Getting Started in

HEDGE FUNDS

SECOND EDITION

Daniel A. Strachman

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To My Wife, Felice,
and My Daughter, Leah

Contents

Acknowledgments

The idea for the first edition of this book came to me in the mid-1990s while working at Cantor Fitzgerald and, as a result of a number of unique events, the book became a reality in 2000. Now Wiley is publishing a second edition. Over the past year or so, I have tried to update the pages of this book to make it as relevant as possible for those interested in learning more about hedge funds and the hedge fund industry. I hope that you, the reader, find it worthwhile and, more importantly, worthy of your time. Your interest in hedge funds has made this book possible, and I thank you very much for your interest in this fascinating subject.

Like it or not, hedge funds are here to stay. As an investment vehicle they are no longer considered an alternative investment but rather an important investment in a diversified portfolio. And although hedge funds have not yet become "traditional," in the months and years ahead the differences that separate traditional investments and hedge funds are going to become smaller and smaller. Hedge funds are not going anywhere because people understand the value of creating a portfolio that is hedged against market volatility. Hedge funds are for investors of all shapes and sizes and play an important role in the future of the financial markets. Hedge funds are important and are finally getting the respect they deserve.

To write this book I called on many of the usual suspects who have helped me over the years to make me look good in print. Without their help, I probably would not have been able to complete this project. They are of course Viki Goldman, the greatest librarian and researcher I have ever met and Sam Graff, the only true newspaper man left in the tri-state area. Thank you for the hard work you always contribute to make my work better. I truly appreciate it.

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DANIEL A. STRACHMAN

New York, New York
June 2005

Why Hedge Funds?

In the past eight years, hedge funds have gone from relative obscurity to being a topic of cocktail party chatter and reports on the evening news.

Hedge funds and those who manage and invest in them have become the most talked about investment since the Internet initial public offerings (IPOs). The rise from obscurity began with the astronomical returns that many hedge funds posted during the euphoria that has swept the investment world in recent years. Now, the interest has been sparked by the opposite: losses racked up in the past few years by many of the hedge fund world's most famous and sought-after managers. At the beginning of the new millennium, the issues for investors were "How do I invest?" and "How much can I expect?" At the halfway point of the decade the issues had become "How do I get my money out?" and "Is there anything left?" After the technology bubble burst and investors realized that there was more to making money in the markets than simply buying companies with .com in their name, they began to look to alternatives. In this case the alternative happened to be the hedge fund. Why did they look to hedge funds for returns? The answer is the same as that given by Willie Horton when he was asked why he robbed banks—because that's where the money is. Unlike the technology bubble that lasted a mere three years, the hedge fund craze is here to stay. Once again, the greed that was deemed good in the 1980s is back in favor among investors. However, today instead of hoping to ride the tails of takeover artists, investors are looking to hedge fund managers for the returns they so desperately crave.

Over the years, hedge fund managers, like most money managers as a group, have experienced their ups and downs. In the late 1990s and the early part of 2000, many of the investment world's biggest and brightest stars posted significant losses and in some cases were forced to liquidate their hedge funds. Today as then investors do not want to believe that these so-called Midas traders could make such drastic mistakes and run into so much trouble. Since the initial stories broke, the markets have turned for the better. As can be expected, some funds were able to stop the hemorrhaging, having been left with significantly less money under management. Others have seen their funds grow by leaps and bounds. In the midst of the carnage many pundits believed that the hedge fund business was finished. The truth is exactly the opposite. Hedge funds are here to stay. Sure, some may be wiped out or close their doors voluntarily, but there will always be someone else willing to open another hedge fund.

prime broker
service offered by major brokerage firms providing clearance, settlement, trading, and custody functions for hedge funds.

Not only are hedge funds thriving, the *prime brokers*, administrators, lawyers, and accountants who service them are, too. The reason? Wall Street is about making money—and running a hedge fund provides one of the greatest ways to do it.

This book is intended to provide an overview of the hedge fund industry. It covers many of the most important subjects surrounding running and investing in these investment vehicles. Certainly there is no one way to invest in hedge funds, as there are so many different funds with just as many different investment strategies and philosophies. A key goal of this book is to provide an objective view of the industry, one that gives you an understanding of the complex world of hedge funds that has dramatically changed since the concept was created in the late 1940s.

The growing importance and impact of hedge funds make it a subject that all investors should seek to understand. That's especially true because there are so many misconceptions about the industry.

Today, many people outside Wall Street believe that Long-Term Capital Management LP and George Soros are the sole representatives of the entire hedge fund industry. This is just not the case. Although it is difficult to give an exact number, at last count there were more than 8,000 hedge funds with roughly $850 billion under management. While the Soros organization is generally considered to be the most famous hedge fund manager and Long-Term Capital is probably the most notorious hedge fund organization, they are a far cry from representing the entire industry. The industry stretches all over the world and ranges from men and women who manage titanic sums of money to those who manage a relative pittance.

The common perception is quite different from reality. The perception of the hedge fund world is that of gunslingers and traders who manage billions of dollars by the seat of their pants. The reality is that most hedge funds have far less than $100 million under management and, in most cases, every single trade that is executed is a calculated move. But no matter how often or how much the managers talk to the press, they can't seem to shed the stigma of being gunslingers. A careful look, however, will show there is probably more risk to investing in an ordinary mutual fund than in most hedge funds because hedge funds are able to go both long and short the market. Mutual fund managers are generally only able to go one way—long the market, which means that should the market enter a prolonged period of negative returns it will be extremely difficult for the mutual fund to put up positive numbers—whereas a hedge fund manager can take advantage of the downside by going short. Another critical difference between hedge funds and mutual funds that in my opinion makes them less risky is that in most cases, hedge fund managers put all of their own capital into their own fund. In short, they put their money where their mouths are. The losses or gains directly affect the size of their own bank accounts along with those of their investors.

People who think that hedge funds are run by ruthless men and women looking to make a buck at any cost do not understand the basic concept of hedge fund management. Although a few managers may operate in this fashion, most do not. Most are interested in two things: preserving capital and making money for their partners. The hedge fund industry is a stay-rich business—not a get-rich business. If you ask managers what is the most important aspect of their business, they will tell you: the preservation of capital. It takes money to make money. If you lose capital, you limit your resources to invest further and you soon will be out of business. By limiting risk and not betting the ranch on a single investment, they will live to invest another day. For hedge fund managers, slow and steady wins the race. The men and women who run hedge funds are some of the most dedicated money managers in the world. This dedication shows in their ability to continually outperform the market.

There is a big difference between hedge funds and mutual funds. The first is the size of the industry. The largest hedge fund complex has less than $20 billion in assets under management while the largest mutual fund has more than $100 billion in assets under management. All mutual funds are highly regulated by the Securities and Exchange Commission (SEC) and are open to any and all investors, assuming they can meet the minimum investment requirements. Hedge funds are not open to the general public, only to accredited investors and institutions. Accredited investors as defined by the SEC are individuals who have a net worth of a million dollars or who have had net income of $200,000 in the past two years and have reasonable expectations of continued income at that level. Hedge funds are not allowed to advertise.

The SEC does not allow mutual fund managers to use *derivatives* or to sell securities short to enhance performance. Hedge funds can use any legal means necessary to produce results. Most mutual fund managers are paid on the basis of the amount of assets they attract, while hedge fund managers are paid for performance. Unlike mutual fund investing, hedge fund investing is about calculating how to perform in good and bad markets through the use of investment strategies that consist of *long positions* and *short positions*. Whereas mutual fund managers are limited to taking long positions in stocks and bonds, hedge fund managers are able to use a much more extensive array of investment strategies such as the use of shorting and derivatives. It is all about capital preservation and healthy returns.

derivatives
securities that take their values from another security.

long position
a transaction to purchase shares of a stock resulting in a net positive position.

short position
a transaction to sell shares of stock that the investor does not own.

In the large hedge fund complexes, accountability for the funds rests with multiple managers, analysts, and traders. In smaller organizations, a single individual is accountable for the funds. Most hedge fund organizations usually consist of a small staff working with the manager. While the size and scope of the organizations vary, all hedge funds seek to provide investors with a valuable service: capital preservation mixed with healthy returns. The common theme among all hedge fund managers is to use investment strategies that create a diversified portfolio that over time will outperform the market regardless of market conditions.

The purpose of this book is to provide an introduction that explores these types of operations. I purposely did not examine managers and funds that are covered in the popular press. Instead I spent time getting to know managers who are known on Wall Street but not outside it. They manage portfolios ranging in size from $2 million to over $2 billion. In some cases they operate by themselves out of a small office with one assistant. Others have multiple offices around the globe with staffs of a hundred or more.

The idea of the book is to provide you with a clearer view at how these people operate in the various markets that they trade. Because each employs different trading methodologies and investment philosophies, this book provides you with a unique look at the business of managing money. It will, I hope, give you the insight you need to find alternative means to achieve your investment goals. While all the managers are different, they all have two things in common: They use some piece of the same business model and each is an entrepreneur.

While profiles of managers make up a significant portion of this book, other pages describe the history of the industry and how it has evolved. George Soros, Michael Steinhardt, and Julian Robertson, unlike what many have been led to believe, did not create the hedge fund industry. They may have advanced the concept, but the idea and the term were created by journalist Alfred Winslow Jones, a visionary who used his knowledge of sociology and his reporting skills to come up with the idea in the late 1940s while researching an article for *Fortune* magazine.

leverage
means of enhancing return or value without increasing investment. Buying securities on margin is an example of leverage.

Jones's basic concept is simple: By combining the use of long and short positions coupled with the use of *leverage*, a manager should be able to outperform the market in good times and to limit losses in bad times. Today most hedge funds employ the same concept. Like everything else, however, each manager uses his or her own unique style and therefore some may use more leverage than others, and some may not go short at all. All are out to beat the indexes while limiting losses. The right way to look at hedge fund performance is by absolute returns, regardless of market conditions.

Hedge funds continue to thrive because this concept works.

Evidence lies in the number of people and firms that have grown to support hedge funds. Many of these supporting cast members believe that providing goods and services to the industry will be just as profitable as investing in or operating a hedge fund. These people range from consultants and brokers to lawyers and accountants. It is very easy to find a firm that will not only recommend a manager to potential investors but also help a manager find office space, set up phone lines, and install computers. People from all walks of Wall Street have gotten into the hedge fund business, making it relatively easy not only to open a hedge fund but to learn about and invest in one as well.

To understand how hedge funds operate, you need to understand the styles and strategies their managers use. While most conventional money managers own securities in hopes of price appreciation, many hedge fund managers employ alternative strategies that do not rely on the market's going up: short selling, risk *arbitrage*, and the trading of derivatives. Most hedge funds employ strategies that allow them to hedge against risk to ensure that no matter which way the market moves, they are protected against loss.

arbitrage
a financial transaction involving simultaneous purchase in one market and sale in a different market.

There are many benefits to investing in hedge funds. First, I believe that the best and brightest minds in money management have migrated from mutual funds and brokerages to the hedge fund industry. Paying managers for performance ensures that the investor is going to get the fairest shake and that their interest is aligned with the investor's. Add the fact that managers have their own money in the fund and that they can go long and short, and that should be enough for investors to know that their money is in good hands.

As an investor, however, you need to understand what you are getting into and be willing to do research to learn about the manager and the various strategies employed. One of the biggest mistakes people make with any kind of investment is not taking the time to do research. A smart investor is a well-researched investor. If a manager is unwilling to spend time discussing strategy, skills, and background, then investors probably should look elsewhere.

Another mistake is chasing so-called hot money—which is money that flows to the best-performing manager for a quarter or two. The right thing to do is to find managers who perform consistently over time. As an investor you should expect up months and quarters and down months and quarters and, more important, information regarding both periods. It is important to understand where the manager's performance is or is not coming from.

One of the basic tenets of sound investing is portfolio diversification. You should expect managers to explain how they employ it in their portfolios. One of the greatest lessons of the near self-destruction of Long-Term Capital is the need for investors to understand how and where their money is being invested. The idea that a manager wants an investor to have blind faith is ridiculous. Managers should be held accountable and investors should demand to know what is being done with their money.

Despite lapses by some managers and all the media attention, writing this book has made it even more obvious to me that hedge funds are good for investors and managers alike. I believe that by the time you are done reading this book you will believe this as well.

Chapter 1

Hedge Fund Basics

For the better part of the past twenty years, the only time the press mentioned hedge funds was when one blew up or some sort of crisis hit one of the world's many markets. All that changed in the late summer of 1998. The currency crisis in Asia spread to Russia, then crept into Europe, and finally hit the shores of the United States in mid-July and early August. Many who follow the markets assumed that things were bad and were going to stay that way for a very long time. And of course the first people who were looked at when the volatility hit was the hedge fund community. Although no one knew for sure what was going on and who and how much was lost, one thing was clear: Many of the most famous hedge funds were in trouble.

After weeks of speculation and rumors, the market finally heard the truth: The world's "greatest investor" and his colleagues had made a mistake. At a little before 4 P.M. eastern standard time (EST) on Wednesday, August 26, Stanley Druckenmiller made the announcement on CNBC in a matter-of-fact way: The Soros organization, in particular its flagship hedge fund, the Quantum Fund, had lost more than $2 billion in recent weeks in the wake of the currency