



Whereas the size of the mutual-fund industry in terms of assets and offerings has merely returned to its level of 2000, hedge funds have doubled in size and number, according to Hedge Fund Research, a consultancy (see chart 1). In 2004 alone around 400 new hedge funds were created, bringing the known total (many others escape scrutiny) of 7,000 into rough parity with the number of mutual funds.

The start-up fever is especially acute in the many hedge-villes dotting Greenwich, Darien, Rowayton and other lovely, affluent towns in southern Connecticut. New funds begin daily, some in spare rooms in someone's home, others in waterfront offices with parking for yachts. In Manhattan, midtown office towers serve as hedge-fund warehouses. Tiny windowless offices house unknown operators trying to build a track record. Full-floor suites filled with lavish artwork, gyms and kitchens that bubble over with superb (and healthy) food are the domain of successful funds. The same is true in Boston, San Francisco and London.



While there have been numerous pronouncements that the tide will soon turn, nothing suggests this is imminent. Quite the opposite. Initially sold only to wealthy individuals, then the family offices of wealthy individuals, increasingly hedge funds are now being sought out by large institutions. Foundations and endowments, the least regulated component of the institutional world, came first; company and public pensions are now piling in. The State of New York announced in January that it might put some of its \$88 billion pension fund into hedge funds, joining those managing the pension funds of teachers in Texas and Ohio as well as public employees in Chicago and California. If institutions merely meet the amount they currently intend to invest in hedge funds, another \$250 billion will be flowing into the industry, according to Greenwich Associates, a consultancy.

What might hold them back is not desire, but capacity. Such is the popularity of hedge funds that many of the largest are closed or, as they say in the trade, "soft-closed", meaning that entry requires special pleading—and many plead. Caxton Associates, Moore Capital, Renaissance Technologies, SAC Capital Advisors, Maverick Capital, and Highbridge Capital Management, all carrying excellent records and managing billions of dollars, are considered too inaccessible to be included in a Standard & Poor's index of investible funds. Unable to get into established winners, investors are pouring money into managers with no track record but good pedigrees. Last November, Eric Mindich, formerly of Goldman Sachs, raised \$3 billion for a new fund. His old partner, Dinakar Singh, will open an equally big fund this month. It is widely believed that either one could have raised two or three times as much money.

Given the enthusiasm, at the very least it should be clear what all these customers are buying. In fact, that is a surprisingly hard question. Unlike mutual funds, which are strictly defined under America's 1940 Investment Act, hedge funds operate under exemptions to the law. Theoretically that limits their audience to sophisticated

and affluent investors. In reality, clever lawyers, lots of money and astute marketing have expanded the exemption so that they can be sold to anyone, do almost anything and keep whatever they do, and who they do it for, a secret.

Some hedge funds actually hedge, meaning they attempt to invest in a manner that offsets adverse market movements. But since they also want to capture returns, the hedge is never complete and many funds do not even bother (see chart 2). Responding to institutional demand, notes Greenwich Associates, some new hedge funds restrict themselves to holding long positions in common stocks, just like ordinary mutual funds or, for that matter, traditional accounts managed by brokers on behalf of clients.

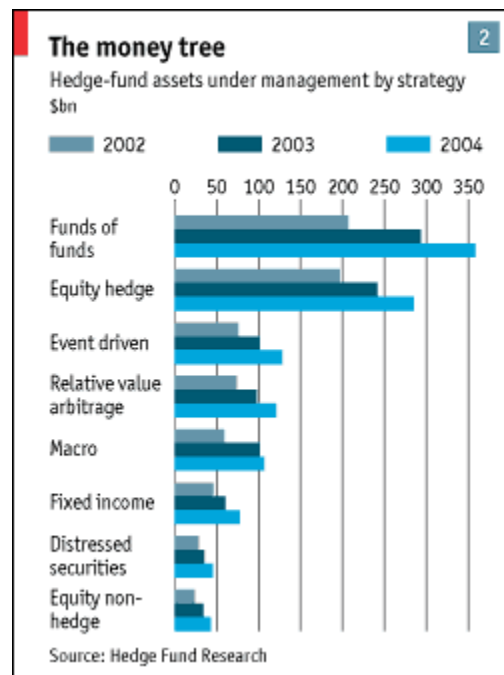
Hedge funds have some common characteristics. They are usually pooled investments (like mutual funds) structured as private partnerships (unlike mutual funds). Many carry substantial leverage and are quite rigid about the flow of money from clients. Initial "lock-ups" for as long as four or five years are not uncommon; rarely is money allowed to come in or go out more than monthly. This restriction allows hedge funds to take positions in the most illiquid corners of the market including options, futures, derivatives, and unusually structured securities.

### Where's the money?

Increasingly, the large funds that have succeeded flit from one area to another. Last year and the year before, when lots of companies were coming out of bankruptcy and the economy was improving, successful funds dominated the market for distressed debt.

Since hedge funds can account for more than half the daily volume on the New York Stock Exchange and can have an equally large presence in every other financial market, where they might be today is anyone's guess.

Investors value this ability to embrace opportunities, magnify returns through leverage, and take difficult positions because of a stable base of assets. But they have not always been so keen. Mutual funds, if structured correctly, can have the same characteristics (though there are some liquidity restrictions). A big reason why mutual funds approach investing differently is that when they tried to take a flexible approach in the mid-1990s they were torn apart by consultants and customers for so-called "style drift". Complaints reached a crescendo in 1996 when Jeffrey Vinik was hounded out of running what was then the single largest fund, Fidelity's Magellan, for moving from stock to bonds just a bit before the investment cycle turned.



Under pressure from the press and pension consultants, most (but not all) mutual funds began to follow narrow pre-designated benchmarks that were tightly limited to a class of investing, such as shares of companies included in the S&P 500 index, or an even narrower subset, for example a mid-cap benchmark. That helped performance in the soaring equity markets at the end of the last decade, but also contributed to their wretched results during the bear market of 2000 to 2002. It also undermined mutual-fund fee structures. Customers realised that much of the funds' performance simply mimicked the relevant index. Many chose to invest in index funds instead, because these charge far smaller management fees. (Perhaps appropriately, Mr Vinik, who has been something of a genius in identifying trends, reincarnated himself as an outstanding hedge-fund manager.)

The bear market prompted many investors to think it might be good to have money with an investment manager who knows when to invest and, ideally, where to invest, and works within a format that allows him to do so. Relatively good returns, meaning better performance than the market, has become a bit less important than absolute returns (ie, not losing money, especially when the market falls). Mr Vinik's move into bonds would now be considered within the context of astute risk control. Institutions aspire to hire managers who can provide high "alpha", meaning risk-adjusted returns. But it may amount to much the same thing—making money and not losing it.

A clever mutual-fund manager could, of course, pursue this approach in the new environment. But it has become much more sensible to start a hedge fund. Why? Because, to cite a phrase of the moment, a hedge fund is "a compensation scheme masquerading as an asset class". Whereas the average mutual fund charges 1% or 2% of assets, and smart buyers can pay a fraction of that, hedge funds charge 1% or 2% plus a big slug of profits, typically 20%, but often more. One well-known, but secretive, fund based on Long Island is reputed to charge 5% of assets plus 44% of profits. Another leading fund charges no maintenance fee but 50% of profits. An industry consultant says he has seen a new fund that will receive 80% of any excess above a guaranteed return linked to a well-known index. Even these huge costs do not really reflect what investors pay, since most hedge funds agree to conduct business through a prime broker, which extracts fees through stock- and bond-lending charges, as well as trading costs based on the fund's net asset value.

The benefits of this kind of relationship for a manager and for the Wall Street firms are obvious. In a report published in 2003, Bernstein Research reckoned that the size of the hedge-fund industry was one-sixth that of the mutual-fund industry, but already provided more revenues. If true, the situation is now even more dramatic. People attracted to the idea of working in the investment world for the money (a sizeable percentage) cannot shift into hedge funds fast enough. Nor can the investment banks, which are losing good employees but enjoy the solace that many become exceedingly good customers.

## **To bank or to hedge?**

*Institutional Investor's* obsessively read list of most-highly-paid hedge-fund managers starts with familiar names (George Soros: \$750m), but 16 others made at least \$100m in 2003. As impressive as the earnings are at the top, they are even more striking viewed from the bottom. Business-school graduates note that a job at

investment banks often lasts only until the first bump in the market. Salaries are high, but pressure from those above you is higher still and there is constant carping about costs. A bad year at a hedge fund may result in unemployment, but a good year means good compensation amid excellent resources: costly data terminals and abundant creature comforts, such as fresh fruit, flowers and parties.

Banks might gripe about these comparisons were they not battling so hard for hedge-fund business. At a time when mutual and pension funds have become ever more reluctant to pay the traditional five cents a share for trades, hedge funds pay up to four times that amount if in the process they can receive good ideas or particularly effective execution. This makes sense because the hedge fund's compensation is tied to outperformance, not efficiency.

And trading is just the beginning for banks. Hedge funds want hot issues, structured derivatives, margin, stock-lending for short sales and the equivalent for fixed-income, clearing and settlement, customer support and marketing. The money coming from all these transactions and fees is enormous. Svilen Ivanov of the Boston Consulting Group reckons hedge funds received \$45 billion in revenues last year, of which one-third to half was profits. Although there is some overlap in the numbers, investment banks collected \$15 billion either directly from hedge funds or because of them, producing \$6 billion in profits. For individual firms, hedge funds were critical to last year's performance. They produced one-quarter of Goldman Sachs's profits, estimates Guy Moszkowski of Merrill Lynch, and only a slightly smaller slug of Morgan Stanley's returns.

## **Performing for whom?**

Oddly, given the spectacular wealth that hedge funds produce for their own managers and for investment firms, they do not, overall, seem to produce much wealth for clients. Certainly the highest-performing funds have produced breathtaking returns. Renaissance has earned almost 40% annually for more than a decade, SAC in excess of 30%. There are many others with excellent records. But there are good reasons to believe that these are rare exceptions. Whatever the merits of high fees—the ability to attract talent, a performance-oriented incentive structure that discourages bloat—they are almost certainly exceeded by the problems.

The most evident is the drag which high fees put on performance. Historically, an investor able to outperform the broad market by two percentage points annually has been considered something of a genius. But that barely covers the maintenance of the average hedge fund. High fees tied to performance also encourage hedge funds to take big risks. Winners might just be lucky and their luck may be offset by the losses of others. A third problem caused by high fees is attrition. Successful managers become rich, possibly too rich to care about work, in just a few years. Managers that disappoint are quickly put out of business by angry clients, or they may shut down voluntarily because earning a performance bonus will require catching up to a prior "high-water mark" first. Last year around 270 funds closed. The available information on hedge funds suggests they typically last only a few years.

That adds complexity to the task of selecting a fund that will do well in the future. It also plays havoc with any indices used to track hedge-fund performance. A paper\* published last November by Burton Malkiel, a professor at Princeton, and Atanu Saha, of the Analysis Group, a consultancy, presents a frightening picture of what is left out of the most commonly cited benchmarks. Hedge funds report their performance only when they want to, and consequently stop reporting in the months that they are collapsing. Unsuccessful hedge funds may never report. Clever hedge-fund organisers may seed many funds, operate them for a few years, then announce in public only the most successful ones, “backfilling” the performance data from prior periods—ie, projecting what the fund might have earned before it existed if it had pursued the same strategy. Worst of all, bad funds tend to disappear along with their records. Only one-quarter of the 600 funds that reported data in 1996 still exist. Recalculating results, Mr Malkiel concludes that for all their vaunted talent, hedge funds perform less well than cheaper mutual funds.

A second paper, in the *Journal of Investment Management*\*\*, concludes that, because of their double fee structure, hedge funds of funds (ie, funds that buy into dozens of other hedge funds, following the “fund of funds” approach that has become common in the private-equity market) perform worse than individual hedge funds. Yet such funds have become popular, especially with investment consultants, because they are seen as diversifying risk.

And even this somewhat patchy record may overstate the potential for hedge-fund success. Hedge-fund returns, relative to market returns, have been fading. This may be true for a number of reasons, including low interest rates (hedge funds often hold big cash balances while they wait for bright ideas); the result of so many hedge funds getting into the business and, often, pursuing the same strategies; the possibility that the supply of hedge funds has outstripped the talent to run them; or simple chance. “Why should the appeal of rich fees be limited to smart managers?” asks Howard Marks of Oaktree Management, a hedge-fund adviser in Los Angeles.

Nor do hedge funds represent a fresh start for their scandal-tainted industry. A small fund named Canary Capital was at the heart of the late-trading, market-timing scandal. Other funds have been prosecuted for allocating fees to brokers who never executed trades; violating fiduciary obligations by shifting good investments to personal accounts; and using funds for personal expenses. All of these are hard for outsiders to detect.

## **Dog for sale, \$10m**

The largest area of transgression, and one that is almost certain to arise more in the future, is the incorrect valuation of securities held in funds. All securities are, to some degree, hard to price. The less liquid they are, the harder this becomes and hedge funds specialise in illiquid securities. Even if a hedge fund wants to value its portfolio correctly, it could make mistakes. If it had other motives—and because compensation is a multiple of returns this cannot be ruled out—disaster could follow.

The SEC has brought 51 cases (11% of all its enforcement actions) against hedge funds, claiming damages in excess of \$1 billion. Known prosecutions, as well as others that have yet to be disclosed, encompass around 400 funds. In only three of

these cases were investors made whole, a result the SEC blames in part on the fact that it is able to investigate a fund only in response to receipt of a complaint.

That is due to change next year. Last December, William Donaldson, chairman of the SEC, pushed through new regulations for hedge funds. Funds will have to register, meaning they will have to acknowledge their existence and submit to inspection by the SEC of their books and records. It would be no surprise if a series of announcements were to follow about hedge funds repricing their assets downwards and also, perhaps, reviewing how much they charge for compensation (the details of performance bonuses are complex and there is an assumption that they are mostly resolved in favour of managers).

Whether the new rules will act as a deterrent to abuses by managers or, more importantly, whether they will do anything to slow the industry's momentum remains to be seen. The bigger it grows, the more the boundaries between hedge funds and traditional asset management are blurring. But on current trends, hedge funds' second trillion dollars of assets will arrive even faster than the first.

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\* "Hedge funds: Risk and Return". Working paper.

\*\* "Fees on Fees in Funds of Funds" by Stephen J. Brown, William N. Goetzmann and Bing Liang.