

The Myth of Hedge Funds

Are Hedge Funds The Fireflies Ahead of The Storm?

Alexander M. Ineichen, CFA¹

First version: 24 October 2001

This version: 24 October 2001

Published in *Journal of Global Financial Markets*, Vol. 2, No. 4

(Winter 2001), pp. 34-46.

Please address all correspondence to:
Alexander Ineichen
UBS Warburg
1 Finsbury Avenue
London EC2M 2PP
United Kingdom
Tel.: +44-20-7568 4944
Fax: +44-20-7568 6457
Email: alexander.ineichen@ubsw.com

¹ Executive Director, Head of Equity Derivatives Research, UBS Warburg, London

Abstract

This article attempts to uncover some of the myths around hedge funds and is designed to de-mystify the investing in hedge funds.

Hedge funds suffer from negative press. The headlines over the past three years have not always been favorable for the industry. Similarities can be drawn to the airline or the derivatives industry where only disasters are reported. Given the negatively biased press coverage of hedge funds and the large reported losses of macro hedge funds in H1 00, the evolution of hedge funds will take a similar route to full acceptance as investment instruments to manage portfolio risk as did derivatives. Since hedge funds are in the public domain, the negative press on derivatives has come to a full standstill.

Hedge fund managers are asset managers with a different return objective than long-only managers. The absolute-return focus has the advantage of having great appeal to most investors but has the disadvantage of not being scalable indefinitely. The future evolution of the asset management industry could see a blend of the two investment philosophies.

Hedge Fund Disasters

Louis Moore Bacon from Moore Capital presented a very intuitive way of classifying hedge fund disasters at the 2000 Hedge Fund Symposium in April 2000 in London. More precisely, he presented five warning signs for investors to look out for when investing in hedge funds. These are:

- (1) Size
- (2) Leverage
- (3) Transparency
- (4) Funding
- (5) Hubris

Size

There is a capacity constraint for every hedge fund style, most likely for every single hedge fund. Recent history has proven that once a fund reaches enormous proportions the alpha diminishes or, even worse, turns negative.

Bacon used Julian Robertson's Tiger Funds as an example. In Bacon's view a hedge fund should de-leverage or return capital to its partners once it reaches a certain size. A hedge fund manager should control size according to its capacity to implement its investment strategy. According to Bacon, Robertson kept on raising money despite respectable organic growth.

Leverage

Leverage and liquidity are interconnected. Both, occasionally, turn the laws of economics upside down, because lower prices bring out less demand and more selling. George Soros, in *The Alchemy of Finance*, talks about ‘reflexivity’.

Blind adherence to economic orthodoxy, plus leverage, he says, lead to boom-bust mania.

Excess leverage is bad. Most examples of financial disasters involved an excess use of leverage. A sound risk management system relates open positions with liquidity. In other words, analyzing a hedge fund’s risk control systems and risk management skill is extremely important.² Much more important than with other money managers who are restricted and/or regulated by internal and/or external regulatory bodies.

Managing hedge funds has at least as much to do with risk management than with picking stocks or following a market. According to Ian Wace (2000) from Marshall Wace Asset Management, the average correlation of the average European hedge fund to the market is 0.89 while the average net market

² Note that there is a difference between risk management and risk measurement. Partners and employees of LTCM were with little doubt the most skilled and experienced risk measurers.

exposure is 85%. He noted that since the returns are derived mainly from market moves, these funds are 'beta merchants, not hedge funds'.

Transparency

Transparency is the third warning sign. Full transparency of current positions is commercially unwise. This is true for hedge funds and proprietary trading desks as well as other money managers of large size. The reason why it is more important for hedge funds is because they involve short positions much more frequently than traditional funds. In many regions, traditional money managers are restricted from selling short.

Short positions require more sensitive treatment than long positions. Many equity hedge funds are involved in illiquid markets, as the inefficiencies are higher in illiquid markets than in liquid markets³. The results of being squeezed

³ Grossman (1976) argues that perfectly informationally efficient markets are an impossibility, for if markets are perfectly efficient, the return to gathering information is nil, in which case there would be little reason to trade and markets would eventually collapse. There must be sufficient 'inefficiencies' to compensate investors for the costs of trading and information gathering.

Haugen and Jorion (1996) show that small-capitalisation stocks show higher returns in January than in other months of the year. This anomaly is well known, they argue, and should be eliminated through arbitrage. Yet it persists.

out of a short position in an illiquid market can be disastrous to overall portfolio performance. One way of controlling this risk is by not unveiling one's positions to the market.

Bacon used the examples of the Hunt brothers and their silver speculation. In 1979 and 1980 the brothers tried to corner the silver market and took managed accounts and charged spectacular fees. They were leveraged 20 to 1, with only 5% margin down. According to Bacon, traders on the trading floor (Bacon at the time was on the floor as well) apparently used to wait until the Hunt's broker entered the elevator that brought him into the trading pit. The runners alarmed the traders in the pit that the broker was on his way. The traders knew that he was going to buy silver so they bought silver beforehand, front-running Hunt's broker until the commodity was limit up. But when the day came to sell, the price collapsed.

The authors argue that it may mean that markets are slower to arbitrage away inefficiencies than previously thought. Chopra, Lakonishok and Ritter (1992) found that small companies and previous losers had an average return of 60-100bp over the three-day announcement period where large companies and winners have a zero average return over those days. This is consistent, they argue, with the concept of over-reaction.

Funding

The fourth of Bacon's warning signs is a mismatch between assets and liabilities, or the terms of funding. The capital invested in a hedge fund should be stable. Hedge funds are long-term investments. Hence, hedge funds have long redemption periods. If the capital base is not secure there is a chance that funds are withdrawn at exactly that moment when they are most needed. Note that many of LTCM's strategies would have worked if they could have held onto their assets for some months longer. Measures that indicate the stability of capital are the redemption periods or the portion of the fund, which belongs to the managers.

One example used by Bacon was Julian Robertson's Tiger Management. Apparently, Julian Robertson was constantly growing by accepting new funds. The funds grew fast without reducing leverage or returning capital to investors. In Bacon's opinion, a hedge fund should keep its capital base stable once it reaches an optimal size, either by closing the fund, returning accumulated gains to investors or reducing leverage.

Hubris

The last point of Louis Bacon's warning signs is the sin of hubris, or arrogance and pride. According to Bacon, hubris can make a manager embrace leverage and size, and care about transparency and the stability of capital. Hubris can

also make a manager reluctant to embrace change. Bacon quotes John Maynard Keynes: ‘When circumstances change, I change my view. What do you do?’

With respect to hubris, consider the following exchange between Myron Scholes, LTCM partner and Nobel laureate, and Andrew Chow, vice president in charge of derivatives for potential investor Conseco Capital. Chow was quoted in the *Wall Street Journal* (16 November 1998) as saying to Scholes: ‘I don’t think there are many pure anomalies that can occur.’ Scholes responded: “As long as there continue to be people like you, we’ll make money.”⁴

This excerpt highlights two aspects: first, it was not necessarily lack of self-confidence that brought down LTCM. Secondly, Myron Scholes highlights that traditional money managers to a large extent focus on relative returns whereas hedge funds focus on making money, ie, absolute returns. The focus on relative returns together with internal as well as external regulatory boundaries has some negative side effects, including market inefficiencies. A topical example of inefficiency in the equity arena is additions and deletions of index constituents. Traditional money managers often ‘have to’ buy stock or subscribe to a large IPO regardless of their fundamental evaluation of the stock. Taking into account an increasing trend towards herd behaviour of traditional

⁴ From Shefrin (2000).

money managers opens a large range of opportunities for non-traditional, ie, alternative investment managers⁵. In essence, Myron Scholes had a good point.

Bacon's Game Theory

Bacon expressed the view that money management is like a game. There are no rules about the game except that it will change. But most importantly, one should avoid becoming the game. Bacon quoted John Kenneth Galbraith who apparently once said, 'There are those who don't know – and those who don't know that they don't know.' Adopting the paraphrase, Bacon distinguished between three types of hedge fund managers:

- (1) There are those who know they are in the game.
 - (2) There are those who don't know they are in the game.
-

⁵ Tracking error between a portfolio and its benchmark is a function of volatility and correlation. If volatility increases, the tracking error increases as a result. The rise of volatility over the past four years has resulted in active managers reducing their active bets, ie, moving closer to their benchmark. Hence the expression 'index huggers' (active managers who are not index fund managers but invest close to the index to avoid being caught on the wrong side of the market). Over the past 18 months there have been celebrated money managers (not to be named here) who stuck to their guns (value investing) and went out of business as a result. Hence, hugging an index is as much about financial risk as well as business risk. Market inefficiencies are the result.

(3) There are those who don't know they are in the game and have become the game.

The first group is attractive to investors. For example, a former convertibles arbitrage desk of an investment bank leaves the bank, opens a hedge fund, has a sound track record, understands the market, has the discipline to focus on the edge, ie, avoid speculation, and has the skill and technology to manage risk. However, this should not make active manager selection obsolete.

The second group should be avoided. Often these hedge fund managers are long-only managers camouflaged as hedge funds. Fundamental research of the individual hedge fund enables the investor to distinguish between those who just were able to raise money from those who are in the game because they have an edge and experience in controlling risk. Analysis of investment philosophy and risk management systems should help distinguishing the first from the second group.

In Mr Bacon's opinion, the third category is the worst. One does not want to be invested in a fund that, in Bacon's terminology, 'becomes the game'. These funds are funds that have met all the five warning signs stated above. Bacon stated three examples of fund managers 'who became the game' and where investors lost money: the Hunt brothers, LTCM and Julian Robertson's Tiger Funds. LTCM, for example, had all of Bacon's warning signs:

Size: LTCM, with total assets of US\$129bn at end-1997, was significantly larger than any other reporting hedge fund family at the time⁶. Only 11 reporting hedge fund families, including LTCM, had total assets exceeding US\$10bn at the end of 1997.

Leverage: The aim was 20-30bp on each position and an annual return for the fund of 30%, which is only achievable through high leverage. The notional amount of LTCM's total OTC derivatives position was US\$1.3trn at end-1997 and US\$1.5trn at end-1998.

Transparency: LTCM's fate got considerably worse once the market knew its positions and how it was going to trade to unwind positions. The fall-out from the liquidation was far greater than it might have been.

Funding: LTCM margined all its capital.

Hubris: According to Bacon it was the 'height of hubris' that after the debacle LTCM claimed that market conditions had been a 'one off', or the 'perfect

⁶ *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management - The Report of The President's Working Group on Financial Markets, April 1999.*

storm'. But it failed to realize that it had been the 'perfect storm'. It had become the game.

Demystifying Hedge Funds

In the following section we highlight some myths regarding hedge funds and more importantly regarding the investment in hedge funds. The myths marked * are adopted from Schneeweis (1998a) or Schneeweis (1998b).

Myth: Investing in Hedge Funds is Unethical

According to the myth, investing in hedge funds is speculative and therefore unethical. We would like to turn the argument around and postulate that for a fiduciary not considering investing in AIS in a portfolio context in general or absolute-return strategies in particular, is, if anything, unethical. The empirical evidence from absolute return managers exploiting inefficiencies and producing high risk-adjusted returns is overwhelming and academia is in the process of confirming that market inefficiencies exist, ie, migrating to a very weak form of market efficiency.

Views and definitions of ethics vary across countries and cultures. Any view, therefore, is subjective and has a strong home bias. The following view is based on the Prudent Expert Rule from ERISA (Employee Retirement Income Security Act) and the Code of Ethics from AIMR (Association of Investment

Management and Research)⁷. Under ERISA, fiduciaries must discharge their duties with respect to the plan⁸:

- Solely in the interest of plan participants and beneficiaries.
- For the exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable plan expenses.
- With the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in like capacity and familiar with

⁷ The AIMR is a global, non-profit organisation of more than 41,000 investment professionals from more than 90 countries worldwide. Through its headquarters in the United States and 94 affiliated societies and chapters throughout the world, AIMR provides knowledge to investment professionals while promoting a high level of standards, ethics, and professionalism within the investment industry. According to the AIMR (1999) Code of Ethics members shall: 1. Act with integrity, competence, dignity, and in an ethical manner when dealing with the public, clients, prospects, employers, employees, and fellow members. 2. Practise and encourage others to practise in a professional and ethical manner that will reflect credit on members and their profession. 3. Strive to maintain and improve their competence and the competence of others in the profession. 4. Use reasonable care and exercise independent professional judgement.

⁸ From AIMR (1999).

such matters would use in the conduct of an enterprise of a like character and with like aims (the Prudent Expert Rule).

- By diversifying the investments of the plan so as to minimise the risk of large losses, unless doing so is clearly not prudent under the circumstances.
- In accordance with the governing plan documents, as long as they are consistent with ERISA.

Assuming ERISA's Prudent Expert Rule is some indication of how a fiduciary should act and AIMR's Code of Ethics is a reference for ethical conduct of a financial professional, investing in hedge funds cannot be categorised as unethical. Taking this argument one step further, one could argue that, if anything, ignoring absolute return strategies and the benefits of its inclusion to a portfolio might be unethical.⁹ The fourth of ERISA's points listed above states that a fiduciary should diversify and reduce risk of large losses. In a portfolio context, risk is reduced by increasing the allocation to less risky assets or introducing assets with low or negative correlation to the core of the portfolio. The strategies by relative-value managers exploiting inefficiencies have proven to be conceptually sound as well as empirically of high risk-

⁹ Amin and Kat (2001), for example, stress that it is important to view hedge funds in a portfolio context and not in isolation.

adjusted returns and low correlation to traditional assets. In addition, once risk to single hedge funds is diversified, large losses hardly occur especially when compared with traditional investments that are essentially long the asset class outright.

The relationship between institutional funds and the agents engaged to manage the portfolio assets has been always provided a fertile breeding ground for conflicts of interest. Institutions seek high risk-adjusted returns, while outside investment advisors pursue substantial, stable flows of fee income. Conflicts arise since the most attractive investment opportunities fail to provide returns in a steady, predictable fashion. To create more secure cash flows, investment firms frequently gather excessive amounts of assets, follow benchmark-hugging strategies, and dilute management efforts across a broad range of product offerings. While fiduciaries attempt to reduce conflicts with investment advisors by crafting appropriate compensation arrangements, interest of fund managers diverge from interests of capital providers even with the most carefully considered deal structures (Swensen 2000).

Myth: Hedge Funds Are An Investment Product from the 1990s*

While the number and size of hedge funds has grown in recent years, hedge funds have existed since the 1940s. It was not until the 1980s that they experienced rapid growth. This growth was due in part to the increase in the number of new financial vehicles as well as changes in technology that

permitted sophisticated investment strategies to be designed and implemented without the infrastructure of a large investment house.

Myths with Respect to Risk

Myth: Hedge Funds Are Risky

This is the one single myth that we believe is actually true. Hedge funds, examined in isolation, are risky – as are technology stocks. However, most investors do not hold single stock portfolios. They diversify stock-specific risk by investing in a range of stocks with different characteristics. To most investors, it is regarded as unwise not to diversify idiosyncratic (stock-specific) risk. It should be similarly unwise not to diversify risk to a single hedge fund.

Schneeweis and Spurgin (1998b) and many others have shown that hedge funds offer an attractive opportunity to diversify an investor's portfolio of stocks and bonds. This is true even if the returns earned by hedge funds in the future are merely on par with that of stocks and bonds. There is no need to see risk-adjusted returns as high as they have been to justify diversification benefits into hedge funds. Any investment with a positive expected return, low volatility and low correlation to the rest of the portfolio will reduce portfolio volatility.

Myth: Hedge Funds Generate Strong Returns in All Market

Conditions

One cannot generalise across all hedge fund styles. Some hedge funds do better than others during bear markets. Unlike the long-only asset management industry, the hedge fund industry is extremely heterogeneous. There is great diversity among different trading and investment styles and strategies.

The hedge funds from the 1960s did extremely poorly during the bear market of the 1970s. Many managers went out of business. Essentially because they were long, leveraged and totally exposed to the market. However, the degree of sophistication of hedge funds employing relative investment strategies has increased since the 1960s. Anecdotal evidence from the bear market starting in Spring 2000 indicates that many directionally biased hedge funds had de-leveraged and were moving into cash as markets fell.

Myth: The Lesson of LTCM Is Not to Invest in Hedge Funds

There are many lessons to be learned from LTCM: (1) diversify, (2) high return investments are also potential low return investments, and (3) trading in illiquid secondary markets is potentially disastrous in extreme market conditions. These are lessons that are true for all investments and have nothing to do with the fact that LTCM was a hedge fund.

A hedge fund is a business. Businesses, unfortunately, occasionally fail and go bankrupt for various reasons. This is one of the main reasons why investors diversify across businesses. Although a repeat of a disaster such as LTCM is regarded as unlikely, some hedge funds are likely go bankrupt in the future, ie, potentially could destroy wealth under management. However, a point can be made that entrepreneurs should have exposure to idiosyncratic risk whereas investors should be exposed to systematic risk. In other words, investors will hold portfolios of hedge funds as opposed to a hand full of hedge funds.

Table 1: Hedge Fund Disaster and Large Losses

Case	Strategy	Date	Loss (US\$ m)	What went wrong?	Risk
Askin Capital Management	Fixed income arbitrage (mortgage-backed securities)	1994	420	Hedge did not work. Liquidity squeeze. Could not meet margin calls. Did not inform investors.	Market
Argonaut Capital Management	Macro	1994	110	Market losses. Departure of general partner.	Market/ business
Vairocana Limited	Fixed income arbitrage	1994	700	Change of strategy from duration-neutral to punt on falling interest rates. Could not calculate proper NAV figures. Investors lost confidence.	Market/ business
Fenchurch Capital Management	Fixed income arbitrage	1995	NA	Change of strategy from US bond basis trading and US yield curve arbitrage to European bonds and equities despite being unacquainted with markets.	Market
Global Systems Fund (Victor Niederhoffer)	Macro	1997	NA	Market losses. Short puts in market correction. Failed margin calls.	Market
LTCM*	Fixed income arbitrage	1998	3600	Market losses. Excess leverage. Margin calls.	Market/ business
Manhattan Investment Fund (Michael Berger)	Long/short equity (short bias)	1999	400	Fictitious statements sent by manager.	Fraud
Princeton Economics International (Martin Armstrong)	Macro	1999	950	Market losses. Fraudulent sale of notes and misrepresentation of assets.	Fraud
Tiger Management***	Macro	2000	2600	Concentrated portfolio, style drift, redemptions, 'mouse clicks and momentum'	Market/ business
Soros Fund***	Macro	2000	NA	Departure of key personnel, lack of opportunity.	Market/ business
Ballybunion Capital Partners	Long/short equity	2000	7	Reporting of false performance figures. Wrong information on web.	Fraud
Maricopa Investment Corp. (David M. Mobley)	Long/short equity (quantitative)	2000	59	Market losses. Reporting of false performance figures. Fraudulent misrepresentation of assets. Ponzi scheme, paying distributions with new investor assets.	Fraud
Cambridge Partners, LLC (John C. Natale)	Long/short equity	2000	45	False audits, tax documents and monthly statements. Overstatement of performance. Pleaded guilty to securities fraud, theft and misappropriation of property.	Fraud
HL Gestion/Volter Fund (Imad Lahoud)	Managed Futures	2000	40	French regulators closed down the money manager because the firm's capital had fallen below the minimum level of €50m required to	Market

Case	Strategy	Date	Loss (US\$ m)	What went wrong?	Risk
Ashbury Capital Partners (Mark Yagalla)	Long/short equity	2001	40	operate in France. Reporting of false performance figures and accused of running a pyramid scheme. Used investors' funds to finance lavish lifestyle.	Fraud
ETJ Partners (E. Thomas Jung)	Relative Value	2001	21	Market losses. Reporting of false performance figures. Fraudulent misrepresentation of assets.	Fraud

Sources: Cottier (1997), Peltz (2001), AP wire, Bloomberg News, UBS Warburg research (2001).

* Initial investors compounded at 18% as LTCM returned funds in 1997 (Lowenstein 2000).

** US\$7.65bn withdrawals between August 1998 and April 2000. Tiger assets went from US\$22.8bn in October 1998 to US\$6bn in March 2000. However, Tiger Management compounded at 24.8% between 1980 and 2000.

*** Quantum fund compounded at 32.1% between 1969 and 2000. US\$3bn were redeemed when Druckenmiller announced his departure.

Table 1 shows a list of some of the more recent casualties. We believe there are only a few cases, if any, where markets are to be blamed. The losses or defaults are a function of organisational malpractice, ie, business risk. It is business risk, if:

- Key staff leave the firm and the firms' edge walks out of the door.
- A fund is inappropriately funded with respect to its market risk.
- The hedge does not work.
- A hedge fund manager departs field of expertise without telling investors.
- A hedge fund manager selling Internet stocks and reports high positive returns while stocks skyrocket and nobody harbours suspicions.
- Even fraud is not atypical for the hedge fund industry, but is a risk of corporate life (otherwise firms could allocate funds spent for legal advice in productive projects).

There are many ironies surrounding the collapse of LTCM. One is that the brightest academics in finance together with the most skilled investment professionals on Wall Street caused one of the largest disasters in financial history.

Another interesting aspect is that LTCM is the one single hedge fund that is most commonly known. The irony is that LTCM was a very atypical hedge fund. Its trading strategies were more in line with those of a capital market intermediary. When investors or issuers needed to change their positions or risk exposures, they would go to an investment bank or dealer to buy or sell securities or structured products. In turn, the dealer would utilise the capital markets to cover this exposure. LTCM was often on the other end of these transactions, in some sense wholesaling risk to the intermediary who was working directly with clients. LTCM viewed its main competitors as the trading desks at large Wall Street firms rather than traditional hedge funds.

Myth: The Failure of a Single Hedge Fund Is Cause for Concern*

Many hedge funds failed before LTCM, and many could fail in the future. Some failed quietly, returning some investor capital after liquidating positions. Others, like LTCM, failed in a more spectacular fashion. The failure of a single firm or investment product is always of concern to the investors as well as those who invest in similar ventures. However, modern investment theory points out that no person should have a sizeable portion of their wealth invested in any

one investment product. In short, unless one has a perfect forecast of the future, diversification is a laudable concept with dealing with uncertainty. The stock market has survived the bankruptcy of many companies. This does not mean that stocks are bad investments. It does not even mean that the investors in a company that loses money ex-post initially made the wrong choice. The most notable aspect of the LTCM is not its near collapse, but in the fact that many highly sophisticated investors held a single large portion of their wealth in the single fund, which is completely contrary to modern investment principals.

Myth: All leverage is Bad*

Leverage is derived from raising capital externally, ie, not through shareholders or partners, and is common in most corporate structures. One must remember that leverage itself is not something to be avoided. Banks, for example, are levered about 15 to 1. Residential real estate is typically levered 5 to 1 (a 20% down payment is common, with 80% borrowed). From the sample universe of a recent Van Money Manager Research report around 72% used leverage.

However, only around 20% use leverage above 2 to 1.

Myths with Respect to Investment Strategy

Myth: Hedge Funds Are Always Hedged Hence the Name 'Hedge' Funds

Some funds that are called hedge funds do not actually hedge market risk.

Because the term is applied to a wide range of alternative funds, it also encompasses funds that may use high-risk strategies without hedging against

market risk. For example, a global macro strategy may speculate on changes in countries' economic policies that impact interest rates, which impact all financial instruments, while using high degrees of leverage. The returns can be high, but so can the losses, as the leveraged directional investments (which are not hedged) tend to make the largest impact on performance.

Many hedge funds, however, do seek to hedge against various types of market risk in one way or another, making consistency and stability of return, rather than magnitude, their key priority. Event-driven strategies, for example, such as investing in distressed or special situations reduce risk by being uncorrelated to the markets. They may buy interest-paying bonds or trade claims of companies undergoing reorganisation, bankruptcy, or some other corporate restructuring – counting on events specific to a company, rather than more random macro trends, to affect their investment.

Thus, some hedge funds are generally able to deliver consistent returns with lower risk of loss. Long/short equity funds, while dependent on the direction of markets, hedge out some of this market risk through short positions that provide profits in a market downturn to offset losses made by the long positions. Equity market neutral funds that invest equally in long and short equity portfolios, generally in the same styles of the market, are not correlated to market movements.

Myth: Selling Short Is the Opposite of Buying Long

Mutual funds are normally restricted from selling short. The regulatory environment, however, is only one issue with respect to short selling. Selling short is not the opposite of going long. Most equity investors have a long-only mentality and are less familiar with hedging, managing risk and the dynamics of short positions.

Short positions behave differently than long positions. The portfolio consequences of adverse price movements require greater diversification of short positions. If a stock moves against a short seller by increasing in price, the position increases in size. To take advantage of the now more attractively priced short-sale opportunity, the short seller faces the uncomfortable prospect of further increasing the position. Starting with a modest allocation to a particular short idea allows an increase in position size without creating an uncomfortable concentration in a single stock. Contrast the dynamics of a losing short position with the behaviour of a losing long position. As the long position's price declines, it becomes a smaller portion of the portfolio, reducing its impact on returns and facilitating new purchases at the newly discounted, relatively more attractive price levels.

There also is a technical difference between buying and selling short. To execute a short sell, the investor has to borrow securities to deliver to the buyer on the other side of the trade. If the lender recalls the shares, the short seller has

to cover, ie, buy back and deliver the stock. When the market for borrowing a particular security becomes tight, short sellers face a short squeeze. Security borrowers tend to have the most trouble with small, less liquid companies, which are exactly the type of security most likely to present interesting short-sale opportunities.

Myth: Hedge Funds Are Unique in Their Investment Strategies*

Some hedge funds can be viewed as the privatisation of the trading floor of investment banks. New technology has permitted investment professionals to leave investment banks and trade externally what for years was conducted only internally. The strategies are not new. Insurance companies, endowments, and other institutional investors have invested in alternative investments such as private debt, private equity and derivative strategies for years. What is new is that when these large, diversified investors took losses in a particular product, it often was hidden by their gains in other areas. For a single hedge fund, the lack of product diversification heightens its risk, but does not necessarily increase the risk of its investors, who should be well diversified across a number of hedge funds and a number of asset classes.

Myth: Hedge Funds Do Not Invest, They Just Trade*

Ackermann (1998) has shown that one of the principal economic benefits provided by hedge funds is their ability to provide capital to relatively illiquid investment markets. Investment in liquid assets can be accomplished easily through mutual funds, which are highly regulated and offer the ability to

redeem assets instantly. Hedge funds can require investors to lock up capital for many years, which allows them to make investments that are highly illiquid. It is surprising and perhaps ironic that many of the same people who have been critical of short-term trading and favour long-term investing are now critical of hedge funds, which exist primarily to invest in less liquid, long-term investments or to permit other investors, such as banks, to redeem themselves out of investment positions they no longer wish to hold.

Myths with Respect to Economic Logic

Myth: Hedge Funds Offer No Economic Value*

Hedge funds invest in a wide variety of investment arenas including private equity, private debt, merger and acquisitions, and emerging markets. Without their participation, many worthwhile projects could not find the necessary financing. In addition, hedge funds trade in financial products, offering liquidity to other investors in these assets. The primary use of derivative products is to offer a mechanism for firms to reduce or manage their own risk. Financial innovations such as mortgage-backed bonds provided a means for individuals and institutions to raise capital more efficiently. Recent innovations are much more exotic but have the same objective – allow one to effectively raise capital and manage risk. In many cases, hedge funds are a primary purchaser of these new securities, both in the primary market and the secondary market. Without hedge funds, financial markets could have fewer risk management choices and, for some projects, a higher cost of capital.

Myth: The Failure of LTCM Was the Failure of the Market*

Financial markets are not people. LTCM was a combination of many human failures. Most of the reasons behind the failure may be laid directly on the traders at LTCM who took highly leveraged positions while failing to divulge to creditors the extent of this leverage. But the credit officers at the banks are equally culpable for their willingness to extend even more credit without adequate information about the potential risks. A future problem to be solved is how to manage the individual human appetite (however unattainable) for return without risk combined with banks desire for return with limited risk and with societies need for risk capital which requires the existence of financial institutions and traders as financial intermediaries.

Myth: Hedge Funds Cause Worldwide Crisis

Numerous academic research studies have shown that hedge funds were not the cause of the Asian crisis or other major world economic collapses¹⁰. It is true

¹⁰ See for example Brown, Goetzmann, and Park (2000). Authors tested the hypothesis whether hedge funds in the currency markets caused the crash in the Malaysian Ringgit as suggested by the Malaysian prime minister Mohamad Mahathir. While not alone in holding currency fund operators like George Soros responsible for the currency crisis, Mohamad Mahathir was clearly the most outspoken. The authors empirical analysis of the dynamics of hedge funds and Asian currencies suggested little evidence that hedge fund managers as a

that in today's financial markets, capital reacts quickly to information. As a result, when countries or firms fail to live up to their promises – over-build, over-buy, over-monetise – funds flee and the market reacts quickly. While such capital flight may have its own associated problems, the alternative to free flows is almost always worse. If investors are afraid of an inability to retrieve capital, it simply will never go there in the first place.

Fung and Hsieh (2000) analysed the role of hedge funds during some macro turbulence in the 1990s, of which many were attributed to action by hedge funds resulting negatively bias in the industry's reputation. The authors concluded:

1. Hedge fund activities were prominent and probably exerted market impact during several episodes;
2. There was no evidence that hedge funds used positive feedback trading in any of these episodes;

group caused the crash. In particular, it is difficult to believe, the authors conclude, that George Soros was responsible for a 'bear raid' on the ringgit when the performance of three of his funds was less than stellar. If anything, it appears that the top ten hedge funds were buying into the ringgit as it fell in the

3. Hedge funds did not act as a single group;
4. There was no evidence that hedge funds deliberately herded other investors to doing the same thing.

The evidence indicates that, by themselves, hedge funds were not likely to have caused the market turmoil analysed in the paper. Rather, the evidence indicates that some highly leveraged trades, practised by hedge funds as well as other market participants, can lead to market disruptions when they are unwound subsequently. The unwinding of the leveraged 'carry trades' led to the 1994 Mexican Peso Crisis, in which hedge funds had no discernible role. The unwinding of the leveraged 'carry trades' also resulted in the 1992 ERM Crisis and the 1997 Asian Currency Crisis, in which hedge funds had a significant role alongside other, much larger, market participants. However, hedge funds were not the cause for the unwinding of the carry trades.

The following table lists some financial disasters where hedge funds were blamed to have caused the havoc and the true cause.

late summer and early fall of 1997. The authors draw the same conclusion for other Asian currencies.

Table 2: Cause and Effect of Financial Disasters Where Hedge Funds Were Blamed

Effect	Cause
The 1992 ERM Crisis	<p>It is beyond doubt that macro hedge funds had a significant short position in sterling in 1992 that impacted the market. It is, however, difficult to determine whether this position 'caused' the sterling devaluation, because it coincided with net capital outflows from the UK. The prologue to the 1992 ERM crisis was the 'conversion' play, estimated to be around US\$300bn by the IMF. Altogether, European Central Bank interventions amounted to roughly US\$100bn. The US\$11.7bn in hedge fund positions coincided with at least another US\$90bn of sales in European currencies.</p> <p>Fung and Hsieh find neither herding nor positive feedback trading.</p>
The 1994 Mexican Peso Crisis	<p>General capital outflow of US\$5.1bn from the Mexican debt market in Q4 1994 followed by US\$11.5bn in the next nine months. The IMF concluded that Mexican residents, not foreign investors, played the leading role in the 1994 crisis.</p>
The 1997 Asian Currency Crisis	<p>Macro hedge funds had sizeable gains in July 1997, when the Thai baht devalued 23%. Stanley Drucker Miller, who headed the daily operations of the Quantum Fund, confirmed the existence of short positions in the Thai baht and Malaysian ringgit in a <i>Wall Street Journal</i> interview. The position sizes were not disclosed. The popular press assumed that the short position was large and profitable. It turned out that the monthly returns of large macro hedge funds were more correlated with the US equity market than with Asian currencies.</p> <p>The Asian crisis was much reminiscent of the ERM Crisis of 1992. Substantial amounts of 'carry trades' were involved in the build-up of both crises. These carry trades allowed Thai corporations and banks to borrow in foreign currencies, which had a lower interest rate than the domestic currency. As long as the domestic currency did not depreciate, the foreign currency loans represented a cheap source of funding. In the end, the carry trade led to an unsustainable equilibrium. By fixing the exchange rate, the Thai Central Bank was indirectly paying a risk premium to foreign investors to support domestic funding needs. However, when these foreign 'lenders' are themselves highly leveraged institutions such as proprietary desks from investment banks (and occasionally leveraged domestic corporations), the resultant equilibrium is at best tenuous.</p> <p>In July 1997, for whatever reason, some foreign lenders decided to unwind their carry trades in Thailand. They sold baht and bought dollars in the spot market, putting tremendous pressure on the baht.</p> <p>Fung and Hsieh draw the same conclusions as the IMF: 1. Hedge funds positions were relatively modest at the beginning of the crisis. 2. Hedge funds did not utilise positive feedback trading to destabilise the Asian markets. If anything, they displayed some contrarian trading in being long the Indonesian rupiah while it was still falling. 3. Hedge funds cannot be blamed for herding other investors to doing the same trade. The underlying economic fundamentals were ripe for an 'accident' to happen.</p>

Source: Fung and Hsieh (2000), Eichengreen and Mathieson (1999)

In a surprise reversal of the long-honoured tradition of vilifying hedge funds as perpetrators of global market calamities, the Monetary Authority of Singapore in January 1999 announced its intent to attract hedge funds. In a statement reported by *Bloomberg News* (4 January 1999), Ms Teo Swee Lian stated:

‘There are proprietary trading departments of perfectly respectable banks that punt the market. They are more damaging than hedge funds. Do we say ‘no’ to the banks then?’ The recognition of similarities between proprietary trading desks and hedge funds by regulators is positive. This recognition will likely reduce the risk that arbitrary and capricious legislation is expected to be enacted to restrict the activities of hedge funds.

Myth: We Can And Must Control the Financial Marketplace

It is always possible, in hindsight, to see the mistakes that compound on mistakes that lead eventually to collapse. It is often easy, ex post, to see where a simple rule or regulation may have prevented a catastrophe. Improved credit analysis and risk analysis is always a goal, but one can never, and should never, prevent all possible losses. If we never extend credit to a firm or investment strategy that may fail, a large number of worthwhile projects or products would go unfunded. Growth requires investment in risky ventures. Risky ventures imply the possibility of loss. In the long run, a diversified portfolio is expected to offer a return commensurate with the risk.

In 1994, Soros was invited to deliver testimony to the US Congress on the stability of the financial markets, particularly with regard to hedge fund and derivative activity (Chandler 1998). Soros believed that the banking committee was right to be concerned about the stability of markets, saying: ‘Financial markets do have the potential to become unstable and require constant and vigilant supervision to prevent serious dislocations.’ However, he felt that

hedge funds did not cause the instability, preferring to blame institutional investors, who measured their performance relative to their peer group and not by an absolute yardstick. ‘This makes them trend-followers by definition.’

Conclusion

There is still a lot of myth with respect to hedge funds. A lot of the myth is built on anecdotal evidence, oversimplification, myopia or simply a misrepresentation of facts. Although hedge funds are often branded as a separate asset class, a point can be made that hedge fund managers are simply asset managers utilizing other strategies than long-only managers. The major difference between the two is the definition of their return objective: Hedge funds aim for absolute returns by balancing return opportunities and risk. Long-only managers, by contrast, define their return objective in relative terms. Long-only managers aim to win what Charles Ellis (1998) calls ‘The Loser’s Game’, ie, beat the market.

The future path of an economy or stock market is not predictable with any reasonable degree of confidence. Having a year-end target for the S&P 500 in January is similar of having a view on what the weather will be on Christmas Eve twelve months hence. Both systems (weather as well as the economy) are

complex as opposed to determinable.¹¹ Any argument to the contrary must derive from a model with an R2 of 1.00 (Bernstein 1999). However, there is no such thing. Decision making with respect to the future will always involve

¹¹ Until a couple of decades ago, scientists viewed the world as an orderly place governed by immutable laws of nature. Once uncovered, it was believed, these laws would enable scientists to determine the future by extrapolating from historical patterns and cycles. This approach worked well for Sir Isaac Newton. Once he discovered the mathematics of gravity, he was able to predict the motions of our planets. This line of thinking, called determinism, is based on the belief that future events unfold following rules and patterns that determine their course. Current science is proving this deterministic view of the world to be naïve. The theories of chaos and complexity are revealing the future as fundamentally unpredictable. This applies to our economy, the stock market, commodity prices, the weather, animal populations, and many other phenomena. Sherden (1998) analysed sixteen different types of forecasting. He found that from the sixteen, only two – one-day-ahead weather forecasts and the ageing of the population – can be counted on; the rest are about as reliable as the fifty-fifty odds of flipping a coin. An interesting view is that only one of the sixteen – short-term weather forecasts – has any scientific foundation. The rest are typically based on conjecture, unproved theory, and the mere extrapolation of past trends. “...something no more sophisticated than what a child could do with a ruler (or perhaps a protractor).”

uncertainty regardless of the approach used. What we know for sure about equity markets and their volatility is uncertainty itself. There will always be uncertainty.

The above statement is not as fatuous as it may sound. It raises the question of what a money manager should focus on in the long term: expected return or risk. Looking at the world from the view of a risk manager it is obvious: risk. A risk manager would argue that one cannot manage expected return, but one can manage risk. Return is the byproduct of taking risk. Banks today do not manage portfolios, they manage risk. Their long-term investment strategy is to define the risk they want to be exposed to and manage that exposure accordingly. This implies that banks have an absolute-return focus as opposed to a relative-return focus. The same can be said for insurance companies. Insurance companies do not manage their assets according to whether they are bullish or bearish but with respect to their pre-defined risk parameters such as average duration of insured agent or object and asset-liability mix. Potentially, asset management could be in the process of moving in the direction of banks, insurers, and hedge funds, ie defining risk in absolute terms rather than relative terms. One could also argue that the asset management industry is moving back to an absolute return orientation and that the passion with market benchmarks was only a brief blip in the industry's evolution, driven perhaps by an increasing involvement of consultants and trustees. In other words, what we call hedge funds today could

simply be the fireflies ahead of the storm about to be sweeping over the asset management industry.

References

- Ackermann, C. (1998) The impact of Regulatory Restrictions on Fund Performance: A Comparative Study of Hedge Funds and Mutual Funds, FMA Presentation, October 1998.
- AIMR (1999) Standards of Practice Handbook, Eighth edition.
- Amin, Gaurav S. and Harry Kat (2001), 'Hedge Fund Performance 1990-2000 – Do the "Money Machines" Really Add Value?' working paper, July.
- Bacon, Louis Moore, Keynote speech at the 2000 Hedge Fund Symposium, Can Institutions Afford to Ignore Hedge Funds? 27 April 2000, London.
- Bernstein, Peter L (1999), 'Wimps and Consequences,' *Journal of Portfolio Management*, Vol. 26, No 1, Fall, pp. 1.
- Brown, Stephen J.; William N. Goetzmann, and James M. Park (2000) 'Hedge Funds and the Asian Currency Crisis,' *Journal of Portfolio Management*, Vol. 26, No. 4, Summer, pp.95-101.
- Chandler, Beverly (1998) 'Investing with the Hedge Fund Giants – Profit Whether Markets Rise or Fall,' Financial Times Pitman Publishing.
- Chopra, Navin, Josef Lakonishok, and Jay Ritter (1992) 'Measuring Abnormal Performance,' *Journal of Financial Economics*, pp.235-268.
- Cottier, Phillip Dr. (1997) 'Hedge Funds and Managed Futures - Performance, Risks, Strategies and Use in Investment Portfolios,' Verlag Paul Haupt, Bern.
- Eichengreen, Barry, and Donald Mathieson (1999) 'Hedge Funds: What Do We Really Know?' *Economic Issues* No. 19, IMF, September, <http://www.imf.org/external/pubs/ft/issues/issues19/#1>
- Ellis, Charles D. (1998), *Winning the Loser's Game: Timeless Strategies for Successful Investing*, 3rd edition, McGraw-Hill: New York.
- Fung, William, and David A. Hsieh (2000) 'Measuring The Market Impact of Hedge Funds,' *Journal of Empirical Finance*, Vol. 7, Issue 1, pp. 1-36.
- Grossman, S., (1976) 'On the Efficiency of Competitive Stock Markets Where Trades have Diverse Information,' *Journal of Finance*, 31, pp.573-585.
- Haugen, Robert A., Philippe Jorion (1996) 'The January Effect: Still There after All These Years,' *Financial Analyst Journal*, vol. 52, no. 1 (January/February), pp.27-31.
- Peltz, Lois (2001), *The New Investment Superstars – 13 Great Investors and Their Strategies for Superior Returns*, John Wiley, New York.
- Schneeweis, Thomas (1998a), 'Dealing with Myths of Managed Futures,' *Journal of Alternative Investments*, Summer, pp. 9-17.
- Schneeweis, Thomas (1998b), 'Dealing with Myths of Hedge Funds,' *Journal of Alternative Investments*, Winter.
- Schneeweis, Thomas and Richard Spurgin (1998) 'Multi-Factor Analysis of Hedge Fund, Managed Futures, and Mutual Funds Return and Risk Characteristics' *Journal of Alternative Investment Investments*, Fall.
- Shefrin, Hersh (2000) 'Beyond Greed and Fear', Harvard Business School Press, Boston.
- Sherden, William A. (1998), *The Fortune Sellers – The Big Business of Buying and Selling Predictions*, John Wiley, New York.
- Swensen, David F. (2000) "Pioneering Portfolio Management – An Unconventional Approach to Institutional Investment," The Free Press, New York.
- UBS Warburg research (2001) "The Search for Alpha Continues – Do Fund of Hedge Funds Managers Add Value?" September.
- Wace, Ian (2000) "Hedge funds in Europe," speech at the 2000 Hedge Fund Symposium (EIM/EuroHedge/SFI), "Can Institutions Afford to Ignore Hedge Funds?", 27 April 2000, London.