GETTING STARTED IN
HEDGE FUNDS

FROM LAUNCHING A HEDGE FUND TO NEW REGULATION,
THE USE OF LEVERAGE,
AND TOP MANAGER PROFILES

THIRD EDITION

DANIEL A. STRACHMAN

Getting Started in

HEDGE FUNDS

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WILEY

John Wiley & Sons, Inc.

Published by John Wiley & Sons, Inc., Hoboken, New Jersey.
Published simultaneously in Canada.

Library of Congress Cataloging-in-Publication Data:
Strachman, Daniel A., 1971-
Getting started in hedge funds: from launching a hedge fund to new regulation, the use of leverage, and top manager profiles / Daniel A. Strachman. – 3rd ed.
p. cm. – (Getting started in..... ; 88)
Includes bibliographical references and index.
ISBN 978-0-470-63025-9 (pbk.); ISBN 978-1-118-01896-5 (ebk);
ISBN 978-1-118-01897-2 (ebk); ISBN 978-1-118-01898-9 (ebk)
1. Hedge funds. I. Title.
HG4530.S837 2010
332.64'524–dc22

2010023267

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

To my wife, Felice,
my daughter, Leah
and my son, Jonah

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Acknowledgments

The idea for the first edition of this book came to me in the mid-1990s while I was working at Cantor Fitzgerald and, as a result of a number of unique events, that book became a reality in January of 2000. Now some ten years later, Wiley is publishing a third edition.

I started working on this revision in December 2009, and over the past four or five months, 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 pursuit of 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 I believe that the differences that separate traditional investment funds or mutual funds and hedge funds are going to become smaller and smaller. Hedge funds, no matter what the people in Washington say or the popular press writes, are not going anywhere because people understand the value of creating a portfolio that is hedged against market volatility and provides an opportunity to make money regardless of which way the market is moving. Hedge funds are now being used by investors of all shapes and sizes and play an important role in the future of the financial markets around the globe.

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 known and Sam Graff, the only true newspaper man I know in the tri-state area. Thank you both for the hard work you perform to make my work better. I truly appreciate it.

The people at Wiley have once again provided a platform for my work and to all of them, I say thank you. I hope the book is all you intended it to be when you gave me the go-ahead to write it.

I want to thank my family for their support and guidance over the years. It is through your efforts that this book, as well as the others, have been possible.

And finally to Felice, all I can say is thank you for being a provider of inspiration and support to see this project through. I appreciate your effort to keep Leah and Jonah out of the attic so I could complete the manuscript in time to hit the deadline, as well as your willingness to allow me to pursue my dreams day in and day out.

Daniel A. Strachman
Fanwood, NJ
October 2010

Introduction

Why Hedge Funds Now and Forever?

Over the past 10 years, hedge funds have gone from relative obscurity to being a topic of cocktail party chatter and the place to work on the Street to being blamed for everything that is wrong in the world of finance and beyond. Hardly a day goes by without a report of how hedge funds and those who provide services to them are reaping benefits on the backs of unsuspecting and unwilling victims around the globe. In the wake of the credit crisis and the government-led bailout of the banks, hedge funds and those who manage and invest in them have become the most talked about investment products since the Internet initial public offerings (IPOs) of the technology boom.

The rise from obscurity began with the astronomical returns that many hedge funds posted during the euphoria that swept the investment world at the close of the last century and the new century's first decade. These outsized returns have led to interest by investors of all shapes and sizes in years leading up to the credit crisis. In the post–credit crisis environment, interest in hedge funds and those who manage these—often thought of as secretive—investment vehicles 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?" At the end of the decade, the issue was "What happened to the money?"

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 names, they began to look to alternative investments as ways to juice the returns of their portfolios. In this case, the alternative investment happened to be anything and everything that was not considered a mutual fund or exchange traded fund.

Why did investors look to hedge funds for returns? The answer is the same as that given by Willie Sutton when he was asked why he robbed banks—because that's where the money is or is perceived to be on Wall Street.

Unlike the technology bubble that lasted a mere three years, the hedge fund craze is not a bubble, and people realized that these things are here to stay. Once again, the greed that was deemed good in the 1980s came back in favor among investors regardless of Washington's attempt to thwart it.

However, instead of hoping to ride the tails of takeover artists and leveraged buyout kings, today's 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. As I covered in previous editions of this book, at the end of the twentieth century and the early part of the twenty-first century many of the investment world's biggest and brightest hedge fund managers posted significant losses and in some cases were forced to liquidate their hedge funds. Many did not recover or, worse still, recovered only to be busted in the recent credit crisis and market meltdown.

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 and the bailout was implemented, the markets have turned for the better. As can be expected, some funds were able to stop the hemorrhaging at the end of 2008 and experienced stellar returns in 2009.

Those fund managers who did not suffer massive losses in 2008 have seen their funds grow by leaps and bounds in terms of assets under management while those who got spanked by the market—well let's just say, these folks are looking for work these days.

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 either voluntarily or because investors forced a liquidation of the portfolios, but there will always be someone willing to open another hedge fund and companies willing to work with the budding manager.

prime broker

a service offered by brokerage firms provide clearance, settlement, trading, and custody functions for hedge funds.

Not only are hedge funds thriving, but so are the service providers. Prime brokers, administrators, lawyers, and accountants as well as real estate agents, headhunters, marketers, and insurance people are all ready, willing, and able to provide for a hedge fund manager's every need.

The reason?

Wall Street is about making money—and running a hedge fund provides one of the greatest ways to do it, and providing services to those who run hedge funds is also quite lucrative.

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 in light of the credit crisis and because there are so many misconceptions about the industry.

Today, many people outside Wall Street believe that Bernie Madoff, 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, for the purposes of this book let's say that there are more than 8,000 hedge funds with more than a trillion dollars in assets under management. While firms like Soros, Paulson, Maverick, Tiger, and Tudor are generally considered to be the most famous hedge fund managers and most respected, people like Madoff, KL, and Bayou are probably the most notorious fraudsters to use the hedge fund moniker to perpetuate their dirty deeds. However, all of these are a far cry from representing the entire industry. The hedge fund 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.

Madoff in fact did not run a hedge fund but rather was a simple fraudster who managed money for a hedge fund of funds and separate accounts for his victims. Most people get his story wrong. The public believes that Madoff was a hedge fund manager and this belief has put a black eye on the industry. Madoff was a common thief on a grand scale who used the trappings of Wall Street to steal—that is it, nothing more or less. He just did it on a grander scale than anyone.

The common perception about the hedge fund industry is quite different from reality. The perception of the hedge fund industry is that of money managers who are gunslingers and buccaneers, secretly trading billions of dollars by the seat of their pants with little if any thought to risk because of the potential reward.

The reality is that most hedge funds have far less than $500 million in assets under management and, in most cases, every single trade that is executed is a calculated move—one in which risk and reward have been measured before a buy or sell order is placed. It seems that regardless of how often a hedge fund manager talks to the press or appears on one of the financial news networks, the industry cannot seem to shed the stigma of being made up of gunslingers and buccaneers who operate in a secret world.

A careful look at many hedge fund managers, however, will show that 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 manager 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 is that in most cases, hedge fund managers put most if not all of their own capital or net worth 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. The same cannot be said for most mutual funds and those who manage these types of products.

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 more than $80 billion in assets under management while the largest mutual fund complex has more than $2.7 trillion in assets under management.[1]

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, super-accredited investors, and institutions.

There are a number of different types of accredited investors—both individuals and institutions. Individual accredited investors are defined by the SEC as a natural person with income of $200,000 (with a spouse $300,000) in the past two years and have reasonable expectations of continued income at that level and a net worth of $1,000,000.[2] Institutions are defined as being accredited investors if they fall into a number of different categories, including but not limited to the following definitions:[3] In Dodd-Frank Act—commonly referred to as the Financial Reform Act, that President Obama signed into law in July 2010—an investor can not include the value of his or her primary residence when determining if their net worth meets the requirement set forth in the law.

1. A bank, insurance company, registered investment company, business development company, or small business investment company.
2. A charitable organization, corporation, or partnership with assets of more than $5 million.
3. A business in which all the equity owners are accredited investors.

Hedge funds are not allowed to advertise—which is why you do not see billboards or television commercials for managers and their funds.

For the most part, the SEC does not allow mutual fund managers to use derivatives or to sell securities short to enhance performance. This is a major difference.

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.

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.

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.

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 of 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.

Jones's basic concept was 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.

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

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 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.

I believe, and am not alone mind you, that the best and brightest minds in money management have migrated from around Wall Street 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, which allows them to profit from the up and downside of the market, and that should be enough for investors to know that their money is in good hands. However, due diligence is still required before each and every investment, and only once it passes your test is it worthy of your money.

As an investor, 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 Management LP is the need for investors to understand how and where their money is being invested. Madoff, while not a hedge fund, mastered this as well, although he did the opposite: Instead of telling his investors that they were too stupid to understand what was happening with the money, he buried them in paper.

In either case 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 negative media attention, not to mention the attacks by Congress and a number of State Attorneys General, writing the third edition of 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. Throughout the text you may have questions about hedge funds, the economy, or politics. If you do, please feel free to email me at: das@hedgeanswers.com.

Chapter 1

Hedge Fund Basics

It seems to me that the only time the press mentions hedge funds is when one blows up or some sort of crisis hits one of the world's many markets or there is a fraud and investors are robbed or taken to the cleaners. This has been a constant by the media since the summer of 1998.

Step back if you will to the summer of 1998, when Charlton Heston took over the presidency of the National Rifle Association, Compaq Computer bought Digital Equipment Corporation for nine billion dollars, the largest deal in the industry at the time, and the United States embassies in Tanzania and Kenya were bombed, killing 224 people and injuring over 4,500. It was also during this time that a 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 and markets dropped were members of 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 of the time were in serious 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 of significant proportions.