Hedge Funds: Past, present and future
By Rene M Stulz, Journal of Economic Perspectives, Spring 2007

Hedge funds are unregulated pools of money managed with a great deal of flexibility. Thus, hedge fund managers can take short positions, use leverage and make extensive use of derivatives. To get around regulation, hedge funds limit the number of investors and do not make public offerings. It is mostly institutional investors, high net worth individuals and companies which invest in hedge funds.

A hedge fund is usually a collection of funds each designed to optimize taxes for a category of investors. Most American hedge funds combine an offshore fund for foreign investors and an onshore fund for American investors. The offshore fund is usually based in a tax haven while the onshore fund is a limited partnership, again to minimize tax liabilities. The onshore and offshore funds may invest in a master fund. Then the onshore and offshore funds are called feeder funds.

The compensation structure of a hedge fund makes it possible for the managers to make good money if the fund generates good returns. Most hedge funds have a high-water mark clause. If they make a loss in one period, they can get the performance fee only if they have recovered the loss. The high-water mark limits risk taking. But in the event of a large loss, the fund manager may simply decide to close the fund. The tendency for risk taking is quite high as long as the manager does not have a big investment in the fund. As long as no illegal actions have been taken, the trader will not have to return past compensation.

Hedge funds put restrictions on withdrawal of funds by investors. Their disclosures are minimal compared to mutual funds.

Derivatives and short positions are critical in many hedge fund strategies. So, hedge funds can correct mispricing and chase arbitrage opportunities more effectively than mutual funds.

Hedge funds pursue absolute performance as opposed to returns in excess of a benchmark. Funds are expected to be market neutral over time. They are expected to show average performance whether the equity markets do well or not.

Professional investors are more likely to understand the strategies of hedge funds and take a long-term view even if some losses are incurred in the near term. In contrast, ordinary investors may tend to withdraw their funds and force managers to liquidate their positions at a loss. That is why hedge funds look for knowledgeable investors and also put restrictions on redemptions by investors.

The four most common hedge fund styles are: *long-short*, *event-driven*, *macro* and *fixed-income*.

- A *long-short equity hedge fund* takes both long and short positions in stocks. This strategy calls for identification of overvalued and undervalued stocks. Thus, a fund may buy some undervalued stocks and sell stock index futures.

- *Event-driven strategies* attempt to take advantage of opportunities created by corporate actions such as spin offs, M&As, reorganization and bankruptcies. Event driven trading attempts to predict the outcome of a particular transaction and anticipate the optimal time at which to commit the capital.

- *Macro strategies* try to identify mispriced valuations in stock markets, interest rates, forex rates, commodity prices and make leveraged bets on the anticipated price movements.

- *Fixed-income arbitrage funds* attempt to find arbitrage opportunities in the fixed income markets.

Other hedge fund styles include *emerging markets*, *futures* and *convertible arbitrage funds*.

Measuring the performance of a hedge fund and to conclude whether it is superior to that of mutual funds is not easy. First there is no compulsion to disclose performance. So, the sample of funds which voluntarily provide returns may be biased. There are also difficulties in adjusting fund performance for market exposure. An equity mutual fund's returns is best viewed as the return of a basket of stocks plus some component that is unique to the fund. A hedge fund's return is best viewed as a basket of derivatives, with nonlinear pay offs. Another problem is that the past performance of a hedge fund may not give a complete picture of the risk involved. Volatility is not a good measure of mutual fund risk. Volatility may be low and yet there is considerable risk that a hedge fund may lose all its assets. LTCM had lower volatility than the S&P 500 for almost all of its existence. But the fund lost most of its capital in less than a month. There are also problems of valuation. This is because hedge funds hold securities that are not traded on the exchanges. In general, mutual fund returns are not serially correlated but hedge fund returns are. One reason for serial correlation is the flexibility that hedge fund managers have in valuing the securities to massage returns and present a picture of low risk and consistent performance.

Regulators are concerned about the risk of a hedge fund for 4 reasons: investor protection, risks to financial institutions, liquidity risks and excess volatility risks.

Many hedge funds die every year. Some of them in fact die due to investors withdrawing their money after significant losses. Some disappear because of fraud or misreporting. But investor protection may not be critical because of the nature of investors.

Hedge funds can create risks for financial institutions in the way they borrow, undertake securities transactions and act as counterparties in derivative trades.

If many funds have set up similar positions, they may find it difficult to exit at the same time. With low liquidity, hedge funds that rely on trading quickly to control their risks cannot do so.

Hedge funds can also undertake trades that push prices away from fundamental values, leading to excess volatility risk.

Hedge funds do well at eliminating small discrepancies or prices that can be arbitraged. But if asset prices depart systematically from the fundamentals, it may be too much to expect the funds to bring them back to the fundamentals.

Hedge funds also provide liquidity to the markets by buying securities that are temporarily depressed because of market disruptions. But this liquidity may disappear quickly in the presence of a systematic shock. This liquidity withdrawal may worsen the shock.

We can expect the hedge fund industry to perform less well over the next 10 years than in the past 10. As the industry grows in size, it attracts either funds which go into existing strategies or new strategies that cannot be good as the ones already implemented. If more hedge funds chase the same arbitrage opportunities, the faster they get eliminated and less the profits. Take the case of convertible arbitrage funds. Their strategy is typically to buy the convertible instrument and short the stock. But as more and more funds start buying the convertible bond, the price goes up leading to lower returns from this strategy.

Twenty years ago, most of the money flowing into hedge funds was from individuals who by and large gave the managers a free hand. Today with institutional investors, having fiduciary responsibilities being the main contributors, hedge funds are expected to provide more disclosures. That implies not only the need to have more administrative staff but also the risk of information being used against the fund. For example, a large loss may well prompt some investors to withdraw their money. In the case of Amaranth, the well-known hedge fund, one institutional investor pulled out funds after a huge gain due to worries about future risk.

Institutional investors are also more likely to measure performance relative to benchmarks such as a hedge fund index. When benchmarks become important, managers may also become risk verse. They may not try to overshoot the benchmark for fear that at times, the strategy may lead to underperformance. And as benchmarks become more important, performance may also become similar across funds. With the growing importance of institutional investors, the skills of managers will matter less, compared to reporting, risk management, transparency, liquidity and the ability to absorb large new investments. Moreover, such services can be replicated by algorithms without the need to pay high fees to hedge fund managers.

As a hedge fund succeeds, it may also face pressure to become a diversified financial institution. To maximize the value of the assets built by the manager, namely reputation, access to investors and organization, it makes sense to diversify, for example by selling products that are more similar to actively managed mutual funds. Over a period of time as the product line expands, hedge funds will become more like financial institutions.

Meanwhile, mutual funds can implement some of the hedge fund strategies like use of short positions and derivatives. Their performance will become more similar to hedge funds than to plain vanilla mutual funds. And because such funds will charge lower fees, the demand for plain vanilla hedge funds may well drop.

The pressure to increase regulation of hedge funds may increase due to several reasons. Hedge funds have become activist investors. They lend money and borrow shares to vote in corporate control interests, without bearing the risk of stock ownership. Hedge funds are becoming like financial institutions. And regulated financial institutions may well complain about the lack of a level playing field.