated \$1.1 to \$2.2 million on the year for the fund manager.



Return is a function of risk. The challenge for the hedge fund manager is to eliminate some risk while gaining return on investments — not a simple task, which is why hedge fund managers get paid handsomely if they succeed. (For more on risk and return, check out Chapter 6.)

Identifying hedge funds: The long explanation

Okay, I'll go ahead and start covering the gory details of hedge funds. A *hedge fund* is a private partnership that operates with little to no SEC regulation (see Chapter 3). A hedge fund differs from so-called "real money" — traditional investment accounts like mutual funds, pensions, and endowments — because it has more freedom to pursue different investment strategies. In some cases, these unique strategies can lead to huge gains while the traditional market measures languish. The following sections dig deeper into the characteristics of hedge funds, as well as the bonuses that come with funds and the possibility of bias in the reported performances of funds.

Little to no regulatory oversight

Hedge funds don't have to register with the U.S. Securities and Exchange Commission (SEC). The funds and their managers also aren't required to register with the National Association of Securities Dealers (NASD) or the Commodity Futures Trading Commission, the major self-regulatory bodies in the investment business. However, many funds register with these bodies anyway, choosing to give investors peace of mind and many protections otherwise not afforded to them (not including protection from losing money, of course). Whether registered or not, hedge funds can't commit fraud, engage in insider trading, or otherwise violate the laws of the land.

In order to stay free of the yoke of strict regulation, hedge funds agree to accept money only from accredited or qualified investors. *Accredited investors* are individuals with a net worth of at least \$1 million or an annual income of \$200,000 (\$300,000 for a married couple; see Chapter 2 for more information). *Qualified investors* are individuals, trust accounts, or institutional funds with at least \$5 million in investable assets.

The reason for the high-net-worth requirement is that regulators believe people with plenty of money generally understand investment risks and returns better than the average person, and accredited investors can afford to lose money if their investments don't work out. In order to avoid the appearance of improper marketing to unqualified investors, hedge funds tend to stay away from Web sites, and some don't even have listed telephone numbers. You have to prove your accredited status before you can see offering documents from a fund or find out more about a fund's investment style.

Aggressive investment strategies



In order to post a higher return for a given level of risk than otherwise expected (see Chapter 6, which covers risk calculation in much detail), a hedge fund manager has to do things differently than a traditional money manager. This fact is where a hedge fund's relative lack of regulatory oversight becomes important: A hedge fund manager has a broad array of investment techniques at his disposal that aren't feasible for a tightly regulated investor.

Here are a few investment techniques that I cover in great detail in this book:

- ✓ **Short-selling (Chapter 11):** Hedge fund managers buy securities that they think will go up in price. If they spot securities that are likely to go down in price, they borrow them from investors who own them and then sell the securities in an attempt to buy them back at lower prices in order to repay the loans.



- ✓ **Leverage (Chapter 11):** Hedge funds borrow plenty of money in order to increase return — a technique that can also increase risk. The fund has to repay the loan, regardless of how the investment works out.

The use of leverage is a key difference between hedge funds and other types of investments. Most hedge funds rely on leverage to increase their returns relative to the amount of money that they have in their accounts. Because of the risk that comes with the strategy, funds often use leverage only for low-risk investment strategies in order to increase return without taking on undue risk.

- ✓ **The Buffet Line:** Okay, so I made this one up. But hedge fund managers do have a wide range of investment options. They don't have to lock in to stocks and bonds only. They buy and sell securities from around the world, invest in private deals, trade commodities, and speculate in derivatives. They have flexibility that traditional asset managers only dream about. (See Chapters 10 through 13 for more information on the many options.)

Manager bonuses for performance

Another factor that distinguishes a hedge fund from a mutual fund, individual account, or other type of investment portfolio is the fund manager's compensation. Many hedge funds are structured under the so-called *2 and 20* arrangement, meaning that the fund manager receives an annual fee equal to 2 percent of the assets in the fund and an additional bonus equal to 20 percent of the year's profits.

The performance fee is a key factor that separates hedge funds from other types of investments. U.S. Securities and Exchange Commission regulations forbid mutual funds, for example, from charging performance fees. You may find that the percentages differ from the 2 and 20 formula when you start investigating prospective funds, but the management fee plus bonus structure rarely changes.



The hedge fund manager receives a bonus only if the fund makes money. Many investors love that the fund manager's fortunes are tied to theirs. The downside of this rule? After all the investors pay their fees, the hedge fund's great performance relative to other investments may disappear. For information on fees and their effects on performance, see Chapters 2 and 4.



Biased performance data

What gets investors excited about hedge funds is that the funds seem to have fabulous performances at every turn, no matter what the market does. But the great numbers you see in the papers can be misleading.

Hedge funds are private investment partnerships with little to no regulatory oversight, which means that fund managers don't have to report performance numbers to anyone other than their fund investors. Many hedge fund managers report their numbers to different analytical, consulting, and index firms, but they don't have to. Naturally, the funds most likely to participate in outside performance measurement are the ones most likely to have good performance numbers to report — especially if the fund managers are looking to raise more money.

On the other end of the success spectrum, many hedge funds close shop when things aren't going well. If a fund manager is disappointed about losing his performance bonus (see Chapter 2), he may just shut down the fund, return all his investors' money, and move on to another fund or another project. Hedge Fund Research, a consulting firm that tracks the industry (www.hedgefundresearch.com), estimates that 11.4 percent of hedge funds closed in 2005. After a fund shuts down, it doesn't report its data anymore (if it ever did); poorly performing funds are most likely to close, which means that measures of hedge-fund performance have a bias toward good numbers.



You have to do your homework when buying into a hedge fund. You can't rely on a rating service, and you can't rely on the SEC, as you can with a mutual fund or other registered investment. You have to ask a lot of tough questions about who the fund manager is, what he plans for the fund's strategy, and who will be verifying the performance numbers. (Chapter 18 covers this process, called *due diligence*, in more detail.)

Pledging the secret society: Getting hedge fund information

Some hedge funds are very secretive, and for good reason: If other players in the market know how a fund is making its money, they'll try to use the same techniques, and the unique opportunity for the front-running hedge fund may disappear. Hedge funds aren't required to report their performance, disclose their holdings, or take questions from shareholders.

However, that doesn't mean hedge fund managers refuse to tell you anything. A fund must prepare a partnership agreement or offering memorandum for prospective investors that explains the following:

- ✓ The fund's investment style
- ✓ The fund's structure
- ✓ The fund manager's background

A hedge fund should also undergo an annual audit of holdings and performance and give this report to all fund investors. (The fund manager may require you to sign a nondisclosure agreement as a condition of receiving the information, but the information should be made available nonetheless.) But the hedge fund manager doesn't have to give you regular and detailed information, nor should you expect to receive it. (See Chapter 8 for more on transparency issues.)



Beware the hedge fund that gives investors no information or that refuses to agree to an annual audit — that's a blueprint for fraud. See Chapter 18 for more information on doing your due diligence.

Surveying the History of Hedge Funds

Hedge funds haven't been around forever, but they aren't exactly new, either. Their fortunes have varied with those of the markets, and their structures have evolved with the development of modern financial-management theories and techniques.

Knowing the history of hedge funds will give you a sense of how the modern hedge fund market came to be. You'll understand how some of the myths of funds originated and why some of the practices (like fee structure and secrecy) developed over time. And, the history is interesting. Isn't that reason enough? In this section, I cover some of the highlights and lowlights that have come since the development of the first hedge fund in 1949.

Alfred Winslow Jones and the first hedge fund

Alfred Winslow Jones wrote a book in 1941 that examined the attitudes of residents of Akron, Ohio toward large corporations. The book, *Life, Liberty, and Property: A Story of Conflict and a Measurement of Conflicting Rights*, is still in print by the University of Akron Press. When it came out, the magazine *Fortune* reprinted sections of the book, and Jones eventually joined the magazine's editorial staff. While at *Fortune*, he learned quite a bit about investing, and in 1949, he quit the magazine to form a money-managing firm, A.W. Jones & Co., which is still in business in New York.

At *Fortune*, Jones covered some of the developing theories in modern finance — especially the notion that markets were inherently unpredictable. He was determined to find a way to remove the risk from the market, and the way he found was to buy the

shares of stocks expected to go up while selling short the stocks expected to go down. With this strategy, he could remove much of the risk of the market, and his fund would have steady performance year in and year out. I describe this style of investing, sometimes called *long-short investing*, in Chapter 11. And in a twist of fate, *Fortune* first used the term “hedge fund” to describe Jones’ fund in a 1966 article.

Alfred Winslow Jones had two other innovations for the modern hedge fund, both of which have overshadowed his investment style:

- ✓ **His analysis of the Investment Company Act of 1940:** In the analysis, he stated that a private-partnership structure can remain unregistered as long as its investors are accredited.
- ✓ **His fee.** He charged his investors 20 percent of the fund’s profits. More than 50 years later, few hedge fund managers still hedge the way that Jones did, but almost every manager copies his partnership structure and fee schedule.

1966 to 1972: Moving from hedging to speculating

After Alfred Winslow Jones developed a nice business collecting 20 percent of the profits from his partners by using his hedging strategy, other money managers wondered if they could also set up private partnerships and charge 20 percent while following different investment strategies. The answer? Yes. The name “hedge fund” stuck, but the emerging funds were more speculative than hedged. *Hedging* is the process of reducing risk. *Speculating* is the process of seeking a high return by taking on a greater-than-average amount of risk. Although hedging and speculating are opposing strategies, many hedge funds today use both.

The change in strategy took place partly because the stock market was really strong, so short-selling proved to be a losing game (see Chapter 11). Also, because the stock market was so strong, money managers could make a lot of money by borrowing and buying stock.

And then, in 1972, the bottom dropped out. A stock-market bubble that formed at the end of the 1960s finally and totally burst, leaving hedge fund managers with big losses. Some managers who had borrowed heavily (or leveraged; see Chapter 11) found themselves insolvent. Most of the newly formed hedge funds shut their doors, and the aggressive style of investing fell out of favor for about a decade.

George Soros, Julian Robertson, and hedge-fund infamy

George Soros, who co-founded the Quantum Fund with Jim Rogers, and Julian Robertson, who founded the Tiger Fund, are two legendary names in the hedge-fund business. They both formed their funds in the late 1960s to early 1970s go-go era, managed to hold on through the market collapse that took place in 1972, and then started posting spectacular profits in the 1980s.

Both funds followed a macro strategy, which means they looked to profit from big changes in the global macroeconomy (see Chapter 13). They took bets on changes in interest rates, exchange rates, economic development, and commodities prices. They also used options and futures (see Chapter 5) to improve their returns and manage their risks. (In 1988, George Soros published a book about his unconventional approach to investing, *The Alchemy of Finance* [Wiley].)

Both fund managers achieved icon status of sorts in the 1990s, and then both managers ran into trouble. Soros made huge profits by betting (and investing accordingly) that the currencies of several Asian countries were overvalued. He was right, but the resulting collapse of the currencies led to political unrest in Indonesia and Malaysia and turned Soros into a pariah. Julian Robertson believed that the huge increases in technology stocks were overdone in the 1990s, and he was proven right in 2000, but his performance suffered terribly until then. (Chapter 13 dives into these stories more deeply.)

The rise and fall of Long-Term Capital Management

One infamous hedge fund, Long-Term Capital Management, had spectacular performance year after year until it nearly caused a global financial meltdown in 1998. The history of this firm tells a tale of just how little hedging takes place at some of the biggest and best-performing hedge funds.

The 1960s and 1970s brought about huge changes in the way that people thought about finance and investing. Experts developed several new academic theories (you can read about them in Chapters 6 and 14). Some academics realized that they could earn more by managing money than they could by teaching students how to do it, so they quit their university jobs and started hedge funds.

In 1994, John Meriwether, an experienced bond trader at Solomon Brothers, joined with other traders and two professors, Robert Merton and Myron Scholes, to form a fund. The fund's managers took advantage of relatively small differences in the prices of different bonds. Most of their trades were simple and low-risk, but they used a huge amount of borrowed money (known as *leverage*) to turn their simple trades into unusually large returns. In 1997, Merton and Scholes shared the Nobel Prize in Economics, giving their fund a highly academic aura. People thought the fund was filled with investors who had discovered an unusually low-risk way of generating unusually large returns.

In the summer of 1998, the Russian government defaulted on its bonds, which caused investors to panic and trade their European and Japanese bonds for U.S. government bonds. Long-Term Capital Management bet that the small differences in price between the U.S. bonds and the overseas bonds would disappear; instead, the concern over Russia's problems led to large differences in price that steadily widened. The mistake made it difficult for Long-Term Capital Management's managers to repay the large amounts of money that the fund had borrowed, which put pressure on the investors who had given the loans. The Federal Reserve Bank then organized a restructuring plan with the banks that Long-Term Capital Management dealt with in order to prevent a massive financial catastrophe. In total, Long-Term Capital Management lost \$4.6 billion dollars.

The Yale Endowment: Paying institutional attention to hedge funds

The Yale University Endowment, which operates in the financial and trade press, has \$15.2 billion under management as of press time, making it the second-largest college endowment in the world. Its success has driven most of the institutional interest in hedge funds, and institutional interest has created all the demand in the market. The performance of the Yale Endowment is considered a milestone.

It has long kept 25 percent of its assets in hedge funds, and in this avenue, it performs the best out of all the major university endowments. The fund's manager, David Swensen, earned a doctorate in finance at Yale and worked on Wall Street before joining Yale's staff in 1985. Once on board, he decided to diversify the university's money into holdings other than stocks and bonds, adding investments in private equity, oil, timberland, and hedge funds.

Management members at other endowments and foundations have long looked at Yale's performance with green-eyed envy. They've witnessed one of the richest colleges get richer, in part due to hedge-fund investing, and they

want to do the same. By 2005, the National Association of College and University Business Officers reported that 8.7 percent of all college-endowment money was invested in hedge funds, up from 1.8 percent in 1996. And, in 2005, 21.7 percent of the money in endowments larger than \$1 billion was invested in hedge funds.

Generating Alpha

Hedge fund managers all talk about alpha. Their goal is to generate alpha, because alpha is what makes them special. But what the heck is it? Unfortunately, alpha is one of those things that everyone in the business talks about but no one really explains.

Alpha is a term in the Modern (Markowitz) Portfolio Theory (MPT), which I explain in Chapter 6. The theory is a way of explaining how an investment generates its return. The equation used to describe the theory contains four terms:

- ✓ The risk-free rate of return
- ✓ The premium over the risk-free rate that you get for investing in the market
- ✓ Beta
- ✓ Alpha

Beta is the sensitivity of an investment to the market, and *alpha* is the return over and above the market rate that results from the manager's skill or other factors. If a hedge fund hedges out all its market risk, its return comes entirely from alpha.



People aren't always thinking of the Modern (Markowitz) Portfolio Theory when they use alpha. Instead, many people use it as shorthand for whatever a fund does that's special. In basic terms, alpha is the value that the hedge fund manager adds.



In theory, alpha doesn't exist, and if it does exist, it's as likely to be negative (where the fund manager's lack of skill hurts the fund's return) as positive. In practice, some people can generate returns over and above what's expected by the risk that they take, but it isn't that common, and it isn't easy to do.

Introducing Basic Types of Hedge Funds

Despite the ambiguities involved in describing hedge funds, which I outline in detail at the beginning of this chapter, you can sort them into two basic categories: absolute-return funds and directional funds. I look at the differences between the two in the following sections.



Because hedge funds are small, private partnerships, I can't recommend any funds or fund families to you. And because hedge fund managers can use a wide range of strategies to meet their risk and return goals (see the chapters of Part III), I can't tell you that any one strategy will be appropriate for any one type of investment. That's the downside of being a sophisticated, accredited investor: You have to do a lot of work on your own!

Absolute-return funds

Sometimes called a “non-directional fund,” an *absolute-return fund* is designed to generate a steady return no matter what the market is doing. Alfred Winslow Jones managed his pioneering hedge fund with this goal, although the long-short strategy (see Chapter 11) that he used was just one of several methods that snagged him consistent returns (see the section “Alfred Winslow Jones and the first hedge fund”).

Although absolute-return funds are close to the true spirit of the original hedge fund, some consultants and fund managers prefer to stick with the label absolute-return fund rather than “hedge fund.” The thought is that hedge funds are too wild and aggressive, and absolute-return funds are designed to be slow and steady. In truth, the label is just a matter of personal preference.



An absolute-return strategy is most appropriate for a conservative investor who wants low risk and is willing to give up some return in exchange. (See Chapter 9 for more information on structuring your portfolio.) Hedge fund managers can use many different investment tools within an absolute-return strategy, a few of which I present in Part III of this book.



Some say that absolute-return funds generate a bond-like return, because like bonds, absolute-return funds have relatively steady but relatively low returns. The return target on an absolute-return fund is usually higher than the long-term rate of return on bonds, though. A typical absolute-return fund target is 8 percent to 10 percent, which is above the long-term rate of return on bonds and below the long-term rate of return on stock.

Directional funds

Directional funds are hedge funds that don't hedge — at least not fully (see the section “Hedging: The heart of the hedge-fund matter” for more on hedging). Managers of directional funds maintain some exposure to the market, but they try to get higher-than-expected returns for the amount of risk that they take. Because directional funds maintain some exposure to the stock market, they're said to have a *stock-like return*. A fund's returns may not be steady from year to year, but they're likely to be higher over the long run than the returns on an absolute-return fund.

Directional funds are the glamorous funds that grab headlines for posting double or triple returns compared to those of the stock market. The fund managers may not do much hedging, but they have the numbers that get potential investors excited about hedge funds.



A directional strategy is most appropriate for aggressive investors willing to take some risk in exchange for potentially higher returns. (See Chapter 9 for more information on structuring your portfolio.)

Meeting the People in Your Hedge Fund Neighborhood

Many different people work for, with, and around hedge funds. The following sections give you a little who's who so you understand the roles of the people you may come into contact with and of people who play a large role in your hedge fund.

Managers: Hedging for you

The person who organizes the hedge fund and oversees its investment process is the *fund manager* — often called the *portfolio manager* or even PM for short. The fund manager may make all the investment decisions, handling all the trades and research himself, or he may opt to oversee a staff of people who give him advice. (See Chapter 2 for more information on hedge fund managers.) A fund manager who relies on other people to work his magic usually has two important types of employees:

- ✓ **Traders:** The traders are the people who execute the buy-and-sell decisions. They sit in front of computer screens, connected to other traders all over the world, and they punch in commands and yell in the phones.

Traders need to act quickly as news events happen. They have to be alert to the information that comes across their screens, because they're the people who make things happen with the fund.

- ✓ **Analysts:** Traders operate in real time, seeing what's happening in the market and reacting to all occurrences; analysts take a longer view of the world. They crunch the numbers that companies and governments report, ask the necessary questions, and make projections about the future value of securities.

Lawyers: Following the rules

Although hedge funds face little to no regulation, they have to follow a lot of rules in order to maintain that status. Hedge funds need lawyers to help them navigate the regulation exemptions and other compliance responsibilities they face (see Chapter 3), and hedge fund investors need lawyers to ensure that the partnership agreements are in order (see Chapter 2) and to assist with due diligence (see Chapter 18).

Consultants: Studying funds and advising investors

Because big dollars are involved, many hedge fund investors work closely with outside consultants to advise them on their investment decisions. Hedge fund managers also work with consultants — both to find accredited investors through marketing and to make sure that they're meeting their investors' needs. (For more information on working with a consultant, see Chapter 17.)



A consultant can take a fee from an investor or from a hedge fund, but not from both. That way, the consultant stays clear of any conflicts of interest.

Advising investors

A key role for consultants is helping investors make sound investment decisions. Staff members who oversee large institutional accounts — like pensions, foundations, or endowments — rely heavily on outside advisors to ensure that they act appropriately, because these types of accounts hinge on

the best interests of those who benefit from the money. (See Chapters 8 and 10 for more on this responsibility.)

Consultants not only ensure that investors follow the law, but also advise investors on the proper structure of their portfolios in order to help them meet their investment objectives. A consultant analyzes how the investor divides the money among stocks, bonds, and other assets and then recommends alternative allocations that may result in less risk, higher return, or both (see Chapter 9 for more on asset allocation).

Monitoring performance

Investment consultants track the performance of their clients, of course, but they also build relationships with hedge fund managers and collect data on the risk, return, and investment styles of different funds and fund managers. They use the information they collect to advise their clients on investment alternatives. Because you can find only a few central repositories for hedge-fund performance information, and because hedge funds don't have to make their return data public, this is an important service. (See Chapter 14 for more info on evaluating performance.)

Marketing fund managers

Many hedge funds are small organizations. In some cases, the fund managers work alone. These funds have a small number of investors, and they may not allow their investors to take money out for a year or two, so they don't need to do constant marketing. It rarely makes sense for a hedge fund to have a dedicated marketing person on staff.

But that doesn't mean hedge funds don't need to find other investors. When the fund is new or when current investors want to withdraw their money, marketing becomes important. To help find new investors, many hedge funds work with consultants, who bring together investors looking for suitable hedge funds and hedge funds looking for suitable investors.

Paying Fees in a Hedge Fund

Hedge funds are expensive, for a variety of reasons. If a fund manager figures out a way to get an increased return for a given level of risk, he deserves to be paid for the value he creates. And, one reason hedge funds have become so popular is that money managers want to keep the money that they earn instead of getting bonuses only after they meet big corporate overhead. Face it — a good trader would rather keep his gains than share them with an overpaid CEO

who doesn't know a teenie from a tick. (Chapters 2 and 4 contain more information on paying fees, but here I cover the basics.)



A *teenie* is $\frac{1}{16}$ of a dollar. A *tick* is a price change. If the next trade takes a security up in price, it's an *uptick*; if it takes the security down, it's a *downtick*. In the olden days, when everything traded in eighths or teenies, ticks were printed on strips of paper called *ticker tape*. If a person did something notable, like win a World Series or land on the moon, he or she would receive a parade, and everyone at the brokerage firms would open their windows and throw out their used ticker tape (hence, ticker-tape parade).

Almost all hedge fund managers receive two types of fees: management fees and performance fees. More than anything else, this business model, not the investment style, distinguishes hedge funds from other types of investments.

Managing management fees

A *management fee* is a fee that the fund manager receives each year for running the money in the fund. Usually set at 1 percent to 2 percent of assets in a fund, the management fee covers certain operating expenses, salaries for the fund manager and staff, and other costs of doing business. The fund pays other expenses in addition to the management fee, such as trading commissions and interest.

For example, say a hedge fund has \$100,000,000 in assets. It charges a 2-percent management fee, which is \$2,000,000. The fund has an additional \$1,750,000 in trading expenses and interest. The fund investors have to pay fees from the assets whether the fund makes money or bombs.

If the fund's management fee is too low, the fund manager won't be able to run the business effectively or hire the necessary staff. If the fee is too high, the fund manager will make such a nice living that he or she will have little incentive to pursue a performance bonus.

Shelling out your percentage of performance fees

Most hedge funds take a percentage of the profits as a *performance fee* — also called the *incentive fee* or sometimes the *carry*. The industry standard is 20 percent, although some funds take a bigger cut and some take less. You need to read the offering documents you receive from a fund to find out what the fund charges and whether the fund's potential performance justifies the fee.



If the fund loses money, the fund manager gets no performance fee. In most funds, the fund managers can't collect performance fees after losing years until the funds' assets return to their previous high levels, sometimes called the *high-water marks*. You can find a detailed explanation of how these fees work in Chapter 2.

The performance fee means that the fund manager's incentives are closely aligned with those of the fund's investors. As folks on Wall Street say, hedge fund managers eat what they kill. The big problem with the performance fee is that if a fund has a negative year, the fund manager has an incentive to close the fund and start over instead of losing the performance fee. And every fund will have a bad year once in a while.



In many cases, a hedge fund's outstanding performance disappears after the performance fee hits the manager's pocket. You may find that you're paying a lot of money and dealing with many complications to be in a hedge fund when you could get the same net return through a different type of investment, like a mutual fund.

