

# PRINCIPLES & DYNAMICS OF HEDGE FUNDS

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## THE DILEMA

On the surface it may seem unfair to blame traditional money managers for failing to adapt to erratic market. After all, turn on any business channel, and you can see panels of experts jousting over their divergent theories of what's happening in the markets and why. But to say that traditional managers are having trouble adapting to changing times gets right to the crux of the problem.

Over the past five hundred years, mainstream managers have been increasingly united in embracing a specified codified set of principles and beliefs. Since second world war to now, investment theory and principles are guided by a canon that has been formulated by academics, elaborated by investment professionals, and cemented by large institutional investors and consultants. So much so that many took them as gospel truths.

These principles are taught in every business school and have imploded to become so embedded in the money management industry that practitioners could go through their entire careers without questioning any of them, or any of the assumption behind them. More often than not, debate may rage over process or methodology, but rarely over the bedrock principles themselves.

As a result the tenets of traditional money management add up to a rigid and all-pervading mind-set.....

**a way of viewing the markets that I believe has become outdated.**

In the recent past three down phases of the markets market participants lost so much capital and now they have begun to question these theories and principles in earnest.

I and a few believe that traditional money management is deeply flawed. In the past thirty plus years much of the multi-trillion dollar investment industry is built on

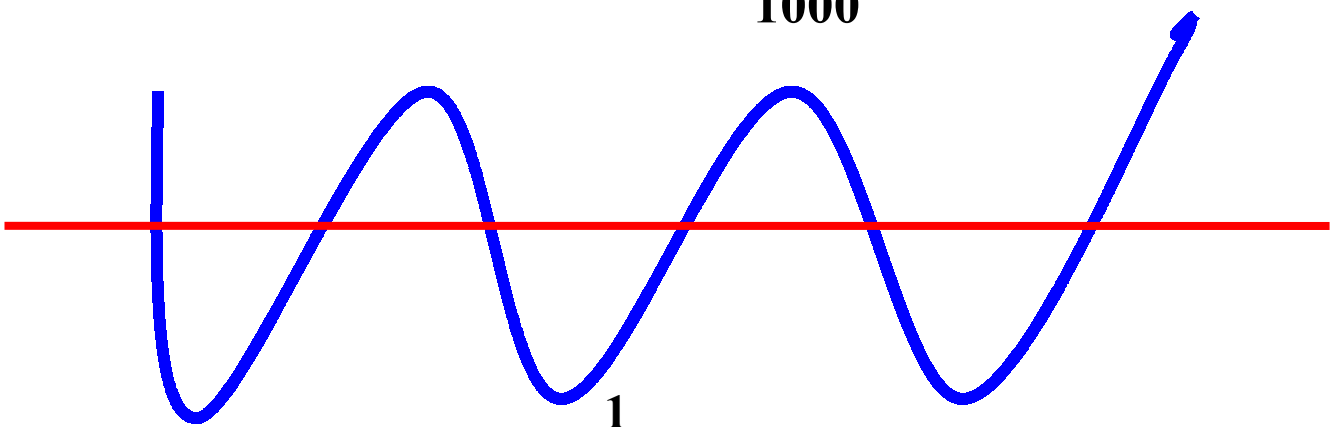
**half-truth,  
incorrect interpretations,  
flawed data,  
unrealistic expectation and projection,  
absurd contradiction.**

**No wonder portfolio based on such ubiquitous accepted doctrines has not produced the results intended.**

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## WHAT IS RISK ?

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**When you manage the downside, then all the upside is yours !**

## **Misconceptions**

MAHATHIR MOHAMAD, prime minister of Malaysia, called them the “highwaymen of the global economy”. Others have described them as “buccaneers” and “gunslingers”. Modern currency crises—the fracturing of Europe’s exchange-rate mechanism in 1992, the Mexican peso crash in 1994, the collapse of East Asia’s currencies in 1997, and the recent attacks on the Russian rouble—are often blamed on them. By placing aggressive bets on currencies, the argument goes, hedge funds destabilize financial markets and drive fragile economies to the wall. Many politicians clamour for greater regulation. The more extreme suggest that the world would be better off without them.

- 1. All hedge funds are volatile**
- 2. They all use global macro strategies and place large directional bets on stocks, currencies, bonds, commodities, and gold, using lots of leverage.**

The erroneous belief that hedge funds per se are "**dangerous**" or "**risky**" is one that is fueled by misconceptions and a lack of understanding in the area. For instance, the meaning of "**hedge**" insinuates **reducing risk**.

Most of the misconceptions are due to several factors such as a lack of regulatory oversight, a lack of transparency, the inability to advertise and even negative press reports. Thus, it is important to understand the very nature of these investment vehicles, as well as the industry itself and how they relate to the traditional markets before broadly categorizing any risk profile.

## The facts

**Less than 5%** of hedge funds are global macro funds like Quantum, Tiger, and Strome.  
**Most hedge funds use derivatives only for hedging or don't use derivatives at all,**  
**Many use no leverage.**

In fact, according to a research paper conducted by **Morgan Stanley Dean Witter & Co.**, in November 2000, "**Hedge funds have produced risk adjusted returns and alpha that are superior to traditional investments.**" While incorporating several databases in the period between January and June 2000, MSDW concluded that all **hedge funds as a composite had an annualized return of 18.9%, while the Standard & Poor's 500 stock Index returned 17.2%.**

**Annualized volatility for hedge funds was less than half of traditional markets, with a 5.5% standard deviation and 13.7% for the S&P 500.**

The **Sharpe Ratio**, a measure of an investment return above a risk free rate divided by its volatility, was exceptionally **better for hedge funds, with a 2.5** compared with a **lower 0.9 for the S&P 500.**

All in all, hedge funds have had much scrutiny in the past few years but have proven to consistently outperform traditional markets on a risk adjusted basis.

For example, in 1987, the year of the stock market crash, while the Standard & Poor's 500-stock index rose 5.24% and growth **mutual funds only 1.02%**, **hedge funds returned 14.49%**. Again, in 1990, when the S&P and equity growth mutual funds registered returns of 3.11 % and **3.82%**, respectively, hedge funds finished the year up **10.97%**.

In 2000, the average hedge fund posted a 7.6% gain, compared with the 10% drop in the blue-chip Standard & Poor's 500 index, according to Hennessee Group, an investment advisory firm in New York.

These **positive returns in difficult markets** were achieved because many hedge funds, as the term implies, "hedge their bets"

## **What is a Hedge Fund?**

**A hedge fund is a term commonly used to describe any fund that isn't a conventional investment fund - that is, any fund using a strategy or set of strategies other than investing long in bonds, equities (mutual funds), and money markets (money market funds).**

**A hedge fund is a fund that can take both long and short positions, use arbitrage, buy and sell undervalued securities, trade options or bonds, and invest in almost any opportunity in any market where it foresees impressive gains at reduced risk.**

## **Hedge funds aims**

**To reduce volatility and risk**

**Attempting to preserve capital**

**Deliver positive returns under all market conditions.**

### **Key Characteristics of Hedge Funds**

- Utilize a variety of financial instruments to reduce risk, enhance returns and minimize the correlation with equity and bond markets.
- Many hedge funds are flexible in their investment options (can use short selling, leverage, derivatives such as puts, calls, options, futures, etc.).
- They vary enormously in terms of investment returns, volatility and risk.
- Not all, hedge fund strategies tend to hedge against downturns in the markets being traded.
- They have the ability to deliver non-market correlated returns.
- They have as an objective consistency of returns and capital preservation rather than magnitude of returns.
- Most hedge funds are managed by experienced investment professionals who are generally disciplined and diligent.
- Pension funds, endowments, insurance companies, private banks and high net worth individuals and families invest in hedge funds to minimize overall portfolio volatility and enhance returns.
- These managers are highly specialized and trade only within their area of expertise and competitive advantage.
- Hedge funds benefit by heavily weighting hedge fund managers' remuneration towards performance incentives, thus attracting the best brains in the investment business.
- Hedge fund managers usually have their own money invested in their fund.

## **Facts About the Hedge Fund Industry**

- \$300-\$400 billion industry and growing at about 20% per year with between 4,000 and 5,000 active hedge funds.
- Most hedge funds are highly specialized, relying on the specific expertise of the manager or management team.
- Performance of many hedge fund strategies, particularly relative value strategies, is not dependent on the direction of the bond or equity markets -- unlike **conventional equity or mutual funds (unit trusts), which are generally 100% exposed to market risk. !!!!**
- Many hedge fund strategies, particularly arbitrage strategies, are limited as to how much capital they can successfully employ before returns diminish. As a result, many successful hedge fund managers limit the amount of capital they will accept.
- **Returns over a sustained period of time have outperformed standard equity and bond indexes with less volatility and less risk of loss than equities.**
- Investing in hedge funds tends to be favored by more sophisticated investors, including many Swiss and other private banks, that have lived through, and understand the consequences of, major stock market corrections. But Asian is somehow inferior to them

## Benefits of Hedge Funds

- Ability to generate positive returns in both rising and **falling** equity and bond markets.
- Hedge funds in a balanced portfolio **reduces overall portfolio risk and volatility and increases returns.**
- Huge variety of hedge fund investment styles – many uncorrelated with each other – provides investors with a wide choice of hedge fund strategies to meet their investment objectives.
- Research proves that **hedge funds have higher returns and lower overall risk than traditional investment funds.**
- Hedge funds provide an ideal long-term investment solution, eliminating the need to **correctly time entry and exit from markets.**
- Hedge funds provide diversification not otherwise available in traditional investing.
- Provides more predictable returns than traditional funds.
- Hedge funds are extremely flexible in their investment options because they use financial instruments generally beyond the reach of mutual funds, which have SEC regulations and disclosure requirements that largely prevent them from using short selling, leverage, concentrated investments, and derivatives. This flexibility, which includes use of hedging strategies to protect downside risk, gives hedge funds the ability to best manage investment risks. The strong results can be linked to performance incentives in addition to investment flexibility.
- Unlike many mutual fund managers, hedge fund managers are usually heavily invested in a significant portion of the funds they run and shares the rewards as well as risks with the investors. "Incentive fees" remunerate hedge fund managers only when returns are positive, whereas mutual funds pay their financial managers according to the volume of assets managed, regardless of performance. This incentive fee structure tends to attract many of Wall Street's best practitioners and other financial experts to the Hedge fund industry.

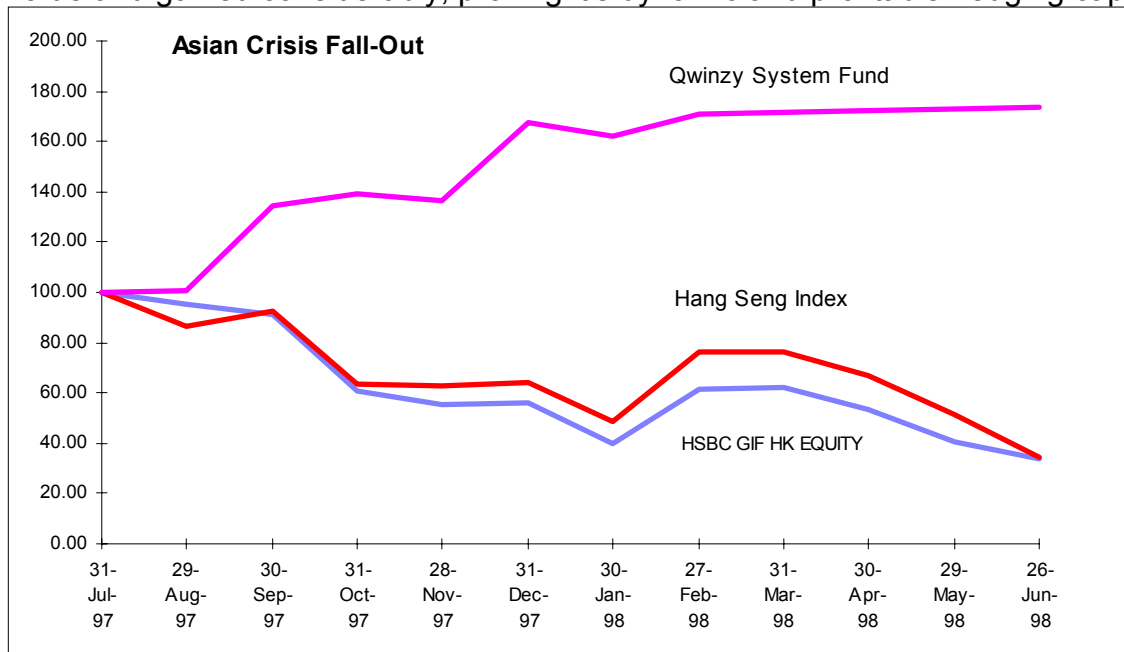
## Hedge Funds Outperform Mutual Funds in Falling Equity Markets

	S&P 500	VAN U.S. Fund Index	Hedge	Morningstar Equity Mutual Fund	Average
1Q90	-3%	2.20%		-2.80%	
3Q90	-13.70%	-3.70%		-15.40%	
2Q91	-0.20%	2.30%		-0.90%	
1Q92	-2.50%	5.00%		-0.70%	
1Q94	-3.80%	-0.80%		-3.20%	
4Q94	-0.02%	-1.20%		-2.60%	
3Q98	-9.90%	-6.10%		-15.00%	
3Q99	-6.20%	2.10%		-3.20%	
2Q00	-2.70%	0.30%		-3.60%	
3Q00	-1.00%	3.00%		0.60%	
4Q00	-7.80%	-2.40%		-7.80%	
1Q01	-11.90%	-1.10%		-12.60%	
Total	-62.72%	-0.40%		-67.20%	

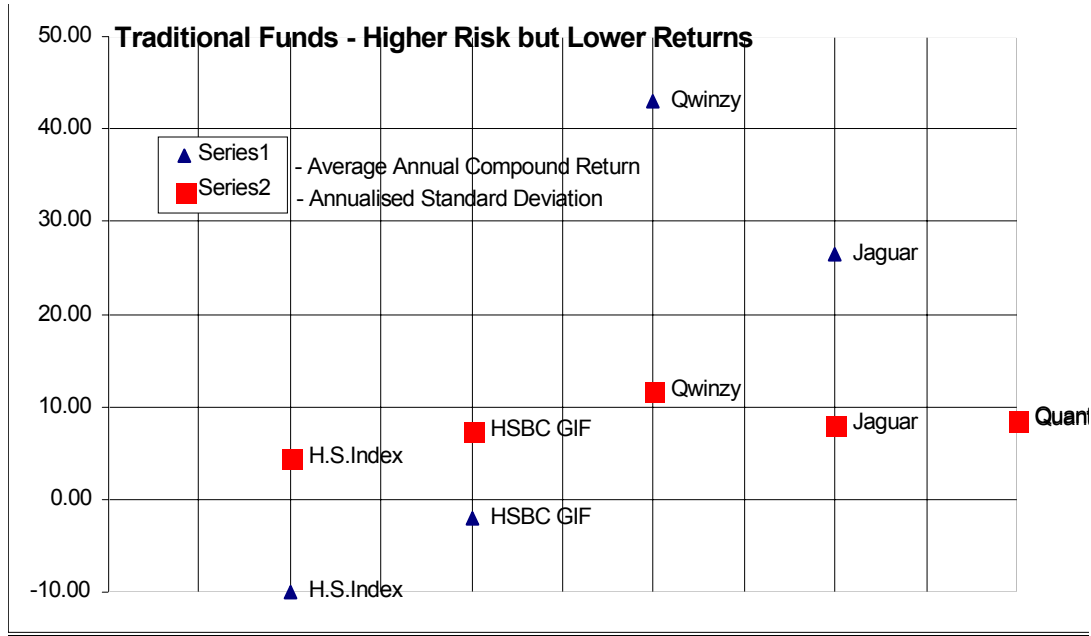
During the last 13.25 years, the S&P 500 Index has had 12 negative quarters, totaling a negative return of 62.72%. During those negative quarters, the average U.S. equity mutual fund had a cumulative negative return of 67.2%, while the average hedge fund had a cumulative negative return of only 0.40%, displaying the ability of hedge funds to preserve capital in falling equity markets.

### HOME GROUND

This chart shows comparative performance specifically during the **Asian Crisis**, which affected Hong Kong in July 1997, just after the 1997 HK's hand over, and is currently still in place ( as at 30<sup>th</sup> June 1998 ). the respective values have been indexed to 100 and monthly percent changes computed and plotted. It will be seen that while the market index and the HSBC GIF Fund's index fell, the system managed portfolio held its value and gained considerably, proving it's dynamic and profitable hedging capabilities.



This scatter chart, positions the traditional investment funds relative to non traditional or Hedge funds, relative to their respective risk reward profiles. Contrary to wrong but popular media generated disillusionment and misinformation, the facts clearly show that the traditional approach actually assumes greater risk but rewards this higher risk with lower returns. Everyone is a hero in a bull market but surviving a bear market is what, the much preached but rarely practised, preservation of capital and sound money management practice is all about.



In conclusion, the various charts comparing the Qwinzy systems' performance with the broad market and several well known funds show that the systems performance is acceptable. It's volatility is justified by higher average annual compound returns and it was able to retain profits gained. It was also able to hold its value in sharply falling markets. Overall, the systems' performance was good, considering the restrictions imposed and assumed (i.e. no reinvestment of profits and no interest earned on cash balances); and that no special asset picking skills were assumed (as in the case of the other Funds) and neither was unjustifiable risk assumed (as in the case of Funds with a lower Sharpe Index). The tests demonstrated that a portfolio using the Qwinzy systems to trade relevant index futures can provide an effective and profitable hedge to compliment long term investments in equities. The systems portfolio could also be a profitable investment on a stand alone basis for the pursuit of absolute returns in both rising and falling market conditions.

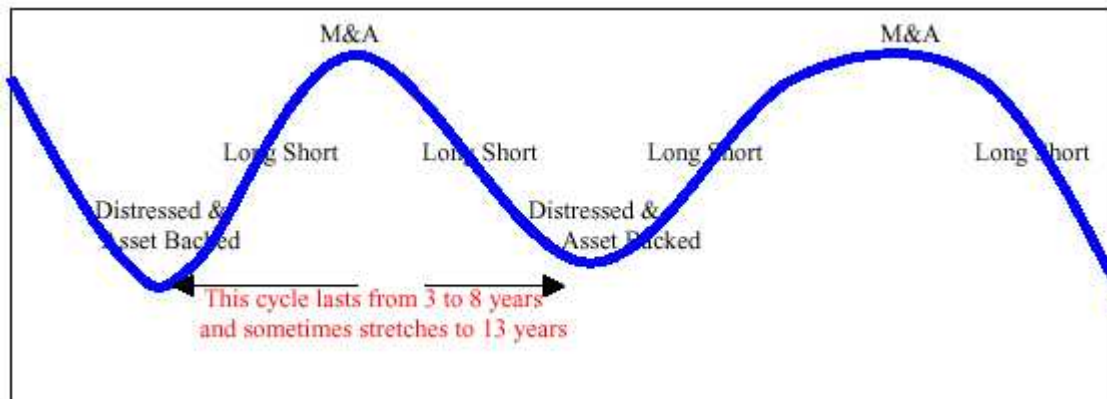
## HOW HEDGE FUNDS WORK?

Approximately **14 distinct investment styles** used by hedge funds Each offering different degrees of risk and return. and importantly not a single style is for all season.

**Therefore, knowing and understanding the characteristics of the many different hedge fund strategies is essential to capitalizing on their variety of investment opportunities for different season. Normally it is rather difficult to have a single strategy for all seasons.**

**In Hong Kong Only a few of us have actually had successful hands on their usage. Furthermore, it is quiet impossible for traditional managers to be converted to hedge specialist as many hedge professionals go against all traditional wisdom at major market inflection point.**

Just for the sake of business, it is rather sad that some financial houses are already unofficially making these sort of hedge funds cocktail to flog to the uneducated uninformed investing public.



This is s-simplified diagram of some of the strategies that are used in different phases of the economy and market conditions. The difficult part of ascertaining which part of the cycle calls for much experience and demands very specialized skill. I personally aware that there are less than ten of us in Hong Kong that have the experience and success in doing this arduous task.

It is important to understand the differences between the various hedge fund strategies because **all hedge funds are not the same** -- *investment returns, volatility, and risk vary enormously among the different hedge fund strategies*. Some strategies which are not correlated to equity markets are able to deliver consistent returns with extremely low risk of loss, while others may be as or more volatile than mutual funds.

Furthermore, **a successful fund of hedge funds cannot be made by just mixing the best of each strategies to form the fund of hedge fund**. This is because in each phases of the economic cycle, certain strategies work best and the others are disastrous although many local IFA firms are trying to mix this sort of fund to add to their products range without knowing the inherent danger of such misuse of hedge funds.

Hedge fund strategies vary enormously – many, but not all, hedge against market downturns – especially important today with volatility and anticipation of corrections in overheated stock markets.

## Hedge Fund Styles

**The predictability of future results shows a strong correlation with the volatility of each strategy. Future performance of strategies with high volatility is far less predictable than future performance from strategies experiencing low or moderate volatility.**

**1. Aggressive Growth:** Invests in equities expected to experience acceleration in growth of earnings per share. Generally high P/E ratios, low or no dividends; often smaller and micro cap stocks which are expected to experience rapid growth. Includes sector specialist funds such as technology, banking, or biotechnology. Hedges by shorting equities where earnings disappointment is expected or by shorting stock indexes. Tends to be "long-biased."

**Expected Volatility: High**

**2. Distressed Securities:** Buys equity, debt, or trade claims at deep discounts of companies in or facing bankruptcy or reorganization. Profits from the market's lack of understanding of the true value of the deeply discounted securities and because the majority of institutional investors cannot own below investment grade securities. (This selling pressure creates the deep discount.) Results generally not dependent on the direction of the markets. **Expected Volatility: Low - Moderate**

**3. Emerging Markets:** Invests in equity or debt of emerging (less mature) markets that tend to have higher inflation and volatile growth. Short selling is not permitted in many emerging markets, and, therefore, effective hedging is often not available, although Brady debt can be partially hedged via U.S. Treasury futures and currency markets. **Expected Volatility: Very High**

**4. Funds of Hedge Funds:** Mix and match hedge funds and other pooled investment vehicles. This blending of different strategies and asset classes aims to provide a more stable long-term investment return than any of the individual funds. Returns, risk, and volatility can be controlled by the mix of underlying strategies and funds. Capital preservation is generally an important consideration. Volatility depends on the mix and ratio of strategies employed. **Expected Volatility: Low - Moderate - High**

**5. Income:** Invests with primary focus on yield or current income rather than solely on capital gains. May utilize leverage to buy bonds and sometimes fixed income derivatives in order to profit from principal appreciation and interest income. **Expected Volatility: Low**

**6. Macro:** Aims to profit from changes in global economies, typically brought about by shifts in government policy that impact interest rates, in turn affecting currency, stock, and bond markets. Participates in all major markets -- equities, bonds, currencies and commodities -- though not always at the same time. Uses leverage and derivatives to accentuate the impact of market moves. Utilizes hedging, but the leveraged directional investments tend to make the largest impact on performance. **Expected Volatility: Very High**

**7. Market Neutral - Arbitrage:** Attempts to hedge out most market risk by taking offsetting positions, often in different securities of the same issuer. For example, can be long convertible bonds and short the underlying issuer's equity. May also use futures to hedge out interest rate risk. Focuses on obtaining returns with low or no correlation to both the equity and bond markets. These relative value strategies include fixed income arbitrage, mortgage backed securities, capital structure arbitrage, and closed-end fund arbitrage. **Expected Volatility: Low**

**8. Market Neutral - Securities Hedging:** Invests equally in long and short equity portfolios generally in the same sectors of the market. Market risk is greatly reduced, but effective stock analysis and stock picking is essential to obtaining meaningful results. Leverage may be used to enhance returns. Usually low or no correlation to the market. Sometimes uses market index futures to hedge out systematic (market) risk. Relative benchmark index usually T-bills. **Expected Volatility: Low**

**9 Market Timing:** Allocates assets among different asset classes depending on the manager's view of the economic or market outlook. Portfolio emphasis may swing widely between asset classes. Unpredictability of market movements and the difficulty of timing entry and exit from markets add to the volatility of this strategy. **Expected Volatility: High**

**10. Opportunistic:** Investment theme changes from strategy to strategy as opportunities arise to profit from events such as IPOs, sudden price changes often caused by an interim earnings disappointment, hostile bids, and other event-driven opportunities. May utilize several of these investing styles at a given time and is not restricted to any particular investment approach or asset class. **Expected Volatility: Variable**

**11. Multi-Strategy:** Investment approach is diversified by employing various strategies simultaneously to realize short- and long-term gains. Other strategies may include systems trading such as trend following and various diversified technical strategies. This style of investing allows the manager to overweight or underweight different strategies to best capitalize on current investment opportunities. **Expected Volatility: Variable**

**12 Short Selling:** Sells securities short in anticipation of being able to rebuy them at a future date at a lower price due to the manager's assessment of the overvaluation of the securities, or the market, or in anticipation of earnings disappointments often due to accounting irregularities, new competition, change of management, etc. Often used as a hedge to offset long-only portfolios and by those who feel the market is approaching a bearish cycle. High risk. **Expected Volatility: Very High**

**13 Special Situations:** Invests in event-driven situations such as mergers, hostile takeovers, reorganizations, or leveraged buyouts. May involve simultaneous purchase of stock in companies being acquired, and the sale of stock in its acquirer, hoping to profit from the spread between the current market price and the ultimate purchase price of the company. May also utilize derivatives to leverage returns and to hedge out interest rate and/or market risk. Results generally not dependent on direction of market. **Expected Volatility: Moderate**

**14 Value:** Invests in securities perceived to be selling at deep discounts to their intrinsic or potential worth. Such securities may be out of favor or underfollowed by analysts. Long-term holding, patience, and strong discipline are often required until the ultimate value is recognized by the market. **Expected Volatility: Low - Moderate**

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