CHAPTER 1

Hedge Fund Growth—What It Means to the Institution

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Open any business publication or daily paper with even moderately in-depth business coverage and you'll see a story about a hedge fund. Most of these stories will describe how hedge funds are unregulated, implying that somehow this means hedge funds are The Wild West of investing, best left to only those willing to brave extraordinary frontiers and the risks associated with them. Other articles concentrate on the latest scandal to touch down on a "hedge fund," not distinguishing between a hedge fund and essentially a crooked enterprise masked as a hedge fund to take advantage of the zeitgeist of today. Finally, stories feature breathless descriptions of the fantastic growth in hedge funds, both in terms of the money they manage collectively as well as the number of funds in total. This book will touch on these issues, but this opening chapter will focus on the last point, specifically as it relates to the effect the tremendous increase in hedge fund formations has had on institutional investors.

The 2006 PerTrac Analytical Platform neatly summarized what daily and trade press have simply termed an "explosion" in hedge funds over the past several years. According to PerTrac's* study of various hedge fund databases[1]:

- Nearly 13,675 single manager hedge funds were identified, up from 8,100 single managers acknowledged in the 2005 study.

*An invaluable source for this and other hedge fund data is Matthias Knab's Opalesque.Com, a site that agglomerates news and other information relating to the alternative investments world. The PerTrac study was reported, for example, at http://www.opalesque.com/main.php?act=archive&and=show&nr=1240&anchor=topic33608#topic33608. The site is not free but few things worth this much are.

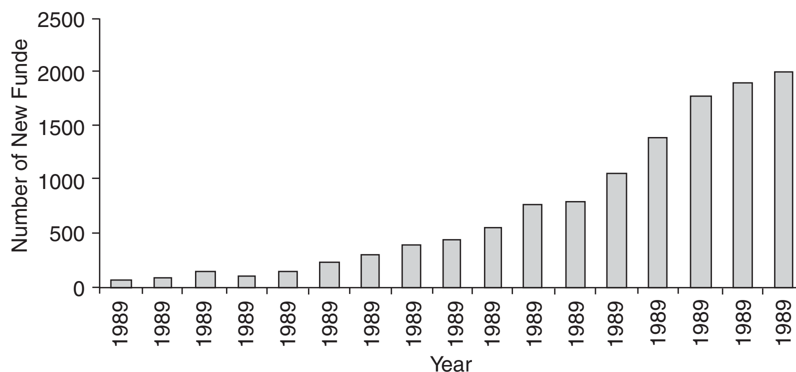

FIGURE 1.1 Number of New Single Manager Hedge Funds by Year
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- Single manager funds totaled more than $1.41 trillion under management.
- Approximately 250 funds have surpassed the $1 billion hurdle. By contrast, more than a third of single manager funds manage less than $25 million.
- Approximately 4,150 of the single manager funds appear to be clones of another fund.
- Figure 1.1 shows a steadily increasing arc of new single manager hedge funds over the past decade and a half; note that this figure does not even take into account those funds that didn't report to any database.

The *Wall Street Journal* added to this analysis by reporting, on January 3, 2007, that hedge funds managed approximately $500 billion five years ago. The *Journal* placed the figure at the time of the article at close to $1.44 trillion.[2]

What does all this growth mean to an institution? Certainly, one upside is capacity, or the ability for institutions to increase their alternative asset allocation percentage if they should wish to do so. Turning this coin over reveals, however, the inherent dangers of any industry that sees its membership increase so rapidly: dilution of talent, and consequently, increase in potential losses stemming from the selection of the wrong fund. Not too long ago most hedge funds had a similar starting point. A classic biography highlighted the manager's graduation from Harvard, followed by a Wharton MBA, a stint at a bulge-bracket investment house and then something of an apprenticeship at a place like Julian Robertson's Tiger Management. When

the manager ultimately broke out on his own, an investor could be assured, knowing the manager had the necessary background to succeed.

Now, this is no longer the case. As hedge funds became more and more popular, and as other opportunities in the financial world became less attractive, if not, at one point, downright less available, the type of person seeking to become a hedge fund manager changed dramatically. From investment bankers to stock analysts, from physicians to pharmacists, from amusement park operators to real estate developers, all of a sudden everyone you know is a hedge fund manager. A few years ago, I attended a basketball camp and at dinner, the 18-some-odd group included an eclectic mix of careers, united only by a love of hoops. Going around the table, the spotlight turned to the only person there who then worked for an investment bank and the only person who by that time had managed to be somewhat universally irritating in his manner. Asked to elaborate on his career, he said he was leaving to start a hedge fund. I am quite certain he had little desire to be a hedge fund manager. His focus was prestige and money, not some innate love of esoteric trading strategies.

It is not the fact that people from so many walks of life are becoming hedge fund managers that is necessarily troubling. Rather, it is the reason they are doing so. Illustrated in the example above (though admittedly lost somewhat in the translation) is the fact that many people are approaching the hedge fund industry as if it were a fast, easy way to make a ton of money, all with a very low barrier to entry. The low barrier to entry part may very well be true (this is probably the best argument for increased regulation, though a libertarian would argue it is the worst); the easy money part is not. People's motivation for becoming a hedge fund matters precisely because running one is not easy. One needs a combination of trading experience, ability to deal with risk, conviction, honesty, and overall business skills (any fund seeking institutional money is no longer a guy clackety-clacking away on his basement computer; no, running an actual business is required now, too). People in it for just the fast riches often will find out the hard way that this industry is not what they thought; the key for the institution, then, is not to be the one colearning this lesson.

The trick for any institution is ferreting out which funds present an acceptable risk. This has been made simultaneously easier and harder by the drastic expansion in hedge funds from which to choose. On the one hand, given the plethora of funds at their disposal institutions no longer have to fear getting shut out of all the funds in which they might like to invest. Conversely, this very abundance of choices means it is no longer so simple to judge the quality of the people running the funds, since these people may very well be unknown to the institution and those in its circle.

Pointedly illustrating this are recent statistics on the heavy concentration of hedge fund assets in a relatively small number of funds. According to a March 2007 piece in *Hedge Fund Daily*, gleaned from its sister publication, *Absolute Return*, a unit of *HedgeFund Intelligence*, 241 U.S. hedge fund firms have more than $1 billion in assets under management.[3] Perhaps most astoundingly, the 20 largest hedge fund firms controlled approximately $386 billion, in total, or almost one third of the global hedge fund assets reported to surveyors.

A February 2007 report in *Hedge Fund Daily* presented slightly different figures, although not contradicting the general concentration point.[4] "The 10 largest hedge funds according to size control 63% of industry assets, according to Milken Institute's *Capital Access Index 2006*, while the top 1% control 19% of all global fund assets. Based on data from HedgeFund.net, the study found that . . . hedge funds with more than $1 billion in assets under management account for only 3% of the total number of funds but 35% of the industry's trillion in assets, while HFs with under $100 million AUM represent about 70% of the number of funds but just 12% of the assets."

The full list was published in *Absolute Return's* March issue. Unless noted otherwise, all asset figures are as of January 1, 2007, and are in the billions. See Table 1.1.

Even if you eliminate the bottom third of hedge funds that reportedly have less than $25 million apiece, what remains is a tremendous number of hedge funds to weed through, if you don't want to, or can't, invest in the aforementioned big boys. Speaking of which, one theory proffered in a recent *HedgeWorld* story is that investors are better served by getting into funds early in the fund's "life cycle."[5] According to this theory, penned by Shoham Cohen, a hedge fund has four stages, similar to what you might expect: introduction, growth, maturity, and decline. As might also be expected,

TABLE 1.1 Top 10 U.S. Hedge Fund Firms—January 2007

JPMorgan Asset Management	$34.00
Goldman Sachs Asset Management	$32.53
Bridgewater Associates	$30.20
D. E. Shaw Group	$26.30
Farallon Capital Management	$26.20
Renaissance Technologies Corp.	$24.00
Och-Ziff Capital Management	$21.00
Cerberus Capital Management	$19.15
Barclays Global Investors	$18.90
ESL Investments	$18.00

he does not believe that it is astute to invest during stage four; rather, he proposes that hedge fund investors often "shy away from funds with track records of less than five years, or assets under management of less than $300 million, in favour of more established funds. These vintage funds are usually past their prime."

Mr. Cohen avers, "Emerging funds can provide better returns, better capital protection, a longer-term investment prospect, and up-to-date investment strategies," while "historically, high-profile funds—in most cases—will add less value."

Although getting in while a fund is young, before it is hot, sounds appealing, these types of funds demand even more stringent due diligence analysis, for by their very nature they do not have the financial track record upon which you can rely.

None of this is meant to suggest in any way that all, or even the majority, of hedge funds are frauds or will blow up at some point soon. However, as with global warming, it now seems that the question isn't whether or not hedge funds are risky, but what can be done about it.

What can be done to lessen the risk of investing in a hedge fund that blows up? Specific prescriptions appear first in Chapter 4 and then throughout this book; it is enough to summarize here that the primary way to avoid the type of headline no one wants to see is due diligence. Proper, thorough research into the hedge fund manager's track record will go a remarkably long way toward ensuring a blow-up–free portfolio; no method is foolproof, of course, but relying on an ad hoc, hodgepodge of industry contacts, guile, and intuition is not only no longer necessary, but it is also no longer effective. And this is possibly the greatest distinction for institutional investors to recognize: the old way of hedge fund investing is no longer possible; no more can you simply invest with managers you know or with whom some acquaintance of yours has direct experience. But this doesn't mean you can't replicate the old experiences; it just means you have to work a lot harder to do so. Still, this work is not without its reward, because at the end of the day you can always move to the next manager on your list if your due diligence review should reveal that the first option is untenable. All in all, this isn't so bad.

DEMAND FOR HEDGE FUNDS

The discussion above focused on the increased supply in hedge funds, suggesting that this was in response, primarily, to hedge funds becoming popular and to their perception as easy money. Another critical factor, of course, and one you are likely to be at least partially aware of, is the concurrent heightened demand for hedge funds in which to invest.

Everyone knows about institutions providing ever-increasing dollars to hedge funds. (*Reuters.com* reported in March 2007 that a survey of more than 40 funds with assets totaling $1 trillion revealed that only 4 percent have no hedge fund investments, down from 16 percent the year before.[6]) Less well known, perhaps, is one of the reasons why this is occurring. According to a January 3, 2007, *Financialnews-US.com* article, the two largest US pension funds, the $225bn California Public Employees Retirement System and the $153bn California State Teachers' Retirement System, combined their unfunded pension liabilities of $49bn, as the state of California sought to address its funding deficits.[7] Though going forward, California and the many other pension plans in this predicament will plausibly seek to change from defined benefit plans to defined contribution plans, this will not address the immediate problem of unfunded, or under-funded, pension plans. One ready solution, however, is investing in more alternatives, including hedge funds, in order to "goose" pension plan returns and hopefully abate or even eliminate the funding gaps that currently exist.

Around this time, *HFN Daily Report* quoted a press release issued by Russell Investment Group, which managed more than $195 billion in assets for advisory clients as of December 31, 2006.[8]

According to the release, Russell Investment Group "predicted a drastic change in pension investment portfolios as corporations respond to pension reform and try to maximize returns while matching liabilities. . . . 'Changes in pension policy are being driven by a variety of pressures, and these pressures are going to push different plans in different directions,' said Bob Collie, director of strategic advice at Russell and contributing author of the *Russell Pension Report 2007*. 'There will be a breaking up of the herd as organizations pursue a wide range of both liability-matching and return-seeking strategies, driven by different responses to recent pension reform and by increasingly diverse corporate objectives.'"

The Russell report added, "Regardless of which strategy or combination of strategies companies ultimately choose, the ability of plans to employ both return-seeking and liability-matching strategies is now more feasible and necessary than ever before, a finding that challenges the traditional presumption that the two investment strategies are mutually exclusive."

Eurakehedge had a related story about institutional investors driving hedge fund growth, based on an extensive survey* conducted in 2006 "through more than 100 in-depth interviews with institutional investors,

*For hard copies of "Institutional Demand for Hedge Funds 2: A Global Perspective," contact The Bank of New York, Hong Kong: Rosemarie Kriesel, rkriesel@bankofny.com.

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investment consultants, hedge funds, funds of hedge funds and industry experts worldwide."[9] This was a follow-up to a similar survey conducted in 2004, both carried out jointly by Bank of New York and Casey, Quirk & Associates.

Among the study's conclusions were that institutional investors are by and large quite satisfied with their hedge fund portfolios and that this satisfaction means hedge funds are here to stay. The study also concluded that as recently as five years ago, hedge fund investors were comprised mostly of individuals, with a smattering of institutions joining in the fray. Now, more than 40 percent of hedge fund money is institutional (frankly, this still seems low to me, and in fact *Institutional Investor News* and *HedgeFund.net* released a report in mid-March 2007 in which Hedgefund.net estimated total hedge fund asset levels at $1.89 trillion, with $953 billion, or just more than 50 percent, from fund of funds[10]); by 2010, the authors expected this number to increase by half (to 60 percent—again, a figure I personally believe understates the case), with total institutional money in hedge funds predicted to be $1 trillion (said with a pinky in the corner of your lip, Dr. Evil–style). As for the whys, the authors believe that institutions are looking for both low correlation with the rest of their assets as well as absolute returns.

Perhaps the most important point from my perspective, albeit one that did not receive top billing in the research paper, was this one, "Factors such as scandal and regulation could slow predicted growth, though we would expect the impact to be marginal." As the following chapters will show, the press treats "hedge fund" scandals the way bears do salmon, ripping them apart rapidly and somewhat indiscriminately. For the hedge fund community, institutions especially, this means that vigilance is the watchword of the day. You can't rely on methods that worked when there were approximately 5 percent of the hedge funds that there are today. Today's hedge fund growth and turnover demands a level of scrutiny that this book will hopefully demonstrate how to execute.

WHAT ABOUT REGULATION? IS REGULATION THE ANSWER?

I guess it depends on the question. Most important for any institution to recognize, however, is that regardless of how stringent regulation becomes, and how successful regulatory agencies are in prosecuting frauds once they occur, regulation is not intended or designed to predict which hedge fund might blow up next. For that, you'll always need due diligence, both operational and manager research. To understand a manager's tendencies and track record, you must delve into these items. No regulatory body can

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possibly replicate your research, not just because they don't have the time or expertise, but also because this is inherently not their focus. Recognize, too, that regulatory bodies admittedly become involved in frauds against investors almost always after a whistleblower points out an ongoing fraud. At this point, you, the investor, can at best hope to recover only a portion of your investment, and you certainly can't prevent the damage from the avalanche of bad press that is sure to follow. We'll explore the role of regulators further in Chapter 8, but for now keep in mind that regulators cannot and do not obviate your need to do due diligence on the managers in which you are seeking to invest.

RECAP

1. Hedge funds are not a passing fad.
2. Institutional interest in hedge funds is likewise a long-term commitment, and is in large part a response to underfunded pension funds.
3. Today, 9,000+ hedge funds versus 500 hedge funds means more choice but also far more chance of finding a bad apple.
4. Ad hoc methods like calling on industry contacts are no longer an efficient or effective means of conducting due diligence on people.
5. Systematic management/people due diligence combined with operational due diligence allows for a great reduction in blow-up risk.