

Introduction & brief history of the hedge fund industry

Relatively little is known about hedge funds despite the fact that they date as far back as the early 1950s. This is primarily because hedge fund managers have traditionally kept a low profile. Until recently hedge funds managed money, almost exclusively for high net worth investors, have therefore preferred to avoid the media spotlight. The result has been that these investment instruments have been poorly covered by mainstream financial journals.

This is somewhat ironic as the first hedge fund manager is generally considered to have been AW Jones, who was a journalist. He created the first long-short equity fund in 1952, although the technique of shorting stocks had already been established by the time Jones started his fund.

The hedge fund industry has developed in numerous different ways over the last 50 years. Today there are between 12 and 20 different hedge fund strategies, depending upon how you define them, and about 9,000 funds with approximately \$1 trillion in assets. No one knows precisely how many hedge funds there are, or what exactly the industry has in assets. This is a reflection of the diverse nature of the business, the fact that it is largely unregulated and its media-averse origins.

The first time the public became aware of hedge funds was during the period when the industry was dominated by global macro managers, in the late 1980s and early 1990s. But global macro is not typical of the hedge fund industry being as it is a strategy that takes large bets on the movements of markets. The view that all hedge funds are buccaneering, high risk and in some way inherently dangerous investment instruments probably dates from this period. After the UK was expelled from the European exchange rate mechanism in 1992 the name of George Soros was almost synonymous with hedge funds. Even today, 13 years later, many people believe that all hedge funds are run in the same way as his Quantum Fund when in fact there are few that are similar. Hedge funds are still described in the media as being high-risk, high-return investment products. Some of them are but the majority of them do not fall into this category.

The great boom in hedge fund investing began towards the end of the 1990s bull market. The amount of money invested in hedge funds has grown from approximately \$400 billion in 1999 to about \$1 trillion today. (This is still small by the standards of the mutual fund industry. The twenty five largest US equity mutual funds alone have assets of about the same size of the entire global hedge fund industry.) The growing involvement of traditional institutional investors in the hedge funds is the most important of several reasons for this relatively large asset growth over the last five years. Pension funds, insurance funds, banks and endowments, for example, are drawn to these products because they are considered to be a good means of obtaining positive returns that are not correlated to other parts of their portfolios.

Explaining Absolute Return investing

What is a hedge fund? Ask ten different investment professionals and you will probably get 10 different definitions. There is no standard or easy way to define them. The term hedge fund is used to describe an ever growing number of investment vehicles, many of which have different objectives and investment styles.

For example, there is all the difference in the world between a conservatively run equity market neutral fund, on the one hand, and a highly leveraged merger-arbitrage fund, on the other. And these days hedge funds are run from mainstream fund management houses as well as by small, specialist boutiques which have been specifically set up for this purpose.

Most hedge funds seek to leverage their returns and will borrow money in order to do this. However the amount of leverage used varies by strategy and indeed even by funds within the same strategy. And hedge funds have the ability to go short, meaning that they can make money when markets decline as well as go up. However not all hedge funds necessarily use much leverage or go short.

(Formon & Associates is careful to select funds that use very little leverage if it is used at all)

But there is one characteristic that all hedge funds share: every hedge fund is seeking to achieve what is known as an Absolute Return.

The term Absolute Return is used to contrast hedge funds with mainstream investment products which are 'long only' in that they cannot go short and therefore bet on securities declining in value. Long only mutual funds, for example, are to a certain extent correlated to the markets in which they operate. Long only investments like equity mutual funds will tend to do well when the market in which they operate is rising and poorly when it is falling. In relative terms a long only fund can even be considered to have had a good year when it has lost 10 percent of its overall value if the index that it is benchmarked to has lost, say, 20 percent. Conversely it might be considered to have done badly if it gained 10 percent in a year in which the index that it is benchmarked to had gained 20 percent.

(Formon & Associates recommends and invests in Exchange Traded Funds (ETF) as the costs associated with Mutual Funds is far higher)

The objective of hedge funds are very different; it is to make positive returns in all market conditions. An absolute return is a positive return. It should do better than the risk free rate of return, such as US Treasuries. An absolute return fund should be aiming to do at least as well as US Treasuries, irrespective of market conditions. This is achieved by shorting securities, as well as going long, and by exploiting arbitrage opportunities in markets. Hedge funds claim to be able to preserve their investors' capital by making a positive return – or at least losing less money than long only funds when markets are performing poorly.

The different hedge fund strategies

Depending upon how they are categorised there are anywhere between 12 and 20 hedge fund strategies, with new ones coming on stream all the time. There are considerable differences between these strategies. Some are more cyclical than others and will perform best in certain market conditions. A number of these strategies can suffer from capacity constraints. Managers in some strategies rely upon exploiting inefficiencies in markets for their success whilst others depend upon making the right calls on the direction of markets.

Long-short equity is the most common strategy for investors diversifying into hedge funds for the first time. But it is only one of these 12 strategies and it is therefore advisable to have some idea about what each of these does, particularly if considering entering the hedge fund world via a diversified fund of funds.

There are various different ways to categorize hedge fund strategies. One common way is to group the strategies into the following categories: event driven, long-short equity, relative value and others.

Event Driven

Distressed

Distressed funds seek to invest in the equity or debt of firms close to or at bankruptcy in anticipation that when these firms are restructured the value of their securities will have increased.

(Formon & Associates uses two funds here in Thames River Hillside Apex and Ashmore EMLIP in this category)

Merger Arbitrage

Typically merger arbitrage funds seek to invest in the stock of companies that will be taken over. These shares usually trade at a discount to the price being offered by the company that is seeking to do the takeover. Often merger arbitrage funds will hedge their positions in the company being acquired by shorting the stock of the company doing the takeover (as the acquiring company's shares tend to fall during the takeover).

Multi Strategy

Multi strategy funds are funds that follow a number of different hedge fund strategies. They are popular with investors that are unsure about what is going on in markets and therefore wish to maintain exposure to a variety of different strategies at the same time.

(Formon & Associates uses Platinum Premier in this category)

Long-Short Equity

Long-short managers – those that are directional, rather than market neutral – seek to invest in companies whose stock price is expected to rise and to short the stock of those companies in which it is anticipated that they will fall. The short

positions reduce the market exposure of the fund's long positions. (For equity market neutral please see the Relative Value category below.)

(Formon & Associates uses Magnum Chaparral in this category, while there is an element of this in LIM Asia Commodities which we use)

Relative Value

Convertible Arbitrage

Typically convertible arbitrage funds buy a company's convertible bond and short the company's stock. Convertible bond managers seek to identify the part of the convertible bond that will provide the best return (such as its yield) whilst hedging other areas.

Equity market neutral

Equity market neutral funds are long-short equity funds that try to pair their long and short positions, usually by matching stocks in the same sector. Market neutral funds are generally considered low risk with little volatility and limited correlation to equity markets.

Fixed Income

Fixed income hedge funds, as their name implies, are funds that take long and short positions in fixed income markets. There are a wide variety of fixed income hedge funds seeking to exploit different areas of the yield curve.

(Formon & Associates uses PIMCO Total Return Bond Fund here)

Others

Global Macro

Global macro funds tend to take macro economic judgments on markets and then try to capture the market trends that they have forecast, often by taking a sizeable and leveraged long or short position. Global macro funds are therefore taking bets on any kind of market movement that they believe that they can profit from.

(Formon & Associates uses Weaving Capital for this strategy)

Managed Futures/CTA

Managed futures and CTA managers are seeking to exploit inefficiencies in markets based upon technical, rather than fundamental, analysis. Most of these funds operate in the managed futures markets and are driven by the computer systems that they have developed to assist them in their trading.

Risk & operational issues

There is a generally held view that hedge funds are in some inherent way ‘risky’ investments. This is probably because of the media. It only tends to pay attention to hedge funds when there is a disaster, such as with the LTCM catastrophe in 1998. Another reason they have a reputation for being risky is because the most famous of the original names of the industry were macro fund managers, as already covered. However global macro is different from many other hedge fund strategies in that it is not seeking to eke out a return by exploiting inefficiencies in markets, as many hedge funds are attempting to do, but to take large bets on market movements.

The truth is that many hedge funds are no more risky than, say, most equity investments. The majority employ derivative instruments to reduce risk rather than to enhance it, for example. In fact many hedge funds are less volatile than most standard long only equity mutual funds.

Nevertheless, as with all other forms of investing, there are risks associated with hedge funds – albeit different ones than those most people new to these investment products would suppose. Some of this risk is measurable as hedge funds employ relatively sophisticated risk models in order to gauge the level of risk that they are undertaking with their investment strategy.

The greatest risk for hedge fund investors tends to be what is not factored into these models – and this can incorporate a wide variety of things. It ranges from day-to-day operational issues through to major unforeseen macro economic events that affect markets. For example, many hedge funds found themselves in difficulty when the US Federal Reserve unexpectedly raised interest rates in the first quarter of 1994. Similarly large numbers of hedge funds were caught out when the Russian government defaulted on its debt repayments in 1998. But it would be unfair to single out hedge funds from major market events; investors in mainstream funds can also be badly affected when these things occur. However it is true to say that hedge funds, which promise absolute returns, are not immune either.

Operational risk

There is a degree of operational risk associated with investing directly in some hedge funds that does not exist with mainstream mutual funds, for example. One industry study concluded that 50 percent of hedge fund failures could be blamed on operational issues whilst just 38 percent were the result of investment mistakes.

What is operational risk? It is something that everyone talks about with regard to hedge funds but is rarely defined. Whilst it is difficult to define it is near impossible to quantify. One way to attempt to define operational risk would be to describe it as all the things that could hurt an investor that are associated with operating a hedge fund. These include issues relating to misrepresentation of the fund’s investment performance, unauthorised trading and misappropriation of assets that are invested in the fund.

Major disasters, such as the frauds, are extremely rare but do occur from time to time. When this happens they are well covered in the press and this, again, adds to the view that hedge funds are in some way inherently dangerous and risky for

investors. Frauds are almost impossible to spot, even for sophisticated hedge fund investors. Some very experienced investors were fooled by Michael Berger's Manhattan Fund, for example.

One of the reasons inexperienced hedge fund investors are advised to approach this asset class via a fund of hedge funds is to reduce operational risk. So even in the unlikely event one of the underlying fund has a disaster (for operational reasons or indeed other) the overall performance of the fund of funds should not be too badly affected.

For someone considering investing directly into a hedge fund it is important not to invest in something that is difficult to understand. Even supposedly sophisticated institutional investors sometimes forget this most basic rule of investing. Many institutions invested in LTCM without understanding what they were doing and subsequently lost a lot of money. Another tip is to read the prospectus. Hedge fund managers can do almost anything they want except invest in real estate. It is absolutely vital that investors understand exactly what is laid out in the prospectus.

(Formon & Associates has a full-time dedicated team to continually monitor the fund managers and has a strict due diligence process)

Use of leverage and derivatives

Many hedge funds employ leverage although this does not necessarily add to the level of risk undertaken by the fund. In fact an astute use of leverage in the face of volatile market conditions can often be a safer way to invest than going long only. And most hedge fund managers that employ leverage do so within a hedged portfolio. How risky is the use of leverage? The standards and levels of leverage are different for each strategy, so it is difficult to generalise. It is estimated that between 15 and 20 percent of the assets of the hedge fund industry are leveraged.

Again it is difficult to generalise about the use of derivatives in terms of risk. The majority of managers use derivatives to reduce, rather than enhance, risk. And derivatives can also be used simply as a fast and efficient means to gain exposure to a market. Rarely are derivatives used by managers to enhance risk.

However there is a concern in the pricing of what are known as OTC derivatives. OTC (over the counter), as opposed to exchange traded, derivatives are difficult to price and provide room for unscrupulous traders to hide their losses.

Boutiques vs. mainstream fund groups

Some people believe that by investing in the hedge funds run by mainstream fund groups a lot of the operational risk issues just outlined can be avoided, or at least substantially reduced. On the other hand many of the most experienced and successful fund of hedge fund managers say that they prefer to invest in the hedge funds of the specialist, independent managers – often referred to as the boutiques. (Boutiques are independent businesses that tend to be run by the managers that have set up their own hedge fund and therefore have a stake in the business.)

However fund of fund managers will also say that they prefer to invest in boutiques that function well on an operational level, as well as on the investment side. Well run hedge funds are likeliest to be the ones that produce the best returns in the long term. These are the businesses that stand the best chance of being successful for

their investors, and owners, in a variety of different market conditions. In short, most successful hedge funds are also well run businesses.

Regulation

The activities of the vast majority of hedge funds are not governed by financial regulators such as the Financial Services Authority in the UK or the Securities and Exchange Commission in the US. Most hedge funds are registered in offshore centres such as the Cayman Islands. The chief reason most hedge funds register offshore is because it provides them a much greater degree of flexibility and freedom than they would have if they were regulated by the FSA, the SEC or another such entity.

The regulatory situation regarding hedge funds is changing around the world. Several countries now permit fund of hedge funds to be distributed to mainstream investors. Hong Kong and Singapore were the first to do this and now various European countries have followed suit. Germany, for example, permits fund of hedge funds to be distributed to its nationals, as does France. And Luxembourg and Ireland, the two countries where much of the European asset management industry has based its mutual funds, have recently amended its laws to make single manager, as well as fund of hedge funds, more accessible to investors. Both the UK and the US have been reviewing their rules and regulations on hedge funds. US based hedge funds will have to be registered with the SEC in 2006.

Capacity

Capacity, or the lack of it, is a growing issue in hedge fund investing. A number of people believe that there is not enough available capacity with successful hedge fund managers to cope with all the new money that is coming into the industry. As well as manager capacity questions there are also strategy capacity concerns.

In some strategies there are only a limited number of trading opportunities. The more managers that pursue these opportunities the more difficult it is therefore for anyone to make money from them. It is believed that the ways of making money in arbitrage and relative value funds has reduced in recent years as more managers have been chasing a diminishing number of trades. The problem for investors is that it was chiefly these strategies – the ones that were exploiting inefficiencies in markets – that offered them the best opportunity of obtaining positive returns that were not correlated to their long only investments.

As the ways of making money in arbitrage and relative value funds has reduced in recent years more hedge fund managers have become directional. In other words more of them are obtaining their returns from making calls on the direction of various markets rather than from those that are exploiting inefficiencies in them. Hedge fund returns have been growing closer to the performance of markets recently.

One solution to the strategy capacity problem is obviously to come up with new strategies. That is being worked on. Opportunities in energy trading and commodities are being explored at the moment, for example. And other strategies, in addition to these, will no doubt also come along.

(Formon & Associates has recently added LIM Asia Commodities to its portfolio range)

Manager capacity is just as important an issue. Some of the most successful managers with proven track records are closed to new investors – although a fair proportion of these will take new money from fund of fund managers with whom they have a relationship. This means that some of the new money coming into the industry has to be allocated to managers that are less experienced or who might not have such an outstanding track record.

Of course there are new managers setting up hedge funds almost every day, which means that the talent pool is continually being expanded. And there are very successful managers with outstanding track records which are not closed. But there is still a danger the relatively large quantity of assets coming into the hedge fund industry will not all be able to be allocated efficiently in the short term.

The task of finding the right strategies and managers is going to become ever more important in the future given the relatively large amount of money that is looking to be invested in hedge funds. Innovations in strategies and the growing number of managers coming into the industry will reduce the problem. But in the short term capacity constraints are an issue in some areas of the industry.

Performance

There is a trend to lower volatility in hedge fund performance at the moment, and some believe that this will make it more difficult to achieve double digit returns in the future. This is put down to the fact that much of the new money entering the business is said to be more risk averse than was the case in the 1990s. Institutional investors, for example, tend to look for funds with low volatility when allocating to this asset class. If this trend continues hedge fund investment could become more of a means of achieving capital preservation rather than rapid accumulation.

There will always be hedge funds with double digit returns; the point is that they may well be a smaller proportion of the universe of managers than was the case until recently. Individual manager selection, to repeat, is certain to become even more important than it already was.

(Formon & Associates has dedicated team to continually monitor and seek out these managers in order to maintain superior returns than the Hedge Fund Index)

It is therefore becoming increasingly difficult to generalise about overall hedge fund performance. Within these strategies there can be an enormous difference in the performance of individual funds.

Fund of funds

It is advisable to look at investing in this asset class, at least to begin with, via a fund of funds structure.

Fund of hedge funds have grown in number and size substantially over the last few years. They have proved to be popular with both private and institutional investors and have become the most common route into the industry for new money. A recent industry study reported that fund of funds now are responsible for half of all the hedge fund industry's assets. In the future they may very well be responsible for the majority.

Investors like fund of fund because they are effectively outsourcing all the many issues relating to hedge fund investing to an organisation that is expert in this area. For private investors they are infinitely more accessible than underlying funds as regulators in many countries now allow fund of funds to be distributed to the retail market. Fund of funds are obviously a good way of gaining exposure to the wide variety of managers and strategies. Many of these managers would not otherwise be accessible to investors.

(Formon & Associates uses Platinum Premier in the category to gain exposure to these managers)

But just as there are an almost infinite variety of hedge funds so they are a wide array of fund of funds. There are approximately 700 fund of hedge fund groups with something close to 2,000 fund of funds. At close to 2,000 funds it is increasingly difficult to generalise about the overall performance of the fund of hedge funds industry. Fund of funds vary almost as much as single manager funds. At one end of the scale there are the multi billion dollar fund of funds mainly serving institutional clients. At the other end of the scale there are boutiques investing on behalf of a few individuals. And some fund of hedge funds are diversified whilst others specialise on specific strategies.

Conclusion

The hedge fund industry is changing substantially at the moment. It is becoming much more accessible to mainstream investors and is consequently less secretive and more transparent than it once was. The enormous surge in assets that the industry has experienced over the last few years has put hedge funds more into the spotlight than they used to be. Nevertheless hedge funds continue to be poorly covered by the media and are invariably described as high risk investment instruments to distinguish them from other forms of investing.

A better way to view hedge funds would be to think of them as three dimensional investment instruments. Hedge funds are able to use a much wider variety of means to achieve their goals than long only investment products. Hedge funds can sit almost anywhere on the risk, return spectrum. The fact that they are able to do this in a variety of different market conditions is probably the chief reason that they have become so popular in recent years.