Chapter 1

# Hedge Fund Basics

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It seems to me that the only time the press mentions hedge funds is when one blows up or some sort of crisis hits one of the world's many markets or there is a fraud and investors are robbed or taken to the cleaners. This has been a constant by the media since the summer of 1998.

Step back if you will to the summer of 1998, when Charlton Heston took over the presidency of the National Rifle Association, Compaq Computer bought Digital Equipment Corporation for nine billion dollars, the largest deal in the industry at the time, and the United States embassies in Tanzania and Kenya were bombed, killing 224 people and injuring over 4,500. It was also during this time that a currency crisis in Asia spread to Russia, then crept into Europe, and finally hit the shores of the United States in mid-July and early August.

Many who follow the markets assumed that things were bad and were going to stay that way for a very long time. And of course the first people who were looked at when the volatility hit and markets dropped were members of the hedge fund community. Although no one knew for sure what was going on and who and how much was lost, one thing was clear: Many of the most famous hedge funds of the time were in serious trouble.

After weeks of speculation and rumors, the market finally heard the truth: The world's "greatest investor" and his colleagues had made a mistake of significant proportions.

At a little before 4 P.M. Eastern Standard Time (EST) on Wednesday, August 26, 1992, Stanley Druckenmiller made the announcement on CNBC in a matter-of-fact way: The Soros organization, in particular its flagship hedge fund, the Quantum Fund, had lost more than $2 billion in recent weeks in the wake of the currency crisis in Russia. The fund had invested heavily in the Russian markets and the trades had gone against them. When the ruble collapsed, the liquidity dried up, and there was nothing left to do but hold on to a bunch of worthless slips of paper. During the interview, Druckenmiller did mention that although the fund had sustained significant losses in its Russian investments, overall its total return was still positive for the year, with gains upwards of 19 percent. However, in the months that followed, the Soros organization announced significant changes to the operation, including closing one fund that lost over 30 percent.

When asked by the CNBC reporter where the losses came from, Druckenmiller was not specific. It appeared that it was not one trade but a series of trades that had gone against them. The next day, the *New York Times* reported that the fund had also posted losses in dollar bond trades.

When Druckenmiller made the announcement, the Russian equity markets had been down over 80 percent and the government had frozen currency trading as well as stopped paying interest on its debts. The Asian flu had spread, and Russia and many of the other former Soviet republics looked to be in trouble. The difference was that in Russia and the surrounding countries, things looked quite a bit worse than in east Asia.

Although there had been rumors of hedge fund misfortunes and mistakes in these regions, no one knew the true size and scope of the losses. Druckenmiller's announcement was the tip of a very big iceberg and the beginning of a trend in the hedge fund industry, one that was a first: to be open and honest about losses. Hedge fund managers en masse seemed to be stepping up to the plate and admitting publicly that they had made mistakes and had sustained significant losses.

The day after the Soros organization spoke up, a number of other hedge fund managers issued similar statements. Druckenmiller's interview turned out to be the first of several such admissions of losses by famed fund managers. And the losses were staggering.

One fund lost over 85 percent of its assets, going from over $300 million under management to around $25 million. Another said it had lost over $200 million. Others lost between 10 and 20 percent of their assets. They all had come out publicly to lick their wounds, a sort of Wall Street mea culpa.

When the carnage first hit, it seemed that everyone except Julian Robertson, the mastermind behind Tiger Management, the largest hedge fund complex in the world at the time, was the only "name" fund manager not to post losses. Yet even that proved not to be true.

In a statement on September 16, 1998, Robertson said that his funds had lost $2.1 billion or 10 percent of the $20-odd billion he had under management. The losses seemed to come in the early part of September and stemmed from a long-profitable bet on the yen's continuing to fall against the dollar. Because the yen instead appreciated, a number of Robertson's trades declined in value.[1] The funds also saw losses on trades executed in Hong Kong when government authorities intervened in the stock and futures markets to ward off foreign speculators.

Still, like Soros, Tiger was up significantly for the first eight months of 1998. These numbers echoed the funds' performance in recent years with returns in 1996 of over 38 percent and in 1997 of 56 percent. In a letter to investors explaining the losses, Robertson cautioned that the volatility of various markets would make it difficult to continue to post positive returns month after month.

"Sometimes we are going to have a very bad month," he wrote. "We are going to lose money in Russia and in our U.S. longs, and the diversification elsewhere is not going to make up for that, at least not right away. You should be prepared for this."

One of Robertson's investors, who requested anonymity, said that she could not believe all the bad press Robertson received for admitting to the losses. She also questioned whether the reporters really knew what they were talking about when they wrote stories on hedge funds.

"He had some losses, but he is also having a very good year," she said. "The press treats him unfairly because they don't understand what he does or how he does it. They also don't understand how he could be up so much when the mutual funds they themselves are investing in are not performing as well."

However, things were worse at Tiger than the public believed. On November 2, 1998, *The Wall Street Journal* ran a story titled "Robertson's Funds Become Paper Tigers as Blue October Leads to Red Ink for '98." According to the story, the funds had lost over 17 percent, or about $3.4 billion through October, which wiped out all of the funds' gains for the year. The funds' total losses through the end of October were approximately $5.5 billion, leaving Tiger with assets of around $17 billion, and it was expected to post losses of 3 percent for the month of November. By the middle of December the funds were down approximately 4 percent for the year.[2] On top of the losses, the funds also faced a number of withdrawals from investors both in the United States and abroad. Although a number of industry watchers and observers seemed to believe that Tiger had significant amounts of withdrawals, the firm's public relations firm denied that this was the case. The spokesperson did say that the funds did have "some withdrawals but nothing significant."

Robertson's letter to investors seemed to be the only words of wisdom that investors, traders, and brokers could hold on to as the carnage in the

hedge fund industry unfolded. Every day for the next four or five weeks, the financial pages were filled with stories similar to the tales of Robertson's and Soros' woes.

After all the dust settled and the losses were realized, the hedge fund industry entered its dark period, a direct result of the losses that many big funds posted and the fact that it was the dawn of the technology stock where no investor could do wrong. This period lasted until the tech bubble burst and investors realized that they needed professionals handling their money and that they could not make money on their own. However, in spite of the years that followed the collapse of Russia, it was clear that Soros and Robertson, both true money masters, and others like them were going to give way to a new breed of managers. The stimulus for this change in the industry was the result of the following incident. The next 10 years saw a series of ups and downs for the hedge fund industry—mostly ups. The industry and those who relied on hedge funds continued to thrive well into the 21st century. However, as the first decade of the new millennium drew to a close, the hedge fund industry and much of the financial systems were turned upside down.

In some ways one could say the events of the summer of 1998 prepared the powers that be and investors around the globe for the events that occurred during the credit crisis of 2008 and the revelation of the Madoff fraud. In order to understand why, one needs to first look at an event that shocked the world 10 years earlier.

## The Near Collapse of Long-Term Capital Management

For most of the summer of 1998, the news about the financial markets was not good. Although many expected to see a recovery in the third and fourth quarter, things took a turn for the worse on September 21, 1998, when the story broke that a large hedge fund was about to collapse and take markets around the globe with it.

For weeks leading up to that Monday, there had been speculation that Long-Term Capital Management LP (LTCM), a hedge fund with more than $3 billion in assets and run by one of Wall Street's smartest traders, was on the brink of collapse. Earlier in the summer, the firm had announced that it had lost over 44 percent of its assets. Rumors about it not being able to meet *margin calls* were running rampant through Wall Street.

The first real signs that something was dreadfully wrong came when the press broke a story that the New York Stock Exchange had launched an inquiry to determine if the fund was meeting its margin calls from brokers. There had been speculation that some of the brokers were giving Long-Term Capital

special treatment and not making it meet its margin obligations, and the NYSE was trying to find out if it was true.

**margin call**

demand that an investor deposit enough money or securities to bring a margin account up to the minimum maintenance requirements.

Initially, things at the fund seemed to be under control. It was believed that its managers had put a stop to the hemorrhaging and its operation was returning to normal. These rumors were part truth and part myth. Nobody on Wall Street—not the traders, not the brokers, and least of all the firms that had lent to Long-Term Capital—wanted to believe that it was in dire straits. This was not some whiz kid trader who had just gotten out of business school and was flying by the seat of his pants. This was John Meriwether, the person who had invented and mastered the use of rocket science to make significant returns while limiting risk.

The fund was more than Meriwether; it was managed by some of the smartest minds around Wall Street's trading desks. At the time, Long-Term Capital's partners list read like a who's who of Wall Street's elite. People like Robert Merton and Myron Scholes, both Nobel economics laureates, as well as David Mullins, a former vice chairman of the Federal Reserve Board, were the people making trading decisions and managing its assets. And there were a number of former Salomon Brothers trading whizzes as well as a handful of Ph.D.s whom Meriwether had groomed personally.

How could this fund blow up? The question seemed ludicrous, especially because the market conditions that existed had often proved to be the ones in which this kind of fund thrived. Wall Street believed that it was impossible for Meriwether to be going the way of Victor Niederhoffer or David Askin—two other high-profile hedge fund managers who lost everything when funds they operated blew up in the mid-1990s.

Everyone, including himself, believed that Meriwether was the king of quants, as traders who use *quantitative analysis* and mathematics are called, a true master of the universe. People believed that the press had gotten things wrong and that of course the fund would be able to weather the storm.

**quantitative analysis**

security analysis that uses objective statistical information to determine when to buy and sell securities.

"He has done it before," they said. "Of course he will do it again." Yet by the end of September 1998, there was one word to describe the previous statement: *wrong*.

The markets had gotten the best of Meriwether and his partners. He and his team of Ph.D.s and Nobel laureates had made mistakes that could not be reversed. They

had bet the farm and then some and were on the brink of losing it all. The problem was a combination of leverage, risk, and, of course, greed—three ingredients that when mixed together produce one thing: unsustainable losses.

The first news stories came out in late August and early September, after Meriwether announced in a letter to investors that the fund had lost a significant amount of assets. In his letter, which was subsequently published on Bloomberg, Meriwether blamed a number of circumstances for the losses. Still, he said, he and his colleagues and partners believed that the markets would turn in their favor; as long as they continued on the same path, investors would see light at the end of a very dark tunnel.

The letter stated, "Losses of this magnitude are a shock to us as they surely are to you," and that although the firm prided itself on its ability to post returns that are not correlated to the global bond, stock, or currency markets, too much happened too quickly for it to make things right. As with most of Meriwether's communications with investors, the letter did not delve into the types of trades or markets in which the fund was investing. The letter also did not discuss the amounts of leverage Long-Term Capital was using in its drive to capture enormous profits with even the slightest uptick. Nor did it explain that Meriwether had started to trade stock arbitrage positions, something completely different from the bond and currency plays with which he earned his stripes. The letter also failed to mention that the fund had borrowed money from itself to cover its operating expenses.

The simplest explanation of what happened to LTCM is that because multiple markets were hit with multiple crises at the same time—a perfect storm, if you will—there was no way for it to limit its losses or make money. Everything LTCM tried to do failed. Basically, everything that could have gone wrong did. Although the firm specialized in finding unique situations regardless of the condition of the market and employed many "if, then" scenarios, the one thing the partners never were able to figure out was what to do if everything they planned for happened at the same time. The strength of Long-Term Capital's operation rested on the managers' ability to determine what would happen to the prices of many securities when various events hit the market, but their black boxes never told them what would occur if everything they thought possible happened at the same time.

For example, it was widely reported that the fund was short U.S. Treasuries and long high-yield paper and other more risky illiquid investments. The idea was that as Treasury prices fell, yields would increase and the other types of debt instruments would rise in price.

The exact opposite happened. When the turmoil hit the markets, there was an immediate flight to quality, resulting in a significant increase in Treasury prices and a significant decrease in prices of riskier investments. Instead of converging, the trade diverged and ended up going in the wrong direction on both sides of the ticket. When prices of Treasuries shoot up, the yield goes

down, and likewise when the prices of high-yield debt go down, the yield increases. Markets that were illiquid to begin with became even more illiquid, and the Treasury market, which has enormous liquidity at all times, showed its lowest yields in a generation.

To understand how the firm could have lost so much so quickly and supposedly even put the world markets at great risk, one first needs to understand how Long-Term Capital operated. The firm specialized in bond arbitrage, a trading strategy Meriwether mastered while working at Salomon Brothers in the 1980s. Traders, using very complex mathematical formulas, capitalize on small price discrepancies among securities in various markets. The idea is to exploit the prices of certain bonds by buying or selling the security based on the perceived value, not the current market value.

The idea behind Long-Term Capital from its outset was to employ this strategy to capture significant profits while enjoying insignificant amounts of risk. Meriwether and his partners were not interested in making a killing on a single trade but rather in picking up small amounts with relatively minor swings in the market from multiple trades. The idea was to employ enough leverage that even the slightest market movement would cause the firm to profit quite handsomely.

If they bought a stock at $100, they would not wait for it to go to $120 or $180 but rather would sell out when it hit $101. Making a dollar does not seem like much, but because their leverage was in excess of 20 to 1 they were able to make big profits on the very small (1 percent) movement. With $100 of equity, the fund would have been able to control $2,000 worth of stock. So in this hypothetical situation, the profit would have been approximately 20 percent. If a $100 investment leveraged at 20 to 1 goes up 10 percent, the trade yields a $200 profit, or a yield of 200 percent on the initial $100, a tripling in value.[3]

In the aftermath of the fund's meltdown, there was of course a lot of Monday morning quarterbacking with very little explanation of what went wrong. The *New York Times* managed to get some unique color on the situation:

> As one Salomon Brothers veteran described it, [Meriwether's] fund was like a roulette player betting on red and doubling up its bets each time the wheel stopped on black. "A gambler with $1,000 will probably lose," he said. "A gambler with $1 billion will wind up owning the casino, because it is a mathematical certainty that red will come up eventually—but you have to have enough chips to stay at the table until that happens."[4]

One thing for sure is that to stay at the table, Meriwether used significant amounts of leverage. The problem was that at Long-Term Capital, leverage got out of hand.

The first indication that things had taken a turn for the worse was in July 1998. Meriwether announced that the fund had posted a loss of some $300 million for the month of June. It was the first time the fund had posted a loss for a month since its inception four years earlier. Reports at the time questioned the veil of secrecy that surrounded the fund's trading and it was unclear where the losses were coming from. The fund had operated in complete silence when it came to discussing strategy or positions, because it believed that once people understood where it was making money, they could determine where its next moves would be and copy its strategies. Very few outside Meriwether's inner circle knew what markets the fund was trading in and where profits and losses originated.

Initial reports had the losses coming from the turmoil that rocked the mortgage-backed securities markets. Still, because of the size of the losses, people suspected that the firm had losses elsewhere, including the currency and U.S. Treasuries markets.

It was quite a shock to many on Wall Street when the losses were announced. For years, Long-Term Capital had performed extremely well and its leader was considered to be too smart to make mistakes. Many others could make mistakes and fail but not John Meriwether and his quants. Wall Street believed that these men and women walked on water. The firm perpetuated the myth time and time again by putting up strong returns, no matter what the condition of the market.

In 1995, the firm was up over 42 percent, net of fees, while in 1996 and 1997 it was up 41 percent and 17 percent respectively. Long-Term Capital did not just beat the indexes; it trounced them.

Still, never would the statement "Past performance is no indication of future results" become more pertinent than during the summer of 1998.

On a very hot day in August, a person I was interviewing for the first edition of this book told me that Long-Term Capital's losses for June were just the tip of the iceberg; the firm had sustained enormous losses the previous Friday when buyers dumped corporate bonds and bought Treasuries, sending yields to their lowest point in 20 years. The person told me that a friend had just come from a meeting with a New York investor who said he was pulling out of Long-Term Capital and that Meriwether was on the verge of bankruptcy. I was shocked. On my way out of the interview, I immediately called friends at New York newspapers to try the story. It was possible that other superstars had blown up and of course many smaller hedge funds run by inexperienced managers had failed.

The thought of LTCM failing was ridiculous—it just did not make sense. Its managers were some of the best and brightest on the Street, and it just did not seem possible. However, by mid-morning the story had been confirmed; a number of people said that the fund had posted significant losses and looked to be going under.

The next day a number of stories appeared in the papers confirming that Meriwether had lost a significant amount and that the fund needed a large capital infusion to stay afloat. Things looked quite grim for the fund.

It was the first indication that September was going to be a very long month for Long-Term Capital's management and investors, its trading partners, and the entire hedge fund industry.

The story came out because someone leaked a letter that Meriwether had written to investors explaining the situation and requesting new capital. He asked that investors be patient and that they supply him with new capital to "take full advantage of this unusually attractive environment."

People who spoke with him about the letter explained that he believed that by attracting new capital, he would be able to put a hold on the losses and be able to take advantage of the inevitable turnaround that was about to come. However, others believed that it had the makings of a Ponzi scheme.

"By continuing to employ strategies that had worked in the past, John believed he would be able to recover from this dreadful situation," a hedge fund manager who is close to Meriwether said. "The problem was people had lost faith. Never had the statement 'you're only as good as your last trade' been more prevalent on Wall Street."

Acknowledgment of the problem came a little too late to stop the hemorrhaging. By the time Meriwether asked for more money, the losses were too great. Even if investors had decided to pony up the extra dollars, they would have only been able to stave off the inevitable for a little while because the need for cash was so great. The well had dried up and the opportunities, it seemed, no longer existed.

At the time he wrote to investors, Meriwether probably did not have any idea where the money to bail out his firm would come from nor the extent of what the bailout would cost. Besides looking for capital from his investors, Meriwether approached outsiders, including Warren Buffett and George Soros, all of whom turned him down.

Buffett did resurface, but as a potential purchaser of the operation, not as an investor. He, along with Goldman Sachs Group LP and American International Group Inc., offered to buy the entire operation from Meriwether and to assume the fund's massive portfolios. Meriwether said no, because he did not want to give up control. The press seemed to believe that Meriwether's ego had gotten in the way of getting the deal done with Buffett.

The situation came to a head on Monday, September 21, 1998, when Wall Street's most powerful and influential players got calls from representatives of the Federal Reserve Bank of New York. Some of the recipients were surprised that the Fed was going to intervene in a situation over which it had no direct control.

The president of the New York Fed requested that Wall Street's elite meet to discuss the fate of one of its own. Not since the days of J. P. Morgan had such a group of Wall Street moguls assembled in one room with the intention of devising a plan to save an institution as well as possibly themselves.

Initially, people credited the New York Fed as the stimulus for the bailout, but subsequent reports credited John Corzine, co-managing partner at Goldman Sachs and future senator from New Jersey, as the person who got the ball rolling. Still, it is believed that the Fed prompted him after it started questioning the amount of money Long-Term Capital owed companies under its supervision. It has been suggested that both Goldman Sachs and Merrill Lynch & Co. Inc. had been on the brink of losing so much money because of Long-Term Capital's inability to pay that the Federal Reserve was worried that the firms might themselves be pushed to the brink of insolvency should the fund go bankrupt. Unlike other bankruptcies, when hedge funds go out of business all of their positions are liquidated immediately, in most cases at fire-sale prices. It is unknown exactly how much money was at stake, but it is clear that trillions of dollars would have been wiped out if there had been a forced liquidation.

It was also clear that the fund had come to the end of its rope. It needed money to meet its margin obligations or else havoc would reign over the world's already tumultuous markets. For the first time in a very long time the federal government determined that an organization was "too big to fail," and it was going to do everything in its power to ensure that it did not fail. Prior to its involvement in the LTCM bailout, the federal government had deemed Chrysler too big to fail and bailed the struggling car maker out in the 1970s with a series of loan guarantees and contracts.

Did the Fed do the right thing? The people I spoke with seemed divided on the issue. Although the debate will go on for some time, one thing is for sure: In light of the takeover by the consortium, Long-Term Capital was able to right itself and started earning money again in the fourth quarter of 1998.

The Federal Reserve had hoped that Goldman Sachs would find a buyer for the fund, but when that failed, it asked the dozen or so companies to come up with a workable solution to this very serious problem.

When the announcement was made that the potential buyer had walked, David Komansky, chairman of Merrill Lynch at the time, took over the discussion to determine to what extent the companies would contribute to keep Long-Term Capital alive and possibly keep a number of themselves from collapsing as well.

After much discussion, including some who said they did not want to participate in the bailout but had their minds changed, 14 companies decided to contribute to the bailout, committing sums ranging from $100 million to $350 million. One that did not participate was Bear Stearns & Co., Inc. It

**TABLE 1.1 Bailout of Long-Term Capital Management**

| | |
|---|---|
| $100 Million | $300 Million |
| Bangque Paribas | Bankers Trust |
| Crédit Agricole | Barclays |
| Lehman Brothers | Chase Manhattan |
| | Credit Suisse First Boston |
| $125 Million | Deutsche Bank |
| Société Générale | Goldman Sachs |
| | JPMorgan |
| | Merrill Lynch |
| | Morgan Stanley |
| | Salomon Smith Barney |
| | Union Bank of Switzerland |

*Source: Wall Street Journal*, November 16, 1998.

was agreed that it should not chip in to the bailout because its risk as Long-Term Capital's clearing broker significantly outweighed the risk posed to other contributors. Table 1.1 illustrates to what extent each company contributed to the bailout.

Although—because of the secrecy surrounding the operation—it is unclear who lost what, it is apparent that many of Wall Street's most senior executives took some very big hits when the firm went down. The rescue plan reduced all of the investors' stakes to under 10 percent of what they had been. Executives of some of Wall Street's most prestigious companies—including Merrill Lynch, Bear Stearns, and PaineWebber Group Inc.—faced personal losses. A number of partners at the famed consulting firm McKinsey & Co. lost money as well.

The irony of the situation is that in the wake of the collapse, *The Wall Street Journal*, the *New York Times,* and the *New York Post* all reported that a number of investors were quite happy that earlier in 1998 Long-Term Capital had returned money to them. Yet most investors who received money back were quite upset at the time. In December 1997, Long-Term Capital had returned approximately $2.7 billion to investors ranging from small money managers to PaineWebber and the Bank of China.

The only firm on Wall Street that seemed to have done well with Long-Term Capital was PaineWebber.[5] It and its chairman and chief executive, Donald Marron, had invested $100 million and $10 million in the fund respectively. Both, however, received money back in 1997. According to a number of reports, the firm more than doubled its investment and Marron got enough money back to at least break even.

Other Wall Streeters were not so lucky. Bear Stearns chief executive James Cayne and executive vice president Warren Spector are believed to have lost more than $9 million each. Merrill Lynch's Komansky, who along with over a hundred of his colleagues had invested approximately $22 million in the fund, saw that position reduced to less than $2 million once the bailout was complete.

The idea that a hedge fund got too big to fail is quite remarkable. By the time the bailout agreement was reached, Long-Term Capital had received commitments in excess of $3.5 billion to be used to meet margin calls and to cover operating expenses. The bailout was designed to ensure that the firm would not collapse and cause credit markets around the world to cave in from dumping its positions. It is believed that if the fund had been forced to liquidate, it might have caused the undermining of more than $1 trillion in assets. However, this is pure speculation and we will never really know what could have happened had the fund truly gone down.

This experience makes it quite clear that the bull market of the mid- and late 1990s had gotten out of control and once again an enormous level of greed had come over the Street. The only way Long-Term Capital was able to become so large was that it was lent money without any regard for whether it could pay back what it borrowed. The lenders looked instead to the fees associated with the transactions and the continuous stream of revenue the firm would provide to line the brokerages' and banks' pockets.

In the wake of the Long-Term Capital disaster, the calls for hedge fund reform and regulation swept the nation and the world. Congress held hearings and industry observers cried foul, but hedge funds took a backseat to the scandal and impeachment that rocked the White House. Nothing came of the hearings and no new regulations were put in place.

The *New York Times* reported that one Wall Street executive who was briefed on the negotiations that led to the bailout said he had learned a lesson about his own firm's operation after reviewing its exposure to Long-Term Capital.

"We will never let our exposure to one counterparty get to these levels again—never. He had gotten too big for the market," he said of Meriwether. "Everybody gave him too much money."[6]

A few months after the bailout, however, things had started to turn around for Long-Term Capital Management and Meriwether. First the hedge fund reported profits and then came the speculation the fund was looking to buy out its saviors and that if an amicable arrangement could not be met, Meriwether would start a new investment vehicle. While the buyout never seemed to materialize, the fund's financial situation had completely turned around by the spring of 1999. Meriwether and his partners had paid back a significant portion of the bailout and had started talking about a new fund that they planned on launching.

In the early fall, Long-Term Capital had paid back close to 75 percent of the bailout to the consortium of financial institutions that had saved it a year earlier. The consortium issued a statement at the end of September stating that "the portfolio is in excellent shape" and that the risk profile of the fund had been reduced by nearly 90 percent. One of the stipulations of the bailout was that before Long-Term Capital's managers could operate a new fund, they had to repay 90 percent of the money the banks put into it. This meant that the fund needed to repay an additional $600 million to the consortium before Meriwether and his partners could raise money for a new fund.

By December 1999, LTCM fully repaid the banks that had prevented its collapse. Weeks later, the fund was quietly closed. Some investors are still sitting on losses. Meriwether has since gone on to launch a new hedge fund that employs similar investment strategies as LTCM called JWM Partners LLC.

The near collapse of LTCM set the stage for the future explosion of hedge fund managers and demand of investors for these sorts of investments.

Many market followers, historians, and practitioners like to say that the marker moves in cycles. Some say seven-year cycles, others say 10-year cycles. I am not sure—I am not a student of the markets—and therefore have no comment or view. I will say, however, people only seem to know that a cycle has ended after something has happened.

That being said, the bailout of LTCM created a precedent for the events of 2007 and 2008 to take place. In fact, some would say that bailing out a single hedge fund in 1998 provided the blue print for the bailout of the banks, auto makers, and mortgage lenders in 2008.

## The Credit Crisis and Hedge Funds

One would have to have been hiding under a rock for the last 18 to 24 months to not have some view, idea, concept, or belief of what went wrong in the world to cause the collapse of Wall Street firms, the automakers, the mortgage industry, and the erosion of millions of jobs not just in the United States but around the world.

The world literally was turned upside down during this time and at the time of this writing, mid-2010 has still not recovered from the destruction, implosion, and nationalization of the financial industry.

Left was right, right was left, up was down, down was up, you get the drift. It was shocking, sad, and frustrating to watch the events unfold and witness the carnage literally right before all of our eyes.

The hedge fund industry took a lot and continues to receive quite a bit of flak for its role in the crisis and the potential for future problems due to leverage and lack of regulation. For awhile, Wall Street as a whole got the blame, however,

in light of the political losses experienced by the Obama administration in early 2010, that tune had changed as well.

Hedge funds, Wall Street, and "greedy" bankers were still the cause of the problem according to most in Washington but now also the lack of regulation and the ability to enforce regulation is a big reason for the failures and erosion of capital.

It is all politics. Light a fire on the right so we don't see what is happening on the left. Regulation in particular is one subject that will be covered later in the book, but for now, remember this: Regulation is only as good as those who enforce it. If there is no enforcement, well, the regulation is worth little more than the paper it is written on.

The failure of two Bear Stearns hedge funds, the subsequent fire sale of the company to J.P. Morgan Chase, the bankruptcy of Lehman Brothers, and the bailout of many of the nations'—if not the worlds'—financial companies and automakers shocked most, if not all people, regardless of their economic strata or educational background.

Not since the Great Depression or at least in my lifetime, has there been such a level of government intervention into so many different areas of commerce. However, shocked as I was with "nationalization" of the banks by the Federal Government in the early part of the fall of 2008, what was more mind boggling and shocking was the failure of many hedge funds during this time. I am not talking about Madoff and the feeder funds here—this was a crime or at least fraud. I am talking about the inability of many of whom I believed were the best and brightest money managers in the world to make money during the volatility, and in turn post massive losses because of the failure.

Legends were smoked. Losses in the double digits were everywhere, and I for one was disgusted by this news as it flashed almost daily on my screens. I remember pulling into my garage in December 2008, and talking to a friend of mine who manages an endowment about the losses some of these "Hedge Fund Legends" had posted.

It was as if I just found out the Red Sox really did not win the World Series in 2004 and 2007. You see, unlike most people who follow sports and discuss game statistics with their friends, I follow managers. I discuss performance, strategy, and assets under management the way most people talk about hits, steals, and strikeouts. And just like people were devastated to learn of the fixing of the World Series by the Chicago White Sox in 1919, I was devastated when I heard and received reports about how bad these so-called hedge fund experts performed during 2007 and 2008.

The reality was that many of these so-called Legends and Brightest Managers turned out to be nothing more than closet indexers who run expensive mutual funds. They had sold me and their investors a bill of goods. This was never more apparent than when year-end numbers came out in early 2009.

According to The Barclay Hedge Fund Index, an index that measures the average performance of all hedge funds that report information to the company, the industry was down more than 21.63 percent.[7]

The hedge fund industry failed to deliver on its ability to make money in good and bad markets. The crisis caused many hedge funds to put up numbers that were just atrocious. The numbers at some of the most famous and respected hedge funds came in at year-end 2008 down 20 percent, down 30 percent, and, in one or two cases, down more than 50 percent. It was a bloodbath for investors and managers alike.

It frankly made me sick; I for one had always told people that one of the main reasons for investing in these sorts of investment vehicles was that when the market zigged, these investment vehicles zagged and vice versa. Well, in light of the numbers put up in 2008, that was just not the case.

I am not going to name names or provide details other than to say that many of the hedge funds that got clobbered in 2008 should have lost the faith of their investors. Much has been written about the losses experienced by many funds, funds that were not fraud per se—funds that simply did not know how to deal with volatility and as such seemed to be the last ones out of positions. The losses experienced by some of these funds are completely unacceptable, and investors need to take this abysmal performance into consideration prior to investing in any fund regardless of how they have recovered in 2009, 2010 and beyond.

There were some bright spots in the industry during the credit crisis, the most famous being John Paulson. His ability to call the credit crisis and stick with his call when people thought he was crazy and the positions moved against him is something completely unique. Paulson showed his investors that he had conviction and was willing to stick with his research and hypothesis regardless of what the rest of the Street was saying. I applaud him for his efforts. He is a rare find in today's crowded marketplace of managers. However, that being said, remember past performance is not an indication of future performance. Lightning does not often strike the same place twice, and therefore due diligence still needs to be completed. One of the best lessons to come out of the devastation and fraud was the need for thorough and continued due diligence.

One needs to understand what is happening with the money and get answers to the questions about strategy creation and implementation.

The credit crisis as a whole and its effect on hedge funds has been covered ad nauseum by most of the major media outlets, the popular press, the not-so-popular press, and in books, magazine articles, and blogs.

My belief is that once the credit crisis hit and we saw just how bad some of these managers performed, we all received a wake-up call for better due diligence. Never before has it been more important to perform due diligence and get under the skin of the managers and how they manage money. Due

**TABLE 1.2 Barclay Hedge Fund Index Historical Data**

| | *Jan* | *Feb* | *Mar* | *Apr* | *May* | *Jun* | *Jul* | *Aug* | *Sep* | *Oct* | *Nov* | *Dec* |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 1997 | 3.620% | 1.180% | –0.990% | 0.490% | 4.060% | 3.110% | 4.700% | 0.520% | 4.050% | –1.270% | –0.190% | 1.290% |
| 1998 | –0.190% | 3.760% | 3.540% | 1.150% | –1.680% | 0.230% | –0.460% | –7.810% | 1.050% | 2.170% | 3.780% | 2.950% |
| 1999 | 2.230% | –0.840% | 3.480% | 4.920% | 1.150% | 4.130% | 0.820% | 0.320% | 0.740% | 1.900% | 5.330% | 7.730% |
| 2000 | 0.950% | 6.760% | 1.740% | –1.470% | –1.000% | 3.260% | 0.060% | 3.740% | –0.710% | –1.070% | –2.520% | 2.200% |
| 2001 | 3.040% | –1.440% | –1.110% | 2.020% | 1.470% | 0.510% | –0.570% | –0.180% | –2.580% | 1.840% | 2.020% | 1.710% |
| 2002 | 0.660% | –0.480% | 1.870% | 0.620% | 0.380% | –1.490% | –2.240% | 0.590% | –1.240% | 0.720% | 2.090% | 0.010% |
| 2003 | 0.530% | 0.090% | 0.120% | 2.530% | 3.230% | 1.350% | 1.160% | 1.660% | 0.970% | 2.290% | 0.940% | 1.830% |
| 2004 | 1.810% | 1.140% | 0.650% | –1.220% | –0.440% | 0.700% | –0.850% | 0.120% | 1.520% | 0.840% | 2.700% | 1.560% |
| 2005 | 0.120% | 2.020% | –0.860% | –1.530% | 0.850% | 1.520% | 2.290% | 1.060% | 2.180% | –1.410% | 1.920% | 2.140% |
| 2006 | 3.500% | 0.610% | 1.970% | 1.730% | –1.840% | –0.390% | 0.020% | 0.960% | 0.110% | 1.800% | 1.760% | 1.610% |
| 2007 | 1.130% | 0.790% | 0.910% | 1.590% | 2.000% | 0.720% | 0.370% | –1.450% | 2.510% | 2.870% | –2.070% | 0.520% |
| 2008 | –3.260% | 1.230% | –2.380% | 1.930% | 1.820% | –1.730% | –2.100% | –1.210% | –6.990% | –8.410% | –2.800% | 0.370% |
| 2009 | –0.140% | –1.460% | 2.040% | 4.270% | 5.570% | 0.370% | 2.970% | 1.780% | 3.190% | –0.060% | 1.330% | 1.840% |
| 2010 | –0.410% | 0.760% | 2.820% | 1.270% | –3.210%* | –0.930%** | | | | | | |

*Source*: BarclayHedge Ltd. (www.barclayhedge.com).

* Estimated performance for May 2010 calculated with reported data from 2,828 funds.

** Estimated performance for June 2010 calculated with reported data from 576 funds.

diligence is key. It is something that everyone regardless of pedigree, experience, assets under management, and track record needs to go through before any investment is made. Ask questions and demand answers. If you have questions about due diligence or are looking for information on the credit crisis and hedge funds, email me at das@hedgeanswers.com

## A Brief History of Hedge Funds

It used to be that if you queried students at business schools about where they wanted to work after graduation, responses would be names like Salomon Brothers, Goldman Sachs, or Morgan Stanley, as well as General Motors, Coca-Cola, or IBM.

Now, however, students say they want to work for firms like SAC Capital, Maverick Capital, and The Clinton Group—in other words, hedge funds, organizations that were not on the radar screen of Middle America until the near collapse of Long-Term Capital. Still, on Wall Street these firms have always been looked at with awe.

Once considered a small and obscure pocket of the Street, hedge funds and the firms that run them represent one of the fastest-growing areas of the financial world regardless of how the economy is performing. Unlike traditional investment vehicles, which can only make, for the most part, one way bets, hedge funds can go both long and short so they should be able to thrive regardless of market conditions and volatility. In short, these types of investments should always be making money.

To understand how the hedge fund industry evolved, one needs first to understand where the concept came from. First, however let's define what a hedge fund is and how it works.

The term hedge fund was coined by Alfred Winslow Jones, a sociologist, author, and financial journalist who got interested in the markets while writing about Wall Street for *Fortune* magazine in the 1940s.

Jones started the first known hedge fund in 1949 and as such defined the term by his style of investing, management, and organizational structure.

Although Jones is credited with laying the foundation for the industry, many on Wall Street believe Roy Neuberger, the founder of the securities firm Neuberger Berman, Inc., was the person who created the concept of a hedge fund. Others believe it was Benjamin Graham, the father of securities analysis, who devised the method and formula for paying managers.

Regardless, when people think of the history of hedge funds and where they came from, they always think of Alfred Winslow Jones.

The problem is that many do not know about the Jones organization or his investment style or how he defined his hedge fund. In fact, there had not

been an article of substance written about Jones for more than 20 years until October 1998, when *Grant's Interest Rate Observer* published a significant story on Jones in the wake of the near collapse of Long-Term Capital.

The industry has changed quite substantially since Jones launched his fund, A. W. Jones & Co. The most important change is to the definition of what he created.

Today the popular press defines hedge funds as private investment pools of money that wealthy individuals, families, and institutions invest in to protect assets and to achieve rates of return above and in fact well beyond those offered by mutual funds or other investment opportunities. For the most part, the press is correct with this part of its definition; however, the problems start when the press uses words like secretive, aggressive, and leverage to describe the actions of hedge fund managers.

Where it errs is in defining the methodology as well as the concept of these private investment vehicles for sophisticated investors.

More importantly, in light of recent industry changes and pending regulations, the hedge fund industry is going to be open to more and more investors. Investors with as little as $50,000 can now access hedge funds either directly or through funds of funds and exchange traded funds.

By the end of 2010 , investors with as little as $10,000 will be able to own hedge funds in their portfolios as new products are being created to give these folks a taste of Wall Street's forbidden fruit. The industry is becoming more and more mainstream as a direct result of traditional long-only managers' inability to put up consistent returns over a long period of time and the simple realization that markets don't always rise and therefore portfolios need to be hedged. Today, retail investors have realized that they need to be both long and short in the market just as Jones did more than 50-odd years ago.

The intricacies of how hedge funds operate as well as who invests in them and why will be discussed in later chapters of the book. The term "hedge fund" is like most things on Wall Street—it sounds tricky, but once it is dissected it is quite easy to understand.

It is my belief from talking to colleagues, relatives, and friends of Jones that he had no intention of creating a product that was difficult or one that would have such a lasting effect on Wall Street and investors.

Rather, I believe he would have wanted the masses to understand his idea of the use of hedged stock positions to minimize risk and would have hoped that it—the strategy—would be employed widely throughout the investing world.

One of the reasons hedge funds operated in relative obscurity until the Long-Term Capital debacle is because of the lack of interest in these products by the press. Prior to 1998, there were very few substantial pieces written about the industry and its role on the Street. Reporters seemed to be afraid of scratching more than the surface about how hedge funds work, but truly enjoyed using

the term and people affiliated with hedge funds in headlines for shock purposes and to sell papers. In early 2010, some of the great headlines included "Wall Street's Golden Boy Paulson Loses Some Glister"[8] and "Hedge Fund's 'Terminator' Buy Upheld".[9]

These are simple words and phrases that are used to grab attention with little or no explanation or background. That is okay, after all the headline is supposed to pull you into the story. The problem is the stories do not always do a good job of describing what is happening and leave the reader wanting more.

Fault for obscurity cannot be blamed solely on the press. Many hedge fund managers refuse to talk to the media because of Securities and Exchange Commission rules regarding marketing and solicitation. The SEC does not allow managers to market their funds or to solicit investors that are not prequalified, and talking to the press could be construed as marketing and soliciting. And nobody wants to get charged with soliciting. Still, there is quite a decent flow of information to the media, and news usually gets out. It may not always be the best information and the sources may be questionable but it does get out. That being said, I believe that if the SEC relaxed some of its rules around solicitation and marketing, the information would still be weak and the coverage sloppy. There is a lack of understanding about why talking to the press is important and what benefit it can play in building a business on the part of the hedge fund industry, and as such—rules or no rules—the industry will remain tight-lipped.

For the most part, everyone I asked to talk about their own business and the industry spoke freely and I believe honestly about what they do and how they do it. Also, in the past few years or so, in light of a number of frauds and crises, it seems managers are opening up more. This, in my opinion, can only help the industry.

Since Jones created the hedge fund industry, only three articles have been written about him that have any real merit or worth in my opinion. Two are by the same journalist and ran in *Fortune* magazine, while the third was published in *Institutional Investor.*

To understand how important the articles are to the industry, we first need to understand the Jones model. No matter how far managers today deviate from the definition, each and every one operates with some of Jones's original characteristics.

According to Jones, as described by Carol Loomis in her January 1970 article in *Fortune* titled "Hard Times Come to the Hedge Funds" (still considered to be one of the definitive articles on Jones and the industry), a hedge fund is a *limited liability company* structured so as to give the general partners—the managers—a share of the profits earned on the investor's money. Further, a hedge fund always uses leverage and always carries some short positions. Jones called his investment vehicle a "hedged fund"—a fund that is hedged and is

**limited liability company**

a legal structure that is the hedge fund investment vehicle.

**management fee**

fee paid to the manager for day-to-day operation of the hedge fund.

**performance fee**

fee paid to manager based on how well the investment strategy performs.

protected against market swings by the structure of its long and short positions. Somewhere along the line Wall Street's powers that be dropped the "d."

The method for sharing in the profits is defined in the hedge fund's fee structure. Under the Jones scenario, the managers receive 20 percent of the portfolio's profits—and nothing else. Therefore they have quite an incentive to pick winners and, more importantly, to do right by the investors.

In recent years, managers have added a management fee of 1 to 1.5 percent of assets to the 20 percent performance fee. It is unclear who decided to add this fee, but like most things on Wall Street, when it works, people copy it. This fee basically allows the managers to cover the cost of maintaining the fund's operations as well as providing a bit of a salary. The Jones organization never levied management fees on its partners.

According to Robert Burch, Jones's son-in-law and the current operator of A. W. Jones & Co., Jones never believed in management fees.

"He believed that [management fees] would only breed more assets and take away from the concept of performance and induce the fact that you could make more money building assets than through performing according to the model," says Burch. "Jones was concerned with performance and did not want to be distracted by asset-gathering."

For the most part, the Jones model worked well in both up and down markets, as it was intended to do. In its first 20 years of operation, the system worked so well that the Jones fund never had a losing year. It was not until the bear market of the late 1960s and 1970 that it posted losses.

The hedge fund industry has truly grown very large very fast. It seems that everyone who wants to be in the money management business wants to work for or own a hedge fund. This is not theory but practice, as many mutual fund managers, traders, and analysts are jumping ship to start their own funds. As Wall Street failures mounted and tens of thousands of people were laid off, many looked to starting a hedge fund as a way to get back in the game. These people are setting up entities that they call a hedge fund and—voilà!—they are in the business.

The problem is that many who are calling themselves hedge fund managers are not. To have a hedge fund you have to *hedge*. Therefore, those who do not hedge but call themselves a hedge fund are operating nothing more than a very expensive mutual fund.

Many managers still follow the classic Jones model, using leverage and having long and short positions that allow you to maximize returns while limiting risks in both rising and falling markets. Probably the person who best exemplifies the Jones model today is Julian Robertson.

Robertson, who is discussed in Chapter 2, is considered by most to be the person who took over Jones's spot as the dean of the hedge fund industry. Although his fund organization has evolved quite considerably over the last 10 years, Robertson continues to exemplify what Jones had in mind when he defined and developed his idea.

Robertson, who covered Jones while he worked at Kidder Peabody, built an enormously successful business—Tiger Management—at one time managing in excess of $20 billion. Like most other hedge fund managers, Robertson lost a considerable amount of money in the turmoil of 1998—more than 10 percent of his assets under management—and in the wake of the euphoria surrounding technology stocks opted to shut his funds down and return assets to investors rather than invest in stocks of companies that he "did not understand."

Today Robertson operates a hedge fund incubator, working with new managers to help them build their businesses while actively trading the markets with his own capital. Robertson's legacy is that his organization bred success, and many of the people who passed through Tiger's doors have gone on to do great things in the hedge fund industry. It is estimated that nearly 20 percent of all of the assets allocated to hedge funds are run by someone who formerly worked at Tiger—one of the so-called Tiger Cubs. Although Robertson is known to be an arrogant, egomaniacal hard worker, he is possibly the greatest money manager of all time and quite a gentleman.

"Julian is the natural successor to Jones," says Burch. "He has built a business around the principles and disciplines that Jones used to build his business. He understands the Jones model and uses it to make superior returns regardless of market conditions."

## The Current State of the Hedge Fund Industry

It is impossible to get an absolute number of how many hedge funds exist or the exact amount of assets the industry as a whole has under management. The numbers of both change as fast as you can make telephone calls to people who

track this information. The SEC requires mutual funds and corporations to report financial information quarterly, which makes these data literally just a click away.

With hedge funds it is not so easy. There is no regulation or requirement for fund managers to report data. Many fund managers are quite happy reporting data when profits are up; but as soon as things go south, the information does not flow so freely. Often, a fund manager also ignores the tracking companies when the fund reaches investor capacity and can no longer accept investment dollars from outside its current group of investors. In this case, the fund manager no longer needs the tracking service, because new investors will only have to be turned away.

For the purposes of this book, I am going to define the size and scope of the industry as follows: There are over 10,000 hedge funds with $1.6 trillion in assets under management at year-end 2009.[10] In 1971, an SEC report on institutional investors estimated that hedge funds had $1.06 billion under management.[11] At the time, the SEC found that Alfred Winslow Jones's organization had just under 23 percent of all of the assets under management placed with hedge funds.[12] Hedge fund industry data is not hard to come by—there are many sources—however, because there is no requirement that managers report performance or assets under management data to a single source, many including myself question the quality of that data. That being said, Table 1.3 details assets under management since 1997, which clearly shows the trajectory of the hedge fund industry.

Today, a hedge fund can be any sort of private investment vehicle that is created as either a limited partnership or a limited liability corporation. In either case, the vehicle falls under very narrow SEC and Internal Revenue Service (IRS) rules and regulations. Hedge funds are limited as to how many investors they can have, either 100 or 500 depending on their structure and on the types of investors they can accept into their portfolios. The structure also determines the type of investors it can accept, either accredited or superaccredited.[13] Institutions that include nonfinancial companies are able to invest in either type of fund.

Beginning in 1998, in the wake of LTCM, Congress and other U.S. officials have begun pressing for more controls and monitoring systems for the industry. For the most part, little if anything of substance had been done to increase regulation prior to 2004.

In the fall of 2004, the SEC voted to require all hedge fund managers with 15 or more investors and $25 million or more in assets under management to register as a Registered Investment Advisor. The ruling was adopted by the SEC and put in place effective February 1, 2006. The idea behind the regulation was that, once registered, the fund manager would come under the authority of the SEC similar to the way mutual funds are regulated by

**TABLE 1.3 Hedge Fund ($ Billion)**

| | Hedge Fund Industry ($B) |
|---|---|
| Dec-97 | $ 118.23 |
| Dec-98 | $ 143.10 |
| Dec-99 | $ 188.90 |
| Dec-00 | $ 236.61 |
| Dec-01 | $ 321.92 |
| Dec-02 | $ 505.45 |
| Dec-03 | $ 825.64 |
| Dec-04 | $ 1,228.96 |
| Dec-05 | $ 1,360.71 |
| Dec-06 | $ 1,713.10 |
| Dec-07 | $ 2,136.83 |
| Dec-08 | $ 1,297.21 |
| 1st Qtr 2009 | $ 1,171.87 |
| 2nd Qtr 2009 | $ 1,169.43 |
| 3rd Qtr 2009 | $ 1,205.57 |

*Source:* BarclayHedge Ltd. (www.barclayhedge.com).

the commission. However, the regulation was challenged in court by Phil Goldstein, and he won. The rule was done away with, and the SEC refused to reinstate it or something like it. Since the collapse of two Bear Stearns hedge funds and the ensuing credit crisis and financial meltdown, Congress has been actively working on developing some sort of laws to regulate this so-called unregulated industry. However, as of this writing, nothing has been put in place, and it is believed that nothing will be put forth until after the midterm elections. There has been much written about Goldstein and his victory. One great story appeared in *Fortune* magazine titled "The Man Who Beat the SEC." It is worth a Google.

The reason many of Wall Street's traders and would-be traders are flocking to set up and work for hedge funds is because the industry is considered by some to be the last bastion of capitalism.

"When we started, it was very difficult to get through the paperwork and raise capital," says Jim Rogers, who was George Soros's partner for more than 10 years. "Now it is very easy and people specialize in setting up the funds and raising capital. It is probably the most efficient way to make money in the financial world."

Rogers's sentiments are echoed in an article about hedge funds that appeared in the popular press. The article describes a number of start-up funds and their managers. Why do they leave their soft jobs at white-shoe investment firms to go out on their own? The answers: freedom and money.

According to one article, written by Bethany McLean of *Fortune* magazine, "No other career in finance gives you the freedom to be your own boss and invest in anything, anywhere, that gets your juices flowing," or provides these people with the opportunity to "get so rich, so fast, so young."[14]

McLean quoted one manager's quip: "I can wager your money on the Knicks game if I want."[15] This is true, it is legal, and it is very, very scary.

A number of former Jones employees have said that many of these people would not have been able to work for their company nor to succeed in the markets in which the Jones organization thrived. Clearly statements like the one above were not what Jones had in mind when he developed hedge funds.

Still, to understand this and where the idea of a hedge fund came from as well as how the business was born, one needs to learn about the father of it all.

## Alfred Winslow Jones—The Original Hedge Fund Manager

Alfred Winslow Jones started what has come to be known as the first hedge fund in 1949. His basic investment strategy was to use leverage in combination with long and short sales in order to hedge risk should the market turn against him.

Jones, who died at the age of 88 in June of 1989, devised a formula for the vehicle while researching a freelance article for *Fortune* titled "Fashion in Forecasting," which ran in the March 1949 issue. To research the piece, he spent many hours speaking with some of Wall Street's great traders and brokers. Upon learning their methods, he devised his own ideas on investing based around the concept of hedging—something very few people did in those days. And so with three partners he launched the fund at the age of 49.

"My father took a very long time to find himself," says Anthony Jones, one of Jones's two children. "He graduated from college with some of the same loose ends that many people who graduate have today and basically tried a number of things before he realized what he wanted to do."

After traveling the world on a tramp steamer as purser, he believed he had found himself when he joined the Foreign Service.

"He was in Germany in the early thirties and watched the rise of Hitler and then was assigned to Venezuela, and the prospect of going from Berlin to

Venezuela was so depressing that he quit the Foreign Service," Tony Jones says. "He came to the United States and got involved in sociology."

Jones's interests in sociology and the idea of how social movements developed led him to enter Columbia University. He earned a Ph.D. in sociology in 1941, and it was at Columbia that he met Benjamin Graham.

"His graduate work was interrupted by my parents' marriage, and their honeymoon took them to civil war Spain," says Tony Jones. "In Spain they did a survey for the Quakers—neither of them carried a rifle or drove an ambulance—and toured around with interesting people reporting on civilian relief."

Upon returning to the United States, Jones took a job with *Fortune*, where he worked until 1946. Whether he knew it or not, it was here where he would be laying the groundwork for a lifetime career.

After leaving *Fortune*, he worked as a freelancer for it and other magazines, writing on social and political issues as well as finance. The research and reporting Jones did for "Fashion in Forecasting" convinced him that working on Wall Street was not as difficult as many believed.

"He would come home every day while he was reporting the piece and tell me that he did not learn anything new," recalled his widow, Mary. "After a while he started working on an idea and finally came up with something he believed would work." Mary Jones died on January 8, 1999, at the age of 91.

The article looked at how stock market behavior was interpreted by technicians of statistics, charts, and trends. The following is an excerpt of the piece:

> The standard, old-fashioned method of predicting the course of the stock market is first to look at facts and figures external to the market itself, and then examine stock prices to see whether they are too high or too low. Freight-car loadings, commodity prices, bank clearings, the outlook for tax legislation, political prospects, the danger of war, and countless other factors determine corporations' earnings and dividends, and these, combined with money rates, are supposed to (and in the long run do) determine the prices of common stocks. But in the meantime awkward things get in the way (and in the long run, as Keynes said, we shall be dead).
>
> In the late summer of 1946, for instance, the Dow Jones industrial stock average dropped in five weeks from 205 to 163, part of the move to a minor panic. In spite of the stock market, business was good before the break, remained good through it, and has been good ever since.

> Nevertheless there are market analysts, whose concern is the internal character of the market, who could see the decline coming. To get these predictive powers they study the statistics that the stock market itself grinds out day after day. Refined, manipulated in various ways, and interpreted, these data are sold by probably as many as twenty stock-market services and are used independently by hundreds, perhaps thousands, of individuals. They are increasingly used by brokerage firms, by some because the users believe in them and by others because their use brings in business.[16]

"I was a young kid at the time the business was started, and I have no recollection of when he stopped going to work at *Fortune* or writing and started going to work for himself," says Tony Jones. "I do have quite fond memories of going to visit him at his office down at 80 Broad Street in the heart of Wall Street."

Jones's model for his fund had a very simple formula. He basically used leverage and short sales to create a system that allowed him to concentrate on stock picking rather than market timing.

According to Tony Jones, he realized very early on that he was not a good stock picker. Indeed, Tony Jones believes that it was this realization that led him to expand the organization, bringing in budding Wall Street stars to run the partnership's money, to the point where it became successful.

"He was a good salesman; he knew people to raise money from, and was a good organizer and administrator. But when it came to picking stocks, he had no particular talent," he says. "This meant that his job was to find people who did have talent."

Working for and with the Jones organization was very lucrative. All partners received a piece of the 20 percent that Jones was paid by the limited partners, and they were able to invest in the vehicle.

Brokers knew that if they had an idea and the Jones people liked it, they could sell it over the phone. One broker told me that he used to like to run all of his ideas by the Jones people before calling other clients. He knew that they would act immediately if they liked his idea, but also would tell him if the situation would not work and in turn helped him from pushing a bad stock.

"These were some of the smartest and savviest investors and traders of the time," the broker says. "They gave you a straight scoop on the situation. It was a lot of fun covering the account."

In addition to developing the hedge fund, the Jones organization perfected the art of paying brokers to give up ideas. Although the firm executed most of its orders through Neuberger Berman, Inc., it paid brokers for ideas. Should a broker call on one of Jones's managers, he knew that if the manager used his idea, he would be paid regardless of where the order was executed.

"When Jones's people got an idea, they would call us and execute the order and tell us where the idea came from," remembers Roy Neuberger. "We would give up half of the commission to the guy who came up with the idea, whether he worked for us or not. At the time I did not think the exchange would let us do it. But they did, no ifs, ands, or buts; it was perfectly all right with them."

Neuberger continues, "For many years, the Jones account was the firm's most important account. But it was more than business. We were friends; both he and his wife were friends of my wife and me, and we socialized together."

Jones's strength seemed to be in people as well as ideas. His organization gave birth to many successful managers.

"There were a whole bunch of people who used to work for my father that went on their own," recalls Tony Jones. "After a while he began a business of farming the money out and created a sort of hedge fund of hedge funds."

"Jones made no attempt to pick stocks; he was an executive," says Neuberger. "He understood how to get things done and how to find people to execute his ideas."

One former Jones employee told me that the hardest part of working for Jones was actually getting the invitation to work for him. Jones used a number of techniques to tell the good from the bad, one of which was a paper portfolio program.

"In order to work for my father you first had to prove yourself," Tony Jones says. "To prove yourself, you needed to manage a play portfolio of stocks over a period of, say, six months or so. Every day, you had to call in your trades to the firm and they would be 'executed.' It was only after my father was able to watch how the manager was doing with the play money that he invited them in as partners."

The firm tallied up the profits and losses and examined not only how well the prospective managers performed but also how they did it.

"When it came to hiring managers, my father was very cautious," Tony Jones says. "He wanted to know how they operated and watched very carefully to see what types of decisions they made with the play money. If everything worked out, they got a job."

Another interesting point of the Jones organization was that he did not fire people. If you performed poorly, he simply did not give you any more money to manage and took pieces away little by little so eventually there was nothing left. And the manager had to leave.

From all accounts, Jones was very satisfied and proud of his invention and he appreciated the publicity that he received. Yet he was not very interested in talking about money or the stock market.

"Jones was not a man who was very interested in Wall Street or making money; rather he was interested in the intellectual challenge of it all," says son-in-law Burch. "Although he made a lot of money, he was not very interested

in spending and gave a lot of his money away, creating things like the Reverse Peace Corps and other foundations to help people here in the United States."

Jones was very involved with a number of charitable organizations in New York City. One cause to which he was a major contributor and in which his son and daughter are still quite active is the Henry Street Settlement.

Founded in 1893 by Lillian Wald on Manhattan's Lower East Side, the Henry Street Settlement provides programs that range from transitional residences for homeless families and a mental health clinic to a senior services center and a community arts center.

"My father liked to travel to Third World countries. He liked to have a mission, but he had a notion that a number of nations criticized the United States for not doing enough to help out on their own shores and that drew him to Henry Street," remembers Dale Burch, Jones's daughter. "He liked the fact that it helped the community from within itself."

Jones also created an operation called Globalization for Youth, an antipoverty program that used a number of resources to keep children from getting into trouble.

"These are the types of things we talked about," says Tony Jones. "He was very concerned with family solidarity and all of the theories that evolved in the late fifties and early sixties that are currently social work orthodoxy."

Once he launched his fund, he very rarely talked about what he did or how he did it. "When you had dinner with Jones, you always had four or five guys from various parts of the world," recalls Burch. "You didn't know if that night you were going to discuss some pending revolt in Albania or what language they were speaking in Iran.

"It was an interesting challenge to participate in the dinner conversation. The discussion was never about money and never about Wall Street—his mind way beyond that," he continues.

Tony Jones recalls that when the family went to their country home in Connecticut, his mother would drive and his father would go through the evening newspaper with a list of all the stocks his managers had and calculate how they had done that day.

That was the extent to which he brought the business home.

"There was absolutely no time for discussions of what stocks might go up or down at home," says Tony Jones.

Jones did not have many of the characteristics of other Wall Street legends. For example, according to his son, at Christmastime when the brokerages his firm did business with wanted to give him presents, he would accept only items that could be consumed.

"Many of the Wall Street firms tried desperately to give him gifts as a thank-you for all of the revenue he generated, and he would never accept anything except for something he could eat in the next week," Tony Jones recollects.

"We got a Christmas turkey from Neuberger Berman but when it came to gold cuff links or the like, forget about it."

Roy Neuberger called Jones a thinker, not necessarily a hard worker, a sentiment that seems to be echoed by his son.

"My father's entire life was preoccupied with ideas, some crazy and some not so crazy," Tony Jones says. "He had the capacity to read a book and then just get on the phone and call the author up and have lunch. He got to know people and many things and was constantly thinking about everything under the sun."

According to Tony Jones, after his father read a book claiming that the works of Shakespeare had been written by the 16th Earl of Oxford, he decided that the theory was sound and talked about it for two years.

"After his journalism days, and getting in the business, he did not really have long-term interests," Tony Jones says. "He was more interested in things he could focus on short-term. The idea of tackling big projects was not something he was interested in."

Beside countless articles, Jones did publish one book, *Life, Liberty, and Property*, in 1941, based on his doctoral dissertation. According to Daniel Nelson, a history professor at the University of Akron, it was the rarest of dissertations: technically sophisticated, engaging, and addressed to a general audience. A new edition of the book was published in March 1999 by the University of Akron Press.

Although most of the articles written about Jones say he had planned to write a second book, his son says he wanted to but "it would have been a monumental task." When Jones retired from the hedge fund business completely in 1982, he was satisfied with the business but not with it being his life's work.

"Later on in his life, he wanted to write a memoir but could not focus himself on getting it done," Tony Jones says. "There was nothing about running his business that required real concentration—it was a brainstorm kind of thing, and he was good at it."

Jones did not simply hit an age and retire. Rather, he started to give up his duties at the firm and eventually turned the reins over to Lester Kissel. Kissel, a lawyer from the firm Seward & Kissel and an original partner in A. W. Jones & Co., assumed control for a few years. Because of conflicts over the direction of the organization, he was asked to step down, and, after a brief stint by Jones, Burch took over. Today Burch and his son run A. W. Jones in New York City as a fund of funds.

"My father was not at the top of his game when he turned things over to Kissel," says Tony Jones. "Kissel was a lawyer, not a businessman. He never did anything intentionally to harm my father, but he did hurt the business."

By today's standards, Jones did not become extraordinarily wealthy from the business. Still, he spent the bulk of the money he did have on charities, not on lavish living.

However, one of Jones's great loves was his 200-acre estate in Connecticut that allowed him to enjoy the outdoors.

"My father was a landscape visionary," says his son. "He was always trying to figure out things to do with water and moving land around.

"His mind was all over the place," he continues. "Everything he did, did not require an enormous amount of steady follow-through on his part. He had a lot of good ideas and made them reality."

Tony Jones believes his father's reason for switching from journalism to Wall Street was that he wanted to live comfortably, and he knew that he could not achieve that as a journalist.

"He had carved out a unique niche for himself writing but realized that he would never be able to live the kind of lifestyle he wanted to being a journalist," says Tony Jones. "My father was also determined to find out if his crazy idea would work."

Although most people point to the research for the *Fortune* article as the genesis, a number I talked to seem to think a combination of things led him to the hedge fund concept.

It is quite clear that while Jones was studying at Columbia he had many conversations with Graham and learned investing strategies from him. This may be where the seeds of the idea were planted.

Jones did know another Graham follower, Warren Buffett, and the two lunched together from time to time.

"The principles of the hedge fund were clearly developed and created by Alfred. However, some of his investment strategies may have come from his discussions with Buffett and Graham," says Burch. "He was the first to put the ideas down on paper and then actually put them to use."

Jones defined the three principles of hedge funds as follows:

1. You had to be short all the time.
2. You always use leverage.
3. The manager receives a fee of 20 percent of all profits.

"It was the combinations of shorting, the use of leverage, and the fee structure, which is how Jones defined what a hedge fund was all about," says Burch.

Jones believed that by aggressively picking long stocks and neutralizing market swings by also being short, he would be able to put up extraordinary performance numbers while reducing risks.

At all times, Jones's funds maintained a number of short positions that would enable them to have a hedge against a drop in the market, which limited his downside exposure. It is impossible to get a complete accounting of the fund's track record because of the private nature of its activities and investors.

According to Jones's *New York Times* obituary, in the 10 years prior to 1968 the firm had posted gains up to 1,000 percent. It is estimated that the Jones fund had over $200 million under management at the end of that period.

Soon after that, however, things began to not go very well and the Jones organization, like many other hedge funds, took a serious hit. By year-end 1970, the Securities and Exchange Commission estimated that the fund organization had a mere $30 million under management. It is unclear exactly where the money went, but some was lost to market mistakes and the rest vanished as partners pulled out.

Interestingly enough, the only fund the SEC tracked during that same time period that did not see a decrease in assets was Steinhardt Fine Berkowitz & Co., headed by the soon-to-be-legendary Michael Steinhardt.

By 1977, when the hedge fund industry had plummeted from over $2 billion to roughly $250 million under management, many in the industry thought the concept had seen its day.

Jones himself was quoted in an article in *Institutional Investor* in May 1977 as saying, "I don't believe it [a hedge fund] is ever going to become a big part of the investment scene as it was in the 1960s. . . . The hedge fund does not have a terrific future."[17]

Indeed, as with all things associated with the markets, hedge funds had been going through a rough time; but the cycle soon righted itself. Slowly but surely, through the late 1970s and the 1980s, the industry got back on its feet. It was the bull market of the 1990s, however, that really put hedge funds on the map.

Today the combination of shorting and going long in stocks is second nature to even the most immature Wall Streeter, but 30 years ago it was a daring concept.

Loomis, in her piece "Hard Times Come to the Hedge Funds," wrote that her previous story on hedge funds, "The Jones Nobody Keeps Up With," inspired some people to start their own funds, using "the article about Jones as a sort of prospectus, relying on it for help in explaining, and selling, the hedge fund concept to investors."[18]

Slowly but surely, Jones is continuing to get the recognition he deserves. Whether people realize it or not, and I think most do, Alfred Winslow Jones, the sociologist and businessman, created one of Wall Street's most important concepts. His invention gave life to thousands of entrepreneurs and has made and will continue to make many people very wealthy for years to come.