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The Global Institutionalisation of Hedge Funds.

People today are talking about hedge funds as though this 'mystery' of investment management is coming of age. Since the concepts where first formalised with the secret formation of the first hedge fund in 1949 by Alfred Jones (an Australian), this sector has been mostly misunderstood.

So what is all the noise about? Why now? Why the debate on whether to invest in hedge funds or not? Are hedge funds a new asset class? What does this all mean for you, the investor?

This paper will attempt to answer these questions and put forward some definitions and background to assist those of us wishing to place the 'hedge fund' label into context in a modern portfolio allocation and ensure that investment policy continues to be modelled intelligently.

It is interesting to note that Benjamin Graham (1894-1976) the father of value investing and perhaps the most influential investor of all time provides valuable insights into his methods in the classic investor handbook first published in 1949 "The Intelligent Investor".

In his summary of investment methods the following description caught my eye.

'A summary of the Graham-Newman Methods' – In 30 years of the Graham- Newman Corporation operating that is between 1926-1956 the following strategies were utilised. Arbitrage; Liquidations (Events); Related Hedges; Net-current-asset (or bargain) issues – the opportunistic trading of stocks and working capital bargains.

Warren Buffet said "To me, Ben Graham was far more than an author or a teacher. More than any other man except my father, he influenced my life."[1]

Another brilliant economist and investor, John Maynard Keynes offered the following advice. "I believe now that successful investment depends on three principles:

1. A careful selection of a few investments (or a few types of investments)....
2. A steadfast holding of these in fairly large units through thick and thin...
3. A *balanced* investment position, i.e. a variety of risks in spite of individual holdings being large, and if <u>possible opposed risks</u>...."[2]

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[1] Preface to Benjamin Graham '*The Intelligent Investor'– Fourth Revised Edition,* 1984 (1st published 1949) – Harper Business.
[2]Extracts from, John Maynard Keynes,*'The General Theory of Employment Interest and Money, 1936*, pp154-158. New York: Harcourt Brace Janovich, Inc.

What struck me was that the investment style descriptions above fitted very well with the way in which hedge fund managers appear to operate. Let us consider the major categories of hedge fund styles as expressed by Tremont, a hedge fund advisory and research firm.

"PRIMARY INVESTMENT CATEGORIES OF HEDGE FUNDS

Hedge funds are not homogeneous. While over 80% of the total assets under management in the industry are invested in the equity markets, the investment disciplines used are diverse and distinct. As defined by Tremont and TASS there are 10 primary investment categories in the hedge fund industry. These are: Long/short Equity; Equity Market Neutral; Event Driven; Convertible Arbitrage; Fixed Income Relative Value/Arbitrage; Global Macro; Short Sellers; Emerging Markets; Managed Futures; Funds of Funds.

LONG/SHORT EQUITY

This directional strategy involves equity orientated investing, on both the long and short side of the market. The objective is not to be market neutral. The manager has the ability to shift from value to growth, and from small, medium to large capitalization stocks, and from net long position to a net short position. The strategy may hedge with options and futures. The focus may be regional, such as long/short US equity; long/short European equity; or sector specific such as long and short technology stocks, long and short healthcare stocks. Long/short equity funds tend to construct and hold portfolios that are significantly more concentrated than traditional fund managers.

Long/Short Equity represents 49% of all assets under management.

CONVERTIBLE ARBITRAGE

This strategy is identified by hedged investing in the convertible securities of a company. A typical investment position is long the convertible and short the common stock of the company issuing the convertible. Positions are designed to generate profits from the bond and the short sale, while protecting principal from directional market moves. Hedge funds may limit their activities to a single market (e.g. the US), or they may invest globally.

There are two components to the overall return from a convertible arbitrage position. Static Return and Volatility Return.

The Static Return is comprised of the following:

Coupon from the convertible bond plus the interest rebate on the cash from the short sale minus the dividend on the underlying short stock.

The Volatility Return is comprised of profits generated by short-term position adjustments of the short stock position. Adjustments are necessary to account for the changing ratio of stock needed to hedge the underlying convertible bonds as prices fluctuate.

Leverage may be employed to augment both the static and volatility return.

*All Asset figures as at 31st December 2000.

Convertible Arbitrage represents 5.5% of all assets under management.

EVENT DRIVEN

The strategy is categorized by equity orientated investing designed to capture price movement generated by an anticipated corporate event. The Event Driven category primarily includes: risk (or merger) arbitrage, and distressed securities investing. It also includes Regulation D (Reg D) investing and High Yield investing.

RISK ARBITRAGE

Risk arbitrage specialists invest simultaneously in long and short positions in both companies involved in a merger or acquisition. Risk arbitrageurs are typically long the stock of the company being acquired and short the stock of the acquiring company. The risk to the arbitrageur is that the deal fails. Risk arbitrageurs seek to capture the price differential between the stock of the target and the stock of the acquirer. Profits result as the price of the target stock converges with the stock price of the acquirer. Risk arbitrage positions are considered to be uncorrelated to overall market direction with the principal risk being “deal risk” i.e. that the deal fails to go through.

DISTRESSED SECURITIES

Distressed securities funds invest in the debt, equity or trade claims of companies that are in financial distress, typically in bankruptcy. In this context, distressed means companies in need of legal action or restructuring to revive them, not companies in need of FDA approved medication. These securities generally trade at substantial discounts to par value. Hedge fund managers can invest in a range of instruments from secured debt (at the low end of the risk scale) to common stock (at the high end of the risk scale). The strategy exploits the fact that many investors are unable to hold below investment grade securities. Further, few analysts cover the distressed market, ensuring that, for the knowledgeable hedge fund managers prepared to do their homework, many un-researched and inexpensive opportunities can exist.
Distressed managers can follow either an active or passive approach. Active managers get onto the creditor committees and assist the recovery or reorganization process. Passive managers buy the distressed securities and either hold them until they appreciate to the desired level, or trade them. Distressed managers can benefit substantially from the creativity of financial engineers. The growing complexity of debt instruments can provide extensive opportunities for the credit analyst and distressed manager. Distressed debt investing often results in a manager holding “cheap” equity in a newly reorganized company.

REGULATION D

This strategy, usually called Reg D, involves investing in micro and small capitalization public companies which are raising money in the private capital markets. The manager can invest via the stock, via convertibles or other derivatives. Investments usually take the form of receiving a convertible bond or convertible preferred issue in return for an injection of capital. What is unique about these securities is that, unlike, standard convertible bonds or preferreds, the exercise price either floats or is subject to a look back provision. This has the effect of insulating the investor from a decline in the price of the underlying stock. Typically the investor will be long the convertible, short a percentage of common stock and also hold warrants. On the effective dates of the transaction the manager can exercise , if he chooses to, and convert into common stock at a better market price.

HIGH YIELD

The politically correct phrase for “junk bonds”, high yield investing involves applying a buy/hold, or a trading strategy to high yield securities. Managers may buy the high yield debt of a company that they think will get a credit upgrade or that might be in a position to redeem the outstanding high coupon issue. Other areas of opportunity include buying the discounted bonds of companies that are potential take over targets. Some managers combine these strategies with levered pools of bank debt. Portfolio securities are generally sold when they reach upside or downside price targets, or if the issuer of the securities, or industry fundamentals change materially.

Until recently high yield was primarily a US focused strategy. However, today it can be global. Some managers include emerging market bonds, others limit themselves to investment grade countries only.

Event Driven represents 19% of all assets under management.

EQUITY MARKET NEUTRAL

The investment strategy is designed to exploit equity market inefficiencies and usually involves being simultaneously long and short matched equity portfolios of the same size within a country. Market neutral portfolios are designed to be either beta or currency neutral (equal currency – long and short) or both. Well-designed portfolios typically control for industry, sector, market capitalization and other exposures. Leverage is often used to enhance returns. Statistical arbitrage is theoretically designed to be an equity market neutral strategy. To date, liquidity concerns have limited the activity primarily to the US, Japanese and UK equity markets.

Equity Market Neutral represents 6% of all assets under management.

GLOBAL MACRO

Global macro managers carry long and short positions in any of the world’s major capital or derivative markets. These positions reflect their view on overall market direction as influenced by major economic trends and/or events.

The portfolios of these funds can include stocks, bonds, currencies, and/or commodities in cash or derivative format. The funds may use highly opportunistic investment strategies investing on both the long and short side of the markets. The portfolios can be highly leveraged. Most of these macro hedge funds invest globally, in both developed and emerging markets.

There are two schools of global macro manager. Those who come from a long/short equity background and those who come from a derivative trading background. Macro funds run by companies like Tiger Investment Management and Soros Fund Management were originally invested primarily in US equities. The success of these managers at stock picking resulted over time in substantial increases in assets under management. As the funds increased in size, it became increasingly difficult to take meaningful positions in smaller-capitalization stocks (the stocks often preferred by the equity hedge fund managers because they are generally under-researched by the brokerage community). Consequently, the funds started gravitating towards more liquid securities and markets in which bigger bets could be placed.

Funds run by Moore Capital, Caxton, and Tudor Investment Corp developed from a futures trading discipline which, by its very nature, was both global and macro economic in scope. The freeing up of the global currency markets and the development of non-US financial futures markets in the 1980s provided an increasing number of investment and trading opportunities not previously available to investment managers.

Global Macro represents 8.5% of all assets under management.

FIXED INCOME ARBITRAGE

The fixed income arbitrageur attempts to profit from price anomalies between related interest rate instruments. The majority of managers trade globally, although a few just focus on the US market. In order to generate returns sufficient to exceed the transaction costs, leverage may range from 10 times up to 150 times NAV employed. Genuine fixed income arbitrageurs typically aim to deliver steady returns with low volatility, due to the fact that the directional risk is mitigated by hedging against interest rate movements, or by the use of spread trades. Fixed income arbitrage can include interest rate swap arbitrage, US and non-US government bond arbitrage, forward yield curve arbitrage, and Mortgage Backed Securities Arbitrage.

MORTGAGE BACKED SECURITIES ARBITRAGE

The mortgage backed securities strategy specializes in arbitraging mortgage backed securities and their derivatives. This strategy takes place primarily in the United States. The market is over the counter and extremely complex. The two greatest risks are prepayment and valuation; all securities are marked to market, but the pricing and valuation models used by the different participants may vary, and overall market liquidity has a huge impact.

Fixed Income Arbitrage represents 5.6% of all assets under management.

DEDICATED SHORT BIAS

As recently as three years ago there was a robust category of hedge funds known as “dedicated short sellers”. However, the ravages of the current bull run have reduced their ranks to all but a handful of funds. Recently there has emerged a category of funds committed to maintaining net short as opposed to pure short exposure.

The short biased managers invest mostly in short positions in equities and equity derivative products. To be classified as a short biased manager, the short bias of the manager's portfolio must be constantly greater than zero. To effect the short sale, the manager borrows the stock from a counter party (often its prime broker) and sells it in the market. The proceeds from the sale are kept by the broker as collateral. An additional margin of typically 5% to 50% must be deposited in the form of liquid securities. The margin is adjusted daily. Leverage is created because margin is below 100%. Short selling can be time consuming and expensive. The manager needs very efficient stock borrowing and lending facilities. Because of this, short positions are sometimes implemented by selling forward; selling stock index futures or buying put options and put warrants on single stocks or stock indices.

It is generally accepted that the short side of the market can be much less efficient than the long side of the market. Restrictions on short selling vary from jurisdiction to jurisdiction. For example, the United States has its "uptick" rule (namely you cannot initiate a new short sell position when the price of the stock is going down); Europe does not have an uptick rule; and in many emerging markets short selling is simply not possible. Derivatives can be used to get around some of these issues, particularly in the US.

Dedicated short bias represents 0.4% of all assets under management.

EMERGING MARKETS

This strategy involves equity or fixed income investing focusing on emerging markets around the world. Certain commentators regard emerging market hedge funds as a contradiction in terms. Many of the emerging markets do not allow short selling, nor do they offer viable futures or other derivative products with which to hedge.

Emerging Markets represents 3% of all assets under management.

MANAGED FUTURES

The managed futures traders, otherwise called commodity trading advisers (CTAs), trade in the listed financial and commodity futures markets around the world. They may also trade in the global currency markets. Most traders apply their individual disciplines to the markets using a systematic approach; while a small percentage use a discretionary approach. The systematic approach tends to use price and market specific information in determining the investment decisions. The discretionary approach tends to use price, market information as well as broader economic and political fundamentals in determining the investment decisions. Most CTAs trade a very diversified range of markets and contracts and seek to identify trends in each market/contract. Differences include: time horizons, asset allocation, contract selection, contract weighting, the treatment of short term market "noise", and use of leverage.

Most CTAs are regulated by the CFTC as opposed to the SEC in the United States.

Managed Futures represents 3% of all assets under management."[3]

So certainly we can see similarities of investment styles and risk management appearing in all descriptive styles and strategies dating back to 1949. But now comes the interesting part, many of these strategies work in the long run and produce good results.

The consistent success of performance vs. risk with the use of hedge fund style investing and the expansion of knowledge of such trading styles continues to attract more funding and as such more 'feeder' structures continue to appear to capture assets for the allocation to 'hedge fund operators'. Such structures are able to offer both the investor and the analyst transparency and risk management solutions.

Now even the peak body for post-graduate training of investment professionals 'The Association of Investment Management and Research' (CFA Charterholders – see www.aimr.org) is offering seminars on the area of 'Hedge Fund Management'. Their first seminar held in November 2001 saw attendees from USA; United Kingdom; Belgium; The Netherlands; People's Republic of China and Australia. Surely an indicator that members who predominately work with the 'very high' net worth and institutional money management sectors are wanting to ensure that they are up-to-date with this current trend. A trend that is seeing additional billions of dollars each quarter being allocated to managers adopting the styles of investment management defined above. In fact the rate of growth of hedge fund management is currently outstripping the rate of growth of all other investment management sectors. We see this trend accelerating, globally. The reason is simple. Where else can we find returns outstripping the S&P 500 by 21% year to date with similar or lower risk?[4] (standard deviation)

As expertise and knowledge among investment professionals has spread so has the acceptance of hedge funds. Where proprietary traders have left banks and other institutions to form 'funds', so too the 'seeds' of hedge fund management have been scattered further and further afield.

This experience has parallels elsewhere in 'investment evolution'. Take the formation and then expansion of Money Market Accounts in the 1950's- 60's with Merrill Lynch offering the first such structures in the USA and the subsequent global expansion in these Cash Management Trust's and Funds in the 1980's. Now this style of managing cash is often part of an investors' portfolio, but it was not that long ago this simple investment option was very confusing to many investors.

By this stage we understand that hedge funds are a way of investing, not an asset class. Today the trading of financial markets instruments in the 'hedge fund style' is being accessed by many, with new participants emerging daily. No longer is such trading expertise the domain of a few large institutions, or groups of maverick traders with their big balance sheets and possessing the right information technology. Now some 6000 'independent' managed funds occupy this industry sector.

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[3] Tremont Partners, Inc. & TASS Investment Research Ltd. '*The Case For Hedge Funds 2nd Edition'* April 2001.

[4] Van Hedge Fund Advisers International. *Hedge Funds Outperform Major Indices Year to Date – November 23, 2001* – issued via e-mail service Hedgefundsworld – 21 December 2001.

We also know from research of Tremont that capital under management in hedge funds ('hedge fund style management') exceeds USD$600bn, twice the size of the total Australian funds management industry, the eighth largest in the World[5].

We certainly understand that the effect of including exposure to a basket of hedge funds reduces overall risk in a portfolio. And most importantly will, as opposed to a current traditional 'long' only portfolio, produce superior consistent returns. We certainly see this growth trend expanding at least at a rate consistent with the expanding spread of hedge fund trading knowledge.

So what does this mean for us going forward, particularly in the Asian region? Certainly the financial markets of Singapore, Australia and Hong Kong are moving toward mutual recognition and not integration. Co-trading initiative are already underway with Australia and the Singapore Exchange[6]. These dealings will in time enable some of the styles of investing we have described to be explored with ease across borders.

However anomalies in product structuring will exist for some time to come with most nations excluding the USA and Australia requiring both trustees and managers for collective investment schemes. But rest assured the growth of this sector will continue as the institutional investors, all over the World continue to benefit from the styles and strategies that 'hedge fund' management brings to the portfolio asset allocation process.

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[5] Source: IFSA- Investment & Financial Services Association Limited. December, 2001.
[6] Alan Cameron, '*Mutual Recognition Reduces Regulatory Barriers in the Asia Pacific'* – Axiss Markets Perspective p.10 – a publication sponsored by the centre for Global Finance, Sydney – December 2001 – Capital Markets Magazines.