

Hedge Funds – How Did Bernie Do It?

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“Wealth is not measured by just what we have, but rather by what we have for which we would not take money.” - Anonymous

Every investor is familiar with the story of Bernie Madoff. What we know is that he created an enormous Ponzi scheme using hedge funds as a backdrop. What most investors do not know is what a hedge fund **really is**. In this week’s article we will look at how hedge funds came into existence, what they really are, and how they fit into our clients' overall portfolios.

A hedge fund is a private, aggressively managed investment fund that utilizes sophisticated strategies in both the international and domestic markets. These funds are designed to offset losses during a market downturn and/or provide additional returns during a market upswing.

The first hedge fund began in 1949 and was created by sociologist and financial journalist Alfred W. Jones. To neutralize the effect of overall market movement, Jones balanced his portfolio by investing in both “long” and “short” positions. A “long” position is made by an investor that expects a stock to rise in value. Conversely, a “short” position is a way for an investor to profit from the falling price of a stock. Jones was therefore the first money manager to combine a hedged investment strategy using leverage and shared risk. Jones’ fund outperformed the best mutual fund for years. By 1968 there were almost 200 hedge funds, but many ceased trading during the Recession of 1969-70 and the 1973-1974 stock market crash. The decline of hedge funds lasted over 15 years. However, the bull market of the late 1980s created more high net worth investors. These investors, looking for enhanced returns, started to invest in hedge funds. This trend continued into the 1990s and the new millennium. As of January 2011, total assets under management in hedge funds were estimated at almost \$2 trillion.

Hedge funds are open to a limited number of accredited or qualified investors who meet a criteria set by regulators. As they are not generally sold to the “common investor”, they have not historically been subject to the same restrictions that govern other investment fund advisers. However, hedge funds must comply with many of the same statutory and regulatory restrictions as other institutional market participants. New regulations were introduced in the U.S. and EU in 2010. These regulations required managers to report more information, leading to greater transparency. Due to recent unfavorable press regarding the illegal practices of some fund managers, such as Madoff, the perception in the general public is that hedge fund investing carries significant risk. According to the *Financial Times*, “big hedge funds have some of the most sophisticated and exacting risk management practices anywhere in asset management.” They are likely to have comprehensive risk management systems in place. Most have “risk officers” who both measure and manage risks, but are otherwise not involved in trading.

These funds employ a wide range of trading strategies. Generally speaking, their investment strategies fall into four main categories:

Global macro: Investments take sizable stakes in the bond or currency markets in anticipation of global macroeconomic events, in order to generate a risk-adjusted return.

Directional: These funds utilize market movements, trends, or inconsistencies when picking stocks across a variety of markets.

Event driven: The strategies of these funds involve situations in which underlying investment opportunity and risk are associated with an event such as corporate consolidations, recapitalizations, bankruptcies, and liquidations.

Relative value: Strategies in these funds take advantage of relative discrepancies in price between securities. The price discrepancy can occur due to mispricing of securities compared to related securities, the underlying security or the market overall.

As hedge funds add diversification to investment portfolios, they can be a tool to reduce overall portfolio risk exposure. Managers use particular trading strategies and instruments, with the specific aim of reducing market risks and producing returns relatively uncorrelated with market indices. According to a report by the Hennessee group, hedge funds were approximately one-third less volatile than the S&P 500 between 1993 and 2010.

Performance statistics for individual hedge funds are difficult to obtain, as the funds have historically not been required to report their performance to a central repository. One estimate however states that hedge funds returned 11.4 percent per year, representing a 6.7 percent return above overall market performance before fees. Another agency reporting between 2000 and 2009 states that hedge funds outperformed other investments, with stocks falling -2.6 percent per year over the decade and hedge funds rising +6.54 percent.

These funds are typically open-ended, meaning that the fund will periodically accept further investment and allow investors to withdraw their money from the fund. Shares are not typically traded, and there is not profit distribution prior to redemption. This contrasts with closed-ended funds, which either have a limited number of shares which are traded among investors and which distributes profits, or which has a limited lifespan at the end of which capital is returned to investors. Hedge funds use a variety of fee structures and their annual management fee may range from 2 percent to 4 percent. A difference between hedge funds and more traditional funds is a hedge fund manager receives a performance fee of 20 to 50 percent. The fee is calculated as a percentage of the fund's profits, usually counting both realized and unrealized profits.

According to the 7Twelve Portfolio concept, hedge funds are attractive because they have a modest correlation with traditional assets, such as equities. This means that they potentially have a valuable role as diversifiers, reducing overall portfolio risk. However, investors must keep in mind that hedge funds are highly individual and rely for the most part on the experience and knowledge of the fund manager. TPI has done the due diligence for our clients and is positioned to make recommendations based on individual client risk tolerance. Please contact us if you have any questions or comments.