CHAPTER 1

Hedge Funds Past, Present, and Future

Knowledge is power. If you've picked up this book, chances are that you already have some knowledge of the hedge fund industry (and if you don't, go back and read my book *Getting Started in Hedge Funds*, John Wiley & Sons, 2005). Maybe you're an investor, and you want the inside story on how to find the hedge fund that's the right home for your assets. Maybe you're a new hedge fund manager, in need of tips on choosing an attorney or a third-party administrator. Or maybe you're a veteran hedge fund manager, eager to learn from—and avoid—the fiascos that have brought down some of the biggest names in the business in recent months.

This book is your ticket to that knowledge, and more. Throughout the following chapters, I'll explain how hedge fund managers operate their businesses and what potential investors need to know about these unique investment vehicles—in short, how hedge funds work from both the manager's and investor's side of the industry. You will learn how the hedge fund industry evolved, how various funds operate, why some funds make money regardless of market conditions—and why others don't.

This book is not a "get rich quick" book, and it's not the last word on how money is managed. Rather, this book is your roadmap to money management in the hedge fund industry.

Your mission, if you choose to accept it, is to stick with me throughout the following pages to gain insight into how money is managed. You will then be equipped to apply your new knowledge to your own firm, the fund you work for, or the investments in your personal account.

THE FATHER OF THE HEDGE FUND INDUSTRY

To understand how the hedge fund industry evolved into what it is today, you need to first understand how and why the product was developed. The hedge fund industry was launched by Alfred Winslow Jones, a sociologist, author and financial journalist, who became interested in the markets while writing about stocks for *Fortune* magazine in the late 1940s.

Jones's early career spanned a number of industries and professions. Early on in his job experimentation, Jones realized that his varied interests would not allow him to live the life he wanted for himself and his family. He knew that his journalist's salary wasn't going to cut it, so he looked to the one place he knew would provide him the income he wanted in order to live the way he wanted to live—Wall Street. "My father was a simple man who had lots of ideas and executed most of them," said Anthony Jones. "If he had an interest in something he would explore it, become comfortable with it, and move onto the next item on his list."

"When he read a book, he would call the author and invite him to dinner," he continued. "That was the type of person he was. He wanted to learn all the time."

Jones, who died in June 1989 at the age of 88, devised the formula for his investment vehicle while researching a freelance article, *Fashion Forecasting,* for the March 1949 issue of *Fortune* magazine. To research the piece, Jones spent many hours speaking with the greatest money managers, traders and brokers of the time, to understand how they operated and made investment decisions. Upon learning—or at least believing—that he had a thorough understanding of how Wall Street operated, he set about creating his *own* ideas about what would and would not work in the market. And the hedge fund was born.

In 1949 in Lower Manhattan, Jones and four friends launched the first hedge fund, with Jones as managing partner. Hedge funds initially began as a means to protect against risk in the markets, to "hedge one's bets" and to leverage opportunities in the market through a combination of long-stock holding and short-stock selling.

Jones based his investment strategy on a very simple theory: that by "going long" (making money for the investor when the price of the security increases) and "going short," (identifying overvalued shares and buying them when the price decreases), he could create a portfolio that would weather market fluctuations and deliver solid and consistent returns to investors, regardless of which way the market moved. The concept worked: His investors lost money in only 3 of Jones's 34 years in the business. As his son, Anthony Jones, has noted, "My father was not a great stock picker, he was a great idea man . . . He realized early on that he didn't know how to pick stocks, and was able to find people who could help him manage the assets, while he managed and grew the business."

Initially, upon launching the partnership, Jones called his investment vehicle a "hedged fund," a fund that is hedged and is protected against market swings by a portfolio consisting of long and short positions. Over the years, the powers that be on Wall Street dropped the "d" and began to call everything that is not a mutual fund, exchange-traded fund, or private equity, a hedge fund. Today, hedge funds are classified based not on their investment portfolios, but rather on their fee structures. If a fund has a management fee and an incentive fee, it is considered a hedge fund.

Although the Jones approach became the model for all future hedge funds, today, hedge funds today come in all shapes and sizes. Trade strategies have evolved, and now range from long/short equity and merger arbitrage to fixed income duration speculation and global macro. Estimates put the number of hedge funds operating worldwide at more than 15,000, managing more than two trillion dollars in client assets.[1]

Hedge funds are not for everybody. These products are only available to well heeled investors. That being said, one thing is certain: More than 50 years after the birth of A.W. Jones and Company, hedge funds are here to stay.

WHY INVEST IN HEDGE FUNDS?

Hedge funds are like most things on Wall Street. They sound complicated, but once they're dissected, they're quite easy to understand. The underlying concept is very simple: Hedge fund managers use a series of positions to minimize the risk of loss during a market collapse, thereby protecting your portfolio. Again, this is simple in theory, but in practice, it can be quite difficult to achieve.

So why would anyone invest in hedge funds? Certainly, there are other ways to grow your money with less risk. The "perfect" hedge doesn't exist. A perfect hedge would require taking *all* market risk out of the portfolio; what you're left with, in that instance, is a portfolio that provides the risk-free rate of return, less the commissions charged by the broker.

Of course, this is problematic because *anyone* can get the risk-free rate of return by buying Treasuries; more important, investors can buy exchange-traded funds with little effort. So why do they need you? Investors need hedge funds—and their managers—because they want to invest in products that deliver *greater* returns than the average of the markets. Hedge fund investors are more than willing to pay managers who can achieve this on a consistent basis.

Your job, as a manager, is to create a portfolio that delivers solid, consistent returns by using all of the arrows in Wall Street's quiver without taking on significantly more risk than the market as a whole. Hedge fund managers need to know the market well enough to recognize opportunity: in other words, to know when stocks, bonds, options, futures, and synthetics—as well as the other instruments that allow Wall Street to make a profit—are undervalued, to buy accordingly, and to wait for the market to realize the instrument's value so that they can turn a profit. Unfortunately, it doesn't always work that way.

In some cases, a hedge fund manager might believe that a stock or security is undervalued based on his or her research or market intelligence, but the rest of the market may not see it. The result? The position loses money. Hedge fund managers are supposed to create portfolios that zig when the market zags, and zag when the markets zig, avoiding or at least reducing losses through hedging. For the purposes of this book, hedging, in its simplest definition, is the reduction of volatility in a portfolio.

Hedge fund managers reduce volatility through shorting stocks, bonds or other financial instruments and through the use of various option strategies and other derivatives. Managers use straight short transactions and spreads, straddles and forward contracts to make sure the portfolio is protected during up and down periods. Wall Street is very good at devising traditional and synthetic short strategies, which are used by managers to manage volatility and risk. To learn more about options and derivatives, read *Getting Started in Options* (John Wiley & Sons, 2007) by Michael C. Thomsett and *Getting Started in Futures* (John Wiley & Sons, 2005) by Todd Lofton.

Since the first hedge fund was launched, these investment vehicles have been viewed with awe—and some suspicion—by professionals and the public at large. Hedge funds are supposed to do "right" by investors, regardless of market conditions. Because they are not governed by the rules of traditional asset management firms, hedge fund managers literally can use any legal means at their disposal to extract money from the markets, going short or long as market conditions warrant. Managers can employ a combination of longs and shorts, throw in some futures for good measure, or focus on options and leverage in order to make money. Hedge fund managers do not have to stick to one strategy, style or tool.

The general public—and even, perhaps, some fairly savvy mutual or hedge fund investors—often initially assume that hedge funds and mutual funds operate in the same way. Although both are pooled investment vehicles—funds in which a number of investors entrust their money to a manager, who then buys and sells securities with those assets to, ideally, make a profit—that's where the similarity ends.

One of the key differences between hedge funds and mutual funds is that hedge fund managers are empowered to pursue absolute return strategies, whereas mutual funds typically only offer relative return strategies. This means, in essence, that hedge funds are measured on their specific performance and not on how their performance compares to a predetermined benchmark, such as the S&P 500 or Lipper Small Cap Index.

Mutual funds, by contrast, are for the most part equity based, fixed-income based, or a combination of both. That means that, with few exceptions, mutual funds can only go long, and therefore can only make money when the markets rise. If a mutual fund is long, and the stock market is doing well, the portfolio should increase in value. However, if the market is not doing well, the portfolio will suffer losses. Here's how mutual fund managers construct their portfolios: They use their stock-picking skills to build a portfolio that they expect to perform well over time, and that will provide an edge over the indices used to benchmark their fund's performance (again, for example, the S&P 500 or the Lipper Small Cap Index). If they can outperform the index—even by just a few basis points—their investors are generally happy, and the manager's reputation remains intact.

Of course, there are other differences between mutual funds and hedge funds, beyond simply their performance measurements. Mutual funds are open-ended investment companies; they sell their shares to the general public through multiple marketing channels. Hedge funds are limited in the number of investors they can have, either 100 or 500, depending on their structure, and are open to only accredited investors or qualified purchasers. Most hedge funds in the United States are either limited partnerships or limited liability companies and as such, are exempt from the Securities Act of 1933.

Ultimately, as you compare mutual funds and hedge funds, you need to remember that a rising tide raises all boats, but when the tide rolls out, the boats will sink. Mutual funds are likely to suffer losses—sometimes severe—in bad economic times. But hedge funds don't need a rising market to make money. In a down market, hedge fund managers can go short, or use other hedging strategies, to make money and/or protect profits. Mutual funds don't have the same flexibility.

Very few managers are able to completely minimize risk to the point that it does not cost some piece of the performance. However, there are hundreds of managers who use shorts and short-like positions to provide a cushion to the portfolio that allows for protection when things head south. This isn't an easy task, and few get it right consistently over the long term. Later chapters will provide more detail about how you can be one of these lucky few.

UNDERSTANDING THE MARKET

Before you learn what you need to know about money management in the hedge fund industry, you first need to learn about the current state of the hedge fund industry itself. In Chapter 2, we'll examine this in more detail.

But you also need to give some thought to the state of the market today. And, as even the most casual market observer can tell you, in recent years, it has become *extremely* volatile. In the financial industry, 2007 and 2008

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will be remembered as the years of the subprime mortgage meltdown and the ensuing collapse of Bear Stearns Companies.

As of this writing, in May 2008, the jury is still out on what exactly happened to the credit markets. The finger pointing has begun, but it's not yet clear if any action will be taken by the federal government to determine how and why the markets collapsed. Although Washington's blame machine immediately called on Attorney General Michael B. Mukasey to begin an inquiry, he and his lieutenants seem unable to find anybody to go after. In any event, it is clear that the Treasury, the Federal Reserve, and possibly Congress, will all—either together or independently—issue reports on what went wrong. By the time they're issued, these reports will likely be worth little more then the paper they were printed on.

However, the situation with Bear Stearns is much more fluid, interesting to follow, and easy to get one's head around. On March 16, 2008, in the wake of the near-collapse/near-bankruptcy of the venerable Wall Street firm, its board of directors voted to sell the company for a fire sale price of $2.00 per share, or $236 million, to JPMorgan Chase & Company. Just a few days earlier, Bear Stearns had seen its stock valued at $3.5 billion, trading at nearly $33 per share. A year prior, Bear's stock was selling for $170 per share.

Now, the firm had to choose between one of two options, both unpleasant: Sell on the cheap or go bankrupt. In an extremely rare move, the Federal Reserve brokered a deal between a near-death Bear and a financially strong JPMorgan, providing nearly $30 billion in financing to cover Bear Stearns's assets, which included massive pools of mortgage-backed securities with little or no liquidity.[2] According to the *Wall Street Journal*, the Federal Reserve's move was the single largest advance to a single company by the central bank. The speed of Bear Stearns' collapse prompted the Federal Reserve to move quickly to stave off a prolonged recession based on continued defaults and dislocation in the credit markets. Many people, including Wall Streeters, Wall Street historians, and, most of all, Bear Stearns employees, are still trying to figure out what caused the bank to fall so quickly and to wind up in such an untenable situation.

At this point, however, there isn't anything that anyone can do it about it. On May 29, 2008, in a mere 10-minute shareholder meeting, JPMorgan Chase's purchase of Bear Stearns was approved, heralding a speedy and ignominious end to the 85-year-old firm.[3]

WHAT HAPPENED AT BEAR, AND WHY

This book is not going to help dispel any myths that might be circulating, or uncover new information about what happened—I'll leave that to others.

But nonetheless, it is important that you understand some of what occurred and why. The credit market meltdown began in the summer of 2007, in the wake of the subprime lending crises. It became harder to borrow money, and both individuals and institutions began to worry that without liquidity, a recession would take grip of the economy. As summer turned to fall and fall to winter, the economy didn't seem to be getting stronger. Oil, gold, and a number of other commodities reached record levels, while the equity markets continued to operate with extreme volatility. All the while, the market for mortgage-backed securities and the pools of assets that make up these securities were becoming less and less liquid.

"The spread for these securities was so wide you could drive a truck through it," said Richard Bookbinder, managing partner of a New York-based fund of funds. "There were some funds that traded in this space that were unable to deliver a performance number because they couldn't price their portfolios. It was a very difficult time."

One hedge fund firm of my acquaintance had to suspend calculating the fund's net asset value at that point, because it could not nail down prices for many of its positions. It was in a tight spot, because it had to deal with shareholders who wanted to redeem their investments, and the fund and its administrator had no way to calculate the true value of the portfolio. It was the first time I saw something like this happen, which should tell you something about how the market was trending in the summer of 2007.

As a major player in the mortgage-backed market, Bear Stearns suffered significantly. The firm was trapped—it was running out of cash, and the assets it carried on its books no longer could be priced at a level that would allow them to be sold. Bear borrowed as much as it could from the Federal Reserve through the structured deal with JPMorgan Chase, but eventually was left with no other alternative but to sell itself to the bank in order to avoid bankruptcy. As noted above, the initial sale price was \$2 per share; however, JPMorgan revised that number to \$10 per share a week later.

There are many layers of this onion to peel away, and I am sure someone will write a book about the actions that led to the company's demise. For our purposes, think of it this way: The company was squeezed into nonexistence because it no longer had the cash to cover its operations. In the macrocosm, the firm was trapped in a situation not unlike that of many other Americans who, in the microcosm, are on the verge of losing their homes because they can't pay the mortgage. Bear owed massive amounts of money and no longer had the wherewithal to cover its bills.

The bailout by the Federal Reserve is not unprecedented; in fact, the government has a way of sticking its nose into the business of the people, whether for good or ill. The actions taken by the Federal Reserve to coordinate the Bear Stearns sale were somewhat reminiscent of the bailout it orchestrated of Long-Term Capital Management in 1998, 10 years prior. That particular hedge fund was teetering on the brink of collapse, unable to meet its margin calls and on the verge of being liquidated.

In that situation, the Federal Reserve worked with 14 investment houses and banks, persuading those firms to lend the company more than $3.625 billion in return for control of the firm and its assets. The bailout worked out quite well for those who participated; the fund was wound down and the positions in the fund were liquidated at a profit. The difference in the Bear Stearns deal is that, in this case, the Federal Reserve (read, "you and me: the U.S. taxpayer") has money at risk. If the deal, or more important, the positions, fail, the Federal Reserve is going to have to make good on those losses.

In the short term, I suspect that many people believe this to be a smart move on the Fed's part. Over the long term, though, the questions will keep coming: questions like, "Why did the Feds have to get involved and put money at risk?" Here's my question: Why was Bear not allowed to fail, go bankrupt, and go through the bankruptcy process? Isn't that what makes markets efficient? And isn't that what Wall Street needs to do in order to preserve that market efficiency?

It's still too early to predict what may happen, but as of this writing, investors expect their Bear Stearns deals to close somewhere north of $10 per share. Most of us expect JPMorgan Chase to lay off a considerable number of the 14,000-odd people who work for Bear Stearns. But JPMorgan will likely also be able to take advantage of a number of opportunities, bought literally on the cheap, to solidify their own position both on Wall Street and Main Street in terms of service provision to both retail and institutional investors. In the end, the final chapter written on Bear Stearns will very likely begin the book on the success of JPMorgan Chase.

The ripple effects of the mortgage mess and the Bear Stearns bailout will likely be felt for some time. As of the spring of 2008, there's talk of recession everywhere, with some economists believing we're already in one. The U.S. economy lost a staggering 240,000 jobs in the first three months of 2008.[4]

What should you take away from all of this? If nothing else, this information should convince you that managing money is very difficult. It takes a lot of work and an enormous amount of research. You'll need patience, discipline, and humility. Sure, the advent of technology and the ubiquity of the Internet mean that data and information flow freely with the click of a mouse, but data and information are not equal to years of experience and training. Furthermore, having information does not mean that you know how to use it. Managing money is a skill. It is a skill that is taught, learned, and executed by professionals.

The news isn't all bad. Financial managers—whether of hedge funds, mutual funds, or other investment vehicles—can ride out the bad times by making sound and reasoned decisions. Historically, hedge funds have actually gained popularity during market crashes. Although the hedge fund industry has grown steadily over the past 60 or so years, it plateaued for most of the 1980s—until the market crash led traders, brokers, and bankers to reconsider their traditional income streams.

It's important to remember that there are many people who call themselves money managers, or even hedge fund managers, but the number of people that actually manage money well over a consistent period of time are few and far between. This is something that you need to understand if you want to play the game. It is difficult to be successful: Many are called, but only a few will make it. If you're ready to take the plunge, read on.

WHY THIS BOOK?

Today, the Jones model provides the basic foundation for all hedge funds. Again, the concept is quite simple: to create a vehicle that goes long and short the market in an effort to make money, regardless of market conditions. When Jones was managing money, he went long and short equities. Today, however, hedge funds around the world use investment styles and strategies of all shapes and sizes to make investments, and trade any and all types of securities so that their investors will profit. We'll talk about some of these strategies in the following chapters.

The hedge fund industry today is quite different from its birth, or even from five or six years ago. Five or 10 years from now, it will likely look different than it does today. The industry today is made up of both massive investment complexes that manage tens of billions of dollars in hedge funds to small-time operators that only manage perhaps a million or two dollars. And there are funds of every size and shape in between.

In *The Fundamentals of Hedge Fund Management* (John Wiley & Sons, 2007), I spent the better part of the book explaining how a hedge fund comes to life and operates as a business. I discussed the infrastructure, the technology, the people, the documents, the legal aspects, the tax aspects and everything else that goes into the day-to-day operations of hedge funds. I did *not* cover how money is managed.

In this book, we'll review some of those basics. But for the most part, this book is about how money is managed: how hedge fund managers take a dollar, put it to work in the marketplace, and make a return on it. I'll provide you with a view of various strategies, across multiple disciplines, which all come down to one thing: making money for investors. We'll talk

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about how some specific hedge fund managers—the best of the best—have leveraged these strategies to make money for their investors—and, in the process, for themselves.

This book is the story of how hedge funds manage money and how investors allocate assets to hedge funds.