

# Evaluating and Implementing Hedge Fund Strategies

The experience of managers and investors

Third Edition

## Chapter 1

# An overview of themes and issues

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### The purpose of this book

‘Meet Kate Reddy, hedge fund manager and mother of two. She can juggle nine different currencies in five different time zones and get herself and two children washed and dressed and out of the house in half an hour’. So reads the jacket cover on Allison Pearson’s novel, *I Don’t Know How She Does It*, which was published in 2002 and made it onto *The New York Times* book review best-seller list for a number of weeks. The book is characterised by ‘humour, drama and bracing wisdom’. I know this only because the same jacket cover tells me so. I realise that the book is really not about hedge funds but rather ‘the dilemma of working motherhood at the start of the twenty-first century’ (again, the jacket covers tells me so). Yet the book bugs me a bit, for several reasons.

First, it irks me to think that Allison Pearson has probably already sold the film rights to her witty bauble of a book. I have not had any takers for the cinematic version of the vastly more informative tome that is now in your hands since its first edition in 1996.

Second, I suppose it is a mildly amusing sign of the times that after a three-year bear market, hedge funds have seeped into popular culture as something trendy. At least this is better than being reviled by the financial press and politicians as financial pirates who manipulate markets (remember how Malaysia’s President Mahathir demonised George Soros after the collapse of the ringgit or how the Bank of England fingered him as the culprit who broke the pound?). However, there is something still unsettling about hedge funds becoming ‘cool’, especially when the pace of institutional interest is starting to pick up speed. The smart investor is always wary of the crowd, especially when the crowd is comprised of a herd of elephants.

Most annoying, though, is that even when the book is about hedge funds, it isn’t about hedge funds. Rather than portraying hedge fund managers realistically as the hard working, insightful iconoclasts that they are, it falls back on some of the same old, tired stereotypes the industry has been tagged with for too long. Kate is a hedge fund manager at the fictional Edwin Morgan Forster, ‘which ranks in the top 10 money managers in the United Kingdom and in the top 50 globally in terms of assets, and which, for five years running, has been voted money manager of the year’. Here is Kate addressing six new trainees:

‘You will, I’m sure already be familiar with the term fund manager. Put at its simplest, a fund manager is a high-class gambler. My job is to study the form of companies around the world, assess the going rate in the markets for their products, check out the track record of jockeys, stick a big chunk of money on the best bet and then hope to hell that they don’t fall at the first fence.’

Like Captain Renault at Rick's Café Americain in *Casablanca*, I am shocked, shocked to find that gambling is going on in here! How can such a refined and civilised pursuit as managing a hedge fund be sullied in such a way! I am sure that all hedge fund investors with any semblance of experience will recognise Kate Reddy's cartoonish characterisation for just what it is and respond with justifiably righteous indignation.

And like Captain Renault, we will all murmur a polite 'oh, thank you very much' when the croupier says 'your winnings, sir'. We are indignant perhaps because a small kernel of truth lurks within the humour of it all. Speculation is the 'bad rap' the industry must rise above but speculation is the vice that hedge fund investors and managers alike must always guard against precisely because the beauty (and danger) of hedge funds is that they can be so flexible in the way they invest.

Which brings us, surprisingly enough, to the purpose of this book. This third edition of *Evaluating and Implementing Hedge Fund Strategies* aims to foster an open and honest dialogue among managers and investors about what works and what does not work in hedge funds, what is attractive and what is unattractive, how to distinguish between the realities and the myths.

Since the second edition of this book in 1999, when there was only a modest shelf full of specialist volumes available, readers have benefited from a raft of new offerings on the industry. In particular, there are some excellent overviews. However, there still is no comprehensive survey, handbook or 'how to' manual. There never can be, because the field is too diverse, complex and dynamic. This book itself has been greatly expanded, revised and updated. Not only are the topics even broader than before, more than half of the authors are new. Yet it is neither primer nor procedural. Rather, it is a collection of essays written by and for professional investors as well as serious students seeking an insightful overview of the trends, developments and issues facing hedge funds. At one level, the chapters in this book are intended to delve into how hedge fund managers and investors 'tick'. At a broader level, though, the book is meant to have some enduring value as a set of reflections on the past, present and future of hedge funds. It is also meant to have some practical use. Hence the title for the book: *Evaluating and Implementing Hedge Fund Strategies*.

While the book has been written for a diverse audience comprising investors, institutions, intermediaries and money managers, each of the authors has taken a deeply personal approach to addressing the issues they believe are important. As editor, I asked the contributors to consider the following questions: How do you view your general area? What have been the trends? What is your particular approach and how has it evolved? From a conceptual point of view, what are the sources of risk and return in your area? What are their dynamics? How have they changed? What has not changed? As a hedge fund manager/investor, what has been your particular approach to exploiting these sources of risk and return? What strategies have worked over the years? What has not? Why? What is the outlook for your area? How do you expect things to develop going forward? What alternative scenarios are likely?

I am pleased to report that all of the contributors have succeeded in wrestling with these questions. I am also pleased to report that while many answers have been formulated, there are many that remain inchoate or elusive. This is only to be expected, again considering how diverse and dynamic the whole field of hedge funds is. Indeed, if there is any unifying conclusion to be drawn from this book, it is that hedge funds are so diverse and dynamic. When I set out to organise this book, I was concerned that we would end up with everyone saying the same thing. I should have known better. After all, put two hedge fund managers in a room and you will get three arguments. Even though the popular impression is that the hedge fund world is a

monolithic one, surrounded by murk and mystery, pull aside the curtain and you will find some very serious (and ultimately very human) disagreements and divergences within the industry.

## The structure of this book

The diversity, dynamics, disagreements and divergences that animate the hedge fund industry are reflected throughout the structure and content of this book. The topics addressed within the chapters have been divided into six broad sections:

- Part I: Introduction
- Part II: Evaluating opportunities – managers’ strategies
- Part III: Evaluating opportunities – investors’ strategies
- Part IV: Assessing risk and risk control
- Part V: Hedge funds and public policy
- Part VI: Legal and regulatory issues

‘Part I: Introduction’, includes this overview and five diverse chapters, which lay out the history and background of the industry, address the basic rationale for hedge funds and provide a basic set of definitions.

‘Part II: Evaluating opportunities – managers’ strategies’, represents the ‘supply side’ of the industry. It is made up of presentations by 12 seasoned hedge fund managers who explore critically the challenges and opportunities they face within their particular discipline of investing, ranging from hedged equity investing to fixed-income arbitrage.

‘Part III: Evaluating opportunities – investors’ strategies’, represents the ‘demand side’ of the industry. It comprises discussions by 10 hands-on investors of the uses and abuses, the pros and the cons of utilising hedge funds. Also included is the due diligence questionnaire developed by the Alternative Investment Management Association (AIMA), which is in Appendix 1.

‘Part IV: Assessing risk and risk control’, addresses what perhaps has become the most important topic within the field. It includes in-depth reviews by five practitioners who approach the issues from very different but related directions, as one is a manager, two are investors/intermediaries, one is an accountant/auditor and one is a prime broker.

‘Part V: Hedge funds and public policy’, explores how hedge funds relate to economic developments and how they affect the behaviour of securities markets. The four contributors not only share very thoughtful reflections on the issues but also offer some very useful guidance to policy makers.

‘Part VI: Legal and regulatory issues’, comprises five chapters that provide much needed clarity for those seeking guidance through the very complex tangle of undergrowth that surrounds hedge funds. Also included is an IOSCO report, which is in Appendix 2, on regulatory and investor protection issues.

Following are general reviews of the issues raised within each part of the book.

## Understanding the beast – a review of Part I: Introduction

Asking someone to define what a hedge fund is reminds me of the old tale about the five blind men who try to define an elephant. The first blind man approaches the animal and gets hold of a leg. ‘Ah, this animal is like a tree’, he concludes. The next feels an ear. ‘No, here’s a wing.

It must be a sort of bird', and so on. So it is with hedge funds. Just when you think you have a firm grasp on any one part of the beast, you have to concede that someone else has identified something that may not be so apparent.

It is therefore impressive that Ted Caldwell in his chapter, 'Market gravity and hedge fund aerodynamics: the prudent approach to hedge fund classification', is able to draw such clear distinctions among the flora and fauna that make up the hedge fund landscape. The key is understanding the elementary nature of hedge funds, which Caldwell does by referring back to the original concept of a hedged fund as developed by A.W. Jones.<sup>1</sup> Lars Jaeger adds to the discussion by systematically analysing the sources of returns for hedge funds. The chapters of Antoine Bernheim and Lois Peltz provide further background by laying out the historical context within which hedge funds have developed. Antoine Bernheim gives a particularly telling explanation of what offshore funds are and how they have evolved into what they are today and more importantly how they continue to evolve in response to market developments and investor behaviour. Lois Peltz details the key events that are shaping the industry and what the implications may be going forward. Finally, Jon Bren offers a trenchant reality check, by relating broad principles to hard experience in 'Lessons learned from investing in hedge funds over the years'.

From an objective viewpoint, the common denominators among hedge funds would seem to consist of little more than the following: (i) they are commingled pools that are offered via private placements to a relatively limited number of institutions and sophisticated investors, and (ii) the manager receives an incentive fee. Beyond these characteristics, there is nothing monolithic or typical about the universe of hedge funds.

The reality is that there are hedge funds and there are hedge funds, and there are hedge funds. Some of the most well-known hedge fund managers attained celebrity-like fame (or in some cases infamy) in recent years, having achieved often spectacular performance with large, leveraged 'bets' on the direction of markets, currencies and interest rates. Other, perhaps less well-known managers have maintained a more traditional 'hedged' approach, while still others have focused on fairly narrow areas of specialisation, ranging from convertible arbitrage and short selling, to emerging markets, fixed-income arbitrage and quantitative 'market-neutral' strategies. Each has had periods when they were heroes and each has had periods when they were goats.

Even within these various 'types' of funds there are distinctions. Some are managed by seasoned professionals (cynics would say 'tired veterans'). Others are run by young start ups ('up starts'). Some are overseeing substantial assets ('too big and unwieldy'), while others are quite small ('untested and non-viable'). Certain managers adhere to well-defined investment disciplines ('inflexible'), while others are highly opportunistic in their approach ('unfocused').

Which (if any) of these types deserves to inherit the title of the True Hedge Fund? This question is touched on not just by Ted Caldwell, it is debated by virtually all of the contributors throughout the book. While categorising managers can be useful, more often than not the reality is that any given manager should be profiled as a bundle of characteristics, not a type. The issues are listed below.

## The evolution of the hedge fund

### The traditional definition

- US focus
- equity orientation; style specialisation

- hedged long-short
- low profile
- very small organisations

**The contemporary definition**

- global investment scope
- use of multiple asset classes; opportunistic
- derivatives used to hedge and/or augment positions
- high visibility
- large organisations

**Proliferation of categories and approaches**

**Investment styles**

- equities
- multi-strategy
- merger arbitrage; risk arbitrage
- convertible arbitrage
- fixed-income arbitrage
- strategic investing
- special situations
- closed-end fund arbitrage
- high-yield and distressed securities
- short selling
- pairs trading
- index arbitrage
- industry specialisation
- emerging markets
- etc

**Portfolio manager techniques**

- US versus global
- analytical versus quantitative
- hedged versus directional
- bottom-up versus top-down
- value versus growth
- fundamental versus technical
- concentrated versus diversified
- securities versus derivatives
- long-term investing versus short-term trading
- use of new issues, private placements, etc
- etc

**The spectrum of return objectives**

- high absolute returns
- relative returns

## PART I: INTRODUCTION

- stability of returns
- long-term versus short-term performance

### **The array of risk characteristics**

- short-term volatility versus long-term performance
- volatility relative to a market index or benchmark
- consistency of returns
- risk of permanent loss
- portfolio diversification; concentration
- degree and type of hedging
- liquidity
- use of leverage
- exposure to interest rates, credit, volatility, other factors
- disclosure/trust/communication

### **Intelligence reports from the front lines – a review of Part II: Evaluating opportunities – managers’ strategies**

Since *all* investing is a matter of dealing with uncertainty and the passage of time, there will always be an eternal debate about who is more likely to succeed, the patient investor who maintains his conviction or the quick trader who is flexible and adaptable.<sup>2</sup> Likewise, there will never be agreement on whether it is more effective to be a top-down strategist who tries to anticipate macroeconomic trends and market developments, or a bottom-up analyst who concentrates on the characteristics of specific securities. To the former, who may regard himself as a visionary navigator, the latter resembles a highly trained but nonetheless near-sighted helmsman who may not have recognised his mistake of having signed on to the Titanic until it is too late. On the other hand, the latter, who styles himself after a fine craftsman or connoisseur, may question the sanity of the former for having left terra firma in the first place. Trying to convince anyone that one approach is better than the other is often like discussing religion. No matter how tolerant you may be, when you know your way is right it is hard to understand how the other guy can be such an unenlightened heathen.

If there are any eternal truths, one of them is that there is no such thing as the ‘world’s best money manager’. There never has been. Another eternal truth is that the dispersion of results among hedge funds, even within a relatively narrow sub-sector of the industry, can be very wide. This is because managers have such tremendous latitude in what they can do. The fact is that there are great managers but no one outperforms all the time. Indeed, as history has shown, any manager eventually goes through a period(s) in which he underperforms, whether in absolute terms or relative to whatever benchmark is relevant. Furthermore, virtually *all* investment styles go through periods of underperformance, whether due to changes in market conditions, overcrowding and too much money, or simple reversion to the mean. We have seen it happen in the past to growth stock managers, arbitrageurs, short sellers, market-neutral, macro players and the like.

The tide always turns, though. Furthermore, macro trends have transformed the investment process into a much more complex and global one. As Michael Lewitt points out in his chapter, ‘Understanding credit cycles and hedge fund strategies’, there are market forces that surround all money managers and all styles of investing. It may be perilous to assume one can outsmart

the market but it is equally perilous to outsmart oneself by ignoring the market. Similarly, recognising market trends can inform the manager on where opportunities (and risk) will be.

These notions are at the very core of what it means to hedge market risk (or alternatively, to embrace market opportunity). Roddy Campbell, Shuhei Abe, Bruce Richards, Lou Hanover and Michael Rulle pursue very different strategies but for all of them the investment process entails identifying specific opportunities within trends. In ‘European event and arbitrage investing’, Roddy Campbell looks at bottom-up, event-driven investments within the context of the restructuring of Europe. In ‘Long-short investment strategy in Japan’, Shuhei Abe’s broad, top-down view of the transformation of Japan’s economy informs his approach to stock selection. Bruce Richards and Lou Hanover develop a framework for taking advantage of volatility arising from economic developments in ‘Emerging markets’. For Michael Rulle’s ‘Trend following: performance, risk and correlation characteristics’, the interplay between cyclical and secular trends is literally the name of the game.

There may be tides and winds that buffet all investors but perhaps one way to adapt is to dive beneath the waves where the forces are more muted. John Paulson in ‘Adding alpha in merger arbitrage’ and Jason Huemer in ‘The hedge fund manager’s edge: an overview of event investing’ take up the banner of the ‘micro’ approach. Yes, there is always an ebb and flow of corporate activity, and John Paulson and Jason Huemer would be the first to tell you how this can put a spin on their areas of focus. However, these managers find opportunity in specific events, not the general trends. This is also the case for Luke Imperatore, who describes ‘Asset-backed investing’, where detailed analysis of specific pieces of paper can make or break an investment.

It would be overly simplistic to overemphasise this dichotomous portrayal of competing hedge fund strategies, macro versus micro. The fact is that there are many dimensions and shades of grey in this picture. Certainly the interplay of trends and specific events becomes most tumultuous in the day-in, day-out tension between the immovable object of the equity market and the irresistible force of stock valuation. While a number of the chapters in this part of the book explore some of the more exotic strategies, Lee Ainslie re-examines the basics. In ‘Hedged equity investing’, Lee Ainslie offers an insider’s view of what it takes to run a classic hedged fund.

Another stream of activity in the hedge fund world is made up of a variety of disparate quantitative techniques. Again, even as such strategies are designed to mitigate the impact of market behaviour, trends and developments within the markets themselves have an inescapable influence on the efficacy of such strategies. For Bruce Jacobs and Kenneth Levy, the beauty of quantitative techniques is in designing portfolios to be unperturbed by the markets, as explained in ‘Using a long-short portfolio to neutralise market risk and enhance active returns’. Fixed-income arbitrage is undoubtedly one of the more complex areas of the hedge fund world. Michael Pintar in ‘Fixed-income arbitrage’ elucidates many of the ins and outs of these complex strategies. Similarly, Michael Boyd reveals the dynamic nature of convertible arbitrage in ‘Convertible arbitrage: the manager’s perspective’. All three show how even the most advanced quantitative analysis must be tempered with a realistic understanding of how markets work. As one pundit once put it, ‘The market is designed to fool as many people as possible at any one time’.

It is difficult to notice, but if there is agreement among the contributors on anything, it is that running a successful hedge fund is hard work that requires fortitude and perseverance. As Robert Wilson, a well-regarded hedge fund manager who is now retired, once said, ‘In this business, 20 per cent of the time you feel omnipotent, 60 per cent of the time you feel frus-

trated, and 20 per cent of the time you feel merely despondent'. Few others would allow such an admission openly, but most would concur, at least in private.

## **Charting the seas – a review of Part III: Evaluating opportunities – investors' strategies**

Why invest in hedge funds? In one of his movies, the ever-neurotic Woody Allen has a marvellous explanation for why he persists in behaving the way he does. He talks about a crazy uncle who thinks he is a chicken. Why doesn't he bring this relative to a psychiatrist? 'Because', Woody admits, 'I need the eggs'.

After a year like 1998, when hedge fund disaster stories were splashed on the business pages of every local newspaper, the story has some resonance to it. However, for every disaster, there were dozens and dozens of other funds that managed to navigate the rocks and storms without incident, or at least without fear of sinking, even if they did take on water. Perhaps another story is more appropriate. In late September 1998, I was hurrying through Grand Central train station in Manhattan, preoccupied with the questions of the day. This was at the height of investors' fears that global markets were in danger of being dragged down by the sinking juggernaut known as Long-Term Capital. Coincidentally, it was also a point in time when the tide of popularity for the film, *Titanic*, had finally reached an ebb. I suddenly noticed a T-shirt go by. It had a simple message: 'The ship sank. Get over it'. It may not have been an epiphany, but it did make me chuckle out loud.

Yes, a mighty ship, once thought invincible, sank under the weight of its own hubris. However, transportation did not cease. Many other ships sailed on. Indeed, hull design and navigational technology improved. In other words, before I abuse this analogy too much farther, investors allocate some portion of their money to a variety of hedge funds because they exhibit different patterns of returns, different sets of risk characteristics and thus different exposures to the market. Yes, for many private investors superior, absolute returns are the motivation for being in non-traditional investments. However, the other motivation is diversification. The validity of this rationale became increasingly apparent after March 2000, when the stock market bubble burst and hedge funds generally showed how being hedged could make a difference in the ensuing three-year bear market.

Tom Schneeweis and Richard Spurgin make it clear in their chapter, 'Quantitative analysis of return and risk characteristics of hedge funds, managed futures and mutual funds', that the performance of non-traditional investments *à la* hedge funds tends to be less dependent on the market or is even negatively correlated. Thus, as James Berens, Judith Posnikoff and Alexandra Coffey demonstrate in their chapter, 'Institutional investors: incorporating hedge funds into the asset allocation process', non-traditional investment vehicles such as hedge funds have grown significantly in popularity, partly due to their returns, partly due to their role in hedging or trading around market risk. Hedge funds are not going to replace conventional managers but the opportunity to enhance returns while reducing systematic risk can be a compelling motivation to invest in this area. A global perspective on these trends is provided by Sohail Jaffer in 'Analysing the evolution of the European hedge fund industry' and Peter Douglas in 'Hedge funds in Asia'.

The foundation for investing in hedge funds, or any investment for that matter, is understanding one's investment objectives and expectations. Perhaps it was said best by the great baseball player and inadvertent investment thinker, Yogi Berra, who once remarked, 'If you

don't know where you are going, you might wind up somewhere else when you get there'. Determining a clear investment policy and understanding the investment environment is important in determining how and what kind of hedge funds an investor might utilise. Stuart Leaf provides his own thought-provoking version of a crystal ball for these questions in 'Understanding continuing trends in hedge funds'.

Developing an investment outlook is one thing. Understanding the behaviour of specific hedge funds is another. Roxanne Martino in 'The due diligence process', Thomas Weber in 'Quantitative analysis of hedge funds' and Jeff Tarrant in 'The life cycle of hedge fund managers' offer keen insights into assessing individual hedge fund managers. In particular, they share their experience in peering through the façade and digging behind the numbers to understand the realities of hedge funds. Rounding out the practical side of the process, Emma Mugridge makes available a valuable tool, the AIMA due diligence questionnaire, in Appendix 1.

All that is left is to integrate theory and analysis, and put together an actual investment programme. Lloyd Hascoe shares his personal experience in 'Utilising hedge funds: the experiences of a private investor', in which he provides a unique, decade-long case study. In marked contrast to Lloyd Hascoe's highly targeted approach, Jeff Bramel explores 'Hedge fund benchmarking and indexation', which has emerged as a tool for investors seeking to gain broad exposure to the asset class of hedge funds.

## **Before hiring a knife juggler, count his fingers – a review of Part IV: Assessing risk and risk control**

Somerset Maugham, the author of the book *The Razor's Edge*, once wrote that there were three rules to writing a novel (unfortunately no one knew what they were). Similarly there are three rules to managing risk in a hedge fund. Fortunately, our contributors to this section do know what they are.

- *Rule 1.* As Paul Singer points out in 'Risk control and risk management', risk from a manager's point of view is a far more complex consideration than merely the simple but widespread notion of 'volatility'. It requires careful, thoughtful management and judgement of realistic expectations and potential surprise.
- *Rule 2.* Guy Hurley explains in 'Qualitative aspects of analysing risk and monitoring managers', that risk from an investor's point of view is ultimately a matter of judgement. This requires understanding a manager's character, culture and philosophy, and how these may change over time. In 'Hedge fund transparency', Jim Hedges delves into one particularly important aspect of the investor's process of gaining an understanding of, and trust in, a manager.
- *Rule 3.* Mike Tremmel makes it clear in 'Assessing risk and risk control: operational issues', that the best laid plans of managers and investors can come to naught if they are not implemented and administered with the proper controls. Chris Pesce elaborates on how critical 'The evolving role of the prime broker' can be. As more hedge funds engage in increasingly complex strategies, invest in more diverse global markets and utilise more exotic instruments, the need to control the trade and settlement functions as well as manage information and measure prices and performance will become commensurately more acute. None of these areas should be underestimated.

## **Stop me before I speculate again – a review of Part V: Hedge funds and public policy**

On a flight to Hong Kong from Vancouver in November of 1997, I found myself sitting next to a fellow who turned out to be an engineer from Malaysia. Markets throughout the Pacific had been in a steep dive for a number of weeks and my seat-mate's eyebrows rose when I mentioned that I was in the investment business. 'Asian markets have been very difficult', he stated stiffly. Yes, I had heard something about that, I dead panned. 'You know why, don't you?' he asked pointedly. He then gave me a hard look as he spat out the answer. 'George Soros and all those other hedge funds'.

Such has been the power of the stereotype of hedge funds. For too many years, the financial press perpetuated the image of hedge funds as predatory speculators who move equity, fixed-income and foreign exchange markets by wielding enormous amounts of leverage and aggressively trading derivatives. Fortunately, members of the media have taken a more realistic, or at least less shrill, view as they came to realise the hedge fund industry represents only a thin sliver of the world's capital markets. After all, hedge funds are dwarfed by the insurance industry, mutual funds, pension funds, central banks and the proprietary trading desks of securities firms. Moreover, many hedge funds never trade any currencies or futures.

Are hedge funds to blame for bouts of market turmoil? Do they need to be regulated? According to the contributors in this section of the book the answer is: yes, no, maybe and then some. George Soros' 'Hedge funds and dynamic hedging' is excerpted from Congressional testimony delivered in 1994. It reads with surprising relevance and freshness in the wake of the events of 1998 and the post-2000 bear market. Henry Kaufman, in 'What bankers don't know', another prophetic piece, does know just where to lay the blame. In contrast, Barry Eichengreen and Donald Mathieson provide a scholarly approach to a difficult topic in 'Hedge funds and financial markets: implications for policy' which is excerpted from IMF Working Paper #166. More recently, the Securities and Exchange Commission has been much in the news regarding possible regulation of hedge funds. Jim Chanos' 'Short selling, hedge funds and public policy considerations' is adapted from his presentation at the Commission's roundtable on hedge funds which was held in May 2003. In addition to a clear and sensible explanation of the role of short selling in the markets, Jim Chanos also provides a very interesting practitioner's view of how a short seller analyses opportunities.

## **Taming the wild footnote – a review of Part VI: Legal and regulatory issues**

Why bother to read the fine print in that turgid, impenetrable pile of paper known as the Prospectus? If you don't, you may some day wish you did. Hedge fund investing is not easy and it is not made any easier by the legal, regulatory and tax issues. The five chapters in this section will dispel any despair you may have about approaching this complex thicket of considerations. Phil Harris and his team provide a detailed road map for managers in 'Structuring hedge funds: an overview of business, legal and regulatory considerations for managers'. Eric Sippel and Christopher Rupright smooth the way for investors in 'Investing in hedge funds: an overview of business, legal and regulatory considerations for investors'. Eric Bettelheim's 'Marketing alternative investment funds: law and regulation

in Europe’ and Nicholas Hodge’s ‘Marketing alternative investments: law and regulation in the United States’ simplify an otherwise bewildering array of details. Nicholas Hodge does double duty, analysing ‘The evolution and outlook for regulation of hedge funds in the United States’. Finally, in Appendix 2 IOSCO shares their chapter on ‘Regulatory and investor protection issues arising from the participation by retail investors in (funds of) hedge funds’. The latter two contributions are especially important as hedge funds are attracting a wider and wider audience of participants.

### **Lessons to be learned, re-learned and re-learned again**

The holy grail of hedge fund investing can be summed up in one word: edge. Finding an edge is the theme that weaves its way through almost all of the chapters in this book. In some cases the word is used quite explicitly. In others, the word is too sacrosanct to utter or too steeped in mystery to be revealed to mere mortals. However, in the mundane world of slogging away at the chore of trying to add value, it is possible to develop a fairly straightforward checklist of what to look for, and what to avoid.

#### **Potential sources of value added**

- special set of skills, approach
- focused, responsive decision making
- cohesive organisation
- dedication and commitment
- balance of flexibility versus discipline
- niche opportunities; barriers to entry
- etc

#### **Potential impediments to performance**

- growth of assets under management
- adopting new techniques
- taking uncharacteristic risks
- refusal or inability to adapt
- refusal to admit mistakes
- loss of dedication and commitment, lifestyle changes
- change in objectives
- increasing organisational complexity
- organisational disruptions
- turnover of personnel
- lack of operational controls
- etc

#### **Dynamics of the investment environment**

- trending markets versus trading markets
- bullish environments versus bearish conditions

- strength of investment themes
- degree of market inefficiencies
- compression/dispersion of valuation discrepancies

### Style cycles

- robustness of the style versus faddishness, susceptibility to corrections
- degree of inefficiency (opportunity) versus overcrowding
- number of seasoned professionals versus marginal entrants
- investor sentiment: oversupply of capital versus redemptions
- availability and terms of financing, margin

For investors, the solution to adding value must be guided by the careful determination of the blend of performance and risk control they seek, rather than in reacting to yesterday's style shifts. Success will follow for those who (i) practise the fine art and discipline of intelligently diversifying among different yet complementary managers and (ii) make sure their portfolio of managers is always structured to achieve their own carefully defined ends in an ever-changing world.

A fundamental issue is whether it is more effective to follow a core buy and hold approach to achieving and maintaining diversification by investment style and manager or whether more value can be added by engaging in some form of active, strategic asset allocation. In the first approach, the aim is to diversify among different strategies that have proven in the past to be effective over time, and to maintain a balanced allocation among them over the long term. This buy and hold approach requires patience and fortitude. If implemented with discipline, its chief advantage is that it can avoid the typical syndrome of dropping out of perfectly viable strategies when they are temporarily out of favour and chasing after hot areas when they are already peaking. Its chief disadvantage may be that it can be too conservative and backward-looking an approach (opportunities to add value by reallocating to new areas or changing trends will be missed).

The alternative is to take a strategic approach to asset allocation by trying to identify which areas or styles will outperform going forward. This timing approach requires a contrarian attitude and/or an ability to actively redeploy resources. If implemented with courage and good timing, its chief advantage is that it can add significant value over time. Its chief disadvantage can be that value is dissipated if too much reliance is placed on experimenting with promising but untested strategies that do not measure up, or if one's timing is simply wrong.

One underlying concern for those whose quest is to find an edge is how to understand and deal with underperformance. The real question is whether such underperformance is temporary or persists for a protracted period of time. If a manager is underperforming due to something that is peculiar to his particular approach, the analysis may be relatively simple. Is the manager still consistent in his approach or has he changed his stripes? Is he maintaining his investment disciplines or has he started taking uncharacteristic risks? Is the organisation and decision-making process intact or has it been affected by some disruptive change? Are the assets under management still appropriate to the manager's style? Has the manager lost his dedication or become distracted by some change in his personal circumstances? This is why monitoring managers is so critical. Or to quote Yogi Berra again, 'You can observe a lot just by watching'.

If one concludes that the source of the underperformance is transitory, this would be the

worst possible time to throw in the towel. Rather, perseverance is warranted. Indeed, if one still has confidence in the manager, it may be an ideal time to top up one's allocation. After all, a good manager does not become stupid overnight. On the other hand, if the conclusion is that the manager has truly lost his touch, the sooner one moves on, the better.

However, what if a manager is underperforming due to circumstances beyond his control? You may have found the best navigator in the business but if that navigator is on the Titanic it won't matter how good he is. Evaluating the outlook for investment styles, as opposed to investment managers, is far more difficult because it requires evaluating market trends.

The other underlying concern in the quest for an edge is unrecoverable loss (disaster). Often, the problem with a manager whose fund is in a state of collapse is stubbornness. As one pundit put it, 'Markets can remain irrational for longer than you can remain solvent'.<sup>3</sup> Getting out of the way is often smarter for a manager than proving he is right, or as Michael Simoff, a contributor to the second edition, often reminded me, 'If you are going to panic, panic early'. When a manager embraces risk, the investor must be fully cognisant and adjust accordingly. An investor once confronted a hedge fund manager famous for putting on enormous, concentrated positions in volatile futures markets. 'How do you sleep at night knowing your portfolio is so leveraged?' demanded the investor. 'How do you sleep at night knowing you've invested your money with me', was the cool reply.

Unfortunately, despite the clarity and simplicity of so many of these principles, it can be maddeningly difficult to get them to work. So many things can (and do) go wrong. It's as if hedge fund investors are just many coyotes, forever chasing Roadrunner with all those defective contraptions from ACME Supply Co, and never able to catch him.

Now that the industry has grown so much and so many investors have matured in so many ways, are there not some obvious guide posts to successfully selecting hedge funds? To answer this question, I would like to offer the following cautionary case study. To protect the innocent (and the guilty) I cannot name the manager involved but I can assure you the story is true.

If you have read Michael Lewis' book, *Moneyball: The Art of Winning an Unfair Game*, you know that it is not really about Billy Beane or baseball statistics but rather a delicious parable about the hedge fund investor's holy grail, namely finding an edge by identifying extraordinary talent. There is an interesting quote in Michael Lewis' book that is attributed to Cyril Connolly, author of *Enemies of Promise*: 'Whom the gods wish to destroy they first call promising'.

Promising was certainly the best word to describe Manager X when he announced plans to launch his hedge fund. Relatively few funds have been launched with such a full complement of attributes. The key man had served as understudy to an established manager in the business. He even had a record that he could point to, the results of a sub-portfolio for which he had been responsible. Maybe the performance figures weren't audited, maybe they were gross of fees, but you could easily pro forma the proposed fee schedule and see how impressive the numbers were. You could even arbitrarily divide by two and still get an impressive track record!

In addition to pedigree and record, Manager X was more than smart. Some even referred to him as a genius, so keen were his investment insights. Since he was smart, he travelled with all the other smart managers in the business. What a network of beautiful minds to draw upon.

In addition to pedigree, record, intelligence and network, our new candidate was backed by a solid team. The typical hedge fund start-up is a one or two-man band with a handful of junior analysts and maybe a few support persons, all housed in bare and cramped office space

with basic, off-the-shelf turnkey systems provided by a prime broker. Not this time. Manager X knew the importance of marshalling resources. On day one he would open his doors with a broad and deep team, complete with state-of-the-art portfolio systems, proprietary research, multiple lines of credit, the works. In fact, months before opening, the team would be running live with internal capital to make sure that all systems were working smoothly in advance of taking outside money. To top it off, many of the people involved already knew each other quite well or had worked together previously.

In addition to pedigree, record, intelligence, network and organisation, the new fund not only would launch with substantial capital, it would put a cap on contributions and immediately close to new investors to avoid any ongoing distractions from marketing. So excited were investors by Manager X's promise that the fund was oversubscribed long before launch date. The very large fund of funds groups were negotiating for capacity and the small fry were worrying about having their allocations cut back, prompting inflated requests for larger subscriptions in a vain attempt to game the situation.

Finally the fund was launched and investors settled back to watch expectantly for their due diligence on such a marvellous package of ideal hedge fund attributes to pay off. In the first few months, results were modest (impatient investors called it just plain flat). No matter. The manager was simply taking his time putting money to work. This was followed by a period of further modest (flat) results. One had to understand. The investment environment had become increasingly difficult. Then a steady erosion set in. The more that performance slipped, the greater the pressure to repair the damage. Finally 'erosion' gave way to outright draw down. Hot money investors were gnashing their teeth and whining loudly at conferences to anyone who would listen. The institutions were more professional and patient about it. They simply went about their business, quietly preparing their redemption notices.

What no one's due diligence had accounted for was the possibility that the manager might simply start off on the wrong foot. His investment calls were either too early or wrong, although the two are often indistinguishable. Once the redemptions started, the fund shrank dramatically, as did the organisation. Those investors that maintained confidence in the manager and stayed in found themselves wringing their hands as performance continued to erode, prompting further shrinkage in the organisation. Thus came the next wave of redemptions, exacerbating the downward spiral.

Of course, the postscript is that once the organisation shrank to a size that was more manageable for the manager and once he was finally able to clear his head after too long a stretch of uninterrupted frustration, the markets changed, his investment style swung back into favour, he made some smart moves and performance picked up briskly. Maybe the really smart money was the investor who added at that point, reasoning that Manager X had learned so many lessons by now, that he was better equipped than ever to run a hedge fund.

So we come back to the basic conundrum all investors must face, whether to persevere or move on. Even Kate Reddy knew this. Blast, I hate quoting Allison Pearson's book, but here is our friend, Kate, addressing those trainees again:

If the horses I've backed do fall, I have to decide whether we shoot them right away or whether it's worth nursing that broken leg back to health. Remember, ladies and gentlemen, compassion can be expensive but it's not necessarily a waste of your money.

In closing, I offer two more quotes. The first is from Winston Churchill, who said, 'Never

give in, never give in, never, never, never . . . .’ The other is from W.C. Fields, who said, ‘If at first you don’t succeed, try, try again. Then quit. No use being a damn fool about it’. A veritable ying and yang of investment philosophy. Can they both be right? I will leave it to you to decide. In the meantime, I hope you find the material in this book to be valuable and useful and if you know any movie studio agents, please show them the book.

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<sup>1</sup> 'Our market judgement has been very uneven, but if you're hedged, you can do it all on stock selection, which is where we're good.' A.W. Jones, quoted in *New Breed on Wall Street*, Martin Meyer, MacMillan, 1969.

<sup>2</sup> Contrast the above quote with the following attributed to Michael Steinhardt, also taken from Meyer's *New Breed on Wall Street*: 'We emphasize leverage and stock selection, not hedges. You can delude yourself, but the hedging doesn't mean much'. Or the comment made by another manager: 'It's not a difficult intellectual problem for us. We're not wedded to any techniques. When the market changes, we just change along with it'.

<sup>3</sup> The definition of an investment that is down 90 per cent is one that was down 80 per cent and then got cut in half.