1 Introduction

Sveta, what is a hedge fund?

Tanya

Over the past 50 years, the alternative investment industry has grown from a handful of fund managers in the USA into a global business at the forefront of investment innovation. But despite this apparent success, few topics in the financial world seem to evoke such a mixed response as that of alternative investments. Some love them and explain that they are the ultimate tool to bolster returns or help diversifying efficiently traditional portfolios. For example, Alan Greenspan called them "major contributors to the flexibility of the financial system" because they provide a critical source of liquidity for the markets. But at the same time, others hate them, affirm that they are big enough to destabilize markets, claim that their fees would be outlandish or even illegal if extracted from a plain old mutual fund, and suggest prohibiting their activities. As an illustration, Michel Sapin, the French finance minister, recalled that "during the Revolution such people were known as agioteurs, and they were beheaded". More moderately, Franz Müntefering, the chairman of the ruling social democratic party in Germany, recently compared alternative investment funds to "locusts" that wreck havoc on the corporate economy.

Surprisingly, finding a universally accepted definition of what constitutes an alternative investment is devilishly difficult. Some have characterized alternative investments as no-holds-barred pools of capital that escape regulation and are sophisticated enough to take risks that ordinary investors should not take. However, this definition is far too simplistic. The scope of the term "alternative investments" has widened significantly over the years and now encompasses a broad series of assets and investment strategies.

Providing a precise definition of what constitutes an alternative investment is difficult, because what is considered "traditional" and what is labelled "alternative" varies from one organization to another and has also evolved over time. For instance, domestic stocks and actively managed bonds were considered to be alternative investments in the 1960s, and were primarily the domain of high net worth individuals. A similar perception existed for international stocks in the 1970s and for real estate and emerging market equities in the 1980s. Today, these asset classes are included in the core of most investment portfolios. The new alternative investments are private equity, venture capital, commodities, precious metals, art, forestry, and, of course, last but not least, hedge funds. They all share two common characteristics: (i) they still have to gain complete acceptance from the financial community, and (ii) they are regarded as profitable by some marginal investors, but current conventional wisdom has it that they involve significantly more risk.

Whatever the reason, good or bad, no one on either side of the debate denies that alternative investments in general, and hedge funds in particular, are now a significant part of the financial services industry. Indeed, in less than two decades, the hedge fund universe has grown from a small number of firms led by legendary managers (George Soros, Julian Robertson, and others) to a large market with thousands of players and dozens of strategies. Originally exclusively

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serving the needs of very high net worth individuals, the cloistered and mysterious kingdom of hedge funds has progressively opened its doors to private and institutional investors seeking diversification alternatives, lower risks, higher returns, or any combination of these.

Hedge funds have become, and are likely to remain, an important element of modern financial markets. Most investment banks and traditional asset management houses have announced the launch of in-house hedge funds. Commercial banks are also setting up funds of hedge funds. Traditional portfolio managers, often assisted by keen seed investors, leave their employers to start their own hedge funds. Even fresh college graduates start their own hedge funds. In a sense, the hedge fund frenzy is often compared to the dot-com boom of the late 1990s – both have attracted lots of clever people who intend to get rich fast. There are two key differences, however: (i) the dot-com managers created lots of quoted companies that had no revenues, while the hedge fund managers created lots of non-quoted companies with plenty of revenues; and (ii) the dot-com managers created capital, not income, while the hedge fund managers create income, but very little capital. Nevertheless, the hedge fund phenomenon is expected to continue as more institutional and private investors are becoming eligible to invest.

Surprisingly, considerable confusion and misconceptions still exist concerning hedge funds, what they are, what they are not, how they operate and what they can really add to traditional portfolios. At one extreme, exempt from regulation and shrouded in secrecy, hedge funds are often perceived as excessively leveraged high-risk high-return vehicles, managed by sophisticated traders and designed only for the elite. Not only do they offer the prospect of huge financial returns, they also appear to have the ability to undermine central banks and national currencies, and even destabilize international capital markets. This widespread myth was propagated over the past two decades by press reports of spectacular gains and losses achieved by large, but non-representative players run by a few financial buccaneers. At the other extreme, commission-rewarded professional investment advisers claim that hedge funds are capable of offering high absolute returns without incurring additional and unnecessary risks, as well as low correlation with traditional investment performance. This qualifies them as ideal complements to traditional portfolios.

The reality is, of course, far more complex. Hedge funds can no longer be seen as a homogeneous asset class. There are now more than 6000 hedge funds and 3000 funds of hedge funds active in several asset classes, sectors and/or regions. These funds utilize a variety of trading and investment strategies. Within the same investment category, managers differ in the leverage they use, the concentration they apply and the hedging policies they employ. What is needed, therefore, is a common framework to understand and analyse hedge funds rather than a series of unverifiable claims.

As numerous articles and books have been written on hedge funds, why produce a new one? In order to answer this question, let us first see what this book does not attempt to do. First of all, this book does not attempt to promote hedge funds as a promising asset class. Most investment banks and professional investment advisers have produced excellent brochures that fulfil this task and describe the advantages of hedge funds over other types of assets. Wishful thinking and the desire for a free lunch make the consumer/investor very susceptible to this sales pitch. However, one should remember that Wall Street is not an independent source of academic research. Rather it is a manufacturer with a huge vested interest in supporting its products – and the higher the fee, the higher this interest.

Nor does this book attempt to depict hedge funds as being inherently risky, dangerous or over-leveraged. Since the debacle of the hedge fund Long Term Capital Management, it is now common knowledge that the simultaneous use of leverage, concentration of positions, and

volatile or illiquid markets can produce a toxic cocktail of risks. Like any other investment, hedge funds involve risks, and these should be clearly understood before taking the plunge.

Rather, this book attempts to dispel several misconceptions and shed new light on the kingdom of hedge funds. It provides an integrated, up-to-date and comprehensive blend of theoretical and practical analysis of the market, strategies and empirical evidence supporting today's ever more complex, diverse and growing world of hedge funds. It aims at giving readers the fundamental concepts, detailed knowledge, self-confidence and necessary quantitative and qualitative material to fully understand hedge funds, their strategies, and their potential positive and negative contributions to investment portfolios.

This book is meant to stimulate thought and debate, and should always be taken that way. It raises a large number of questions, but certainly does not claim to have all the answers. Some may argue that it is easier to point out the fallacies in others' arguments than to figure out the answers. Still, when fallacies rule the land, somebody has to point at the naked emperor.

One of the merits of this book is that it is self-contained. It does not require any previous knowledge of the field, and can be read and understood by almost anyone. It is intended to be an introduction and at the same time a reference book for any serious finance student or investment professional. For that reason, the level of mathematical and financial knowledge assumed is kept to as modest an extent as possible. This results in some passages being lengthier than expected, but we have preferred to bore a few advanced readers slightly rather than lose many on the way.

This particular intention explains the book's structure. We have divided the material into four parts. Part I is essentially descriptive and covers the historical and structural aspects of hedge funds and their environment. The major characteristics of hedge funds versus traditional funds are carefully examined, as well as the legal framework in the USA and in a number of other selected countries. We believe that this information is necessary to understand the way in which hedge funds are structured as well as the reasons that might justify the secrecy that surrounded them for more than 50 years.

Part II focuses on the various strategies followed by hedge funds. Each strategy is described in detail with its key elements, including the investment process involved, market opportunities and risk management. Several examples and practical cases of real transactions are provided as illustrations. Here again, we have placed more emphasis on economic intuition than on computation. Readers willing to follow the maths can easily refer to some of the technical papers listed in the bibliography.

Part III covers risk and return calculations. Its focus is not on determining whether hedge funds outperform or underperform traditional markets. It is rather on understanding the real meaning of performance statistics used by hedge fund managers and quantitative analysts. We discuss the particular problems encountered during the collection of net asset values and the calculation of simple return and risk statistics – including those that are of concern to practitioners but are rarely treated in finance or statistics textbooks. We also cover the problems associated with the use of historical data in the case of hedge funds, particular attention being devoted to hedge fund databases, indices and benchmarks.

Lastly, Part IV deals with more advanced aspects, principally the matter of investing in hedge funds. Asset allocation and the hedge fund selection process are investigated and illustrated by numerous examples. New investment vehicles such as funds of hedge funds, structured products and capital protected notes linked to hedge funds are also examined.

Writing this book has been a great experience, and it is a pleasure to thank those who provided valuable suggestions and insights along the way. I would naturally like to thank

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Naturally, I must stress that the opinions expressed in this book represent solely my viewpoint and may not reflect the opinions or activities of any of the above-mentioned organizations. It also goes without saying that this book should not be taken as an investment recommendation or as a solicitation. In particular, the few hedge funds that are mentioned explicitly in this book were taken as representative examples, but are not positively or negatively recommended in a given portfolio. Anyone interested in investing in hedge funds should first seek professional *and independent* advice. But in the world of hedge funds, independence is both essential and, unfortunately, often elusive.

It is now time for you to start reading and I hope that you will find some pleasure in doing so. Please address any comments or suggestions to me at f@lhabitant.net