Hedge Funds: Democratizing The World and Democratizing the Industry

An excruciating year for investing:

2008 was an appalling year for investors. Amid the turmoil particularly in the 3rdquarter, hedge funds came under intense attack from government, media, the public, often from their own investors and even from their own prime brokers. Most of these attacks took the form of vitriolic rhetoric, threat of increased regulation, increased margin requirements and plain name calling. Fraudsters, crooks, thieves, locusts, come to mind. Some attacks hurt more than others such as the arbitrary bailouts of Fannie Mae and Freddie Mac, bailing out one company (AIG) but not another (Lehman), pulling the plug on financing. And of course a broad ban on selling short. These measures were largely thought to be helpful of the long only investor, the investor who invests in the long term growth and potential of an economy, and not the locusts who profit from the failings of companies or recessions. So, with all those various kicks in the gut, head, kidneys and teeth, lets see how the hedge fund industry performed in comparison with other asset classes.

For the full year 2008, equities did poorly. Global equities as represented by the MSCI World index returned -43.5%. The S&P500 returned -33.8%, the MSCI Europe -45.5%, the MSCI Far East -40.1%. Global bonds fared slightly better, -10.9%. In commodities, the volatility was extreme and the CRB index ended the year -36.0% and the Rogers Commodity Index -41.4%.

In the same period, the broad HFRI index representing hedge fund performance returned -18.7% and the HFRI FOF index returned -21%. Even if you invested in equity long short which traditionally has a tendency to run a net long exposure, you would have lost 26%. If you invested in market neutral funds, you would have lost 6.15%, merger arbitrage funds lost a paltry 4.97% against a backdrop of collapsing Leverage Buy Outs, a heroic performance. The really big damage came in Asia, where liquidity was withdrawn wholesale as Western investors pulled capital in fear and to patch up balance sheets at home. Beware all emerging markets, problems in developed markets always leads to big retrenchments in liquidity. Distressed debt funds lost 25% despite an environment of distress, why? There were no defaults. So distressed debt fund managers drifted into high yield and felt the brunt of general exposure to credit risk. The time for distressed investing will come but it wasn’t 2008, its unlikely to be early 2009 but when it comes, possibly in late 2009 early 2010, it will be big. One area of particular carnage was Convertible Arbitrage, a complicated, technical, levered strategy which had the rug pulled out from it (in various directions) by regulators banning shorting, brokers recalling leverage and selling out collateral and panicky investors asking for their money back.

Hedge funds for all:

The restriction of hedge funds to only rich people who know what they are doing and can afford to lose big sums of money doesn’t really make much sense. If hedge funds are such a great investment, why restrict it to the rich? If they are such a horrible and risk proposition, why offer it to the rich? Are rich people less sophisticated and therefore more prone to mistakes? Should they be allowed to lose money simply because they can afford it? Hedge funds are more complex and offer a range of riskiness and returns potential. Generally, the higher the potential return, the higher the risk. It allows the investor to choose the level of risk and the type of exposure they want.

Hedge funds are good for market efficiency. But first we need to qualify what we mean by a hedge fund. I take hedge funds to include any investment strategy that has fewer constraints than the long only unlevered strategy. In the equity space at least, this means they can borrow to buy more than they have and they sell what they don’t have by first borrowing it from somebody else. Simply by loosening the constraints on what market participants can do in a market, brings greater price discovery to a market. For the individual investor, having the ability to go short or lever a portfolio can only improve the efficiency of his strategy since he could voluntarily refrain from leverage and shorting. The same argument can be extended, perhaps even more easily to commodities, bonds and currencies. The value of assets is therefore more quickly arrived at and communicated based on the decisions of a greater pool of players reflecting their voluntary, unconstrained decisions. We need more hedge funds and we need a greater proportion of the world’s investable wealth managed in less constrained, more innovative and more varied and diverse ways.

Hedge funds are good for all types of investors. An investor seeking to maximize their wealth, income, well being, would like to do so in as unconstrained a manner as possible. Why place limitations on the tools and strategies available to an investor at all? Regulation should be aimed at investor education and standards of disclosure and transparency. If an investor knows what they are getting into, they should be free to make and lose what they are willing to make or lose.

Complexity is a difficult issue. Many hedge fund strategies are complicated and require considerable research and analysis. The legal and operational aspects of hedge fund structures adds further complexity. Fund of hedge funds and consultants are useful intermediaries. Despite the horrendous performance of many funds of funds, they do provide a useful service in due diligence and portfolio construction, overcoming some of the barriers that face less sophisticated investors.

Retail investors are good for hedge funds. Hedge fund managers have always sought out high net worth, family office, institutional investors hoping to find ‘big tickets’, large, chunky investments which they hoped would represent more stable capital. This approach has proven highly risky. It has resulted in a capital base which is not diversified and not granular enough. Also, professional investors tended to behave the same way, some say badly, and either invest as a herd or rush for the exit as a herd. Retail investors represent a more stable investor base simply because there are more of them, each providing smaller amounts of capital, and their independent decisions based on their individual needs represents a more diversified investor base.

It is time to democratize the markets by encouraging a diversity of investing styles, and it is time to democratize the hedge fund industry by opening it up to different types of investors including retail investors. It is time to take the ‘alternative’ out of alternative investments.