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Hedge Funds: Past, Present, and Future

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Outline

- History of hedge funds
- What are hedge funds?
- Common strategies
- Myths versus Facts
- The future

A little bit of history..

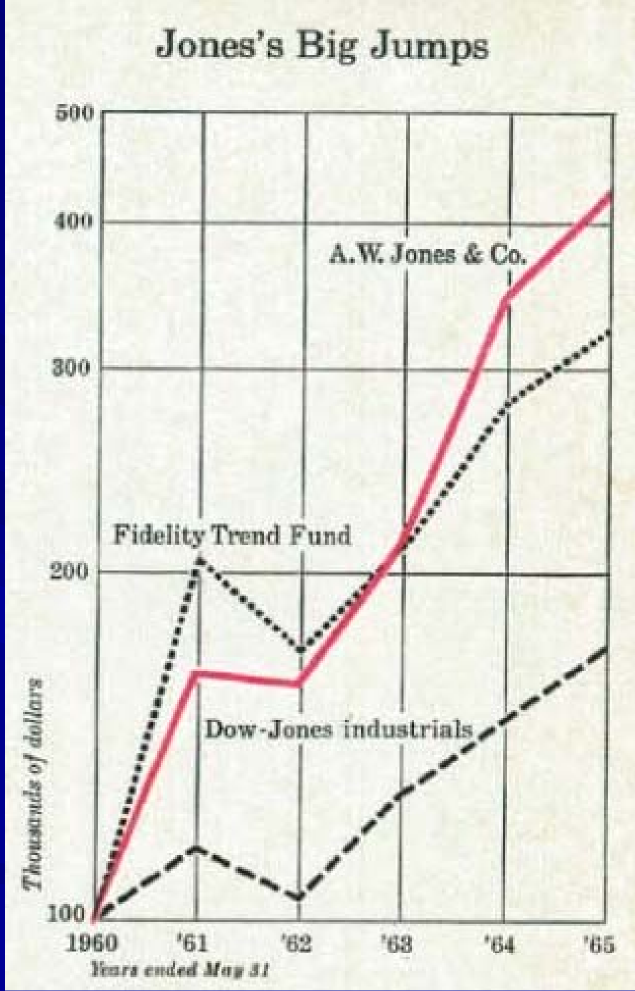
- Alfred Winslow Jones (journalist, sociologist, and fund manager) established the first hedge fund in 1949
- Raised $100,000 with $40,000 of own capital
- Long-short strategy with leverage from financing long positions with the proceeds from short sale
- Charged 20% performance fee but no asset-based management fee

A little bit of history..

- The fund operated under secrecy until 1966 when an article in Fortune by Carol Loomis made his strategy public.
- This article prompted a surge in hedge fund interest in the mid and late 1960s.

The Jones Nobody Keeps Up With

Alfred Winslow Jones



Source: Fortune 1966, http://www.awjones.com/images/Fortune_-_The_Jones_Nobody_Keeps_Up_With.pdf

A little bit of history..

- Hundreds of imitators of the Jones model in the 1960s but deviated from the long-short model due to the strong bull market in the 1960s
- Number of funds lost money and went out of business following the bear market of the 1970s

Bears should have had a fine time in the 1969 market. But some followers of the hedge concept got clobbered on their shorts while being murdered on their longs. Worse than that, the SEC is moving in as

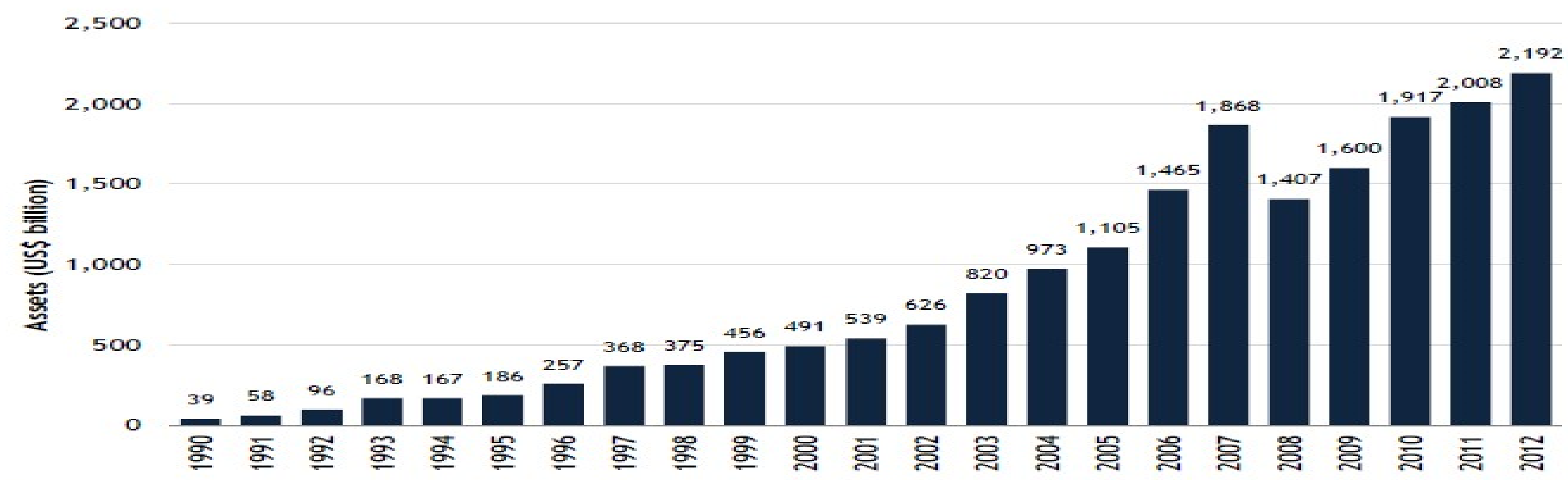
HARD TIMES COME TO THE HEDGE FUNDS

by Carol J. Loomis

Source: Fortune 1970, http://www.awjones.com/images/Hard_Times_Come_to_the_Hedge_Funds-Loomis-Fortune-1-70.pdf

A little bit of history..

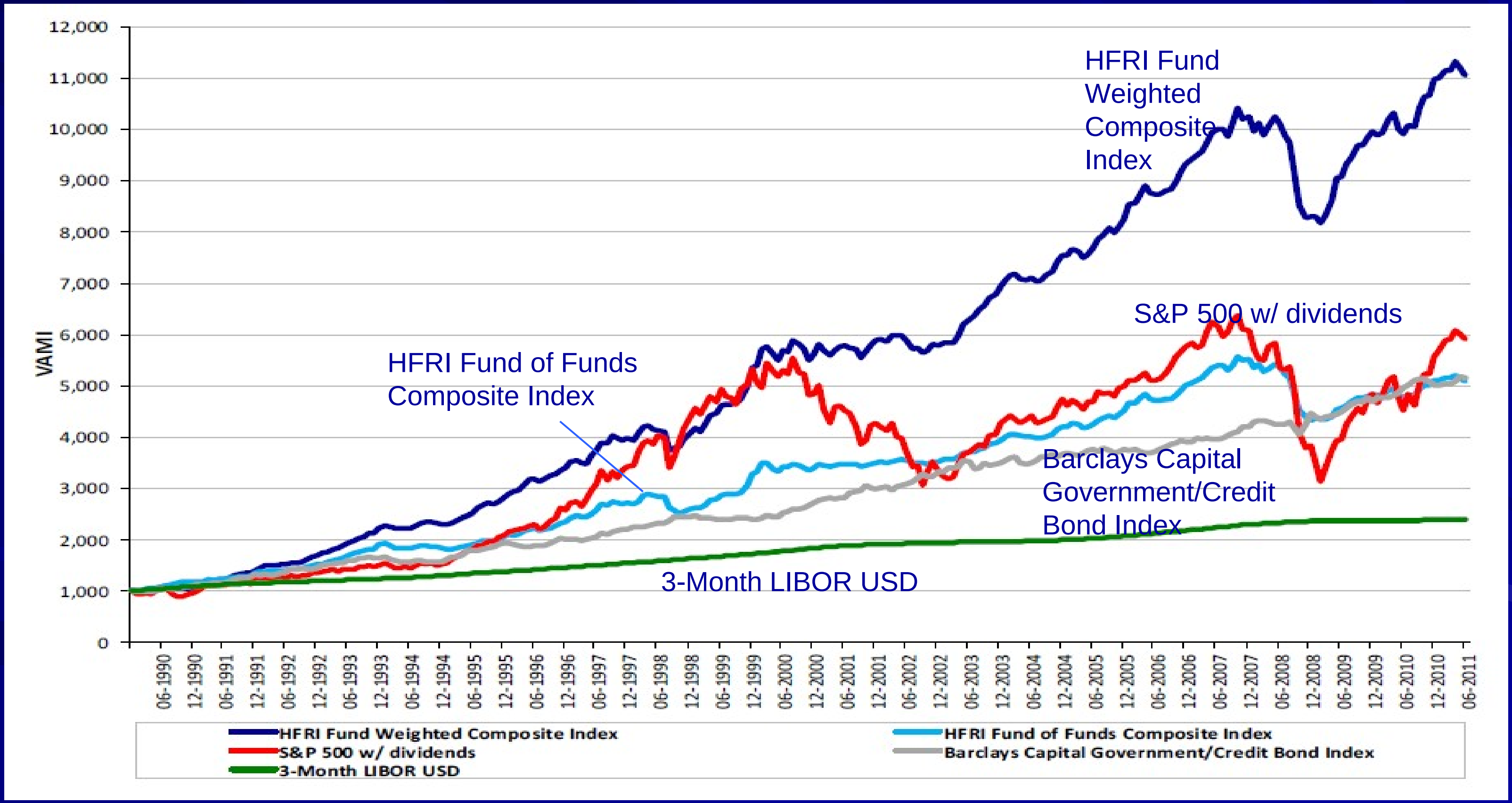
- People forgot about hedge funds until the *Institutional Investor* article in 1986 described the performance of Julian Robertson's Tiger Fund (43% returns net of all fees in contrast to S&P's 18.7% over the six-year period)
- 1980s and early 1990s were dominated by the global macro funds including the famous Quantum fund by George Soros that made billions of dollars in 1992 by betting on British Pound
- Assets under management in global hedge fund industry (1990–2012)



Source: Hedge Fund Research
Notes: HFR 2012 estimates are as of Q3 2012.

Historical Performances

Managers' goal is to achieve ***absolute return***, regardless of what happens in the market.



Source: HFR presentation to: US Department of Labor (2011) https://www.dol.gov/ebsa/pdf/heinz071911.pdf

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What are hedge funds?

- No commonly accepted definition
- Not all funds hedge as in the original long-short model of AW Jones

What are hedge funds?

- Legal structure: *privately* organized pooled investments, avoiding ICA (1940)

Benefits	Limitations
• Bypass ICA (1940) restrictions on: • Leverage • Short-selling • Derivatives trading • Symmetric incentive compensation • Fillings requirements • Daily liquidity providing	• Only offered to accredited investors • Public advertising and disclosure (relieved by the JOBS Act passed in 2012) • High operational risk due to limited information disclosure

What are hedge funds?

Investment universe

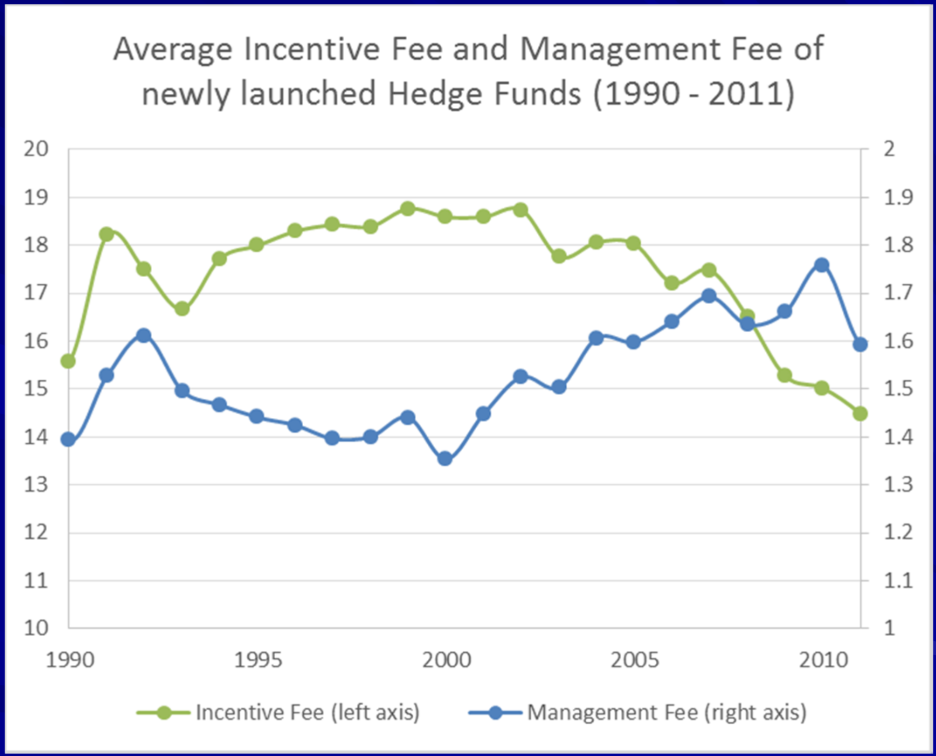
Traditional Asset Classes
Cash
Bonds
Equities
Real Estate
Mutual Funds

Alternative Investments
Credit Derivatives
Private Equity
Managed Futures
Hedge Funds

What are hedge funds?

Unique compensation structure

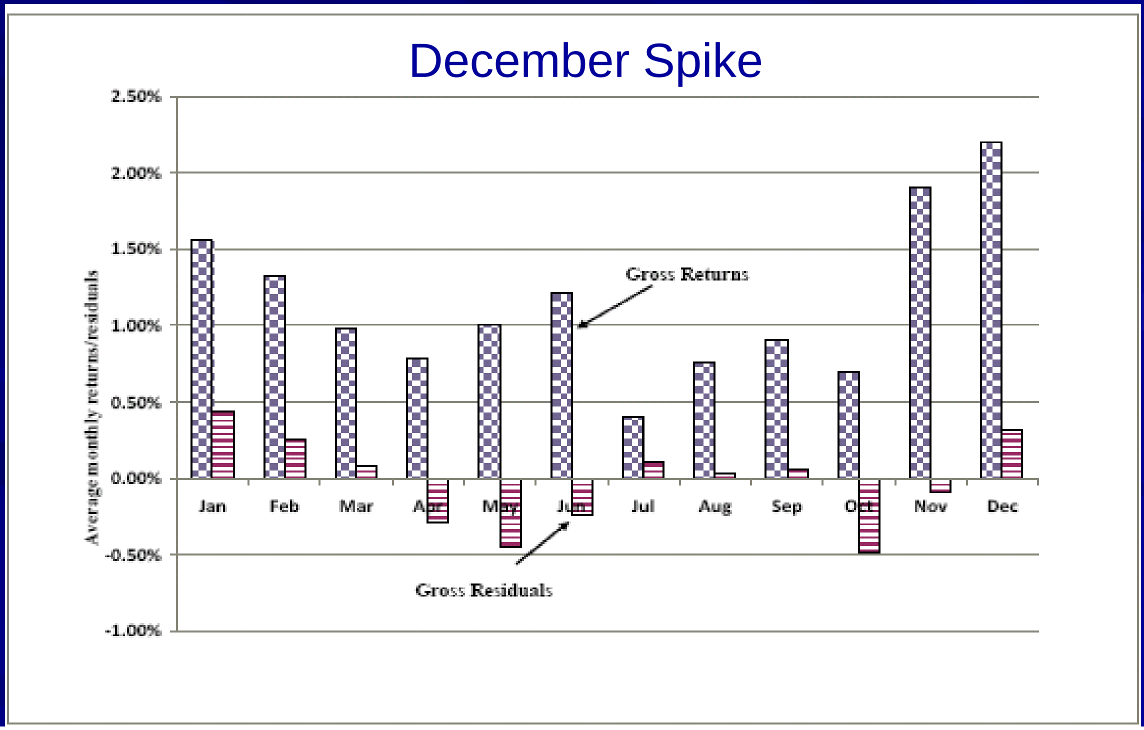
- Management fee: typically 1-2% of AUM
- Incentive / Performance fee: typically 20%
- High water mark: performance fee is not paid unless the fund valuation is over the highest peak in the fund
- Hurdle rate: a return that the fund must generate before performance fee is paid



Source: Data is from the Union Hedge Fund Database created in Agarwal, Daniel, and Naik (2009).

Bright and dark side of compensation

- Efficacy of financial contracts in alleviating agency problems:
  - Better managerial incentives => better performance
  - Higher managerial discretion => better performance
- Also providing incentives for returns manipulation



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Hedge Fund Styles

Directional	Non-directional
• Global Macro • Emerging Markets • Long Only • Sector • Short Bias	• Long/Short • Market-Neutral • Multi-Strategy • Relative Value • Event Driven • Convertible Arbitrage

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Myths vs. Facts

- Myth: HF industry is unregulated.
- Fact: HFs are regulated, but much less compared to MFs.
  - Hedge funds are subject to the anti-fraud provisions of the Securities Act of 1933
  - Dodd-Frank Wall Street Reform and Consumer Protection Act, passed in 2010, requires hedge fund advisors with $150 million or more in assets to register with the SEC
  - Many hedge fund companies register with SEC anyway, perhaps because they believe that registration gives them credibility

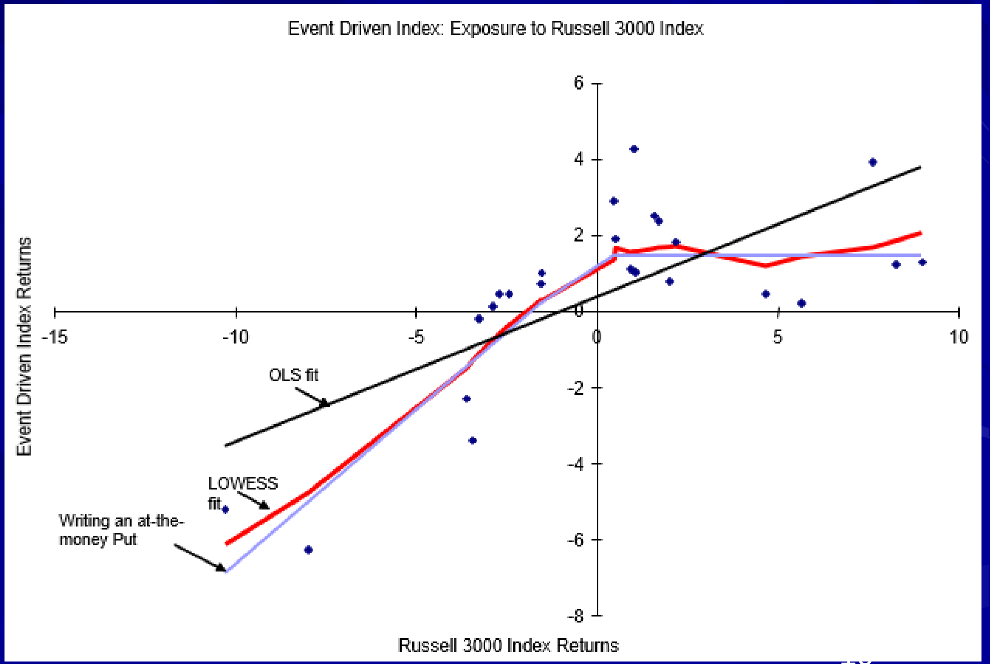
Myths vs. Facts

- Myth: HFs are always hedging.
- Fact: No, not all positions hedge funds take are hedged, either because of high costs or because of intrinsic difficulties in hedging against some risks.

Myths vs. Facts

- Myth: HFs have low correlations with the market.
- Fact: HFs offer option-like features of returns, which have nonlinear association with market returns. When market performs poorly, the correlation increases.

"Picking up pennies in front of a steamroller".



Myths vs. Facts

- Myth: Good HF managers outperform consistently.
- Fact: HF performance persistence is scarce and, if present, only lasts for very short horizons.

  Agarwal and Naik (2000)

  – Persistence in multi-period framework smaller than that in the traditional two-period framework

  – Extent of persistence decreases with the increase in the return measurement intervals

  – Few very good managers - manager selection is crucial

  – Persistence unrelated to the type of strategy followed by the fund

Myths vs. Facts

- Myth: HFs are only accessible to high net worth individuals
- Fact: As more institutions, including pensions and endowments, invest in HFs, more individuals are exposed to HF investments.
  - Preqin Ltd., January 2014: 66% of the money invested in hedge funds comes from institutions.
  - Smaller investors are getting indirect exposure

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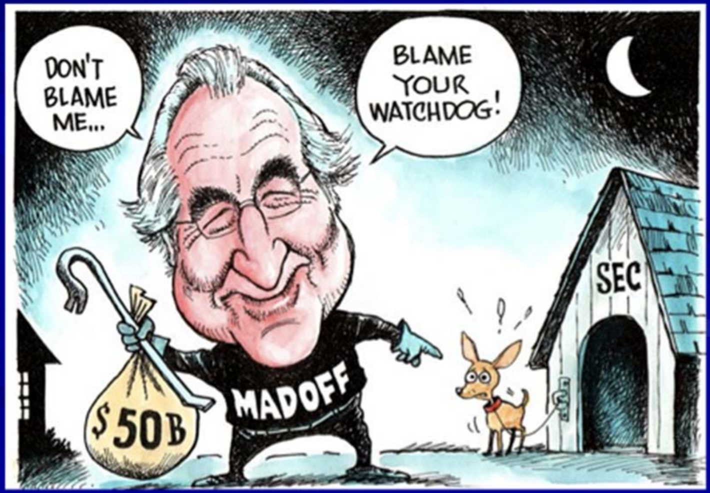
The future

- Regulators are concerned about the risks of hedge funds for at least four reasons:
  - investor protection – frauds (51 cases between 2000 to 2004; SEC estimating the damage to be about $1.1 billion)
  - risks to financial institutions – systemic risk issues
  - liquidity risks – hedge funds selling assets to exit can make matters worse
  - excess volatility risks – increasing the volatility in the market



The future

- Expecting the convergence of hedge funds toward mutual funds:
  - Greater regulation of hedge funds
  - With growing number of institutional investors in hedge funds, the discretion of hedge fund managers will decline to satisfy the fiduciary responsibility of institutional investors
  - As hedge fund assets under management keep growing, some strategies will become unprofitable—which has already occurred
  - Mutual funds mimicking hedge fund strategies