A Primer on Hedge Funds

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Hedge Funds: Perception and Reality

How risky are hedge funds? Although broadly perceived by the investing public to be imprudent investments, in reality, most hedge funds are not. In order to gain useful insight into how hedge funds often provide superior returns with reasonable and controlled exposure to risk, let's begin with a better understanding of why they are *perceived* to be so risky.
Put an apple on a hedge fund manager's head and call it "the truth." Then step off fifty paces and hand a crossbow to a well-intentioned journalist with a steady hand and a mandate to "nail the truth!" As a courtesy, we will presume the hedge fund manager is blind-folded. If the journalist's best shot just barely misses, what happens? More often than not, the journalist's best shot ends up farther from the truth than the original fifty paces.

Over the past three decades, relatively few journalists have nailed the truth about hedge funds, while hundreds of misleading articles have been written by well-meaning journalists. The cumulative result is that "Hedge fund managers — those flamboyant, dice-tossing speculators"' have an image problem.

There have been some glaring failures among hedge funds, and the media serves a useful purpose in disclosing as much as possible about them. But in general, the financial press grossly fails to convey how most hedge funds operate. Besides their focus on a small portion of hedge funds that are not typical of the industry, there are three primary reasons why the financial press so often misleads the public about the risk profiles of most hedge funds: A lack of good sources, an abundance of bad sources, and difficult risk management concepts. Let's consider each.

Sources of Information

Most hedge funds are private limited partnerships, prohibited from advertising. For legal and proprietary reasons, hedge fund managers have traditionally been very reluctant to disclose specifics about their operation, even to investors. They rarely spoke with the press until recent years, and now, they seldom reveal much. Getting reliable information on hedge funds requires a tremendous amount of hard work.

Several advisory services have released statistics about the hedge fund industry over the past several years, and although such statistics may provide a very general performance picture for of a given segment of the hedge fund industry, considerable caution must be used
when reviewing such figures. Even the best performance statistics for the hedge fund industry are greatly skewed by asset weighting (or a lack thereof), voluntary (vs. random) selection, inadequate sampling, and a strong survivor bias. Reporting on such statistics has done nothing to improve the investing public's understanding of hedge funds, and is often quite misleading.

Decades ago, as a last resort, financial journalists came to rely on others in the financial services industry for information on hedge funds. They failed to recognize several major problems with this arrangement: To begin with, industry sources can only speculate what a hedge fund manager is actually doing, even when a source has direct information on some aspect of a fund's activities. Of greater concern, financial industry sources have sometimes been slighted in their efforts to provide services to a hedge fund manager, and

quite frequently, these sources compete directly with hedge funds. Finally, many sources fail to grasp the risk management systems that hedge funds use.

In the mid 1970s, **Institutional Investor**[2] summed up the relationship between hedge funds and the rest of the securities industry like this:
"Today, they [hedge funds] are still targets for an uncanny number of unsavory market rumors, the victims of smear campaigns accusing them of just about everything short of pilfering the napery from the New York Stock Exchange dining room hedge funds are so often branded as villains by other sectors of the investment community."

In 1994, an excellent overview of the industry by **Business Week**[3] characterized the pattern more pointedly. *"Bankers, security industry professionals, mutual fund managers — all are beating the drum…It's no secret that Wall Street hates hedge funds."* But why? *"It's not just jealousy or scapegoating that makes the hedge funds anathema to the powers on Wall Street. Fear is another possibility—fear that the public may demand incentive-based compensation for their funds as well."*

The concept of performance-based compensation may well be unsettling to an industry that charges according to the volume of transactions made or the total assets under management, regardless of whether the customer profits.

The investment services industry is highly competitive, and although most professionals exercise restraint in disparaging the competition, many have made hedge funds the accepted target. Over the past few decades, hedge fund rumor that is fed to reporters one day has become front page news the next! As a result, millions of readers have developed strong misconceptions about the risk profiles of *most* hedge funds.

There is a biting irony in the fact that rumor is often generated about hedge funds on Wall Street, because the operations that most closely resemble some large hedge funds are the proprietary trading desks of big banks and brokerage houses. One main difference is that most hedge funds take on far less risk than many of Wall Street's proprietary trading desks.

Risk Management: Betting vs. Gambling

The other reason why so many journalists have misled readers about the risks of hedge funds is that the concepts of risk management used by hedge funds can be difficult to understand. Many of the tools, and the lexicon applied to them, imply high risk to the average investor and to the journalists who write about their use.

Consider the word "bet," commonly used by hedge fund managers, but also by the entire investment community. Managers do not use the word "bet" to imply "gamble," but journalists often infer that is its meaning. Even though the inference of gambling is not usually correct, it is easily made when viewed in the context of tools like leverage and short selling. These are perceived by most investors as purely speculative tools, but many hedge funds successfully employ them to increase performance while actively managing risk.

Given some highly visible failures, it seems implausible, not just to journalists but to many good investors, that risk can be reasonably managed when using leverage, short sales, and financial derivatives. Yet it can! Let's approach some basic risk management concepts by personalizing them.

How much risk would you take with $1,000 of your hard-earned money, under the following coin flipping scenarios?

1) Would you bet $1,000 on the flip of a coin?

2) Assume a win would pay you $1,200 against your loss of $1,000. Would you bet?

3) What if a win paid the same 1.2 to 1 ratio as in scenario #2, but you could bet in $10 increments and as many times as you wished? Would you bet, and if so, how often and how much?

4) What if you didn't have any cash to bet with, but you did have a bank CD you could borrow $1,000 against? Would you borrow against the CD to execute your bets from scenario #3?

5) Let's now assume the party you are betting against is a corporation with limited capital, making the same $10 bets and paying 1.2 to 1 to thousands of other people. You anticipate the company will go bankrupt long before you want to stop betting. Would you be willing to place an additional bet by selling short the shares of that corporation, in amounts equal to the winnings from your leveraged bets?

Scenario #1 is pure gambling, and if you answered yes, you are reckless with your money. Scenario #2 has an attractive payoff, but the downside risk is too great, at least for most people. Scenario #3 is appealing because your risk of loss on any single coin toss is acceptable, relative to your capital, and the odds heavily favour your making unlimited sums of money from a continuing series of coin tosses.

If you chose not to borrow against your CD nor to short the shares of the corporation under scenarios #4 and #5, you are not psychologically fit for investing in hedge funds. If you chose to bet under scenarios #4 and #5, congratulations; you are becoming an expert at utilizing leverage and short sales to increase performance, while prudently managing risk! Have you considered starting a hedge fund? (Affirmative answers to this question pose a problem we will address later)

Obviously, coin tosses that pay 1.2 to 1 do not entail any skills to come out a winner over time, so let's consider one more example.

When a "scratch" golfer makes a $2 bet on the flip of a coin, be is gambling. On the other hand, when he bets an eight handicapper "$2 Nassau, two down automatics, double the back and 18," he is investing! Never mind if you don't understand this bet. The point is, a scratch golfer fully understands the bet, and the odds are exceedingly high that he will collect a lot more than $2. Bets like this don't win many friends on the golf course (or on Wall Street).

Few financial journalists have taken the time to actually understand risk management as it is used by most hedge funds, relying instead on information fed to them by the competitors of hedge funds. Thus, most of their readers ("prudent men," many who acquired or held IBM at $170 in 1987) reject the suggestion that hedge funds can be very sound investments.

Given a better understanding why hedge funds are unduly perceived to be so risky, let's start over and develop a more legitimate awareness of hedge funds by reviewing their history and development

A Brief History of Hedge Funds

In the beginning, a defining characteristic of hedge funds was that they hedged against the prospect of declining market. Hedging through private agreements is as old as commerce, but most instruments for hedging in a securities portfolio are quite recent; so let's briefly review the evolution of tools for hedging securities.

Hedging is the utilization of a defensive strategy to mitigate or eliminate risk, and it usually entails giving something up. The creation of most tools for hedging in a securities portfolio came through the commodity markets. In turn, the catalyst throughout the development of commodities markets, going back to rice warehouse receipts in 17th century Japan, has been the common desire for producers, processors and merchants to hedge against adverse price changes.

Over the past century, commodity exchanges in the U.S. have become highly developed to meet these needs. Producers of numerous farm, forest, oil, and mineral products sell futures contracts to hedge against

price declines. While protecting themselves against future price declines, they forfeit the right to additional profits if prices rise. Likewise, users of these products often purchase futures contracts to hedge against future price increases, but they forfeit the benefits of future price declines.

Standardization of futures contracts on exchanges made them easily transferable, inviting speculators into the futures markets. Speculators provide two critical services. They willingly take on price risk that the hedgers don't want, and they provide tremendous liquidity, making the exchange markets more efficient.

During the seventies, the exchanges began to develop a number of financial futures for hedging interest rate and currency risk. These developments were followed by futures and options on various equity indexes and options on hundreds of specific stocks. The number of financial instruments for hedging, or speculating, has grown exponentially since 1980.

In addition to standardized financial futures and options, traded on major exchanges, some banks and brokerage houses create a multitude of customized, off-exchange instruments. Some of these contracts are relatively simple and easily transferable; others are exceedingly complex and have very limited markets. Unfortunately, the "D" word (derivatives) is applied equally, if not reasonably, to the entire range of financial instruments, from the most liquid and stable futures and options traded on the exchanges, to the most illiquid and volatile "toxic waste" traded over-the-counter. In spite of the prevailing public perception, most derivatives render far more benefits than harm and are here to stay.

Prior to the development of financial futures, options and other derivatives over the past two decades, the only way to hedge against the market risk in an equity portfolio was to sell a basket of shares short. Information on the practice prior to the advent of hedge funds is sparse, but it was practiced by individuals, institutional investors, and securities brokers as early as the 1920s[4] and probably much earlier.

Alfred Winslow Jones

In 1949, a scholar named Alfred Winslow Jones embarked on his fifth career, establishing what later became regarded as the first hedge fund. Take heart, baby-boomers; he was 48 years old!
Born in Melbourne, Australia, Jones came to the U.S. with his American family when he was four. After graduating from Harvard in 1923, be traveled the world as a purser on a steamer, and in the early 1930s he served as vice consul at the U.S. Embassy in Berlin (at the time Hitler came to power). During the Spanish Civil War, he reported on civilian relief for the Quakers. In 1941, Jones completed a doctorate in sociology at Columbia University, and his thesis, Life, Liberty and Property, became a standard sociology text.

During the forties, Jones became an associate editor of FORTUNE, then wrote for Time and other nonbusiness periodicals. The catalyst for becoming a practicing capitalist appears to have been the research Jones did for his article, *Fashions in Forecasting,* published by FORTUNE[6] in March of 1949. In preparing this piece, he became acquainted with some of the most highly regarded technicians, forecasters, and analysts on Wall Street. Several months before publication of his article, this amateur investor established his investment partnership.

Jones, who died in 1989, is remembered by those who knew him as a kind gentleman with a lifelong, active concern for unfortunate people. By today's standards, some of the social schemes be contemplated would be viewed as socialist; yet with a strange alchemy, Jones proved to be the quintessential capitalist, a man with remarkable entrepreneurial "compass."[7]

The Jones Hedge Fund Model

Relatively few people grasp the beauty and simplicity of Alfred Jones's original hedge fund model. He took two speculative tools, short sales and leverage, and merged them into a conservative investing system. His goal was to shift the burden of performance from market timing to stock picking, and he succeeded.
In 1950, short selling was customarily used for interim speculation in transitory opportunities. Leverage was customarily used for pursuing higher profits, subject to higher risk of capital loss. Jones's approach

was unconventional. He viewed maintaining a basket of shorted stocks as a required asset allocation to hedge against a drop in the overall market. Given this method for controlling market risk, Jones became liberated to amplify stock picking skills with leverage!

Jones regularly calculated the exposure of his capital to market risk using the formula shown below. His method of quantifying market exposure is highly valued by traditional hedge fund managers for its intuitive relevance, yet it is largely ignored or misunderstood by academics and the financial media.

MARKET EXPOSURE = (Long exp. - Short exp.) / Capital

A typical asset allocation for Jones would look like this: Given $1,000 in capital, he would employ leverage to purchase shares valued at $1,100 and sell shares short valued at $400. His gross investment of $1,500 *(150%* of capital) would have a net market exposure of only $700 ($1, 1 00-$400), making this portfolio "70% net long." Although Jones valued stock picking over market timing, he increased or decreased the net market exposure of his portfolio based on his estimation of the strength of the market. Since the market generally rose, Jones was generally "net long."

There are two primary sources of risk in an equity portfolio: stock selection and the market. Jones designed his system to maximize the former and minimize the latter. Of the $1,500 gross investment in the example above, $700 was unhedged and $800 ($400 long and $400 short) was "within the hedge." Investments within the hedge are comprised of equal value long and short selections, and are thus approximately "market neutral." The $700 unhedged portion was exposed to the risks from both stock picking and the market, but the $800 within the hedge was exposed principally to the risks from stock picking.

Likewise, performance within the hedge depends on stock selection more than market direction. In a rising market, good long selections will rise more than the market and ‘good short selections will rise less than the market, yielding a net profit within the hedge. Conversely, in a declining market, good long selections will fall less than the market and good short selections will fall more than the market, again yielding a net profit within the hedge.

As is usually the case, not all of the stock picks in our example are within the hedge. In a declining market, profits from within the hedge may mitigate, but not entirely offset losses from the 70% net long exposure outside the hedge. Even when profits within the hedge don’t offset "naked" exposure, the portfolio is structured to decline less than the market.

In theory, Jones’s hedge fund system would provide superior performance relative to well-managed, long-only portfolios. In practice, it did.

Jones set up his fund as a general partnership in January of 1949 and converted it to a limited partnership in 1952. In addition to hedging with short sales and the using leverage, the third major characteristic of Jones’s fund was its incentive fee structure. None of these three characteristics were original or unique when Jones established his fund, but the way in which he combined them was. He operated in relative secrecy for about seventeen years; but in time, his secret got out, and his system became the model for the hedge fund industry.

Jones initially considered using a "hurdle" based incentive fee, which rewards the general partner for performance in excess of an agreed upon benchmark, either fixed or variable (such as the Dow Jones Index). He settled on a straight incentive of 20% of realized profits. There was no asset-based fee, nor was there a "high watermark" provision requiring the general partner to make up losses prior to taking additional incentive fees. Expenses were paid 20% by the general partner and 80% by the limited partners, except that salaries were paid entirely by the general partner.

Significantly, Jones agreed to keep all of his investment capital in the fund. He clearly acknowledged that it was unreasonable for him to receive high incentive fees for risking his partners’ capital, unless be took the

same risks with his own. Since Jones was imminently aware of the premium his system placed on good stock selection, be became uncomfortable with its dependency on his individual stock picking skills.

The compelling need for manager diversification moved Jones to convert his partnership into the first multi-manager hedge fund in 1954, by bringing Dick Radcliffe in to run a portion of the portfolio. Over the years Jones had as many as eight independent portfolio managers at a time running money for the partnership. Many of these managers ran a model portfolio to demonstrate their stock picking skills prior to being hired by Jones.

These portfolio managers were given tremendous autonomy, as long as they were not making duplicate or opposing investments. In essence, Jones had created a well-diversified fund of funds, at a time when there were no other hedge funds in existence. By 1984, there were some excellent hedge funds operating on Jones's principles, and at age 82, he amended his partnership agreement, formally becoming a fund of funds investing in a diversified selection of outside managers.

Jones never bid to create market neutrality by keeping all of his investments within the hedge. He did, however, seek to find a reliable measure for what he called "velocity," or the speed at which a stock's price would change in relation to changes in the market, as a stock picking aid. Velocity was akin to beta, as we use it to quantify volatility. Jones and his portfolio managers toiled with the concept of velocity for decades, never finding a useful method for reliably predicting a stock's behaviour.

Successful hedge funds afford an excellent environment for the incubation of new hedge fund managers, and Jones's partnership, as we might expect, produced the first fledglings. Carl Jones (no relation), who came in shortly after Dick, was the first of A. W. Jones's managers to set up his own hedge fund, City Associates, in 1964. Dick Radcliffe left a year later, teaming with Barton Biggs to establish Fairfield Partners.

Other incentive-based partnerships were set up in the mid-fifties, including Warren Buffett's Omaha-based Buffett Partners and Walter Schloss's WJS Partners, but their funds were styled with a long bias after Benjamin Graham's partnership. Under today's broadened definition, these funds would also be considered hedge funds, but regularly shorting shares to hedge market risk was not central to their investment strategies.

1966 to 1969: Proliferation

At the beginning of 1966, the hedge fund industry was still in its infancy with no more than a handful of Jones style hedge funds in operation. A watershed event occurred that April with the publication of *The Jones Nobody Keeps Up With* in FORTUNE[8], penned by Carol J. Loomis.

Mutual funds had become the darlings of the era, and like today, investors were spellbound by their performance rankings. Loomis's article shocked the investment community by describing something called a "hedge fund," run by an unknown (at least to the investment community) sociologist named Alfred Jones. It was handily outperforming the best mutual funds, after deducting an inconceivable 20% incentive fee! Over the prior five years, the best mutual fund was the Fidelity Trend Fund; yet Jones bettered it by 44%, after all fees and expenses. Over ten years, the best mutual .fund was the Dreyfus Fund; yet Jones bettered it by 87%.

Needless to say, the Loomis article provided ample fantasy fodder for both investors and money managers. Investors estimated the impact of hedge fund investing on their portfolios and began inquiring how to find such an investment. Money managers estimated the impact of 20% incentive fees on their incomes and began setting up hedge funds.

But how do you run a hedge fund? Loomis covered that, too, providing a virtual blueprint of Jones's

structure and operation. It's reasonable to presume Xerox machines were working overtime on Wall Street and across the country, as the first great stampede into hedge funds got under way.

Although we don't know how many hedge funds were established in the three-year flurry following Loomis's article, estimates range from 140 to several hundred. Michael Steinhardt and George Soros were among those setting up funds at the time. The SEC found 215 investment partnerships in a survey for the year ending 1968 and concluded that 140 of these were hedge funds, with the majority formed that year.

This was the zenith of the "go-go years," and a bull market was raging. The broad equity markets, as reflected in the Value Line Composite Index, rose some 55% in 1967 and 1968. The legion of new hedge fund managers soon discovered that hedging a portfolio with short sales is time consuming, difficult, and costly, especially in a bull market. Jones observed that selling equities short is a strategy that simply does not suit the psychological makeup of most equity managers, in any market.

The intoxicating combination of incentive fees and leverage in a bull market seduced most of the new hedge fund managers into using high margin with only token hedging, if any at all. These unhedged managers were, as we say, "swimming naked."

1969-1974: Contraction

A favourite axiom of hedge fund managers who continuously allocate the substantial effort and expense required for prudent hedging in a leveraged portfolio, even in bull markets, is this: "You don't know who's swimming naked until the tide goes out.''

In the final few days of 1968, the tide started out. Between then and the end of 1974, there were two powerful undertows in the equities markets, separated by a period of relative tranquillity. Although the second of these (73-74) is more renowned, the first (69-70) was more damaging to the young hedge fund industry, because most of the new managers were swimming naked. For the 28 largest hedge funds in the SEC survey at year end 1968, assets under management declined 70% (from losses and withdrawals) by year end 1970, and five of them were shut down. Smaller funds fared worse.

From 1969 through 1974, the broad market, measured by the Value Line Composite Index, declined more than 70%. Blue chip stocks, measured by the S&P 500 with dividends reinvested, fell only *5%* over the 69-70 downdraft; yet the broad market declined some 43%. The following two years were the eye of the storm, when the blue chips rose some 36%, and the broad market rose about 10%. The second downdraft, 73-74, took the blue chips down about 37%, and the broad market fell a devastating 57%.

From the Spring of 1966 through the end of 1974, the hedge fund industry had ballooned and burst, but a number of well-managed funds survived and quietly carried on. Among the managers who endured were Alfred Jones, George Soros and Michael Steinhardt.

The lesson of these broad market undertows has been lost on many hedge fund managers swimming naked in the 1990s.

The New Modalities

The financial press has influenced the creation of hedge funds since the mid 1960s. Indeed, the correlation between revealing articles on hedge funds and the creation of new funds was dramatic in 1966-68. Although the relationship may not have continued as one of cause and effect, there have certainly been strong parallels ever since.

In the decade following the 1974 market bottom, hedge funds returned to operating in relative obscurity, as

they had prior to April of 1966. The investment community largely forgot about them. During this period, comparatively few hedge funds were established, but among them was one of the best.

In May of 1986, an imposing face on the cover of Institutional Investor[9] compelled readers to explore *The red-hot world of Julian Robertson.* This cover story, by Julie Rohrer, was prominent among several articles that reintroduced investors to the astonishing potential of hedge funds. Rohrer reported that Robertson's Tiger Fund had been compounding at 43% during its first six years, net of expenses and incentive fees. Performance prior to deducting expenses and incentive fees had been about 50% per year. This compared to 18.7% for the S&P 500 during the same period.

Importantly, the article established that Robertson was an investor, not a trader, and that he always hedged his portfolio with short sales. This was textbook Alfred Jones investing, not high stakes gambling. Rohrer's piece also shed light on how, in 1985, Robertson began adopting newly developed financial instruments to prudently and profitably improve on Jones's original model (although she never mentioned Jones). Robertson called these instruments, not available to Jones in his prime, "the new modalities."

Robertson had made his first significant "global macro play" in early 1985, anticipating the dollar would decline against Swiss francs, deutsche marks, sterling, and the yen. His Tiger Fund, and offshore sister fund Jaguar, spent some $7 million on foreign currency call options, limiting downside risk to less than 2% of capital. Over several months, profits from the bet exceeded several hundred percent of the capital risked. Citing this example, Rohrer demonstrated how a good manager, operating from a base of well-hedged equities, developed strong convictions from the best available information, and, calculating risk, acted affirmatively on those convictions to generate exceptional profits. In essence, she showed a new generation of professionals on Wall Street the difference between a well-run hedge fund and traditional equity management. Many of her readers proved to be latent hedge fund managers who set up their own funds in the following years.

In the mid 1980s, Julian Robertson used the phrase "new modalities" to describe innovations in financial futures and options; but looking back from the mid 1990s, the phrase is equally if not more useful in describing the diversified evolution of hedge fund styles. Hundreds of hedge funds with specialized, nontraditional investing systems bearing no resemblance to Jones's equity hedging, have been established since 1980. For better or worse, use of the term "hedge funds" has expanded to include all incentive based, non-traditional investment funds. These now include: A variety of sector equity funds, dedicated short funds, convertible and merger arbitrage funds, fixed income arbitrage and other relative value trading funds, technical trading funds, distressed securities funds, global macro funds, developed market foreign funds, emerging market funds, a variety of market neutral funds, a variety of derivatives based funds, and more. In addition, there are various types of fund of funds which, like Alfred Jones back in the 1950s, seek to diversify risk among different managers.

Many non-traditional managers actively control risk by hedging via one or more methods, but many do not. Most use leverage, but relatively few lever beyond two times capital. A small minority uses enormous leverage, yet many use little or no leverage at all. A large number of these funds have exceptionally talented managers, but many do not.

Somewhat confusingly, all of these newer funds are now considered "hedge funds." The single unifying element between Alfred Jones and many of these new funds is that all have justified incentive-based fees with the promise of superior performance. Many deliver, but many do not!

Because the hedge fund platform has attracted much of the best investment talent available, along with numerous "wanna-bes," it has repeatedly produced a disproportionately large share of the highest returns at the extreme right of the performance bell curve for half a century. In all probability, it will continue to do so, although the number of mediocre funds increases regularly.

Commingling assets with better hedge fund managers has provided immense gratification for many

investors over the years. Which managers, in retrospect, will have provided comparable gratification to investors a decade from now? This is a challenging question.

The science of investing ponders the past, while the art of investing focuses on the future. Finding good hedge funds requires a reasonable mix of both, and we should focus our attention to the areas that will help the most. In the long run, the three key variables for hedge fund performance are motivation, opportunity, and compass. All three can and should be evaluated for any hedge fund investment.

Motivation

The motivational dynamics of Alfred Jones's original hedge fund model run straight to the core of capitalistic instinct in managers and investors. The critical motives for a manager are high incentives for superior performance, coupled with significant, personal risk of loss. Hedge fund investors should seek to maintain both of these motives in their selections.

Early in the history of the industry, new managers began to alter Jones's formula. Many funds that were set up after 1966, adopted a 1% asset-based fee, in addition to the incentive fee. Most of these attached a "high watermark" requirement in exchange for the inclusion of an asset fee, but many did not.

The original justification for augmenting incentive fees with an asset fee was the presumption of a correlation between size and performance. One does exist. Smaller managers can provide superior performance, because the most profitable inefficiencies in the market are often relatively small. But smaller managers, lacking efficiencies of scale, have relatively high overhead. As such, the asset fee was justified to help defray the expenses of small funds.

Hedge fund investors accepted this rationale, and the prevailing fee structure for the hedge fund industry became 1% of assets plus 20% of profits, subject to a high watermark. Although this is the "standard fee" in the industry today, others exist. These range from George Soros's Quantum Fund, with a 1% asset fee plus a 15% incentive fee, to some newer funds with 2% asset fees and 25% to 30% incentives.

Some long-term hedge fund investors argue that there was implied in the standard fee, and sometimes clearly articulated by hedge fund managers, a commitment to remain small. Jones's motivational dynamics work exceedingly well for most smaller funds, even under the modified standard fee structure, but not so well for larger funds. A range of structural modifications could bring good motivational dynamics back into play for even the largest funds, but consideration of these modifications goes beyond the scope of this introduction.

The fact that "standard hedge fund fees" entitle managers to "mutual fund fees" in a bad year, but mutual fund fees plus 20% of profits in mediocre and good years, has not been lost on hoards of new enrants to the industry. To the degree that investors permit, a migration towards "entitled" hedge fund fees will continue, without a corresponding migration towards superior performance.

There is distinct irony in the evolution of motivational dynamics for hedge funds, particularly as assets under management grow. Alfred Jones, who advocated entitlements for the poor, designed his fund with purely capitalistic incentives. Today, we acknowledge that entitlements can actually harm the poor; yet increasingly, we accept entitlement fee structures for hedge funds.

The original and continuing justification for incentive fees in hedge funds is the inherent promise of superior performance—not average performance, not absolute performance, but superior performance. Prudence dictates that investors fundamentally grasp Jones's motivational dynamics and seek to replicate them in the hedge funds they choose.

Opportunity

Superior performance can only be achieved when sufficient opportunity exists. This may be self-evident, but the shifting tides of opportunity often are not.

Although a gross oversimplification, comparing the level of opportunity for different hedge fund managers (or management styles) to the level of water in reservoirs is useful for visualizing the impact of opportunity on hedge fund performance. Mobility for a boat varies substantially as the water level in the reservoir rises and falls. At very low water levels, a boat may become stranded. In addition, mobility may become restricted due to the overcrowding of boats in the same reservoir. At times it becomes more sensible to tow a boat to a fuller or less crowded reservoir.

What happens if a boat grows into a ship?

Ships are more suited for the high seas and can enter relatively few reservoirs. If a ship does enter a reservoir, it is restricted to only the deepest channels, while small boats move freely about it. A drop in the reservoir's water level can be disastrous for a ship.

Opportunity is influenced by internal and external factors. External variables are often somewhat quantifiable for a given style of management. For instance, distressed security managers are directly impacted by the number and size of bankruptcies and debt restructurings. Risk (i.e. merger) arbitrage managers are impacted by the level of merger activity. Emerging market managers are impacted by the aggregate flow of capital into and out of developing economies. Etc. Almost all investment styles are impacted by increased competition.

The most obvious internal variable influencing opportunity is the size of assets under management. As a hedge fund grows, it may be forced out of an investment style that was central to its performance in earlier years. A number of hedge fund styles are affected by growth in this manner, but some are not. If the performance for a given style drops as assets under management grow, the fund is restricted by capacity limits.

Unfortunately, capacity limits are not often distinct. They vary not only with size, but with size relative to external opportunity. Consider two hedge funds with the same investment style and equal management, one at (or near) its capacity limits but the other well within its capacity limits. Both will likely prosper when opportunity abounds, but in a "dry period" the fund operating well within its limits will likely perform much better. (The qualification for equal management in this example is important, because many small funds appear to operate well within capacity limits; due to limited management resources, they may be operating beyond their capacity limits.)