Hedges on Hedge Funds

How to Successfully Analyze and Select an Investment

JAMES R. HEDGES IV

WILEY

John Wiley & Sons, Inc.

Contents

Foreword ix

Preface xiii

Acknowledgments xxi

CHAPTER 1
The Hedge Fund Alternative 1

CHAPTER 2
Cutting through the Black Box: Transparency and Disclosure 23

CHAPTER 3
The Operational Risk Crisis 43

CHAPTER 4
Best Practices in Hedge Fund Valuation 53

CHAPTER 5
Does Size Matter? 65

CHAPTER 6
Directional Investing through Global Macros and Managed Futures 75

CHAPTER 7
Profiting from the Corporate Life Cycle 93

CHAPTER 8
Evaluating Arbitrage and Relative Value Strategies 111

CHAPTER 9
The Time Is Now for Equity Market Neutral 133

CHAPTER 10
Long-Short Strategies in the Technology Sector 143

CHAPTER 11
The Expansion of European Hedge Funds 151

CHAPTER 12
The Dynamic World of Asian Hedge Funds 167

CHAPTER 13
Hedge Fund Indices: In Search of a Benchmark 187

GLOSSARY 199

ABOUT THE AUTHORS 217

INDEX 221

Foreword

Does the world need another book on hedge funds? For that matter, does the world need another hedge fund? More fundamentally, does the world need another equity, convertible bond, straight bond, option, foreign exchange contract, swaption, or any of the myriad securities that underlie all hedge fund strategies? The per se answer to all of these questions is no, but the practical reality is that we will have more—much more—of all of the above. More books, more funds, more exotic combinations of securities.

Why? Because it is in the nature of markets to innovate. Because the historical record of risk-adjusted returns of the various hedge fund categories is compelling. Because the barriers to hedge fund creation are nearly nonexistent. Because there is a tidal wave of capital that wants better returns with less risk; pension funds, endowments, individuals, and even nations that have not yet supped at the hedge fund trough.

Will the marginal investor reap the risk-adjusted returns that they envision? Maybe. Will the incremental hedge fund operator succeed in providing those returns and therefore prosper? Some. Will various hedge fund strategies tend toward saturation—both by investors and practioners—thereby driving down incremental benefits? Definitely!

As the hedge fund industry enters early maturity, investors and fund managers need to look beyond the immediate imperative of producing attractive returns and contemplate the risks and opportunities in a longer time frame. We should be concerned not only with the durabilty of our strategies, but also such issues as the scalability of individual firms, strategies, and the industry; adequate disclosure and communication (transparency); the evolving regulatory environment; organizational behavior and health; and terminal value—both in terms of product offering and business economics. We need to think about the "going concern" attributes of individual funds and the industry.

As chairman of Cumberland Associates LLC, one of the longest running hedge funds on the planet, these long-term concerns are at least as important as the quotidian requirements of identifying undervalued and overvalued securities through a well-honed research process. I need to attend to the psychological and economic well being of my fellow members and staff, communicate with investors and prospects, cultivate the human and process capital that will be required for succession of ownership and management of our firm, and above all, make sure that we stay focused yet adaptable.

Central to the process of staying competent and adaptable is what I think of as a willingness to ask "dumb questions"; I have built a career on dumb questions asked of thousands of company managements, my colleagues, myself. What I am really talking about is a willingness and even a need to return constantly to fundamental issues as the context of an individual, a company, an industry, or the world evolves. My allies in this process are colleagues, both internal and external, who believe that while they know a thing or two, realize that the shelf life of an insight gets shorter every day.

For the past fifteen years, one of my most valued correspondents in this professional dialectic has been Jim Hedges. I have known him as an analyst, a client, and the proprietor of his own successful advisory and fund of fund business. Jim's hallmarks are the courage, curiosity, and confidence to think broadly, probe deeply, synthesize, and express succinctly. I have always prized his input, even when he made me squirm!

Now you too can experience the pointy end of Jim's intellect and experience. In this book, Jim has posed the "dumb" and sophisticated questions that all investors and investment managers should be asking themselves and has set forth his thoughts for our benefit. But this work is more than a compilation of his own observations and opinions; he has called upon commentators and practitioners who have earned his respect to broaden and deepen this offering.

The utility of this book to the hedge fund investor, particulary the novice, is readily apparent. I happen to think that it should be required reading for the hedge fund professional as well. One of the salient weaknesses of the hedge fund industry is the predominance of the "sole-proprietor" model, in which one personality dominates the deployment of capital. This structure inherently lacks strong checks and balances. If this sounds like your firm you should read this book.

Investors need to recognize that the combination of low barriers to entry and lucrative returns has attracted thousands of new hedge fund proprietors. Investors have exhibited a fairly marked tendency to try to discover "hot" new managers; have overemphasized facile quantitative measures of risk; have underemphasized qualitative, ethical, and structural elements of managers; and have unrealistically projected short or nonexistent performance records. In so doing, they have often incurred much greater risk and/or disappointing returns than they expected.

The explosion in new hedge fund capital is coinciding with broadening distribution and access. The offerings will reach marginally less sophisticated investors—be they institutions or individuals—as the overall probability of gaining "excess" returns diminishes for the hedge fund universe as a whole. The rate of innovation, number of vehicles, and risks in the hedge fund world will proliferate at an ever faster pace. It is incumbent upon investors to educate and protect themselves; this book is an excellent place to start or revew that education.

Bruce G. Wilcox, Chairman
Management Committee,
Cumberland Associates LLC