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Hedge Funds - Past, Present, And Future

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Despite several well-publicized blow-ups and the recent turmoil in the U.S. mortgage markets, hedge funds worldwide continue to enjoy record allocations from **pension** fiduciaries and other sophisticated institutional **investors**. Most cite risk mitigation, portfolio diversification, low correlations, and market outperformance as key reasons to **invest**. Many institutional **investors** are still mystified when it comes to the history of hedge funds, where they are today, and what to expect in the years ahead.

The Past

There have been numerous debates as to when the first hedge fund or portfolio which utilized financial hedges was established. Some believe it dates as far back as the Yodoya rice market in Osaka, Japan, around 1650 where the first 'futures' contracts were utilized. Others point to the tulip mania that hit Amsterdam in the early 17th century. The most widely recognized and referenced official hedge fund was that of Alfred Winslow Jones in 1949. Jones believed he had found a superior manner to manage capital in the equity markets. The basis of his investment strategy was to 'hedge' his long equity exposure by 'shorting' other equities to protect against a market decline. His strategy was to buy equities of good companies while simultaneously selling shares of what he considered poor performing companies. His fund utilized borrowed capital ('leverage') to further enhance returns. The majority of his net worth was invested in the fund. In 1952, Jones transformed his general partnership into a limited partnership and charged the limited partners a 20 per cent incentive fee for managing their assets.

Over time, news of his hedge fund and superior risk-adjusted absolute performance spread. Wealthy individuals seeking better investment returns became interested in hedge funds. Professional investors left established Wall Street firms to set up funds. There were approximately 200 hedge funds by 1968, which included those managed by celebrated luminaries George Soros, Michael Steinhardt, and Warren Buffet.

European and U.S. ultra high net worth individuals were primarily the initial investors. Manager sourcing was performed strictly through word-of-mouth. Due diligence was essentially a handshake. The universe of hedge funds was predominately small and club-like in nature. These investment strategies later evolved from the classic Jones model of long/short equity investing with leverage to merger arbitrage, macro, market neutral, credit based, and more.

High net worth individual investors were followed by foundations and university endowments. A significant proponent of hedge funds and absolute return strategies was David Swenson, the chief investment officer for the Yale University Endowment Fund. Swenson joined Yale's staff in 1985 after years of success on Wall Street. His forward-thinking style of investing diversified Yale's endowment holdings to include hedge funds, private equity, real estate, timber, and other 'alternative' investment strategies in the search for uncorrelated absolute returns. Over the years, the Yale endowment has allocated up to approximately 25 per cent of its assets to hedge funds. The endowment's exceptional, consistent, superior returns far outpaced the performance of other universities which typically allocated 60 per cent of their portfolio to stocks and 40 per cent to bonds. The performance of the Yale fund helped coin the term 'endowment' style of investing.

The Present

The majority of hedge fund investment strategies aim to limit the systemic risk of the markets and securities in which the funds invest. The funds offer qualified investors a more stable alternative to traditional stock and bond investing. However, the term 'hedge fund' is frequently inaccurately used to describe any type of investment partnership. This may include strategies which do not hedge, may be purely directional and speculative, or may invest in illiquid assets.

The hedge fund industry has grown substantially. The Seventh Biannual HFMWeek Hedge Fund Administrators Survey shows there are approximately 11,000 hedge funds worldwide managing in excess of \$2 trillion in assets. This number may be somewhat misleading as the largest 100 hedge funds manage more than 50 per cent of the industry's assets.

Many hedge funds today resemble asset management companies with institutionalized operations, sophisticated risk management tools, and client service. In many ways, they resemble mid-tier investment banks and more traditional investment firms.

As a result, the investor base in hedge funds has changed dramatically. Hedge funds have evolved from servicing high net worth individuals to also servicing sophisticated institutional investors. Pension funds now recognize the benefits that the uncorrelated absolute rates of return hedge funds offer as both direct investments and in portable alpha programs.

The Future

Hedge fund investment strategies continue to develop and change. As the hedge fund industry has expanded and world markets have grown, new strategies have emerged in the ongoing search for uncorrelated, risk-adjusted returns.

In many cases, hedge funds have become predominant players in investing strategies once exclusive to only large investment banks. Hedge funds have also become quasi-banks, offering traditional banking functions such as originating loans and equities directly with growing companies and enterprises.

We believe alternative strategies deployed by hedge funds will continue to evolve. Historically, investors have hired different managers to oversee allocations to distinct strategies. For example, one may hire a private equity manager, a timber manager, and a hedge fund manager. In the future, we expect to see a continued convergence of these strategies among multi-asset alternative investment firms. These strategies will be housed in companies with expertise in the liquid markets as well as private, non-public investments. These managers will structure funds based on a desired market correlation, targeted risk, and targeted return matrix. The strategies these managers will execute will be broad-based and will cover multi-asset classes. Investors will be able to diversify their capital with a desired risk level and targeted return in one multi-asset type fund.

We anticipate a further bifurcation of investment firms. The market will be split between large multi-asset investment funds and small, more nimble, single strategy managers. The innovation in the hedge industry and outperformance will take place at these levels. Large firms will have the infrastructure, personnel, and expertise to develop new alternative investment strategies and be on the forefront of the capital markets. Smaller, more nimble, single strategy managers will be able to exploit the inefficiencies which exist in their given expertise.

In our view, the global hedge fund industry and alternative multi-asset class industry will continue to expand at a record pace. Investors will embrace the importance of risk management in portfolio construction and continue the never-ending hunt for a more stable alternative to traditional stock and bond investing. ■

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