EXPLORING HEDGE FUNDS: A COMPREHENSIVE LOOK AT THEIR HISTORY, CURRENT STATUS, ANALYSES, AND EMERGING TRENDS

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ABSTRACT

This research paper provides a foundational overview of the hedge fund industry. Focusing on the historical evolution and fundamental principles of hedge funds, the paper aims to familiarize readers with the industry's key aspects and current trends.

1. INTRODUCTION

The hedge fund industry plays an increasing role in financial markets. However, most research papers and articles target hedge fund managers and investors with quantitative insights about the industry. Only a few introductory hedge fund papers can be found. Some of them were written 2030 years ago and are simply outdated, while the recent ones include an excessive number of quantitative insights and are aimed at hedge fund managers and investors. As a consequence, we saw a need for an empirical study that would lift the curtain of this rather mystical type of investment funds primarily for those who are starting their journey in exploring hedge funds.

First of all, we will attempt to discuss and propose improvement of the definition of hedge funds. Afterwards, we will briefly go through history of the industry and describe common investment strategies employed by hedge funds e. g. global-macro, and long/short equity. In the next sections, we will cover and discuss fees' structure, regulations, and risk-management of hedge funds. In the end, we will finish by providing our unbiased views about current condition of the industry as a starting point in analyzing the hedge fund industry.

2. HEDGE FUNDS FUNDAMENTALS

2.1 What Are Hedge Funds?

Hedge Funds is the type of investment funds which is usually associated with more risks and higher rates of return than common types of funds. For example, Getmansky (2015) states that 47% of hedge funds close after 5 years of existence. However, it should be noted that there is no ultimate definition of hedge funds. Therefore, we will describe the distinctive features of hedge funds in this chapter.

2.2 Hedging

The term "hedge" originally referred to the practice of using financial instruments, such as derivatives, to offset or "hedge" against potential losses in the value of securities held by the fund.

However, contemporary hedge funds can engage in a wide range of investment strategies, and not all of them involve hedging in the traditional sense.

2.3 The Ultimate Goal of Hedge Funds

Unlike Exchange-Traded Funds (ETFs) or Mutual Funds, which benchmark their performance against a market index, hedge funds typically aim for absolute returns. This means they seek to generate positive returns regardless of the overall market conditions.

2.4 Leverage

In pursuit of amplified returns, many hedge funds use leverage to increase the size of their positions relative to their capital base. Common leverage strategies include margin trading, borrowing, and using derivatives. However, many researchers try to exclude derivatives when calculating leverage of a hedge fund.

2.5 Lower Regulatory Oversight

Funds of this type can potentially invest in a wide range of asset classes and markets and do not have as many restrictions as, for example, mutual funds or ETFs. Moreover, hedge funds are exempt from some disclosure requirements and are overall less regulated than more common investment vehicles.

2.6 Suggested Definition of Hedge Fund

As a result of the above discussion and analysis, the following definition of hedge is proposed: A hedge fund is an actively managed investment vehicle that invests pooled money from a limited group of investors in a variety of assets.

3. HISTORY OF HEDGE FUND INDUSTRY

While there is a more than sufficient number of research papers dedicated to history of the industry, we decided to make an emphasis on two descriptive examples- the “story of success” and “the biggest disappointment”.

3.1 The first hedge fund by Alfred W. Jones

According to Connor and Woo (2000), the term "hedge fund" originated in the 1940s when a financial journalist Alfred W. Jones created a fund that was exempt from The Investment Company Act of 1940. As a consequence, it enabled him to employ greater investment flexibility. The investment strategy of the fund was simple, yet innovative for its time: borrowing money (using leverage) to invest in equities that Jones thought would appreciate and short-selling assets that were in his opinion overpriced, i. e. long/short strategy. In addition, unlike other types of investment funds, Jones’ partnership was charging both management and incentive fees, being two and twenty percent respectively. Seven decades later such practice is still widely used by hedge funds.

The year after the creation of the fund, it earned 17.3%, and during the next decade, it surprisingly outperformed every mutual fund by 87% (Smigel, 2023). The tremendous success of the partnership attracted a lot of attention from investors all-over the world. As a result, an increasing number of hedge funds evolved.

3.2 Long-Term Capital Management (LTCM)

Over the years hedge fund industry witnessed many collapses. The most notable hedge fund failure was arguably the fall of LTCM. Initially, LTCM had a tremendous success. From 1994 to 1997 AUM of the fund grew from $1 billion to more than $7 billion. Moreover, the performance of the fund during that period was over 20% each year (Jorion, 2000).

Unfortunately, The Russian Default of 1998 and the subsequent market turmoil caused severe losses for LTCM. Having $5 billion equity and $125 billion balance sheet, the fund's highly leveraged asset allocations (25:1 and afterwards 45:1) led to a margin call, and its attempts to unwind positions quickly further increased market volatility. As the assets of LTCM became illiquid and the fund was expected to collapse at any moment, such adverse circumstances drew the attention of the regulators. Ultimately, the Federal Reserve facilitated a $3.65 billion offer for 90 percent of the firm’s equity by systematically important banks and brokerage houses. The offer was accepted by the managers of the fund, so the failure of LTCM was avoided.

4. HEDGE FUND INVESTMENT STRATEGIES

Hedge funds employ a variety of investment strategies to generate alpha. These strategies can be broadly categorized based on the types of financial instruments traded, the investment approach, or the level of risk involved. Since the industry is driven by innovation, there is no widely accepted list of hedge fund strategies. While some research papers include up to 15 strategies, this work provides 5 common, yet distinct from each other strategies.

4.1 Long/Short Equity Strategy

As the name suggests, the long/short strategy involves taking both long (buy) and short (sell) positions in equities. Although the initial purpose of using derivatives in this strategy was hedging, most modern long/short hedge funds use them rather as a way to achieve absolute returns than a hedging tool.

4.2 Event-Driven Strategy

Event-driven funds take advantage of specific corporate events, such as mergers and acquisitions, bankruptcies, reorganizations, restructuring, asset sales, or other significant corporate developments. Hedge fund managers seek to profit from price movements driven by these events, often taking both long and short positions.

4.3 Quantitative Strategy

Quantitative hedge funds ("quants") employ systematic and algorithmic approaches to make investment decisions. These funds use mathematical models, statistical techniques, and computer algorithms to analyze large sets of data and identify patterns or trends in financial markets. The goal of quantitative strategies is to generate returns by exploiting quantitative insights and executing trades based on predefined rules.

4.4 Global-Macro Strategy

Global macro funds take a broad approach to financial markets by making investment decisions based on macroeconomic trends and geopolitical events on a global scale. These funds seek to profit from shifts in global economic conditions, interest rates, currencies, commodities, and other macro level factors. Global macro strategies are known for their flexibility and the ability to invest across various asset classes and regions.

4.5 Multi-Strategy

Multi-strategy hedge funds employ a diversified approach by combining various investment strategies within a single fund. This strategy allows hedge fund managers to navigate different market conditions, minimize risk, and potentially enhance returns by leveraging the strengths of multiple strategies. Multi-strategy hedge funds have generally low risk tolerance and are designed to provide flexibility and adaptability to changing market environments.

5. FEES STRUCTURE

5.1 Management Fee

Hedge fund's revenue consists of two types of fees: a management fee and an incentive fee. The management fee is an annual fee that is charged by hedge funds for managing and overseeing the fund's investment portfolio. Being a steady source of income, it is structured as an annual fee based on the fund's assets under management (AUM) and is assessed regardless of the fund's performance. Commonly, the fee ranges from 1% to 2% of AUM.

5.2 Incentive Fee

Hedge fund incentive fee (performance fees) is a key component of the compensation structure for hedge fund managers. Unlike management fees, which are charged regularly, incentive fees are calculated as a percentage of the fund's profits. The typical rate is 20% of profits.

5.3 High-Water Mark and Hurdle Rate

The high-water mark is a mechanism designed to ensure that the fund manager only earns an incentive fee on new profits that exceed the highest previous NAV. The high-water mark is not reset at the beginning of each calendar year. Instead, it continues to track the fund's highest NAV over time and increases only when the fund surpasses its previous peak value.

The hurdle rate is a specified minimum rate of return that fund managers must achieve before they can start earning performance fees or incentive fees. The hurdle rate is usually expressed as a percentage, and it represents a minimum return that the hedge fund must generate. For example, if

the hurdle rate is set at 10%, the fund manager will only be eligible for performance fees on returns exceeding 10%.

6. LEGAL STRUCTURE AND REGULATION

6.1 Legal Structure

The majority of hedge funds are set up as Limited Partnerships or Limited Liabilities Companies (LLC). In this structure, the fund itself does not pay income taxes. Instead, the profits or losses are passed through to the individual investors, who report the income on their personal tax returns, i.e., "pass-through tax treatment". In the United States, hedge fund advisers are generally required to register with the Securities and Exchange Commission under the Investment Advisers Act of 1940. Registration is mandatory for advisers with assets under management (AUM) exceeding a certain threshold, which changes over time. However, some hedge funds that meet certain criteria can qualify for the exemption.

6.2 Regulation

As stated before, one of the key features of hedge funds is that they are not as regulated as other types of investment funds. Overall, hedge funds try to be exempt from as many regulations as they can. The reasons are threefold: lower compliance expenses, unwillingness to disclose their investment decisions so that others would not comprehend their investment algorithm, and flexibility in deciding the leverage and risk-exposure levels, which some regulations might limit. Hedge funds had very little regulation until the beginning of the 2000s. After the collapse of LTCM, there is a trend of increasing regulation and transparency. Honigsberg (2018) argues that after the fall of LTCM, most hedge funds were not regulated by the SEC. As a consequence, the SEC introduced a rule that closed the legal gap in the Investment Advisers Act. Even though the SEC "leads the show" of hedge fund regulatory oversight, after the FED facilitated the take-over of LTCM, it became clear that in case there is a systemic risk to the whole financial system, the FED is ready to intervene. According to Bernanke (2006), "regulators and supervisors should foster an environment in which market discipline- in particular, counterparty risk management- constrains excessive leverage and risk-taking" (para. 5). In our opinion, the aforementioned statement means that FED indirectly regulates hedge funds.

7. RISKS AND RISK-MANAGEMENT

7.1 Risks

Hedge funds are exposed to various risks depending on the fund's strategy. Common risks associated with hedge funds include:

- leverage risks- amplified losses due to borrowed capital or the use of financial derivatives
- liquidity risks- inability to quickly sell or liquidate the fund's assets without causing a significant impact on their prices
- redemptions- requests of investors to withdraw their capital from the fund

7.2 Leverage Risk-Management

During periods of high uncertainty in financial markets hedge funds tend to review their leverage ratios and, in most cases, lower their risk exposures by lowering leverage, i.e., delever. This was especially the case in the first half of 2020, when the mean leverage ratio in hedge funds decreased for more than 60% (Board of Governors of the Federal Reserve System, 2021).

7.3 Quantitative Risk-Management

Quantitative risk management involves the use of mathematical models and data analysis techniques to measure and monitor risk exposures, optimize portfolio construction, and implement risk mitigation strategies. Amongst the most popular approaches to measuring portfolio risk are the variance-based approach and the value-at-risk approach (VaR). However, the variance-based approach cannot be used if a portfolio includes derivatives. Given that derivatives are employed in many hedge fund strategies, VaR might seem as a more appropriate tool for assessing and managing risk. On the other hand, one significant challenge associated with VaR lies in the highly challenging task of accurately estimating the actual probability of low-probability events (Connor & Woo, 2004). As a result, most hedge funds have their own risk management techniques that are not documented in any research papers and remain a secret.

7.4 Lock-up Periods and Redemption Gates

Most hedge funds have lock-up periods during which investors are prohibited from redeeming their investments. Lock-up periods are designed to discourage short-term trading and provide fund managers with stability in managing the fund's portfolio.

While being a less popular mechanism, redemption gates may be implemented by hedge funds to limit the total amount of redemptions during a specific period, especially during times of increased redemption requests.

Both instruments help manage the fund's liquidity and protect remaining investors. Xiao (2020) finds that limiting investors' ability to withdraw funds can decrease the likelihood of failures.

8. TRENDS OF THE INDUSTRY

8.1 A New Level of Diversification

While many multi-strategy hedge funds diversify investment strategies, the largest of them try to diversify not only their investment approaches but entire business. For instance, Citadel LLC and Two Sigma Investments LP were founded as hedge funds. However, they expanded their operations to include market-making businesses separate from their respective hedge funds, Citadel Securities and Two Sigma Securities.

8.2 Lowering Fees

The two and twenty fee structure model introduced by Jones' partnership was an industry standard for many years. However, given that there are over ten thousand hedge funds and the number steadily increases nearly every year, the players of the industry face a fierce competition. Therefore, in the last few years many hedge funds lowered their fees as a way to attract more capital. According to Xiao (2020), the mean management fee of the industry is 1.4% and the mean incentive fee is 17%.

8.3 Liquid Alternatives

Liquid alternatives refer to mutual funds that are designed to replicate the investment approaches associated with hedge funds, offering a more accessible and liquid format compared to traditional hedge funds. While liquid alternatives have generally lower expected rates of return compared to hedge funds, some of them, for example, Managed Futures liquid alternatives outperform their hedge fund counterparts (van Engelen, 2018). Therefore, liquid alternatives can become a full- fledged competitor for hedge funds in the long run.

8.4 Educating Hedge Funds Cadre

Due to a rapid growth of the industry, many hedge funds faced a shortage of talent. A few decades ago, it was very unusual for undergraduate students to land a job in a hedge fund straight after completing a bachelor's degree. Therefore, prominent educational institutions established student- managed investment funds to give an edge to students during the recruiting process. Many of such funds are structured as hedge funds or have significant alternative investment asset allocations. According to Zucker (2023), Black Diamond Capital Investors, a student-run hedge fund ran by Harvard University students, can be named as one of the "world's most exclusive hedge funds". Moreover, with the rise of quantitative hedge funds and increasing qualitative and quantitative research analysis demand, some hedge funds established separate pipelines for PhD students. Investment banking and asset management firms that are considered to be the best career choices before making a transition to hedge funds don't have such practice.

8.5 Increasing Regulation

Press releases and publications of U.S. regulators imply that Hedge Funds have to be more regulated since they impose an increasing influence on financial markets and the financial system as a whole. The main reason that both regulators mildly enforce new regulations might be their fear of hedge funds' immigration to jurisdictions with more favorable regulatory oversight. In this scenario, U.S. regulators will have very few, if any, instruments to regulate hedge funds. Therefore, instead of implementing new fundamental rules, regulators are either "repackaging" the old ones like in the Investment Advisers Act or are implementing new but rather insignificant rules regarding the transparency of hedge funds.

CONCLUSIONS

1. Hedge Funds represent a complex and distinctive investment vehicle capable of delivering both remarkable profits and hedge is an area of huge profits, but at the same time it is a risky area of potentially significant losses.
2. Thriving on the unregulated nature of their operations, they have given rise to various innovative investment strategies. It is only in the last two decades that regulatory authorities have turned their attention to hedge funds oversight, aiming to prevent past uncertainties such as the LTCM crisis and protect investors.
3. As the hedge fund industry continues to transform, one can see that hedge funds are driven by the expansion of their business activities and face an increasing challenge of competing with liquid alternatives.
4. In order to address current talent shortages in the industry, further educational initiatives should be designed and implemented.

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