Hedge Funds Today

Talent Required

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Hedge funds are not mutual funds. The perception that they are has been a source of confusion to both potential investors and potential regulators. Mutual funds developed to enable small investors to pool their wealth so that they could hold diversified portfolios of equities or fixed income instruments. By contrast, an individual hedge fund is not a vehicle for acquiring a diversified portfolio; rather, it is a vehicle for acquiring the specialized talents of its manager. A hedge fund investor achieves diversification by acquiring a diversified portfolio of hedge funds, not by looking to one fund as a vehicle for diversification.

Hedge funds are typically managed by an entrepreneur. He builds a business around ideas about how risk capital can generate high returns. Often, the manager invests a significant portion of his wealth in the fund -- it is his enterprise, rather than a convenient vehicle for pooling assets.

Most investors buy stocks and bonds. Most hedge fund managers do something else. It is hard to characterize what it is that hedge fund managers have in common, other than that they charge performance fees, invest their own money alongside their clients' money, and are not well diversified. However, one thing that many have in common that distinguishes them from mutual fund managers is an active investment process focused on the dynamic nature and/or the interrelatedness of investment opportunities.

Consider some of the major types of strategies. Merger arbitrage involves purchasing acquisition targets, selling short the acquiring company, and holding until consummation of the acquisition. Event arbitrage involves purchasing securities expected to appreciate from a corporate event, while selling related securities that are expected to appreciate by less. Convertible arbitrage strategies involve buying convertible bonds and dynamically trading the company's equity to extract the value of the embedded option. Long-short equity funds should be investing in the relative misvaluations of companies or sectors, by simultaneously buying and (short) selling securities. A macro currency manager (like me) synthetically (using derivatives) invests in the money markets of countries with high expected real returns, and finances in the money markets of countries with low expected real returns.

Hedge fund strategies, especially ones that are considered highly quantitative, are sometimes viewed as a mysterious "black box." Often, however, a seemingly complex strategy can be explained and understood in relatively simple terms. It is easiest to describe the one that I know best. My currency strategy utilizes a fundamental,

macroeconomic-oriented approach. In fact, to us, investing in a currency is not dissimilar from fundamentally investing in the stock of a company.

What are some criteria that make a company attractive as a growth stock investment? Strong earnings growth, earnings that support payment of both interest to creditors as well as dividends to shareholders, and a treasury policy that reflects an aversion to diluting shareholders. How is this analogous to investing in currencies? A high expected return currency investment involves synthetically lending money to a country that has the following criteria: high growth prospects to sustain high short-term interest rates (analogous to high corporate earnings growth to sustain high dividend yields and interest payments), and tight monetary policy (analogous to avoidance of excessive new share issuance). The strategy involves synthetically borrowing in the low expected return country to finance the investment in the high expected return country.

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A fundamental characteristic of this strategy and most hedge fund strategies is that the position is entered into because of a temporary imbalance (in liquidity, risk appetite, market perception, sector or country productivity of capital) that the manager thinks will eventually be resolved in his favor.

Again, herein lies a significant difference between hedge funds and mutual funds. Mutual fund managers often follow a buy and delegate strategy -- delegating capital allocation decisions to the management of the corporations in which they have invested. In contrast, hedge fund managers typically exhibit characteristics more akin to the active management team of an operating company. Corporate business managers will dynamically reallocate corporate capital to maximize shareholder value and return on equity. Similarly, hedge fund managers invest significant time and financial resources to research and actively reallocate capital.

By way of example, our approach to currency investing causes us to operate in much the same way as would a global bank. We look to dynamically shift capital from countries where capital is less productive (low growth, low interest rates, loose monetary policy) to countries where it is more productive (high growth, high interest rates, tight monetary policy). Because of the fact that economic growth and business cycles between major market countries are not perfectly synchronized, we maintain an active, business-minded focus and seek to capitalize on the opportunity to transport capital to the most attractive location. This is no different from a manufacturing company that actively shifts its allocation of corporate capital from one business division to another as opportunities surface and dissipate, all with a view toward maximizing shareholder value.

Hedge funds are also not like mutual funds when it comes to leverage. The use of leverage need not be a bad thing, as is often the perception. Consider the fact that a significant number of successful corporate management teams have relied on debt financing to build valuable franchises and create significant shareholder wealth. An investor in a mutual fund is an investor in the leveraged investments made by the managers of the corporations that the fund owns. A hedge fund typically is not a vehicle whose sole purpose is to leverage a long portfolio, any more than the sole purpose of a leveraged industrial corporation is to use leverage. Rather, leverage is employed as a tool for implementing relative value or dynamic investment strategies.

For example, a currency hedge fund might decide that Australia's economy has greater growth potential than "Euroland," and thus should be able to sustain higher short-term interest rates. The fund might decide to borrow in the Euro money market and lend in the

Australian dollar money market. It is impossible to do this trade without creating a liability (or paying someone else to do so). This use of leverage should be contrasted with a fund that simply borrows to hold 200% of the S&P 500 on its books.

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In essence, a hedge fund is more similar to a single stock than a diversified portfolio of stocks. An investment in a hedge fund is really an investment in a manager and the specialized talent that he possesses to capture profits from a unique strategy. The fund's returns will be no better than its management and the economic environment in which it produces its product. An investor should understand the product being produced and the manager producing it. A hedge fund investment requires the same amount of due diligence as investing as a silent limited partner in an operating business. It is not an appropriate investment for an investor who buys something just because it exists (i.e., for the investor who buys the market portfolio). The returns of a hedge fund strategy often look more like the returns of a single stock than of a mutual fund, as illustrated in the chart alongside.

Hedge fund returns are the outcome of an entrepreneurial activity; its returns do not look like those of a mutual fund which typically represent the outcome of investors pooling their money to buy a diversified portfolio that each is too small to acquire.

The moral of this story? Hedge funds are sufficiently unique in their operations and investments that Congress and the investing public should not choose the same regulatory and investment approach that may have been appropriate for mutual funds.

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