WHITE PAPER NO. 25

The End of The Beginning

GREYCOURT

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White Paper No. 25 – *Hedge Fund Investing: The End of the Beginning*

In roughly the span of time it takes the Dow to drop from 10,500 to 7,500, hedge fund investing has gone from a fringe activity practiced by obscure gnomes to a replacement for day trading as the preoccupation of what remains of the investing public. According to The Hennessee Hedge Fund Advisory Group, hedge fund assets grew an amazing 38% in 2001 alone, to $563 billion.[1] There are at least 6,000 hedge funds in existence, far more than there are stocks on the NYSE. There are so many hedge funds around that, if we don't count money market funds, they are challenging mutual funds as the single most popular investment vehicles in the world. What used to be exclusively the province of wealthy and institutional investors is now hot retail territory. "Retail" hedge funds of funds offered by large financial institutions (including Charles Schwab[2]) and requiring very low minimum investments,[3] are sprouting everywhere.

Why are hedge funds so hot? One reason is that, as a group, hedge funds have produced extraordinary risk-adjusted performance over the past decade. Exhibiting roughly bond-like price volatility, hedge funds have nonetheless clobbered the major equity indices between 1990 and the end of 2001:

Long/short equity hedge funds 20.3%

S&P 500..12.9%

MSCI EAFE ....2.7%[4]

$1 million invested in hedge funds would have grown over that period to nearly $7.5 million, versus $3.6 million for the S&P and a mere $1.3 million for the EAFE.

In addition, while hedge fund returns have come down significantly thus far in 2002 – as a group they are showing flat-to-slightly-negative performance – the stock markets remain mired in their worst showing in thirty years, private equity returns have fallen off the edge of the earth, and even bonds look vulnerable in the face of rising interest rates. So why not hedge funds?

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[1] *From Infamy to Fame – The Rapidly Changing Landscape of the Hedge Fund Industry*, Advent Client News (Advent Software, Inc., 2nd Quarter 2002), p. 1.

[2] *Ibid*, p. 6.

[3] By registering hedge fund investments with the SEC or structuring them as mutual funds, financial firms can avoid limits on the number of investors they can accept and on the accreditation standards that normally apply to hedge fund investors. However, the fees associated with "retail" hedge funds of funds can be staggering: 1% plus 10% of profits. Layered on top of the underlying fund fees, this means that retail investors are paying 2% plus 30% of profits, plus a 5% sales load off the top!

[4] Source: Hedge Fund Research, Inc., Bloomberg L.P., Morgan Stanley Capital International, Inc. Cited in Jonathan Lach, *Investing with Wolves: Classic Hedge Funds – Better than Equities*, The Journal of Wealth Management (Fall 2002), p. 75.

Why not, indeed. The point of this paper is not to suggest that substantial investors avoid hedge funds. On the contrary, Greycourt generally recommends at least some hedge fund exposure to our clients. The point I wish to make is that the game has changed. The easy money has been made in hedge funds, the future will differ significantly from the past, and hedge fund investors will have to proceed with far greater caution going forward. In short, we have seen the end of the beginning for hedge fund investing: it's now a whole new world.

What Is a Hedge Fund?

Before we examine some of the reasons for proceeding carefully in this sector, let's define what it is we're talking about: what, exactly, is a hedge fund? The President's Working Group on Financial Markets, which looked into the causes of the failure of Long Term Capital Management, defined a hedge fund as "a pooled investment vehicle that is privately organized, administered by professional investment managers, and not widely available."[5] This is about as unhelpful a definition as one could wish for, aside from being hopelessly outdated. But it makes the point that hedge funds are very hard to define. Many hedge funds don't hedge at all, for example, and some are quite widely available.

The first hedge fund, so far as we know, was established half a century ago by Alfred Winslow Jones, a former financial reporter. If Jones had $100 to invest he would invest it all in the stock market. He would then borrow another $30 and invest that as well. Then, in order to "hedge" the risk of the leveraged $30, Jones would sell $30 worth of stocks short. His idea was that if his stock picks were very good he would make far more money than a typical long-only investor: he would make money on his long positions, of course, but he would also make money on both his leveraged position and his shorts. If his picks were only "good," he might lose money on his short positions but make it up on his long and leveraged positions. His only real danger, aside from incompetent stock-picking, was a very bad down market, in which his long and leveraged positions would overwhelm his short positions. (This actually happened to Jones in 1969-70.)[6]

Today a "hedge fund" is any investment vehicle organized as a partnership in which the manager shares in the profits and in which (speaking very generally) the manager invests in marketable securities.[7] (In other words, private equity funds don't count.) The manager may or may not sell short; he may or may not employ leverage; he may specialize in a specific niche or market sector or he may migrate from niche to niche and sector to sector. The only way to know what a hedge fund is doing is to speak at length with the manager.

Types of hedge funds

[5] *Hedge Funds, Leverage, and the Lessons of Long Term Capital Management*, The President's Working Group on Financial Markets (1999).

[6] I am indebted to James Grant, an infinitely provocative financial writer and investor, for this description of Jones' hedge fund, A.W. Jones & Co. James Grant, *Yes, But*, Forbes (June 10,2002), p. 220.

[7] Of course, many of the securities purchased by hedge funds are highly illiquid. Because a manager deals in marketable securities, that doesn't mean that his portfolio can be accurately marked-to-market every day.

Firms like Greycourt tend to categorize hedge funds as directional (sometimes called macro funds) and absolute return-oriented (sometimes called non-directional funds). Directional funds employ little or no hedging strategies but simply make bets on their specific ideas, while absolute return-oriented funds hedge their bets by selling short as well as buying long or by employing other hedging strategies. Many hedge funds fall easily into these broad categories, but some do not.

Hedge funds can also be categorized according to the kinds of investment strategies they follow. Following are some examples of strategies a hedge fund might focus on:

Convertible arbitrage

Distressed securities

Emerging markets

Event-driven

Leveraged fixed income

Long/short equity

Opportunistic

Risk arbitrage (merger arbitrage)

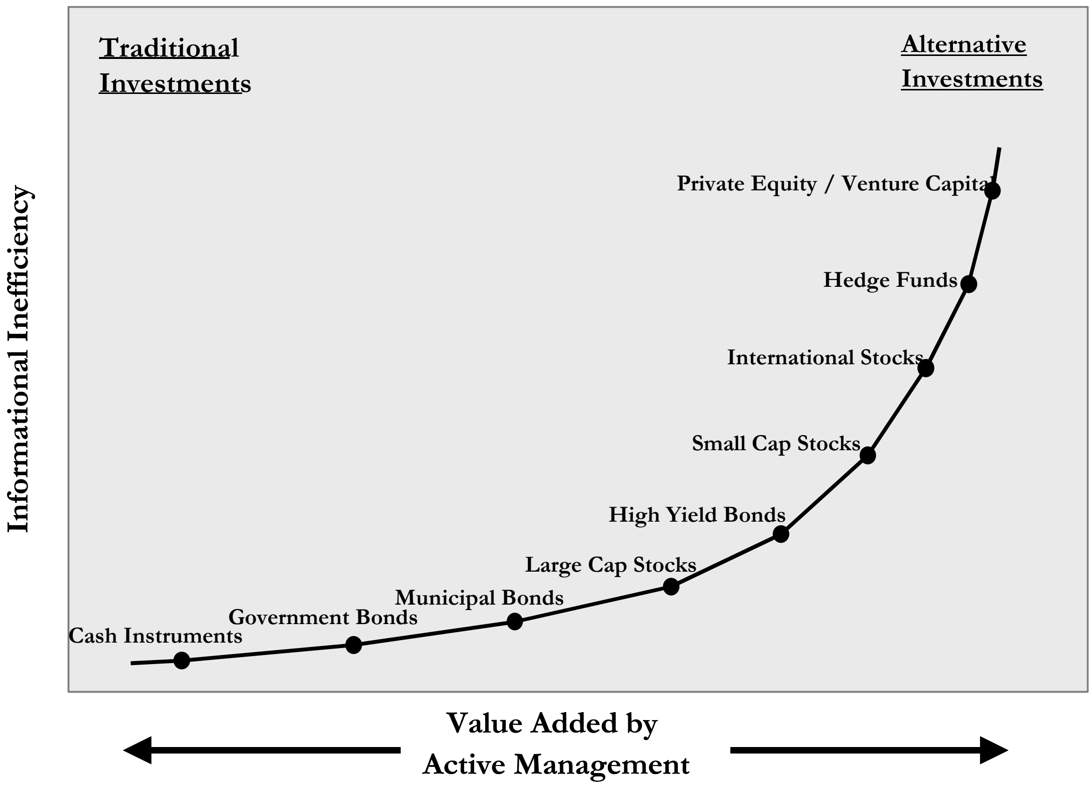
Short-selling

Multi-strategy

Challenges for Hedge Fund Investors

A few years ago advisory firms faced an uphill battle trying to convince investors to add hedge fund exposure to their portfolios. Today the problem is almost the opposite – when Greycourt first encounters new clients they are as likely to have too much hedge fund exposure (or the wrong kind of exposure) as to have not enough. Whether investors are drawn to hedge funds for their return potential, whether they are fleeing debacles in other capital markets, or whether they are simply seeking prudent diversification, the problems today are too much haste, too little caution, diligence that is too superficial.

Probably the main challenge for investors in hedge funds going forward is the one just mentioned: the popularity of hedge fund investing. The more money that pours into a sector, the more difficult it will be for managers to add value. The following chart shows, based on historical data, the relative ability of managers to add value in different asset classes:



The reason managers are able to add little value in, for example, US large cap stocks, is because so much information is available to investors about those stocks. Many, many people are buying those stocks, many financial analysts cover each company, and hence it is extremely difficult for a manager to obtain useful information that other managers don't have. Even if a manager obtains useful information, it is often difficult to exploit it for very long, since transparency is very high in this space. In other words, sustainable outperformance is difficult and rare. As more and more money flows into hedge fund strategies, a similar, albeit less pervasive, phenomenon will surely occur.

Vendors in the hedge fund business will argue that, while some strategies are naturally capacity-constrained – merger arbitrage, for example – others are not.[8] Long/short equity managers and fixed income arbitrage managers play in markets that are measured in the trillions of dollars. Hence, so the argument goes, even a manager with several billion dollars under management will represent only a tiny drop in the vast ocean of opportunities. But this is the wrong measure. In US large caps, the question isn't whether or not any individual manager has a lot or a little money to work with. The question is how much money, and how many players, are at work in the sector. As more and more managers engage in long/short equity or fixed income arbitrage, the information available to everyone in those sectors will

[8] "While one must admit there are capacity issues in some sectors, a careful strategy-by-strategy review suggests this is not a concern for the bulk of the hedge fund industry." R. McFall Lamm, Jr. and Tanya E. Ghaleb-Harter, *An Update on Hedge Fund Performance: Is a Bubble Developing?*, Deutsche Asset Management research monograph (September 1, 2001), p. 3.

expand, leaving even talented managers with little room to run.

More broadly, we should assume that all alpha-based[9] strategies are inherently capacity-constrained. The most talented managers may develop many more good ideas than less talented managers, but less talented managers are exceptionally good at copying successful strategies. Hence, as more and more players enter a field, the half-life of good ideas declines precipitously. In addition, while there may be trillions of dollars invested in global equities and fixed income, the subset of those markets that have value to be exploited is far, far smaller. Managers who identify value and act on it will find that their activities are much more conspicuous than we would imagine if we think only about the aggregate size of the equity and bond markets.

Let's examine some other challenges faced by prospective investors in hedge funds.

Survivorship bias. Earlier, I cited the extraordinary returns achieved by hedge funds over the past ten years. But that data is highly suspicious, not least of all[10] because of the phenomenon of survivorship bias. This phrase refers to the fact that only the most successful hedge fund managers have survived for the ten-year period we are measuring. Less successful managers long ago went out of business, and their demise has imposed a kind of double-whammy on reported returns. First, because they are no longer in business and reporting their results, the (poor) performance of failed managers has been removed from the historical record, dramatically raising the reported performance of "all" managers. Second, because they are no longer managing money, failed managers are no longer turning in those lousy returns, which would continue to bring down the averages.[11] In other words, the actual returns achieved by *investors* in hedge funds over the past ten years are far lower than the actual returns achieved by the surviving managers over that period. In the Lake Woebegone world of hedge funds, all managers are above average.

Volatility and risk. When investors and their advisors design portfolios, they tend to use volatility as a proxy for risk. But in the hedge fund world price volatility does not capture anything like all the risks embedded in the sector. Specifically, volatility ignores the liquidity risk inherent in hedge fund investing, as well as the risk of fraud or other misconduct. Most hedge funds offer only quarterly liquidity, while some impose one-year lockups or even longer. For an investor who needs or wants cash, even a quarter can be an eternity. Fraud, while rare, is hardly unknown among hedge fund managers, and when it happens the consequences for investors in the affected funds can be truly disastrous. The long and short of this is that investors who look only at hedge fund volatility in designing their portfolios will almost certainly end up with an over-exposure to the sector: the apparently attractive combination of low risk (volatility) and high returns will cause hedge funds to dominate the optimizer, resulting in

[9] "Alpha" is a measure of risk-adjusted return. Talented managers deliver a lot of alpha. Less talented managers may deliver high returns, but only by exposing the portfolio to high risk.

[10] Hedge funds are unregulated, do not have to report AIMR-compliant numbers, and often buy illiquid securities with respect to which mark-to-market pricing is unavailable. Hence, manager returns are also inflated by suspect numbers and managed or stale pricing.

[11] Jonathan Lach refers to "the tailwind of survivorship bias." *Op. cit.*, note 4, p. 75.

"optimal" hedge fund exposures of 60% or more.

A diluted manager talent pool. Ten years ago only the most talented managers could hope to be successful in raising money for a hedge fund. These days, however, there is so much demand for hedge fund exposure that it seems as though anyone with a high school diploma can successfully set up a hedge fund. Many newer hedge fund managers do not even have investment track records – they may have been financial analysts, for example. Even those with direct investment experience often have no experience selling stocks short or employing other hedging strategies. Short selling is a nerve-wracking activity in which potential losses are unlimited and potential gains limited – since the price of a stock can't go below zero, though it sometimes seems like it. Therefore, buying stocks long is to selling stocks short what touch football is to Iwo Jima.[12] Other problems with new managers include inexperience managing people and complex back-office challenges.

Too much capital coming into the business. Very few investment strategies can preserve returns when massive amounts of capital pour into the business, and hedge fund investing is no exception. Some of the new capital in the hedge fund world emanates from investors who are thoughtful and experienced, but who must invest so much capital (in order to have any impact on the returns in their gigantic portfolios) that they simply cannot do a good job of putting the money to work.[13] Other capital is coming from sources that have precious little experience investing in hedge funds and who are proceeding with such undue haste that it is clear they are simply exploiting the public's sudden appetite for hedge exposure. A particularly worrisome development involves the advent of so-called "capital guaranteed" products. Many European banks (and, recently, some American banks) have raised massive amounts of capital from inexperienced investors via this tactic, under which the financial institution guarantees investors that they will not lose money in hedge funds if they keep their money invested for some minimum period of time, usually five or six years.[14] Other structured products – typically levered – are also being offered, as well as the retail products described above.[15]

Tax inefficiency. For taxable investors, the gross returns of hedge funds have to be adjusted for their tax inefficiency. And this inefficiency can be huge, since, for most funds, almost all the return is generated in the form of short-term capital gains and ordinary income. There are techniques that can be used to shelter hedge fund gains, or to convert them into long-term gains, but these

[12] With thanks to Dave Berry for this lovely analogy.

[13] Some large pension plans are reportedly planning to invest $1 billion a year in hedge funds for the next five or ten years.

[14] See Erik Portanger and Alistair McDonald, *Hedged Hedge Funds Get Popular in Europe*, Wall Street Journal (September 10, 2002), p. C13. Because in many cases the financial institutions haven't hedged their own obligations to the investors, these institutions are extremely skittish and pull out of funds very quickly following negative performance, wreaking havoc with manager strategies. Serious hedge fund investors would do well to avoid hedge funds that have significant capital-guaranteed products among their investors.

[15] "Democratize the hedge fund business? Sure, and as long as we're at it, let's democratize the New York Philharmonic. We'll all play first horn." James Grant, *op. cit.*, note 6.

techniques bring their own complex challenges.[16]

Lack of transparency. For investors who are used to tracking their portfolios every day (or every hour!), the lack of transparency that characterizes hedge fund portfolios is likely to provide a whole new experience. What is transparency all about?[17] Transparency refers to the ability of an investor in a hedge fund to understand what the manager plans to do,[18] how he plans to do it,[19] and whether he is actually doing it.[20] Without transparency, investors can't understand the nature of the risks they are taking, and hence cannot, for example, hedge those risks by investing with managers using other strategies.[21]

Conflicted prime brokers. In a typical separate account money management arrangement cash and securities are held by a bank acting as custodian. The manager has only a limited power of attorney to direct the investments in the account, but cannot remove cash or securities. The investor is the bank's customer, not the manager. If anything even remotely fishy is going on in the account the bank will notify the investor immediately. Hedge fund accounts, however, are not custodied in the usual sense. Instead, the funds reside with a "prime broker," typically an investment banking/brokerage firm that serves as global custodian, broker, lender (via margin loans), vendor of derivative transactions and even fund raiser for the hedge fund. The customer is the hedge fund, not the investor. Prime brokers play so many roles, have so many conflicts of interest, and earn such large profits for their firms that they cannot be counted on to blow the whistle on shenanigans committed by hedge fund managers with whom they work. With no one watching the store, careful evaluation of the ethical standards of hedge fund managers is crucial to avoiding fraud.

Advantages are also disadvantages. In the upside-down world of hedge funds, virtually every advantage claimed by the industry also represents a potential disadvantage for investors. For example, Jonathan Lach lists the following "burdens" hedge fund managers are able to avoid (relative to other money managers): "excessive capital under management, benchmark objectives, diversification requirements, daily liquidity, and significant organizational time demands."[22] Lach is right, and these are in

[16] For example, hedge funds can be placed in tax-exempt accounts, such as IRAs or charitable foundations. Hedge funds can also be wrapped in on-shore or offshore insurance products. Finally, these days many taxable investors have realized so many losses in their long-only portfolios that hedge fund gains can be sheltered for at least some period of years.

[17] "Hedge fund transparency is like pornography – it is hard to describe, but you know it when you see it." Mark Anson, *Hedge Fund Transparency*, The Journal of Wealth Management (Fall 2002), p. 79.

[18] Try reading a hedge fund offering memorandum and figure out what the hell the manager plans to do with your money.

[19] See the preceding footnote.

[20] In their inquiry into the failure of Long Term Capital Management, the President's Working Group on Financial Markets wrote: "An issue here is whether the LTCM Fund's investors … were aware of the nature of the exposures and risks the hedge fund had accumulated. * * * They almost certainly were not adequately aware since, by most accounts, they exercised minimal scrutiny of the Fund's risk-management practices and risk profile." Quoted in Mark Anson, *op. cit.*, note 16, pp. 81-82. One important reason why LTCM's investors "exercised minimal scrutiny" was that LTCM wouldn't stand for it.

[21] I don't mean to suggest that hedge fund investors need to have full position transparency on a regular basis. I do suggest that many hedge fund managers offer so little in the way of tactical and risk transparency that investors would be better off avoiding such managers altogether.

[22] Lach, *op. cit.*, note 4, p. 77.

fact important advantages of hedge funds. But many investors will view all but the first and last[23] of these not so much as "burdens" but as important risk controls. Or consider the "advantage" that many hedge fund managers have much of their own money invested in their funds. This is certainly an advantage in the sense that such a manager is likely to pay close attention to the business. But that is a different issue from the question whether the manager's interests are aligned with the investors – they typically aren't. If a manager has much of his net worth invested in his fund while a typical investor has only a modest portion of his net worth invested in the fund, the interests of manager and investor are structurally misaligned from the beginning. Moreover, manager and investor may have different time horizons and may have very different feelings about leverage, downside risk, long and short exposures, and so on.

High fees. Hedge fund managers charge annual fees of 1% to 2%, plus 20% of any profits. Some managers are worth every penny of this, but they are rare, indeed. In other words, there is nothing inherent in the hedge fund format[24] to justify such fees – only talent justifies them. Investors who don't aggressively seek out talent are likely to be disappointed in their hedge fund returns in part because too much of the return is going to the manager.

Mischievous fee structures. Hedge funds often have both a "hurdle rate" and a "high water mark." The hurdle rate means that the manager cannot get any part of his 20% share of the profits until the fund has exceeded some pre-set annual rate of return – 8%, for example. The high water mark simply insures that, once a loss is incurred in a fund, the manager cannot receive his 20% share of the profits until the loss has been recovered. Both elements of the fee structure are perfectly fair, but they can easily combine to produce odd incentives. Consider a fund with a 1% annual fee, and 8% hurdle rate and a high water mark provision. The fund starts with $100 million in year one, rises to $200 million in year two (a hell of a year, to be sure), declines to $150 million in year three, and rises to $175 million in year four. In year four, the fund is not yet back to its "high water mark" of $200 million. In addition, the manager has failed, over years two and three, to earn the 8% hurdle rate. Moreover, as the hurdle rate piles up and the high water mark looks more and more unattainable, the manager is faced with receiving nothing but his 1% annual fee for many years. He didn't go into the hedge fund business to earn a 1% fee, so what does he do? As Roland Lochoff puts it, "It is not uncommon for a fund to fall so far underwater that the chance of ever reaching the high water mark is improbable. It simply pays the hedge fund manager to go out of business and start afresh with a new

[23] Even these characteristics can be viewed as disadvantages. Hedge funds can avoid having excessive capital under management by closing to new investors. But this means that, just about the time a sensible investor has concluded that the manager knows what he is doing, it's too late to get in. Organizational time demands are certainly a bugaboo for long-only managers associated with large institutions, but organizational supervision also tends to reduce the kind of fraud and mismanagement that occurs in the hedge fund industry.

[24] Some would argue with this view. R. McFall Lamm, Jr., for example, argues that, "Conceptually, the long-only manager faces a constrained optimization problem [that is, he can only buy long; he can't sell short], while the equity hedge manager is unconstrained." R. McFall Lamm, Jr., *How Good Are Equity Hedge Fund Managers*, Alternative Investment Quarterly (January 2002), p. 21. Conceptually, yes, but the execution challenges facing the unconstrained manager make it likely that only the most talented managers will be able to use the unconstrained vehicle to full advantage.

name."[25] In other words, heads he wins, tails we lose.

Are hedge funds an asset class? Viewed in the usual terms, hedge funds are most certainly not an "asset class" in the usual meaning of the term. They are not homogeneous; it is difficult or impossible to create a benchmark series of returns that will approximate the return of hedge funds; individual hedge fund strategies often have little correlation with each other. Hedge funds, in other words, represent an alternative category of investments, but they are not a traditional asset class. To the extent that hedge fund exposure enables an investor to gain access to more talented managers, and to the extent that, taken as a whole, the hedge fund exposure exhibits a low correlation to equities and bonds, the sector is attractive. But considering hedge funds as an asset class can only lead to mischief.

High tracking error. Investors who have traditionally focused on tracking error to monitor their managers will be sorely disappointed with hedge funds. It is virtually impossible to create a benchmark that will be useful for monitoring a hedge fund portfolio. As a result, whatever benchmark is used, tracking error will be impossibly high – so high as to be largely useless as a manager monitoring tool.[26]

Correlations increase just when you need them not to. Over long periods of time hedge funds have demonstrated low correlations to the equity and fixed income markets. Unfortunately, during liquidity crises (August 1998 and the summer of 2002, for example), the correlations between hedge funds and marketable securities increase dramatically – just when you most need the diversification. In other words, hedge funds provide diversification over the long run but not over the short run.

Investor expectations may be irrational. Looking at the high relative returns generated by hedge funds over the past ten years, many hedge fund investors may be expecting the impossible, namely, that hedge fund returns will remain high even in the face of sustained bear market conditions. But, as Barry Colvin puts it, "Hedge funds attempt to produce returns that are independent of the overall market, but not *despite* the market."[27] For a hedge fund that produced returns of 15% to 20% during the bull market to produce essentially flat returns during the worst bear market in a generation is a very strong performance. Yet, many hedge fund investors have been very unpleasantly surprised by that performance in 2002.

What to Do?

Again, I want to emphasize that a properly designed and implemented portfolio of hedge funds can play an important role in an investment portfolio, reducing risk and, during negative periods in the markets, protecting capital. The point of the discussion above is simply that successful hedge fund investing, going forward, will be vastly more challenging than it has been in the past. Investors will have to spend a great deal more time and effort designing their hedge fund portfolios and a great deal more

[25] Roland Lochoff, *Hedge Funds and Hope*, The Journal of Portfolio Management (Summer 2002), p. 92.

[26] See R. McFall Lamm, Jr., *op cit.*, note 22, p. 23.

[27] Barry H. Colvin, *Hedge Fund Expectations Require Trimming*, Investment News (September 30, 2002), p. 13. (Emphasis in the original.)

time and effort implementing them. As a general rule, for example, investors who cannot afford to devote at least one full-time professional to evaluating and monitoring hedge fund managers should almost certainly invest through a good, experienced[28] hedge fund of funds.

In the future, investing in hedge funds will become more analogous to investing in private equity funds: performance dispersion among funds will widen until, unless you are invested with top quartile funds, you should, like Yogi Berra, have stood in bed.

We will be happy to discuss this memo at your convenience.

GREYCOURT & CO., INC.
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[28] "Of the 450 [hedge] fund of funds reported by one popular database service, less than forty have a five year record and fewer than twenty have a ten year record." Lighthouse Partners, August 2002 Performance Update (September 9, 2002). Lamm and Ghaleb-Harter examined the "wide dispersion of returns for FOFs [funds of funds] in the lowest quartile" and concluded that fund of fund investors have "a higher than normal chance of selecting a FOF that performs very poorly." *Op. cit.*, note 22, p. 11.