If I Only Had a Hedge Fund

By JENNY ANDERSON and RIVA D. ATLAS

It seemed like an ordinary evening at Crobar, the trendy Manhattan nightclub. Two weeks ago, as Counting Crows performed on stage, young women dressed in expensive jeans pushed toward the front with their khaki-clad, mostly older boyfriends. Few, however, were regulars. On this night, the very rich and the merely rich intermingled on the club's two floors - V.I.P.'s upstairs ($1,000 a ticket) and the rest down below ($250).

Most of the 1,250 people gathered for the event, the Robin Hood Foundation charity ball, were part of the city's unlikely new "it" crowd. Richer than Wall Street rich and more willing to take risks than their traditional money management peers, they are the managers behind the staggering growth in hedge funds, those private, lightly regulated investment vehicles aimed at the ultrawealthy, the run-of-the-mill wealthy and, increasingly, the not-so wealthy.

To critics, the frenzy has a very familiar ring. A flood of capital to the latest investment fad. Spectacular accumulation of wealth in a short time. New ventures created easily and often. Those, too, were the hallmarks of the dot-com boom, and, as everyone knows, the bursting of that bubble was far from pleasant. The stampede to hedge funds, some people fear, will be no different.

"It is completely obvious that this will end badly - for the firms, investors, everyone," said Seth Klarman, founder of the Baupost Group, which manages $5 billion. "No area of financial endeavor is immune from the effects of competition."

The numbers are mind-boggling: 15 years ago, hedge funds managed less than $40 billion. Today, the figure is approaching $1 trillion. By contrast, assets in mutual funds grew at an impressive but much slower rate, to $8.1 trillion from $1 trillion, during the same period. The number of hedge fund firms has also grown - to 3,307 last year, up 74 percent from 1,903 in 1999. During the same period, the number of funds created - a manager can start more than one fund at a time - has surged 209 percent, with 1,406 funds introduced in 2004, according to Hedge Fund Research, based in Chicago.

In a way, hedge funds are to mutual funds what Evel Knievel was to weekend motorcyclists. Unlike mutual funds, which are restricted in the ways they can invest, hedge funds can use leverage, trade derivatives and bet that stocks will fall, a technique called shorting. And unlike mutual funds, which generally try to beat a market average, hedge funds seek positive returns, even in down markets.

THE meteoric rise of hedge funds has had a huge impact on the markets, investment banks and investors, who increasingly include institutions like pension funds or endowments. A recent report published by Credit Suisse First Boston said that hedge funds were responsible for up to half of all activity in major markets, including the New York Stock Exchange and the London Stock Exchange.

Investment banks are tripping over one another to service them. According to the same report, Wall Street made $25 billion catering to hedge funds - lending them money, trading for them, helping to structure complex derivative transactions or lending them stock to bet against a company. That's one-eighth of the street's total revenue pool.
Signs that hedge fund managers have become the financial industry's new elite abound. Young, ambitious talent is fleeing Wall Street in search of hedge funds' overnight riches. In hedge fund offices, employees have perks like swimming pools and basketball courts. And in the wedding announcements of The New York Times, hedge fund managers are often well represented.

At cocktail parties throughout Greenwich, Conn. - the informal capital of the hedge fund world - investors sip apple martinis and discuss which funds are in vogue. Because few people outside the industry know exactly how they trade or what they trade, there is a certain mystique to the hedge fund set, which only adds to their allure.

Then there's the wealth effect. Billionaire hedge fund managers are pushing up the price of everything from luxury apartments to artwork. Kenneth Griffin, founder of the Citadel Investment Group, based in Chicago, dished out $60 million for a Cézanne. James G. Dinan, founder of York Capital Management, paid $21 million to buy the Fifth Avenue apartment of $6,000 shower curtain infamy, the one once occupied by L. Dennis Kozlowski of Tyco International.

Predictably, most people in the hedge fund world scoff at the notion of a bubble. "Hedge funds are not an asset class, so there is no asset class to burst," said Jane Buchan, chief executive of Pacific Alternative Asset Management, a fund made up of hedge funds with $7.2 billion under management. "It's not like real estate. Even if you think about people doing silly things for silly reasons, it's not a bubble. If you look at people traveling on the fringes, it might be a bubble."

Indeed, the so-called smart money - rich investors like Thomas H. Lee, the famed leverage buyout maven - could not seem less worried. "Every investment board I am in touch with is interested in hedge funds," said Mr. Lee, ticking off the names of such giants as Calpers and Harvard's endowment fund. Mr. Lee himself has invested a substantial portion of his estimated $1.2 billion net worth in a portfolio of dozens of hedge funds.

Yet, as Mr. Klarman said: "How many venture capital investors in 1999 said, 'We are doomed because of all the money flowing in?' "

Whether the hedge fund boom is a bubble may still be open to debate. But it is certainly not alarmist to wonder about the consequences of such torrid growth, built as it is on the leverage that banks provide managers to double or triple their bets. The Federal Reserve seemed concerned enough last fall, when it set up a group to examine what systemic risks had been created by the explosion of entrants into the market and the aggressiveness with which Wall Street was welcoming them.

The Fed also encouraged the revival of a high-profile watchdog group formed in the wake of the market-shaking 1998 collapse of the Long-Term Capital Management hedge fund. Called the Counterparty Risk Management Policy Group II, it will examine everything from narrow credit spreads - a result of low perceived risk - to the cavalier ways that Wall Street lends to hedge funds.

"Hedge funds are significant market players," Stephen M. Cutler, director of enforcement at the Securities and Exchange Commission, said in an interview. "They use leverage that mutual funds cannot, so the power of that $1 trillion is magnified. Your concern is not just the investors in the hedge funds but the hedge fund's impact on the market."

To impose a modicum of order on the industry, the S.E.C. has required that most hedge fund management firms register as investment advisers by February 2006, a move that an industry trade group has protested.

CONCERNS about hedge funds, however, extend beyond finding out where they are based and whether their managers are felons (two of the objectives of S.E.C. registration). Among other things, it remains a mystery - even to investors - what kind of bizarre financial products are traded by the funds, and how
they value them. Given the potential returns, the incentives for investors to bet the house are huge. And many seasoned money managers have closed their funds, opening the door to newcomers to satisfy demand for ever more funds.

Perhaps topping the list of concerns is the proliferation of funds of funds, pools of hedge funds that are meant to lower risk but that also come with another layer of fees on top of what standard hedge funds charge. By the end of last year, assets in funds of funds had soared to $359 billion, from $84 billion just four years earlier. Traditionally, investors have needed a minimum of $1 million to get into a hedge fund; with the newest of funds, investors with as little as $25,000 to spend can gain entry.

Hedge funds may hit Main Street in other ways. At least one fund of funds, Grosvenor Capital, with $15 billion under management, is weighing an initial offering or a sale, people close to the company said.

Hedge funds are the new blackboards on which dreams of high finance are drawn. For Karim Samii, who enjoyed a successful career at the investment firm W. R. Huff of Morristown, N.J., the decision to start his own hedge fund came on a bright, snowy morning in December 2003, when he and his wife were visiting his in-laws in Hamburg, Germany. "I was jogging around the lake and I said to myself, 'Where do I want to be five years from now?'" he said.

His firm, Pardus Capital, will open for business on April 1. "It's a big bet," said Mr. Samii, 42. "But if you think you're good, you take the risk."

Philip Broenniman, a 39-year-old trader, spent five months in 2003 cobbling together $20 million to start Cadence Investment Partners in New York. In late October, a week before his firm was set to open, two investors pulled $13 million. "We opened our doors with just $7 million," he recalled. A year later, after posting 16 percent gains, the fund has grown to $119 million.

Managers of funds of funds and other entities that invest in hedge funds say they are overwhelmed by the numbers of start-ups. "We saw 600 pitches last year," said Ted Seides, director of investments at Protégé Partners in New York, which invests in new hedge fund firms. Of that number, he said, Protégé ended up backing just nine. "There are a lot of hopes and dreams," he said. Of course, not all dreams come true.

Ask new managers why they are starting funds and the answers often recall the late 1990's: to build something, to test the "pure art of investing," to be an entrepreneur. One two-year industry veteran with $60 million under management describes why he did it: "Because I could."

Even hedge fund experts who pooh-pooh the notion of an investment bubble acknowledge the possibility of a compensation bubble. Instead of just receiving a fixed percentage of the funds they manage, hedge fund managers generally make "1 and 20" - that is, 1 percent of assets under management and 20 percent of profits.

To put that in context, a mutual fund company managing, say, $100 million and earning 1 percent of assets under management makes $1 million. By comparison, a hedge fund making the 1 percent management fee and a 20 percent "carry" takes in $1 million for opening the doors, and an additional $10 million if the fund returns 10 percent. That's $11 million in revenue.

"Hedge funds are an innovation of compensation," said one fund-of-funds executive. "It's a compensation system, not an asset class." The comment is meant to be positive: in hedge funds, compensation is aligned with absolute performance. In the mutual fund industry, by contrast, compensation is usually tied to performance against a benchmark, like a Standard & Poor's index, or assets under management.

Will fees come down? Few people think so. "If you lower your fee, they think something's wrong with you," said one longtime manager who described the fees as "absurd."
In fact, fees have been moving higher. When Carl C. Icahn, the famed takeover trader, raised a $2 billion fund last year, he demanded 2.5 percent of assets and 25 percent of the profit.

In 2003, the 25 highest-paid hedge fund managers earned more than $200 million, on average, according to a survey by Institutional Investor magazine. The top-ranked manager, George Soros, took home $750 million that year. At No. 2 was David Tepper, manager of the $3 billion Appaloosa funds, who earned $510 million, according to the magazine.

The lure of hedge funds, of course, is not supposed to be the high pay but the outsized returns. Lately, the results have been less than compelling. Over the 10-year period that ended last December, hedge funds had an average annualized return of 12.57 percent, according to an index maintained by Hedge Fund Research. That is just slightly ahead of the 12.07 percent return of the S.& P. 500 during that period, though hedge funds earned their return with half the volatility.

During the market downturn, however, hedge funds did hold up well. In both 2000 and 2001, for example, the average hedge fund rose nearly 5 percent, according to Hedge Fund Research. That compares with declines of 9 percent in the S.& P. 500 in 2000 and nearly 12 percent the next year.

In 2004, however, the average hedge fund rose around 9 percent, lagging behind the S.& P. by nearly two percentage points, Hedge Fund Research has reported. During the first two months this year, the latest data available, hedge funds were up nearly 2 percent, compared with a flat return for the S.& P.

Many in the industry say the sharp increase in both supply and demand won't destroy the fundamentals of the business. "It is so much the better way of managing money," said Julian Robertson, who got out of the business five years ago after forging a reputation at Tiger Management as one of the most successful hedge fund managers. Today, he keeps a hand in the industry by providing seed money to new hedge funds. "Hedge funds have had about a 10-year place in the sun," he said. "I don't see any reason for that to stop."

Many industry veterans say the party will continue, partly because of the shift in who invests in hedge funds. As recently as 2000, hedge funds were almost exclusively for the very rich. Now institutions want a piece of the action. Pension funds and other institutions are expected to invest as much as $250 billion in hedge funds over the next five years, according to a recent study by the Bank of New York and Casey, Quirk & Associates, a consulting firm. That would ultimately account for half of all money flowing into hedge funds.

But as the pension money comes in, hedge fund returns are likely to go down, as fund managers adapt their strategies to suit the new clientele. Pension funds prize predictability over outsized returns; the average pension fund is looking to make just 8 percent, net of fees, on its hedge fund investments, the Casey Quirk report concluded. That is a far cry from the 25-percent-plus returns generated by rock-star managers like Mr. Soros and Michael Steinhardt.

A possible check on hedge funds is the simple fact that while anyone can start one, the industry has a high casualty rate - especially for the smallest funds, which struggle to attract and keep investors. Untested managers whose returns languish often see their capital flee and are forced to shut down.

"There are very low barriers to entry but very high barriers to staying in business," said Philip Duff, chief executive of FrontPoint, a $4.3 billion hedge fund, citing the average annual life of a hedge fund of 3.5 years. "That's problematic for investors," he said - particularly institutional investors who do not relish moving money around.

"There's a reasonable probability a hedge fund will have a significant problem," Mr. Duff added. The fund, he said, "will be high-profile, and the question is, if and when that happens, does it materially change the growth in demand? My answer is no."
While new funds have flourished, seasoned managers are also absorbing the demand generated by institutions. "In 2004 we saw nine $1 billion-plus start-ups, and 2005 is on track to outpace that number," said Gerard Coughlin, a head of Morgan Stanley's prime brokerage services. "While the high-profile start-ups command great attention, many established managers are busy broadening their product offering and expanding their footprint. The capacity created by these proven managers and high-profile start-ups is effectively raising the bar on what it takes to be successful as a new manager."

Longtime hedge fund investors have faith in the power of Darwinism. "It will be survival of the fittest," said Michael Price, former manager of the Mutual Series mutual funds, who now invests $1.6 billion - a good chunk of it in hedge funds - on behalf of family, friends and two college endowments. "The guys who are not creative or don't know what they are doing won't last."

That is not to say that there is anything stopping them from starting up - and potentially losing investors' money. "There's zero shame involved in launching a fund and failing," said one fund of funds manager who, like many executives in the ultrasecretive hedge fund universe, asked not to be identified.

INDEED, it is not unusual for managers to get a second chance. William A. Ackman once ran Gotham Partners, one of the most successful hedge funds in the 1990's, boasting a list of blue-chip investors that included the Ziff family and Martin Peretz of The New Republic.

By the end of 2002, Mr. Ackman and his business partner, David P. Berkowitz, were forced to shut the fund after they became stuck in a private equity investment they couldn't sell, and some investors demanded their money back. Since then, Mr. Ackman has raised $410 million for a new firm, Pershing Square; he has promised investors in his new fund that he will not make private equity investments.

In the same way that there is no quelling the bulls, there will be no quieting of the critics. The Horvitz family of Cleveland, which made its fortune in road construction, media and real estate, started investing in hedge funds in the 1990's. A decade or so later, it has virtually no money in such funds, said Jeffrey Horvitz, who oversees his family's investments. Too often, he said, the funds produced disappointing returns.

"Hedge funds are no longer attractive," Mr. Horvitz said, noting the influx of start-ups. "I see no relief in sight, especially for taxable investors like us."
A hedge fund analyst explains his stock research process. Full of excellent links to videos, articles, and books. MUST READ! I'm looking for some serious help into how I can open and operate a hedge fund or an investment fund. We want to do things like various forms of investing capital, managing money and possibly offer financial instruments. Basically I want to figure out the best way to structure the company to give us (my partners and I) flexibility to invest in all sorts of assets with our capital. For example, We would like to offer people 1 year 8% or 10% notes, and use the money they give me to invest in things such as tangible real estate, possibly ETFs or securities etc. I know its not a simple task, but any pointers on where to start or what steps to take would be great. Hedge funds are typically only available to sophisticated investors with large amounts of assets to invest (often over $1 million).[2] X Research source.

The term hedge fund comes from the practice of "hedging", which is the practice of reducing risk in an asset by taking a position in a related security to offset any downward price movements. These related securities often take the form of derivatives like futures, options, and forward contracts. Hedge funds are funded through private placements to accredited investors, who must have a net worth of over $1 million (not including the value of your home) or an annual income of over $200,000 (now and going forward). Thirdly, hedge fund investors are typically "locked-in" for a period. Each hedge fund has its own style or niche that it's highly influenced by the fund's management team. Some hedge funds use complicated and high-risk practices that can include seriously leveraged positions and complex algorithms. Only accredited investors--the definition differs by country--can invest in hedge funds. They are typically high net-worth individuals, banks, financial institutions and other large corporations with considerable reserves of capital. In the United States, the Securities and Exchange Commission (SEC) defines an accredited investor in rule 501 of Regulation D. This rule stipulates that an individual--or married couple--can qualify as an accredited investor if they have a net worth of at least $1,000,000, not including equity in a primary residence. First, while hedge funds have requirements for investment (such as being an "accredited" investor with a certain amount of net worth or income), mutual funds typically do not. Additionally, while mutual funds have daily liquidity (meaning their assets can be quickly bought or sold without affecting the market value), hedge funds often do not. Many hedge funds only have subscriptions or redemptions every month or only quarterly (meaning they accept investors that frequently). Still, hedge funds are able to invest in a much wider spread of investments than mutual funds can. So, hedge funds can invest in traditional stocks, bonds and other commodities, but can also invest in things like real estate, the food industry, currencies and more. Signs that hedge fund managers have become the financial industry's new elite abound. Young, ambitious talent is fleeing Wall Street in search of hedge funds' overnight riches. In hedge fund offices, employees have perks like swimming pools and basketball courts. At cocktail parties throughout Greenwich, Conn. -- the informal capital of the hedge fund world -- investors sip apple martinis and discuss which funds are in vogue. Because few people outside the industry know exactly how they trade or what they trade, there is a certain mystique to the hedge fund set, which only adds to their allure. Then there's the wealth effect. Billionaire hedge fund managers are pushing up the price of everything from luxury apartments to artwork.