

With a Steady Hand

Essays on Long-Term Investing

Number 1

The great hedge fund swindle

By Karl-Heinz Thielmann

The last decade in the financial industry has been characterized by the rise of so-called hedge funds. After the technology bubble had burst in 2000, many institutional investors, facing low bond yields, went looking for products that promised high yields combined with low risks. Freed from the restrictions for conventional financial products, hedge funds seemed to be the solution. According to estimates of Hedge Fund Research Inc. (HFRI), approx. \$US 2.2 trillion are currently invested in approx. 9,500 hedge funds worldwide. This amount is more than 8 times higher than 12 years ago.

Hedge funds are investment companies that have no legal restrictions about the use of their capital. They are often domiciled in offshore financial centres. The remuneration of fund managers typically consists of a management fee (in general 2% of the fund volume p.a.) and a performance fee calculated on the basis of the actual value increase achieved by the fund (as a rule, 20% of the profits).

The proponents of hedge funds cite the following reasons for hedge funds being preferable to conventional kinds of financial investment:

- Hedge funds are aimed at achieving a positive and risk-efficient performance, independent of the market environment.
- They are not subject to the legal restrictions for asset managers and can therefore use all financial instruments unrestrictedly while pursuing their purpose. By selling short they can speculate on negative developments. Wagering on positive price movements, they can leverage their positions with derivatives and credit.
- The interests of customers and fund managers are interconnected, because the remuneration of the managers is derived from the actual value increases.

Speed Read:

- *In the last decade, the hedge fund industry has been transformed from a profitable niche business into mediocre mass production.*
- *The public perception of hedge funds, however, is still dominated by the glorious past.*
- *Reasons for the preservation of this distorted view are a positive bias in aggregate performance reporting, the general overstatement of their ability to generate consistent returns, the underestimation of their risks, wrong incentives due to the fee structure and their attractiveness as an instrument for financial crooks.*
- *Hedge funds are only suitable for very experienced and sophisticated investors who are able to identify the few outstanding ones.*

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- There are numerous hedge funds indexes that show a superior long-term performance compared with traditional investments in bonds or shares - with the exception of performance in the crisis year 2008.

Investment strategies of hedge funds are very heterogeneous and it is very difficult to categorise them. However, according to the classification of Hedge Fund Research, Inc. it is possible to distinguish four big groups:

Equity Hedge:

This group pursues strategies focused on maintaining positions, both in the long and short term, primarily in equity and equity derivative securities. Many investment processes are used to make investment decisions, including both quantitative and fundamental methods. Their strategies can be broadly diversified or sector specific. They can also vary strongly in terms of levels of net exposure, leverage employed, holding periods, market capitalization and valuation range.

Event Driven:

Their investments are focused on companies currently or prospectively involved in corporate transactions. These could be mergers, restructurings, deleveraging, tender offers, share buybacks, debt swaps, security issuance or other capital structure adjustments. The security types involved can range from the most senior in the capital structure to the most junior or subordinated security types, and can also include derivative securities. Investment decisions are typically made on the basis of fundamental analyses; quantitative methods do not play a role.

Global Macro:

This group includes a broad range of strategies in which the investment process is based on assessing the movements in underlying economic variables and the impact these have on equity, fixed income, currency and commodity markets. The investment performance is derived from the predicted movements in the selected financial instruments. A variety of methods is employed - discretionary and systematic analysis, top-down and bottom-up, quantitative and fundamental approaches.

The funds for “managed futures” are a group of growing importance within this segment. These funds are focused on quantitative-based trading strategies. In general they apply models or algorithms to identify short-term trends or price inefficiencies and use computerised trading.

Relative Value:

The investment approach in this group is to derive performance from the exploitation of valuation discrepancies in the relationship between multiple securities. A variety of fundamental and quantitative valuation techniques is used to identify investment opportunities. The security types range broadly from equity, fixed income, and derivatives to other security types. Quantitatively driven strategies play a much larger role than with other hedge fund categories. The success of “relative value” is dependent on the way a market mechanism functions, which offsets valuation differences. However, in times of financial market turbulence, this market mechanism might be significantly disturbed.

The first fund that could have been called a hedge fund in today’s sense was founded in 1949 by the investor Alfred W. Jones. He invested predominantly in shares and typically reinforced his positions with loan-financed

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purchases, while selling short the shares he rated negatively. The balance between short sales and loan-financed purchases reflected his general market view. In the event of a positive market expectation, loans were increased and short sales were curtailed; in the event of a negative view, short sales were increased and loans were reduced. Moreover, 20% of all profits generated by the fund went to the manager as a performance fee. The term "hedge funds" was invented in 1966 in a report about Alfred W. Jones by the magazine "Fortune". The article described how, for a period of 10 years, Jones had enjoyed a performance that was 87% better than the best conventional unit trust, despite earning high performance fees. This positive report caused the first small boom of hedge fund inceptions. A lot of investors wanted to benefit from the combination of leverage and performance fees. However, during the stock market turbulences between 1969 and 1974, most of these new establishments lost a lot of capital relatively fast and were dissolved.

There were only a few survivors of these wild "early days" of the hedge fund industry, such as its forefather Jones and others, for example George Soros and Michael Steinhardt, who became very successful later.

Until 1986, hedge funds evolved relatively unnoticed. A small number of managers invested the money of wealthy customers mainly from offshore financial centres. The volumes seldom exceeded a value of several million \$US. However, then the "Institutional Investor" published a report about Julian Robertson and his "Tiger Management Fund", which had achieved an average annual performance of 43% during the 6 years after its inception. This spectacular value increase was achieved by aggressively using derivatives to make concentrated bets on certain economic developments and to exploit market inefficiencies. Many investors wanted to pursue similar strategies in order to participate in this success, and in contrast to the tumultuous years in 1970 several also succeeded. However, the failure rate of funds remained high. In particular, arbitrage funds, whose success was based on systematically exploiting market inefficiencies, came under pressure in phases of rising market uncertainty and fell victim to irrational price movements. Thus, some big funds had to be liquidated in 1994, as turbulences in the US interest markets rendered a lot of trading strategies ineffective. In 1998, the most spectacular bankruptcy of a hedge fund to date happened when the bets of the Long-Term Capital Management (LTCM) fund became so large that it was no longer impossible to unwind them. They had also reached a magnitude that endangered the world financial system. A massive intervention of some of the leading banks led by the US Federal Reserve prevented a general collapse.

Despite these setbacks, the 90s of the last century were generally a successful decade for hedge funds. They were able to establish themselves as a decent form of investment in the financial markets. However, they still remained relatively insignificant in comparison to conventional financial investments. This changed at the end of the stock market boom in 2000. After two decades of continuous price increases, shares were highly valued. The bear market in 2001-2003 hit them especially hard. The bond markets were delivering stable, yet low yields. Hedge funds seemed to be a promising solution in this market environment. On the one hand, they promised high yields. On the other hand, they generated profits regardless of the general financial market trends. This gave hedge funds a very favourable risk profile and resulted in the emergence of a whole industry of specialized consulting companies, investment banks and research institutes. They marketed hedge funds to many investor groups that had previously been sceptical. Above all, however, the spectacular success of David Swensen, the investment manager of the endowment of Yale University, led to the acceptance of hedge funds by many risk cautious investors. Within a few years, he succeeded in doubling the capital of his foundation with investments in hedge funds. Between 2000 and 2007, the assets administered by hedge funds rose at an average yearly rate of approx. 40%. However, with the financial crisis of 2008, the success story came to a

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halt. Although one hedge funds manager - John Paulson – had achieved the largest profit ever made from financial transactions (\$US 15 billion) with his bet against the US property market, most other competitors clearly suffered badly. On the basis of the HFRX Index the average loss in that year was 23.3%. A number of hedge funds had to take far higher losses and were liquidated. Furthermore, the fund of Bernhard Madoff, a New York broker, was revealed to be a case of fraud; he had been deceiving his customers for decades with fictitious performance figures.

Since then, the amount of money invested in hedge funds has recovered and is now close to the level of 2007 again. All in all, the events of 2008 revealed the big weaknesses of hedge funds. Many of their supposed advantages turned out to be the opposite.

Although arguments in favour of hedge funds are rejected, they are still described as a "superior investment product" by many investment consultants, large parts of the financial press and in the marketing materials of hedge funds suppliers. Therefore, this article was named after Julian Temple's film "The Great Rock'n'Roll Swindle" of 1980, which is a satire describing the rise of a punk group with the help of manipulated information. The partly positive image maintained by hedge funds is largely because only very selective information is published about them.

We have identified five problem areas concerning hedge funds. According to our appraisal, their image is too positive with respect to these issues:

- 1) The performance swindle - the performance of hedge funds is often expressed too positively.
- 2) The consistency swindle - their ability to achieve consistent yields is mostly overestimated.
- 3) The risk swindle - the risks linked with hedge funds are mostly underestimated.
- 4) The fee swindle - the usual fee structure does not provide an incentive for long-term performance and it puts investors at a disadvantage.
- 5) Hedge funds themselves as a swindle - the legal construction of hedge funds favours financial deception.

The single issues are explained in more detail in the following sections:

1) The performance swindle

Hedge funds indexes are mainly used to assess the performance of hedge funds and to compare them with traditional investments in shares or bonds. There is a variety of indexes, calculated by conventional index suppliers such as Dow Jones or Standard & Poor's and by specific data suppliers such as Hedge Fund Research Inc. (HFRI) or Barclay Hedge. All suppliers deliver a comprehensive index for all hedge funds and sub-indexes for different strategies. Due to different specifications, these are often difficult to compare.

In contrast to the normal indexes for securities traded on the stock exchange, the values used to calculate the indexes are not derived from official market prices, but are based on information provided by the fund managers themselves. Because hedge funds are unregulated, there are, in principle, no restrictions and controls regarding the choice of valuation methods. There is also no obligation to contribute to the index calculation. Hence, it can be supposed that fund managers prefer favourable valuation techniques. Furthermore, a fund manager is more likely to participate in the index calculation if he can show a positive performance.

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To be included in the indexes, hedge funds must fulfil certain minimum requirements with regard to size, liquidity and transparency. HFRI has selected 2,200 funds for its comprehensive index, which is calculated monthly. Nevertheless, as there are approx. 9,500 funds worldwide, this choice can hardly be viewed as fully representative.

In particular funds that fail relatively early do not appear in the index calculations. In this respect, there is a strong so-called "survivor bias", because funds are only considered for the calculation of indexes if they have been successful for a certain period of time. The number of failed funds is not unimportant because there is considerable fluctuation within the universe of hedge funds. According to data by HFRI, 1,197 new hedge funds were founded in 2011 and 775 were liquidated. We have found estimates that the average life span of a hedge fund is between 3 and 7 years. We regard the higher number as more realistic, but even this figure is not very reassuring for investors. The wide range of estimates also shows that it is difficult to obtain reliable information.

Another problem with performance measurement by hedge funds indexes arises with popular indexes such as the HFRX Monthly Index because they weight the funds equally. Therefore, successful small- and medium-sized funds are overrepresented, because they are given the same weighting as cumbersome big funds. In addition, performance comparison based indexes do not take into account the volume of the hedge fund industry. Simon Lack pointed out in his book "The Hedge Fund Mirage" (Wiley publishing company, Hoboken, 2012) that a performance of 7.3% p.a. was recorded for the hedge funds measured by the HFRX Index between 1998 and 2010. However, this positive performance was achieved mainly at the beginning of the period when only few investors were active. Indeed, after the high inflows at the middle of decade, the performance figures decreased. A big chunk of the investors was only able to achieve low or even negative investment results. If this volume effect is considered, Lack calculates an average performance figure of 2.2% p.a. for 1998-2010 - not a very impressive number.

Even if hedge funds indexes are accepted as a measure of performance, in spite of all their methodical problems, these have indicated a very disappointing performance during the last years in comparison to conventional finance products such as stocks and bonds. The HFRX Global Hedge Fund Index for big funds has dropped by 1.6% since the end of 2009, while the broader HFRX Aggregate Index has increased by only 7.3% in the same period.

2) The consistency swindle

Many hedge funds managers claim that they have found a methodology that allows them to generate stable yields for the long term by exploiting market inefficiencies. Nevertheless, this seems very questionable.

On the one hand, financial markets can be understood as "complex adaptive systems", so systems are able to learn and to originate surprises. When an investor identifies specific market inefficiencies, he can initially generate high returns out of them. This attracts other investors who apply a similar strategy. This, in turn, leads to a decrease in profit opportunities for everybody and finally puts an end to the market inefficiency. As a result of this "learning process" of the markets, often a strategy based on a specific methodology only works well for a limited period of time. This has also been reflected in the performance of a lot of hedge funds, which have only been able to achieve low returns after the tremendous performance in their early years.

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If we consider big hedge funds that have been successful in the long term, we can conclude that these consist essentially of two groups: global macro funds such as Bridgewater Pure Alpha or the George Soros Quantum Endowment Fund as well as equity funds such as Seth Klarman's Baupost. The performance of global macro funds results from the ability of the management teams to react adaptably to market situations and enter aggressive bets. They operate opportunistically and are not always right. This can lead to extreme variations in performance; therefore, they are anything but consistent. Their recipe for success is not really a systematic approach, but the quality of their management. Successful equity funds such as Baupost use similar methods to classical fund managers or the industry's forefather, Alfred W. Jones: shares are selected on the basis of a fundamental analysis. Positions are either leveraged by means of derivatives or short-term positions are taken in the event of a negative market view. However, in the short-term the success of this strategy is dependent on market fluctuations and therefore cannot really be called consistent.

Therefore, the assumption that hedge funds are able to combine long-term success with consistent performance patterns must be considered as very questionable. Funds that have been successful for several decades often seem relatively inconsistent from a short- to medium-term point of view.

3) The risk swindle

One of the principal reasons for the growing popularity of hedge funds with many institutional investors in the last decade has been that they have supposedly improved the risk characteristics of their portfolios by including hedge funds. In particular, two arguments have been emphasized:

- Hedge funds are supposed to be uncorrelated to other investment classes. Therefore the inclusion of hedge funds in a portfolio of securities can improve diversification and lead to a significant risk decrease for the portfolio as a whole.
- Hedge funds have superior risk-return relationships compared with conventional finance products.

However, a low correlation between hedge funds and financial market indexes can only be established for most categories for the time before the financial crisis in 2008. After 2008, hedge funds in general moved in similar directions to the big share indexes. An explanation for this could be that ultimately their performance is dependent on global economic developments, even if the opposite is asserted. At the moment, only managed futures consistently show low correlations with stocks and bonds.

Besides, hedge funds are not small and independent anymore like they were 20 years ago. With their big volumes, they have become important components of the market consensus themselves and reflect the market opinion with their holdings. Therefore, it is not surprising if their results are similar to the general market performance.

A problem with the calculation of individual risk measures is that the data for hedge funds are mainly only issued monthly and depend on the information published by fund managers, as is the case for the calculation of performance. In particular, the use of volatility as a measure of risk is very problematic when only monthly data is used. The figures are therefore not sufficiently comparable. Furthermore, volatility only reflects the price risk, but not the default risk and the liquidity risk. The default risk is exceptionally high for all hedge funds, because they try to increase performance with leverage and are therefore extremely vulnerable to unexpected market movements. In addition, hedge funds are dependent on the credit standing of their

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counterparts, mostly international investment banks. Thus the bankruptcy of Lehman Brothers also engulfed related hedge funds in the abyss. In addition, liquidity risk is particularly relevant for big hedge funds and should not to be underestimated. LTCM failed in 1998 above all because its own holdings had become far too big to sell them on a market free of frictions. Ironically, before its failure, LTCM was able to create itself an image as a low-risk fund because its performance showed very little volatility.

4) The fee swindle

According to the rationale of many hedge fund adherents, the participation of the fund management in the absolute returns pools the interests of both the manager and the client. Fund managers should only be able to earn a lot of money if the customer earns a lot of money. Therefore, the managers should have an economic incentive to handle the money entrusted to them responsibly in the long term. However, unfortunately, this is not the case in the real world. Simon Lack calculated in his book "The Hedge Fund Mirage" that between 1998 and 2010 the hedge funds included in the HFRX index made \$US 70 billion in profits for their customers, while the managers earned \$US 379 billion in fees. In other words, 84% of the earned profits went to the managers; only 16% remained with the customers. This unfavourable result is due to the fluctuation in investment results. During the good years, investors have to pay a management fee (typically 2% p.a. of the fund volume) and a performance fee (normally 20% of the stated annual yields). In years where losses are made, investors still have to pay the management fee.

A manager whose hedge funds are based on a trading system that works only well for a certain time therefore has an incentive to take very high risks in order to earn as much as possible while the trading system is working. If the system fails, the customer bears the full loss risk. In this respect, the typical reimbursement structure provides no incentive to deal responsibly with customer money. On the contrary, it fosters rip-off investment strategies and encourages managers to take excessive risks.

5) Hedge funds themselves as a swindle

The domiciliation of offshore finance centres without appreciable supervision as well as the valuations carried out by the managers themselves can virtually be seen as an invitation for financial crooks to use hedge funds as a vehicle for their illegal activities. A deception can only be uncovered if customers withdraw money and the fund is not able to meet the due payment from its means.

The most spectacular example of such a scam was Bernhard Madoff's fund. He deceived thousands of investors and investment consultants with imaginary yields for decades, and caused approx \$US 18 billion of damage. Because his performance figures were fictitious, he not only succeeded in showing high yields, but also in calculating favourable risk measures. Therefore he was able to present his fund as particularly beneficial with regard to risk-return relationships. It was only when, at the end of 2008, investors wanted to withdraw more money from the fund than he possibly could pay back that the fraud was unveiled.

In the USA some other deceitful hedge funds managers were exposed after 2008 and convicted, such as Scott Rothstein, who succeeded in misappropriating more than \$US 1 billion within 2 years or Alan Sanford, who embezzled a total of \$US 7 billion within 20 years.

In Germany, between 1995 and 2009, Helmut Kiener used different hedge funds under the name K1 to embezzle approx. € 300 million of investors' money. An amazing feature of the Kiener case was that the finan-

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cial supervisor BaFin tried several times to impose measures against the fraudulent fund manager from 2001 onwards, but was regularly rejected in court.

Another dark side of hedge funds is that some funds use insider information or break financial market rules, obtaining advantages illegally. However, a lot might still be unknown in this respect. The most spectacular case that has been uncovered to date is that of the Galleon Group fund. Its founder Raj Rajaratnam was convicted in 2011 to 11 years in prison and charged a fine of \$US 150 million. He had succeeded in building up an insider network of executives from well-known enterprises such as Goldman Sachs, McKinsey, Intel or IBM who supplied him with exclusive information.

As a result, we can conclude that there are successful hedge funds that have achieved tremendous returns over several years for their investors. However, these funds are an exception. Furthermore, a lot of the successful funds are currently refusing to accept new money from their customers in order to keep their flexibility. Their management cultures date back to a time when hedge funds were still relatively unimportant and adaptable. However, in the meantime, typical hedge funds have become a mass product with opaque risks, modest investment results and high fees. Only experienced investors and genuinely independent consultants can easily identify the few good ones. If you are not one of them, keep away from hedge funds.

I would like to thank Mr Martin Duerr of Gingko Capital for his useful comments and suggestions.

Curriculum vitae of the author:

Karl-Heinz Thielmann holds a degree in Economics from the University of Cologne. His professional career started in 1990 as an Analyst of European stock markets with Dresdner Bank Investment Research. In 1993 he joined Deutscher Investment Trust DIT (today: Allianz Global Investors) as Fund Manager. During his time at DIT, Karl-Heinz Thielmann developed many successful products, e.g. the DIT Wachstum Europa, the first German equity fund to invest explicitly in quality growth shares. Furthermore he received numerous awards for outstanding performance, notably for DIT Großbritannien, a fund dedicated to investments in stocks of the United Kingdom. Since 2001, he has mainly worked as an independent consultant for companies, asset managers and private individuals on matters regarding the capital market. During his years working as an independent adviser, he has helped almost all of his customers to achieve a considerably above-average investment result. Furthermore, he is lecturer for Global Economics at Karlsruhochschule International University in Karlsruhe.

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