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Review Paper

A Literature Investigation on Hedge Funds: Crisscrossing Pompous Edges by Revisiting History

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Abstract

Hedge funds in the previous years have become attractive with regards to money and portfolio management. An investment partnership started by Alfred Jones in 1949 in USA that was regarded as the first Hedge Fund adapted to store and enhance wealth management in the coming times almost for 80 years then. Even the Great Depression period of 1930's and the breakdown of Bretton Wood Conference in 1970 and later on the first oil crisis in 1973-74 also characterized the remarkable growth of hedge funds in money management. But it was in 1998, the near breakdown of Long Term Capital Management (LTCM) that initiated a international liquidity crisis and that called out for the scrutinization of hedge funds typically for their publicized performance problems. It would be more appropriate to exactly figure out how the mood of hedge funds swings and why. For this the paper attempts and presents a chequered history of hedge funds and to explore their current scenario in the present financial world.

Keywords: Hedge Funds, History of Hedge Funds, Financial Industry.

Introduction

Hedge funds have been more prominent in economic extremes. In the time of boom period, hedge funds act as money maker machines but at the times of crises they seek their attention from the global market. It is known that hedge funds witness their evolution through the 20th and 21st centuries. Hedge funds have been used in USA since past 80 years and have paved their ways towards their challenging role mainly attributing to their performance in Great Depression Period which resulted USA as the wealthiest country in the world. This called out a need for the investigation on its origin and evolution. However, the four years period between the end of the war and 1949's recession has bought some very new and inventive ways of wealth creation too. During this time, Alfred Jones, the journalist of Fortune magazine, discovered hedge funds while working on an article about technical analysis on stock markets and its trends[1-4].

Rationale: The study of hedge fund about their history, existence, characteristics and nature is very essential to define them. In the year 2014, Sensex outperformed and resulted in stellar returns. Globally, hedge funds are the important key component of investor's asset allocation. Although in India, it is not present virtually because of the inadequate regulatory structure. Hence there is a need to concretely work on the evolution of hedge funds.

Objectives: i. To explore the evolution of hedge funds. ii. To explore current status of hedge funds in contemporary financial environment.

Methodology

On the basis of literature review (secondary data), an attempt is made to find the story behind the inception of hedge funds and how these miracle money making machines paved their way to a successful transition till date.

Literature Review

The First Hedge Fund: The boom years of 1920 have bought the pool of funds mainly for wealth preservation and capital growth for the investors. The earlier example of hedge fund was the Graham-Newman Partnership which was cited by Warren Buffet during this decade. The investment trend in 1920's was characterized by millions of dollars in the markets but the results were tragic. This was then followed by the Great Depression where many investment banks were shut down owing to heavy losses. Only a few remained in the Second World War. In the year 1940's however still the investments were not systematized. Alfred Jones, the father of modern hedge fund, was born in 1901, Melbourne, Australia. While working over the current investment trends in 1948, he tried his hands being a money manager and invested $40,000 and solicited $60,000 from investors. Using long and short equity model, to hedge market risks, he discovered hedge fund. But initially he failed to attract attention of the investors[1,2,5].

The Rise of the Hedge Fund: In the year 1966, an article in Fortune magazine highlighted that an unclear deal broke mutual funds in the market by its double digit figures and that made hedge fund an industry. Two years within the operations, the industry operated 140 hedge funds. The fund had general partnership, no regulation under US Investment Company Act, 1940 and was only limited to 100 investors but then it was open for the qualified investors. In 1952, the fund was turned into limited partnership and started charging 20% performance fees in addition to its management fees. Further the other managers were also hired to manage the funds. Hence this multi manager approach introduced first fund of hedge funds[2,6-9].

Journey from 1960s to 1990s: By the mid-1960s, Jones' fund was still active and began to inspire imitations, some from investment managers who once worked for Jones. Securities Exchange Commission (SEC) report documented 140 live hedge funds in 1968 (President's Working Group, 1999)[10]. A stock market boom began in the late 60's, led by a group of stocks dubbed the Nifty Fifty, and hedge funds that followed the Jones' long-short style appeared to underperform the overall market. To capture the rising market, hedge fund managers altered their investing strategy. Their funds became directional, abandoned the risk reduction afforded by long-short hedging, and opted for portfolios favoring leveraged long-bias exposure[11]. In 1984, Jones revised the fund's partnership agreement so that it formally became a fund of funds[6,9].

The Era of Financial Distress

The Great Depression: Great Depression Period was characterized by unregulated financial markets leading to speculations, market bubbles and exploitation of unprotected investors which resulted in the imposition of strict government control over the financial markets investment vehicles. After World War II, the mutual fund industry evolved which offered funds of various categories to household like stock funds, bond funds, growth funds and value funds for the some fee. Its long-only-cash benchmark structure became very popular in American Households during the 1950's and 1960's and in early 1970's[3,4].

The Breakdown of Bretton Woods System: Bretton Woods System in early 1970's introduced another trading vehicle for investors where exchange rates could fluctuate. Options and Future markets were also developed to enable highly leveraged trading in financial instruments, currencies and commodities. This was followed by first oil-crisis in 1973-74 which increased the volatility of the prices of many commodities[3,4].

First Oil Crises and the Inception of Hedge Funds: The first oil-crisis and inflation throughout 1970's created opportunities for individuals skilled in commodity trading and hence 'Hedge Funds' evolved. The skilled traders tried to get to the equilibrium prices in currency and commodity markets at a time when big stocks started hitting those markets. The outcome was a profitable activity. Super traders emerged and pools of capital also emerged[3,4]. SEC found 215 investment partnerships in a survey in 1968 out of which 140 of these were classified as hedge funds[6,9]. It was realized that hedging a portfolio using short sales was an expensive, time-consuming activity in a bull market which made hedge fund managers departed from their original strategies of constructing hedged portfolios using both long and short techniques. Many hedge funds had to be closed due to their leveraged, net-long positions in the market downturns of 1969-1970 and 1973-1974 resulting in the failure of the hedge fund industry till mid 1980's[9] when an article in Institutional Investor documented the superior performance of Julian Roberstons Tiger fund, providing an annual return of 43% during the first six years of its existence[12]. This was considered a remarkable triumph, when compared with the 18.7% annual return that the S&P 500 delivered during the same period[9,10]. Julian Robertson started Tiger fund with $8 million in 1980, which extended to $ 22 billion in 1993. The fund's vision was to invest in 200 best companies and go short on 200 worst companies. However, this fund drew the attention and interest of various investors into hedge funds, which further employed various strategies like derivatives[2].

The Dark Ages: In the late 1980s, substantial primary market activity and rapidly rising securities prices ensued a new wave in hedge funds and this increased the number of hedge funds by 1,000 by the early 1990s[8,9]. The bull market days of the early 1990s witnessed a shift of mutual fund industry into the hedge fund industry with greater flexibility and remuneration. The high-profile success of George Soros and Jim Rogers' Quantum Fund that forced the exit of the UK from the European Exchange Rate Mechanism fanned the flames. Hedge funds witnessed same fate as during 1970's during the dot-com bubble burst in the late 1990s and early 2000s[2]. Hedge funds became admired for their profitability, and reviled for their seeming destabilizing influence on world financial markets. In 1992 during the European Exchange Rate Mechanism crisis, George Soros' Quantum Fund, another global macro hedge fund, made over a billion dollars from shorting the British pound. During the Asian Contagion currency crisis, the Thai Baht fell 23% in July 1997. Quantum Fund had shorted the Baht and gained 11.4% that month[13]. Remarkable success stories like these recognized a standing for benefiting from and contributing to financial market confusions[12]. Hedge funds gained particular notoriety when in 1992, when the Quantum Fund managed by George Soros earned USD 1.8 billion by establishing a short position on the British pound and a long position on the Deutschmark. But, the dramatic collapse of the Russian ruble in 1998 led to a USD 2 billion loss for the Quantum Fund[9,10]. This also led to US $4 billion loss for the Long-Term Capital Management Hedge Fund (LTCM) and subsequent collapse in 1998. A widespread market disaster was sidestepped when the Federal Reserve orchestrated the bailout of LTCM. However as note, the industry was developing a bad reputation in the general public, a reputation reinforced by the shortage of information available to the public caused by the lack of reporting requirements[8,9].

Long Term Capital Management Hedge Fund: The year 1990's witnessed the biggest downfall of LTCM, which was the premier hedge fund with a return of 33.7% after fees. It was characterized by low volatility, high leverage with higher returns. But due the collapse of LTCM, hedge fund's leverage ratios fell subsequently. Following this, in the year 1998, the Russian Debt Crisis caused global interest anomalies. This resulted in decline of asset under management in the early 1999. The industry rebounded when the need of increased risk management recommendations was felt. After this, Calpers, California Public Employees' Retirement System, the largest American public pension fund, announced that they would invest up to US$11 billion in hedge funds[10,11,14-18].

The Modern Hedge Fund: Hedge fund investment option was opened to a large number of average investors allowing minimum investment requirements of $25,000[2].

The Resurgence: With the success of earning 50-100 percent annually, by the early 1990's, the total fund under management in hedge fund industry amounted to 100 billion dollars. With the significant returns, the managers usually took a 2 percent fee and investors even after paying fees, were earning 40-50 percent rates of return[4]. At the end of 1999, Tremont Partners estimated as many as 4,000 hedge funds of all shapes, sizes and investment disciplines existed, 2,600 of which were tracked in its data base[19].

The Challenges: Due to a remarkable success of hedge funds, more people wanted to manage their money which became quite difficult. As all hedge funds took alternative strategies, all tended to move into same positions that resulted in highly correlated movement of prices from an outside shock and also added to the volatility of returns which complicated the problem of managing risk in multi-strategy hedge funds. The result was the earlier 40-50 percent returns fell and only 15 percent returns were being fetched from existing hedge funds. During the 1990's, the reality emerged that the hedge fund activity earning the remarkably high returns in the early phase of the industry was limited in scale. The reality that a fund structured to earn 40-50 percent rates of return was not infinitely scalable to the upside was disappointing to the most investors. After 1997-98 Asian/ Russian Debt Crisis, US stock market witnessed those investors which heavily entered into stocks but not in hedge funds because stock markets themselves generated 20-25 percent annual returns, so no investor was ready for hedge funds which generated the same return as that of stocks in addition of the fees. Remarkably, one of the most famous hedge funds 'Quantum Funds' founded by George Soros, enjoyed a substantial return in 1999, but by March 2000, NASDAQ collapsed that made Quantum Fund lost heavily and illustrating a moral hazard problem in hedge fund industry. The outcome was a great learning to the investors to check first the position of manager's own money in the under management along with the outside investors that exercised a great risk management measure by hedge fund managers[3,4].

Development of Funds of Funds: The explosive growth in hedge funds led to a professionally managed portfolio of hedge funds, commonly called 'funds of funds that provided benefits similar to those of hedge funds with lower minimum investment levels, greater diversification, and an additional layer of professional management. Some funds of funds were publicly listed on the stock exchanges in London, Dublin, and Luxembourg[11].

Hedge Funds in Present Context: Hedge funds today are far different from what they were in 1940's and in 1980's. While Albert Jones started the first hedge fund with just $100,000, in 2013 the global hedge fund industry recorded a record high of US$2.4 trillion in assets under management[2]. In April 2012, the capital markets regulator brought all so-called Alternate Investment Funds (AIF) such as Venture Capital funds, Private Equity funds, infrastructure funds and social sector funds under an omnibus regulation with the objective of reducing the investment risk of investors. The regulation classified AIFs under three categories; the third category includes hedge Funds. The requirements to start a hedge fund is too tight as given by SEBI as it requires more than 20 crores of rupees as main requirement of starting a hedge fund. And only certain certified investors are allowed to invest. There are no ratings or performance of any AIF funds publicly available like Mutual funds. Globally, AIFs represent 10% of an investor's assets, so that way, India is at a nascent stage. It is felt that in the coming years AIF industry in India will easily cross the $4-5 billion mark in terms of investments made. Many local hedge funds have started operating and got registered with SEBI, after it has issued guidelines from 2012 (www.quora.com)[20].

Major Deterrents of Hedge Funds in India

Stringent Regulations: There is no such regulated investment vehicle for commodity futures for instance, due to which it is not possible to create a well-diversified cross asset investment portfolio (www.quora.com)[20].

Lack of Awareness: Another major deterrent for hedge funds has been the fact that a major portion of the rich (HNIs) in India, are literally unaware of what a hedge fund is. The only thing they want is high returns. Even if somehow such an investor is ready to invest in a hedge fund, it is extremely risky for a hedge fund to manage money for such a client without a considerable lock in period due to the risk of whimsical withdrawals (www.quora.com)[20].

Present-day Sight: Hedge funds investing in India have become the world's best performers in the year 2015 on expectations that Prime Minister Narendra Modi will revive Asia's third-largest economy. The funds investing in the South Asian nation have returned 26 percent in year 2015 through July, according to Eureka hedge Pte. , that compares with an average 3.5 percent gain for those investing in Asia, 1.9 percent for Greater China, 1.2 percent for Japan, 3.8 percent for

North America and 1.1 percent for Europe, according to Singapore Data Provider. India-focused hedge funds, with a sixth of the $16.5 billion in assets of those investing in Japan, were set for the strongest return in five years after Narendra Modi secured the nation's largest election victory since 1984 in May, 2014. Hedge funds located in India are less than half-a-billion dollars in assets. The Reserve Bank of India (RBI) on 16 November 2015 removed restrictions on AIFs of which hedge funds are a sub-category based in India accepting foreign capital. This paves the way for India-based funds to capture a bigger part of the multi-billion dollar India dedicated hedge fund assets. The total amount managed by all India-dedicated hedge funds is $3.6 billion, of which $3.2 billion is managed by managers based outside the country which is only a minuscule portion of the global hedge fund industry, which has a size of $2.24 trillion, according to data from hedge-fund tracker Eureka hedge. Earlier, India based hedge funds wanting foreign capital had to approach the Foreign Investment Promotion Board, usually without success. The new dispensation allows foreign investors to put their money in all AIF, including hedge funds. Hence, subject to prescribed conditions, investments are likely to happen (www.quora.com)[20].

Conclusion

A report by KPMG, AIMA and the Centre for Hedge Fund Research, Imperial College London, also concluded that the hedge fund industry continued to play a vital role in global financial markets, providing liquidity and having an overall positive impact on a wide range of factors, including price discovery, financial stability, portfolio diversification and more. Hedge funds pioneered mainly for four attributes of money management: Simultaneous trading in range of markets; Utilizing long and short strategies; Employing skills in specific markets and; Incentive based fee structure along with the manager participation in fund performance[3,4]. In the period of Lehman Brothers case hedge funds withdrawal withdrew the stock liquidity as well but however, during Dot Com Bubble, hedge funds heavily demanded liquidity. Hedge funds have to be more advanced as now so as to beat up the benchmarks of the current financial industry needs for more money making and this could only be possible when there would be standardization and development in the regulatory concerns for this industry.

Suggestions: It is suggested that the industry needs to be further regulated and a larger transparency has to be adopted for the sake of favorable market competencies. Hedge funds are subject to characterization according to the market potentials including investors as well as asset class invested in. For the enhancement of the industry further researches should be carried out. Regulatory authorities should consider the new form of hedge funds defining for making guidelines and regulation matters. Greater disclosure norms are to be declared. Their association be created and be made active by the development of the industry. Fund manager's individual performance should be rated. Securities Exchange Board of India should regulate and monitor administration, development and growth of the industry.

Implications: It is implicit that hedge funds are almost eighty years old financial products and becoming relevant in the financial sector. Owing to the economic fluctuations in the existing financial markets hedge funds are becoming popular and attractive destination among the classy set of investors, the individuals as well as the institutions. They can provide risk measurement in the form of risk reduction and risk mitigation. It is a tool through which one can safely invest into and may earn higher returns. Hedge fund is a developing industry which has its own importance, significance and contemporary relevance. They are in major highlight in the developing economies like, India and they are being regarded as one of the unavoidable portfolio by the investors today.

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