Dealing with Myths of Hedge Fund Investment

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Recent events in financial markets have focused interest on the existence and operations of a relatively new form of investment entity, the hedge fund. A hedge fund is a loosely regulated private pooled investment vehicle that can invest in both cash and derivative markets on a leveraged basis for the benefits of its investors. Unfortunately, there are a number of myths surrounding hedge funds and the risk and return opportunities that hedge funds offer. In a short comment one cannot cover in detail all of the misconceptions about the performance of hedge funds or other alternative investments. In fact, one of the central goals of *The Journal of Alternative Investments* is to provide an ongoing forum for research and information about hedge funds and related investment vehicles. This editorial addresses a number of common misconceptions about hedge funds and the events surrounding the collapse of Long Term Capital Management.

Myth: Hedge Funds Are an Investment Product Of The 1990's.

While the number and size of hedge funds have 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 a change in technology that permitted sophisticated investment strategies to be designed and implemented without the infrastructure of a large investment house.

Myth: Hedge Funds Are Unique In Their Investment Strategies

Hedge funds can be viewed as the privatization of the trading floor or investment bank. New technology has permitted investment professionals to leave investment banks and trade proven strategies that for years were traded with internal proprietary capital. 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 investment banks and investors took losses in a particular strategy, 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: The Failure of A Single Hedge Fund Is Cause For Concern

Many hedge funds failed before Long Term Capital, and many will 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 single investment product. In short, unless one has a perfect forecast of the future, diversify, diversify, diversify. 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 initially made the wrong choice. The most notable aspect of the LTCM collapse is not in its collapse, but in the fact that many sophisticated investors held such large portions of their personal wealth in the fund, which is completely contrary to modern investment principles.

Myth: All Hedge Funds Are Risky Because They Use Derivatives

Not all hedge funds use derivatives. Hedge funds employ a wide array of investment strategies including arbitrage strategies, which use derivatives, as well as strategies such as distressed debt, merger arbitrage, emerging market debt and equity that do not. In fact, in the recent market environment, many of those hedge fund strategies that rely heavily on derivatives had superior performance to traditional asset markets. The worst performing hedge funds in 1998 -- emerging market funds -- generally do not use derivatives at all.

Myth: Hedge Funds Are Highly Levered, Risky Investments

The risk and return attributes of hedge funds are determined solely by their investment strategy. Some hedge that funds invest primarily in long-only cash instruments employ little leverage since the underlying asset itself has a high return-to-risk tradeoff. Other hedge funds invest in low-risk strategies such as security arbitrage. These funds use leverage positions in order to offer a reasonable expectation of return. The historical record shows that the typical hedge fund's returns have been less volatility by far than the typical stock or stock mutual fund. Furthermore, hedge funds that make extensive use of derivatives have generally offered returns that are less volatile than the returns of hedge funds that do not use derivatives.

Myth: All Leverage Is Bad

One must remember that leverage itself is not something to be avoided. Banks, for example, are levered about 12 to 1 (about 8%% of assets are equity capital, the rest is loans, deposits, and preferred stock). Residential real estate is typically levered 4 to 1 (a 20% down payment is common, with 80% borrowed). Corporations in risky businesses such as technology stocks and automobile manufactures tend to be financed mostly with equity because of the unpredictability of the returns. The more highly levered an instrument is, the more care one must take to insure that the payment flow is more predictable or large losses are possible.

Myth: Hedge Funds Offer No Economic Value

Hedge funds invest in a wide variety of investment arenas including private equity, private debt, mergers 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 economic function of derivative products is to offer a mechanism for firms to reduce or manage their own risk. Financial innovations such as warrants, oil-linked bonds, and 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 corporations to efficiently raise capital and manage risk. Hedge funds are a primary purchaser of these new securities, both in the primary market and the secondary market. Without hedge funds, corporations will have fewer risk management choices and will have a higher cost of capital.

Myth: The Rescue of Long Term Capital Was Ill-Advised

It is possible, in hindsight, to question whether the partners and employees of LTCM got too much or too little in the bailout. It is also fair to question whether the Fed should have played the role of policemen in the deal rather than let the banks and other creditors fight it out on their own. It is likely that the banks or some investment house would have reached some settlement with LTCM without the Fed's intervention. There was simply too much at stake. The banks had to realize that a mass liquidation of LTCM would have had a disastrous effect on their own balance sheets (as well as on the markets as a whole), and LTCM had little choice but to arrange a capital infusion. Most of the credit, if one wishes to use that word, for putting the bailout together, along with the blame for lax credit controls, belongs to the banks and investment houses that provided LTCM with an almost unlimited line of credit.

Myth: Hedge Funds Cause Worldwide Panics

Numerous academic studies have shown that hedge funds were not the cause of the Asian crisis or other major world economic collapses. It is true 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 -- overbuild, over-buy, over-monetize -- funds flee and the market reacts quickly. While such capital fight may have its own associated problems, the alternative to free flows is almost always worse. If investors are afraid they will be unable to retrieve capital, they will never go there in the first place.

Myth: Hedge Funds Should Are Too Risky To Be Included In An Investor's Portfolio

Academic research has 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 of bonds. We do not need to see risk-adjusted returns as high as they have been in order to justify diversifying into hedge funds.

Myth: Hedge Funds Don't Invest, They Just Trade

Recent academic research 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 favor long-term investing are now critical of hedge funds. These funds are structured to allow managers to make less liquid, long-term investments without the constant worry that investors may choose to cash out at a moments notice.

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, 3) trading in illiquid secondary markets is potentially disastrous in extreme market conditions, 4) an asset that returns in excess of 30% per year, as LTCM did, is a very risky investment. These are, of course, lessons that are true for all investments, and have nothing to do with the fact that LTCM was a hedge fund.

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 made are laid directly on the traders at LTCM who took risky positions while failing to divulge to creditors the extent and risk of their holding. But the credit officers at the banks are equally culpable for their willingness to extend ever 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 with societies need for risk capital which requires the existence of financial institutions and traders as financial intermediaries.

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 project 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 will offer a return commensurate with the risk. All of us must learn to live with that reality.

Myth: There is Nothing Scary About LTCM's Near-Collapse

An investment that can earn 30% in a year may also be poised to lose 30% just as easily in an opposite economic environment. There's nothing scary about that. What is scary is the number of investors bankers, and investment managers who forgot this simple truth and thought LTCM had figured out a way to beat the market without the potential for loss. It wouldn't have taken much for LTCM to survive intact. If Russia maintains fiscal discipline… if Japan takes action to solve its banking crisis… if Malaysia keeps its markets open to foreign investment. Any of these events probably changes LTCM's losses into gains -- and continued praise for LTCM while waiting for the shoe to drop on some future date.

What's next for Hedge Funds….

While the hedge fund community will almost certainly survive, the landscape has certainly changed as a result of Long Term Capital.

1. Many more funds will probably close. The rumor going around that there are more spectacular failures and bailouts waiting in the wings seems unlikely. This is simply because no other fund enjoyed the free ride from creditors that LTCM had. However, many funds that have annual redemption policies are going to have a difficult time surviving into 1999. Many supposedly market-neutral funds have been exposed as being anything but neutral. Their investors will be redeeming their shares and many funds will simply shut down as a result.

2. The funds that survive are going reduce their leverage. There will be backlash from bank credit departments against the surviving funds. Hedge funds will need to post more collateral and the banks will be more conservative in their pricing of the collateral. This will result in lower returns posted by the hedge fund community but also commensurately lower risk. Investors used to 15% annual returns from hedge funds will probably have to get used to 10% for at least the next few years.

3. Investors will diversify their holdings across many hedge funds. One of the most surprising things about investors in hedge funds is that most currently hold relatively few funds. Even funds-of-funds, which are essentially mutual funds that invest in hedge funds, often invest in only a handful of funds. Investors will look at the impact of a 100% loss in one of their funds and realize that the best way to invest in hedge funds is to take small stakes in a large number of funds.

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