

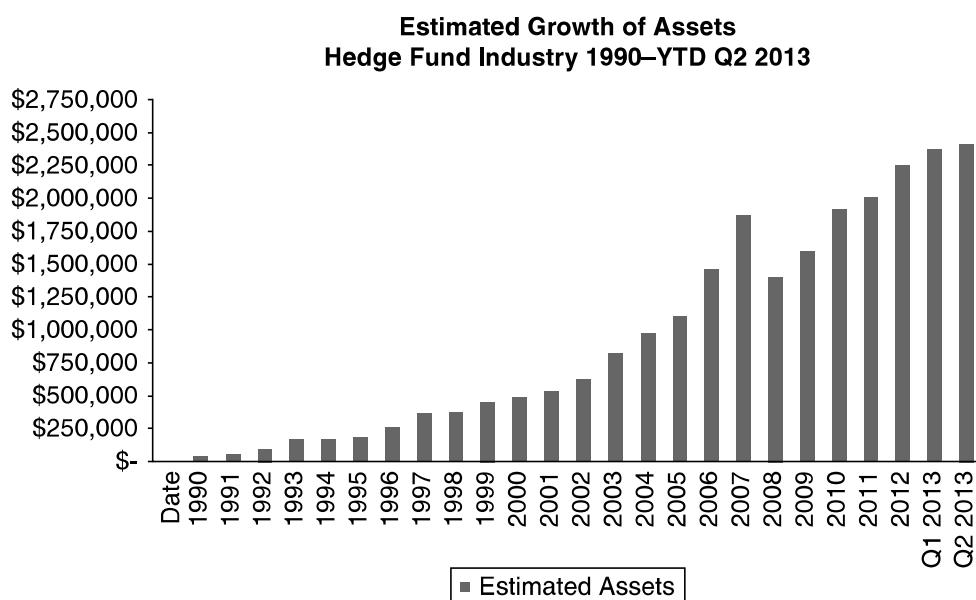
## HEDGE FUNDS: EVIL OR ANGELS IN DISGUISE?

Often the best time to invest is when it appears to be the worst time, when market conditions are deplorable. Smart Money typically has good timing. “The number of public pension plans investing in hedge funds has leapt 50% since 2007 to about 300, according to Preqin. State pension systems had \$63 billion invested in hedge funds as of their fiscal 2010 and are expected to invest another \$20 billion in hedge funds in the next two years, according to a recent report by consultant Cliffwater.”<sup>1</sup> Hedge funds became better not worse after the Great Recession, as so many mistakenly predicted. Hedge funds have become more attractive to investors, both on an institutional and on a retail level. The landscape for hedge funds has ultimately become more competitive. Hedge funds have even lowered their fees. “The overwhelmingly majority of investors interviewed, both large and small, are united in the belief that the industry’s 2 and 20 fee structure is not sustainable—and that a number of the practices in the alternative investment industry (such as gates, side-pockets, etc.) will not endure.”<sup>2</sup> One of the best-known hedge funds, Paul Tudor Jones, lowered fees. Hedge funds were also shown to add value, as evidenced by studies done on institutional investors in hedge funds. Returns also improved. Everett M. Ehrlich in “The Changing Role of Hedge Funds in the Global Economy” examined various institutional investors and “found that real-locating 10 percent of pension portfolios to hedge funds has the potential

to add approximately \$13.67 billion in returns yearly. Our analysis found similar potential for university endowments, which stand to add more than \$1.73 billion in expected returns per year by shifting 10 percent of assets to hedge funds.”<sup>3</sup>

Taking a contrarian view after the Great Recession when it appeared perilous to invest in hedge funds and going against the grain is easier said than done. It takes both courage and discipline. Likewise, discovering and exploring areas that might not necessarily be well understood or are off the beaten path can sometimes lead to the best returns. “A glimpse into the secretive world of large U.S. endowment funds reveals strong, benchmark- and index-topping returns of their hedge fund portfolios. Just six of the 25 largest U.S. endowments provided publicly available, detailed financial information for June 30, the fiscal year-end for many endowments. In examining that information, *Pensions & Investments* found the six had a collective \$89 billion in assets as of June 30, of which \$18.4 billion was in hedge funds.”<sup>4</sup> All assets should be considered when investing and the greater the selection, the more likely an investor will lower risk. The smart money did not abandon hedge funds. Hedge Fund Research (HFR), which tracks hedge funds, showed hedge funds increasing from 1990 to YTD Q2 2013 (Figure 7.1).

The hedge fund industry concluded 2010 with the largest quarterly increase in assets in its history, according to data released today by HFR,

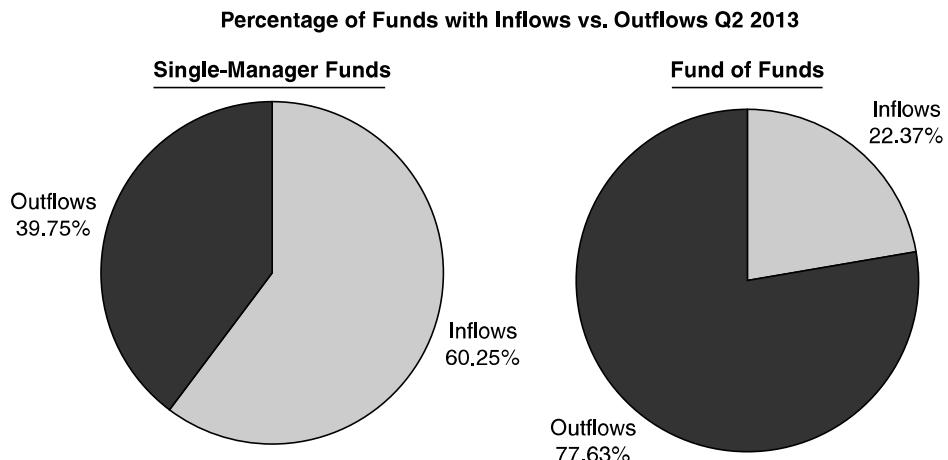


**Figure 7.1** Hedge Fund Growth of Assets.

Source: HFR Global Hedge Fund Industry Reports, © 2013 HFR Inc., [www.hedgefundresearch.com](http://www.hedgefundresearch.com)

the leading provider of hedge fund industry data. “Analysis of asset class returns shows that, after extraordinarily good or bad performance, a reversal of fortunes occurs more often than not.”<sup>5</sup> Flash forward to 2013 and the hedge fund industry grew to approximately \$2.5 trillion. What happened? For starters, institutional investors even began investing directly into hedge funds. “New and experienced institutional investors are more comfortable investing directly in hedge funds either with the assistance of a specialist hedge fund consultant or through a customized hedge fund portfolio managed by a hedge fund-of-funds manager thanks to lessons of the recent past.”<sup>6</sup> The Massachusetts state pension fund, governed by the Pension Reserves Investment Trust, in April 2011, said they would invest directly into hedge funds.<sup>7</sup> The Ohio Public Employees Retirement System (PERS) stated it was investing directly in hedge funds in 2011.<sup>8</sup> “The Fire & Police Pension Association of Colorado, which manages roughly \$3.5 billion, now has 11% of its portfolio allocated to hedge funds after having no cash invested in these funds at the start of the year.”<sup>9</sup> “New Jersey’s State Investment Council, which sets investment policy for the state’s pension, voted last week to raise the target allocation for hedge funds to 10% from 6.7%, which would make hedge funds the \$73 billion fund’s largest alternative investment asset.”<sup>10</sup> Figure 7.2 is a chart of inflows versus outflows.

The “smart money” sought hedge funds like never before. Bridgewater, one of the largest hedge funds with assets around \$100 billion, raised a new fund. “Bridgewater Associates is nearly finished launching



**Figure 7.2** Hedge Fund Inflows and Outflows.

Source: HFR Global Hedge Fund Industry Reports, © 2013 HFR Inc., [www.hedgefundresearch.com](http://www.hedgefundresearch.com)

a \$10 billion fund, the latest sign of the hedge-fund industry's rebound from the 2008 financial crisis.”<sup>11</sup> However, these flows went to single manager hedge funds as opposed to hedge funds of funds. Hedge funds of funds were almost the polar opposite with monthly outflows as opposed to inflows. Growth of defined benefit assets reached an all-time new high.

Total industry assets grew to \$1.917 trillion, reflecting a quarterly increase of nearly \$149 billion, topping the previous record increase of \$140 billion in Q2, 2007.<sup>12</sup> “Hedge fund assets rose to 1.6% from 1.3% of total worldwide assets compared to the previous year.”<sup>13</sup> Pension funds like to invest in hedge funds; they are one of the preferred alternative investments. Hedge funds have compelling risk and reward ratios.

Over the decade that included two horrendous market collapses, hedge funds exhibited better returns, with lower risk than both the S&P 500 and the MSCI World Index.

Hedge funds are likely to continue to grow: “Total industry assets rose to \$2.02 trillion, up \$102 billion in the first quarter. The total tops the pre-crisis record of \$1.93 trillion set in the second quarter of 2008.”<sup>14</sup> Hedge fund assets were only \$38.9 billion in 1990. As of the end of third quarter 2011, hedge fund assets were \$2.04 trillion. According to *Pensions and Investments* analysis of reported hedge fund search and hiring activity, “This year is shaping up to be the strongest for institutional investment in hedge funds since 2007. Institutional investors, especially U.S. public pension plans, have been pouring new money into hedge funds to the tune of \$39.9 billion of net inflows and pending searches year-to-date through Nov. 10.”<sup>15</sup>

## **HEDGE FUND STYLES MOVE IN WAVES (QUANT FUNDS)**

One of the first styles of hedge funds was known as quant funds. Quant funds initially became popular in the 1990s when PhDs headed toward Wall Street. Essentially, a quantitative analyst (“quant”) uses numerical or qualitative techniques. Originally, quants made models for risk assessment or predicting market movements. Today, the term applies to individuals involved in almost any application of mathematics in finance. Statistical

arbitrage and market neutral are two types of popular quant funds. Computers do the trading as opposed to humans. Complex mathematical models analyze large amounts of data and decide which investments should be bought or sold. Many quants follow a momentum strategy; they buy securities rising in price or sell ones dropping in price. They might buy equities with accelerated earnings.

In 2009 most of the securities that did well were high risk and not conservative. For example, high yield (junk bonds) did well. Companies with little or no profits rose in price faster than good companies with earnings, which hurt the quant models. What happened was not supposed to happen and therefore the models failed. 2009 and 2010 were years that caused quant funds trouble: “The assets of a broader universe of quant hedge funds have dwindled by about \$50 billion. One in four quant hedge funds have closed since 2007, according to Lipper Tass.”<sup>16</sup> Many of the models went askew and seemed unprepared for a rogue wave where the majority of securities all plunged at once. Not only did various asset classes plummet at the same time but markets such as the ARP market evaporated, creating a liquidity crises. In essence, the market experienced the perfect storm.

Yet quantitative funds have an important attribute. Whereas human nature can interfere with prudent investment decisions, quant funds are run by computers that show no emotion. “Quantitative trading still has many advantages over its chief competitor, the human brain. From the individual who holds on to losing stocks for too long to overconfident money managers who mistakenly think they can predict financial trends, human nature is capable of placing bad bets time and time again. Psychology and raw emotion often rules the stock market.”<sup>17</sup> Waves change with alternative investments and hedge fund styles. “Welcome to the Age of Quant. As high-speed trading continues to define the markets, quantitative strategies are all the rage, and quants are Wall Street’s hottest stars.”<sup>18</sup> As the hedge fund industry evolved over time, different styles formed.

## HEDGE FUND WAVES

Hedge funds as a whole move in waves as exhibited by all alternative investments. As more data became apparent over time, it became evident that

styles change and move in waves, not too dissimilar from the equity with large cap versus small cap or growth versus value investing. Table 7.1 shows how hedge funds styles changed over the years.

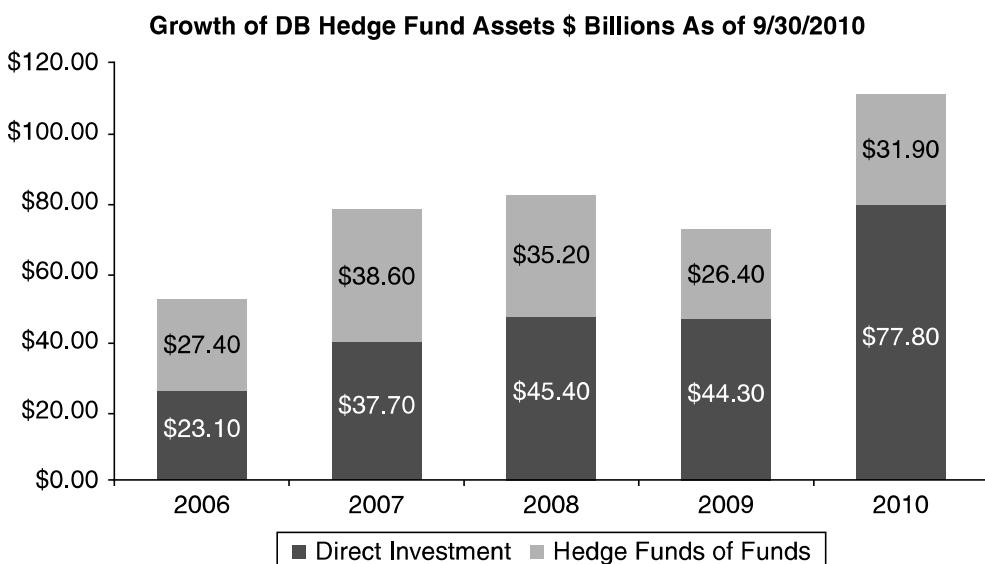
What was popular in the 1990s (Equity Hedge and Macro) was not as popular in 2010. Likewise, what was not in favor in the 1990s (Relative Value and Event Driven) was attractive to investors in 2010. Relative Value attracted more assets from 2010 to 2013 (Figure 7.3).

Increasing assets and number of funds tend to correlate with better performance. As performance did well for Relative Value, new funds were created and more assets were attracted. Relative Value gained more market share. Figure 7.4 is an estimated sub-strategy composition for Relative Value, Q2—2013 with regard to number of funds and assets.

**Table 7.1** Estimated Strategy Composition by Assets under Management

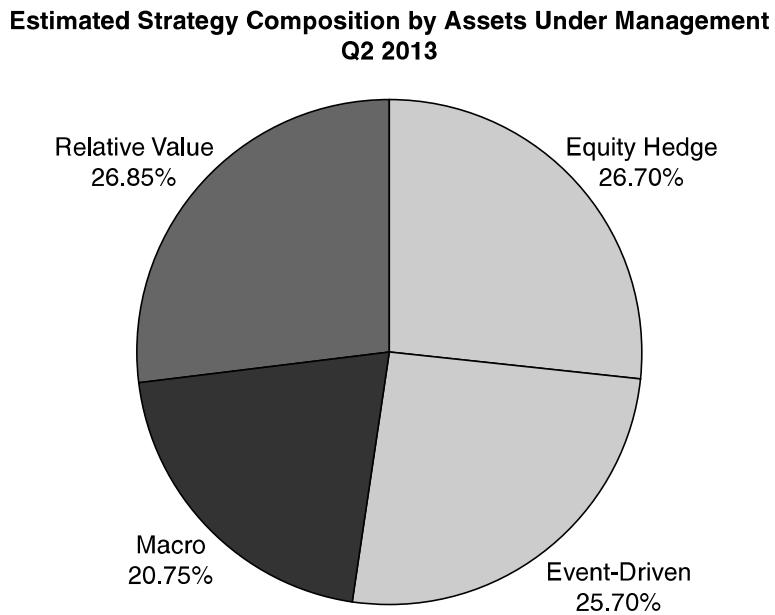
	Q4 1990	Q4 2010
Relative Value	13.88%	24.44%
Equity Hedge Driven	37.07%	29.76%
Event Driven	9.75%	25.94%
Macro	39.30%	19.86%

Source: HFR Global Hedge Fund Industry Reports, © 2013 HFR Inc., [www.hedgefundresearch.com](http://www.hedgefundresearch.com).



**Figure 7.3** Defined Benefit Investments in Hedge Funds.

Source: HFR Global Hedge Fund Industry Reports, © 2013 HFR Inc., [www.hedgefundresearch.com](http://www.hedgefundresearch.com)



**Figure 7.4** Hedge Fund Assets by Strategy.

Source: HFR Global Hedge Fund Industry Reports, © 2013 HFR Inc., [www.hedgefundresearch.com](http://www.hedgefundresearch.com)

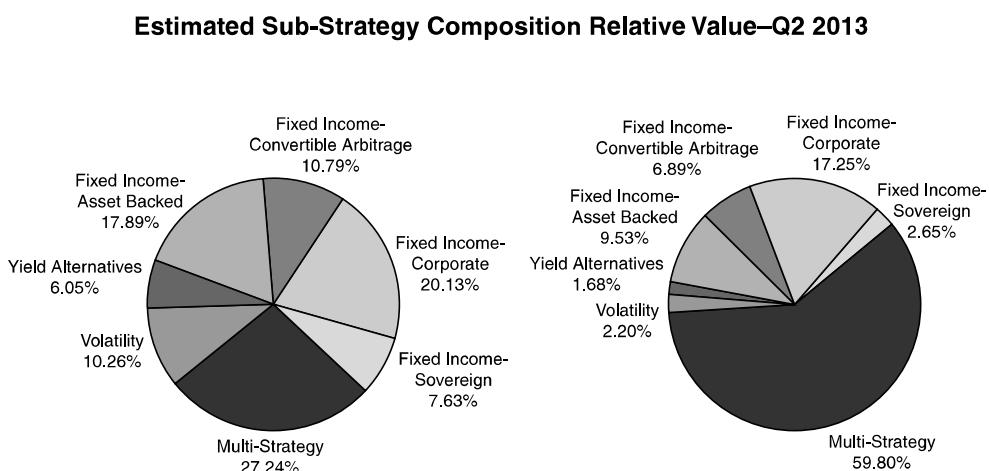
Global Macro dropped to around half of the assets under management. “Macro-focused managers have been tripped up by whiplash-inducing swings in stocks, currencies and commodities, often brought about by the latest twists and turns of impossible-to-time political developments. Stubbornly low U.S. Treasury yields have been a trap for managers worried about inflation and the deteriorating U.S. fiscal outlook. Making matters worse is a tendency of markets around the world to move in lock step.”<sup>19</sup> The European debt crises and problems along with the US Treasuries receiving a downgrade would appear to benefit Macro funds. However, that was not the case and it became increasingly difficult to find special opportunities. “Macro funds generally hunt among global financial markets in search of opportunities created by big-picture economic, fiscal and political trends.”<sup>20</sup>

Global macro was a hedge fund style that performed quite well in 2007 and 2008 when the stock market was hammered. As the stock market turned around in 2009 with the S&P 500 going up 26.47 percent and 2010 (15.08 percent), Global Macro did not fare as well. Global Macro outperformed the S&P 500 in 2000, 2001, and 2002 when the S&P 500 was down -9.09 percent in 2000, -11.85 percent in 2001, and -22.09 percent in 2002. The S&P 500 then outperformed Global Macro in 2003 and 2004. While there can be an anomaly, certain patterns, trends, or cycles (Wave

Theory) can be evidenced with hedge funds and hedge fund styles. When the stock market performed well in 1998 and 1999, the S&P 500 outperformed Global Macro in both years. It is also of interest that the HFRI Wgtd Comp outperformed the HOF Composite every year from 1998 to 2010 except two years (2002 and 2007).

Ideally, the funds being selected for a hedge fund of funds will outperform the index because of active management. The bank or consultant selecting the hedge funds should ideally be picking better hedge funds and buying/selling when appropriate. Presumably, they add value. Hedge funds focusing on Emerging Markets tend to decline the most at the break of a market collapse but they tend to rally the quickest. This trend happened in 2003 and after 2010. Many investors and institutions still afraid of hedge funds claim they do not like the volatility and the wide swings they perceive embody hedge funds. Yet equities exhibit more volatility than the HFRI Fund Wgtd Comp. Returns are more reliable than the wide range exhibited by stocks. A group of hedge funds with different styles will not have as many highs and lows as the S&P 500 Index. For instance, in 1998, the S&P 500 was the best performer. Similarly, it performed the best in 2010. However, during 2001 and 2002, the S&P 500 was the worst performer. A key difference is the ability for a hedge fund to short. Shorting protects on the downside. Figure 7.5 shows the HFRI Indices annual investment returns (2000–YTD Q2 2013).

Hedge fund strategies move in waves, as depicted by the HFRI Indices Annual Investment Returns. Investors, similar to mutual fund investing,



**Figure 7.5** Hedge Fund Sub-strategy Composition.

Source: HFR Global Hedge Fund Industry Reports, © 2013 HFR Inc., [www.hedgefundresearch.com](http://www.hedgefundresearch.com)

frequently chase returns of the best-performing hedge fund strategy. However, hedge fund strategies can move in and out of favor just like stocks or bonds. “The class of hedge fund strategies termed *arbitrage strategies* has historically produced stable, modest returns punctuated by intervals of dramatically poor performance. The weakness stems from an important oversight in modeling: hedge fund returns and their underlying risks factors can have a nonlinear relationship.”<sup>21</sup> In terms of number of hedge funds, Equity Hedge was almost half of all hedge funds by 2013 (Figure 7.6).

A number of the funds cited in *Wave Theory for Alternative Investments* continue to grow and prosper. Ray Dalio’s Bridgewater Associates LP has scored gains of more than \$3.5 billion in its flagship hedge fund and the \$71 billion fund now is up more than 20 percent this year, making it among the best performers in the hedge fund business.<sup>22</sup> Below are net returns of single-manager hedge funds by strategy (Table 7.2).

As of June 2013, Relative Value was at the top of the charts. Charts like these can be useful for an investor to see signs of a particular hedge fund style coming back in vogue. Preqin and HFRI offer excellent charts. Global Macro moves in waves like the other hedge fund styles, and hedge funds as a whole move in waves. As seen by the HFRI Indices Annual Investment Return 2000–TYD Q2 2013, Relative Value was trading higher as well as Distressed Hedge Fund Event Driven. Macro continued to slide.

**Table 7.2** Hedge Fund Waves by Strategy

Apr-13	May-13	Jun-13	Q1 2013	Q2 2013
<b>Event Driven</b> 1.14%	<b>Event Driven</b> 2.02%	<b>Relative Value</b> −0.59%	<b>Event Driven</b> 4.17%	<b>Event Driven</b> 2.30%
<b>CTAs</b> 0.98%	<b>Long/Short</b> 1.33%	<b>Event Driven</b> −0.85%	<b>Long/Short</b> 4.15%	<b>Relative Value</b> 0.82%
<b>Relative Value</b> 0.94%	<b>Multi-Strategy</b> 0.85%	<b>Ctas</b> −1.26%	<b>Relative Value</b> 2.56%	<b>Long/Short</b> 0.32%
<b>Long/Short</b> 0.68%	<b>Relative Value</b> 0.47%	<b>Multi-Strategy</b> −1.49%	<b>Multi-Strategy</b> 2.13%	<b>Multi-Strategy</b> −0.26%
<b>Multi-Strategy</b> 0.39%	<b>Macro Strategies</b> 0.06%	<b>Macro Strategies</b> −1.51%	<b>Ctas</b> 1.24%	<b>Macro Strategies</b> −1.42%
<b>Macro Strategies</b> 0.02%	<b>Ctas</b> −2.02%	<b>Long/Short</b> −1.66%	<b>Macro Strategies</b> 1.14%	<b>Ctas</b> −2.30%

Source: “The Preqin Quarterly Update: Hedge Funds,” Preqin, July 2013, p. 3.

## HFRI Indices Annual Investment Returns (2000 – YTD Q2 2013)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	YTD Q2 2013		
HFRI ED: Mergers & Acq. 13.02%	HFRI RV: Convert-A-ble Gov't/Credit 12.10%	Barclays Emerging Markets 39.36%	HFRI Emerging Markets 21.04%	HFRI ED: Distressed 18.88%	HFRI Emerging Markets 24.28%	HFRI Emerging Markets 24.92%	HFRI Emerging Markets 24.92%	Barclays Gov't/Credit 5.05%	HFRI RV: Convert-A-ble 50.17%	S&P 500 15.08%	Barclays Gov't/Credit 9.24%	S&P 500 15.99%	S&P 500 13.82%			
HFRI EH: Eq. Mkt Nhl 14.55%	HFRI ED: Distressed 13.28%	HFRI RV: Convert-A-ble 9.05%	HFRI Emerging Markets 18.42%	HFRI Equity Hedge 10.60%	HFRI ED: Distressed 15.94%	HFRI Macro 11.11%	HFRI Macro 4.83%	HFRI Emerging Markets 40.24%	HFRI RV: Convert-A-ble 13.07%	HFRI RV: Convert-A-ble 13.07%	HFRI ED: Mergers & Acq. 1.46%	HFRI Relative Value 1.46%	HFRI ED: Distressed 6.79%			
HFRI RV: Convert-A-ble 14.50%	HFRI Event-Driven 12.18%	HFRI Macro 7.44%	HFRI Event-Driven Wgt/Hd Comp 15.01%	HFRI Fund 28.87%	HFRI Event-Driven Wgt/Hd Comp 9.30%	S&P 500 15.78%	HFRI Fund 10.48%	HFRI ED: Distressed 28.13%	HFRI Emerging Markets 11.98%	HFRI ED: Mergers & Acq. 1.46%	HFRI ED: Mergers & Acq. 1.46%	HFRI Emerging Markets 10.37%	HFRI Event-Driven 5.65%			
HFRI Relative Value 13.41%	HFRI Emerging Markets 10.36%	HFRI Relative Value 5.44%	HFRI Event-Driven Mkt Nhl 25.35%	HFRI Event-Driven Mkt Nhl 8.27%	HFRI Event-Driven Mkt Nhl 15.33%	HFRI Event-Driven Mkt Nhl 10.25%	HFRI Event-Driven Mkt Nhl 5.91%	HFRI Event-Driven Mkt Nhl 26.47%	S&P 500 11.73%	HFRI Event-Driven Mkt Nhl 11.73%	HFRI Event-Driven Mkt Nhl 0.15%	HFRI Event-Driven 10.12%	HFRI Equity Hedge 5.34%			
Barclays Gov't/Credit 9.40%	Barclays Gov't/Credit 13.27%	HFRI Macro 5.28%	HFRI Event-Driven Hedge 21.42%	HFRI Macro 7.49%	HFRI Event-Driven Hedge 14.24%	HFRI Fund Wgt/Hd Comp 9.05%	HFRI Fund Wgt/Hd Comp 7.49%	HFRI Fund Wgt/Hd Comp 9.98%	HFRI Fund Wgt/Hd Comp 25.80%	HFRI Fund Wgt/Hd Comp 25.80%	HFRI Event-Driven Mkt Nhl 11.53%	HFRI Event-Driven 11.53%	HFRI Event-Driven 1.79%			
HFRI Equity Hedge 9.09%	HFRI Relative Value 8.92%	HFRI Emerging Markets 3.70%	HFRI Event-Driven Hedge 20.54%	HFRI Equity Hedge 7.68%	HFRI Event-Driven Hedge 7.29%	HFRI FOF Composite 19.55%	HFRI FOF Composite 6.86%	HFRI FOF Composite 6.79%	HFRI Event-Driven Mkt Nhl 8.94%	HFRI Event-Driven Mkt Nhl 8.94%	HFRI Fund Wgt/Hd Comp -19.02%	HFRI Fund Wgt/Hd Comp -19.02%	HFRI ED: Mkt Nhl 11.26%	HFRI RV: Convert-A-ble 8.58%	HFRI Fund Wgt/Hd Comp 3.65%	
HFRI Event-Driven 6.74%	HFRI Macro 6.81%	HFRI RV: Convert-A-ble 6.74%	HFRI FOF Composite 1.02%	HFRI FOF Composite 19.55%	HFRI FOF Composite 6.86%	HFRI FOF Composite 6.79%	HFRI FOF Composite 6.79%	HFRI FOF Composite 7.75%	HFRI Event-Driven Mkt Nhl 7.75%	HFRI Event-Driven Mkt Nhl 7.75%	HFRI FOF Composite 21.36%	HFRI FOF Composite 21.36%	HFRI Event-Driven 11.26%	HFRI Event-Driven 2.12%	HFRI Event-Driven 3.32%	
HFRI Fund Wgt/Hd Comp 4.98%	HFRI Macro 6.71%	HFRI RV: Convert-A-ble 0.98%	HFRI Event-Driven Mkt Nhl 0.98%	HFRI Event-Driven Mkt Nhl 11.61%	HFRI Event-Driven Mkt Nhl 6.25%	HFRI Event-Driven Mkt Nhl 6.25%	HFRI Event-Driven Mkt Nhl 6.22%	HFRI Event-Driven Mkt Nhl 11.71%	HFRI Event-Driven Mkt Nhl 11.71%	HFRI Event-Driven Mkt Nhl 6.61%	HFRI Event-Driven Mkt Nhl 6.61%	HFRI Event-Driven 11.61%	HFRI Event-Driven 5.30%	HFRI Event-Driven 7.41%		
HFRI FOF Composite 4.07%	HFRI Macro 2.80%	HFRI RV: Convert-A-ble 4.62%	HFRI ED: Mergers & Acq. -0.87%	HFRI Relative Value 9.35%	HFRI Relative Value 9.72%	HFRI Relative Value 7.47%	HFRI Relative Value 6.02%	HFRI FOF Composite 10.39%	S&P 500 5.45%	HFRI FOF Composite 5.45%	HFRI Event-Driven Mkt Nhl 26.65%	HFRI Event-Driven Mkt Nhl 26.65%	HFRI Macro 11.46%	HFRI Macro 11.46%	HFRI Macro 4.79%	
HFRI ED: Distressed 2.76%	HFRI ED: Mergers & Acq. 2.76%	HFRI RV: Convert-A-ble 2.76%	HFRI ED: Mergers & Acq. 4.08%	HFRI Event-Driven Mkt Nhl -1.45%	HFRI Event-Driven Mkt Nhl -4.30%	HFRI Event-Driven Mkt Nhl 4.15%	HFRI Event-Driven Mkt Nhl 4.15%	HFRI Macro 8.15%	HFRI RV: Convert-A-ble 5.33%	HFRI RV: Convert-A-ble 5.33%	HFRI ED: Mergers & Acq. 4.81%	HFRI ED: Mergers & Acq. 4.81%	HFRI Macro 5.80%	HFRI Macro 5.80%	HFRI Macro 4.79%	
S&P 500 0.40%	HFRI Macro 1.97%	HFRI Equity Hedge 0.40%	HFRI ED: Mergers & Acq. 1.97%	HFRI Event-Driven Hedge 4.71%	HFRI Event-Driven Hedge 4.71%	HFRI Event-Driven Gov't/Credit 5.07%	HFRI Event-Driven Gov't/Credit 5.07%	HFRI Macro 4.08%	Barclays Gov't/Credit 2.55%	Barclays Gov't/Credit 2.55%	HFRI ED: Mergers & Acq. 5.25%	HFRI ED: Mergers & Acq. 5.25%	HFRI Macro 4.37%	HFRI Macro 4.37%	HFRI Macro 2.76%	
HFRI Emerging Markets -10.71%	S&P 500 -11.65%	S&P 500 -22.05%	S&P 500 0.40%	S&P 500 0.40%	S&P 500 0.40%	S&P 500 2.44%	S&P 500 1.18%	S&P 500 -1.88%	S&P 500 4.07%	S&P 500 5.08%	S&P 500 5.08%	S&P 500 3.16%	S&P 500 3.16%	S&P 500 -0.06%	S&P 500 -0.06%	S&P 500 -2.61%

Figure 7.6 Hedge Fund Indices.

Source: HFR Global Hedge Fund Industry Reports, © 2013 HFR Inc., [www.hedgefundresearch.com](http://www.hedgefundresearch.com)

## BEHAVIORAL FINANCE AND HEDGE FUNDS

One key element that helps hedge funds in a down market is the ability to short unlike mutual funds, which historically were only long. Shorting is not necessarily bad for an investor. As Professor Yu Yuan from Wharton explains, “One of the industrial fields where behavioral finance is the most applied is the hedge fund industry. Many hedge fund managers use behavioral finance knowledge or at least follow behavioral finance spirit to create their trading strategies. Managers also raise capital with consideration of investors’ behavioral rules (or biases).”<sup>23</sup> Part of the phobia or fear of hedge funds is due to the aversion with selling short any security. By nature, we want securities to go up and have a hard time relating to shorting a security. Shorting does not appear to be part of our investment DNA. “Individual investors, due to limited knowledge or behavioral biases, are reluctant to take short positions.”<sup>24</sup> Investors by nature are fearful. Fear sometimes perpetuates fear. The negativity toward hedge funds even transferred to popular strategies such as the quant funds. Because of this, even the beloved quant funds got the cold shoulder from investors.

## INCREASED REGULATION

Increased regulation helped raise the cost of doing business with hedge funds, particularly small ones. The result was both positive and negative. For instance, many small hedge funds could not afford to stay in business, with costs rising especially after the loss in 2008. The way hedge funds are structured, a loss can affect future earnings. While they are trying to make back money for these losses, adding additional costs or expenses, such as with Dodd-Frank, was devastating to a number of hedge funds. Dodd-Frank makes it extremely difficult to start a new hedge fund:

Title IV of the Act, among other things, (i) alters the Securities and Exchange Commission (“SEC”) registration criteria applicable to hedge fund managers and other investment advisers, materially changing the composition of the pool of registered investment advisers, (ii) significantly increases the record-keeping and reporting obligations applicable to registered and unregistered advisers to hedge

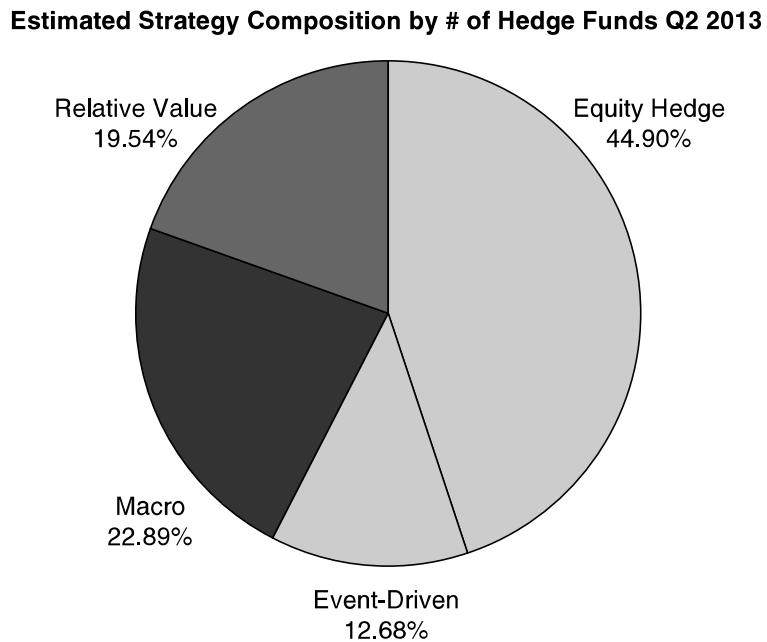
funds and private equity funds, (iii) raises the “accredited investor” standard for individual investor eligibility to participate in private offerings (including offerings by hedge funds and private equity funds), and gives the SEC broad authority to adjust the “accredited investor” standard going forward, and (iv) applies inflation indexing to the “qualified client” standard under which registered advisers are permitted to charge performance-based compensation.<sup>25</sup>

If it is not lucrative for the manager of the fund or any person managing your funds, it is almost certain it will not be for you. No one works for free. “Managers are now more concerned with regulation and governance than they are with investment performance (75% respondents noted that this is one of their most significant challenges).”<sup>26</sup> The Volcker Rule made it even more expensive for hedge funds and private equity funds. The Volcker Rule is also global, not domestic. “Regulation is coming to the alternative asset management industry on both sides of the Atlantic. The impact of various US regulatory and legislature initiatives, including the so called ‘Volcker’ rule, which proposes a ban on proprietary trading by banks, will likely be considerable for the alternative investment industry, as talent migrates towards boutiques.”<sup>27</sup>

The new rules and regulations are so confusing that law firms developed helpful flowcharts to explain some of the countless changes. For instance, Davis Polk put together the flowchart in Figure 7.7.

Small hedge funds that existed before the new regulation are hurting. Because of all the new regulations, it has become increasingly expensive to operate a small hedge fund: Gone are the days of the two-man shop or business school roommates with a clever ideas of managing money.

Hedge funds will most likely move location if they are under siege in a particular country. If government regulation is onerous for hedge funds, they will likely pack up and leave. There have been many situations around the globe where hedge funds were forced to relocate because governments where they were based, became hostile to them: “As of early November, the number of funds located in Malta had grown to more than 500 with 8 billion Euros (\$10.7 billion) under management...The island has benefited



**Figure 7.7** Hedge Fund Strategy Composition by Number of Funds.

Source: HFR Global Hedge Fund Industry Reports, © 2013 HFR Inc., [www.hedgefundresearch.com](http://www.hedgefundresearch.com).

from a growing demand by investors for transparency as well as from fear among hedge funds that the EU was becoming increasingly hostile to firms based out of it.”<sup>28</sup> When an investor sees hedge funds turning into family offices, small funds closing shop or selling, and moving to other countries, it is not a good sign. Government regulation can be excessive and have the opposite effect of what it intended. “There is an ever-more-apparent risk that the harm done by the massive cost and complexity of its regulations, and the effects of its internal inconsistencies, will outweigh what good may yet come from it.”<sup>29</sup> Small investors typically get hurt the most by excessive government regulation. Investors should be cautious when they see surges such as these.

## HEDGE FUND-“LIKE” STRATEGY

A number of new ETFs, indexes, and mutual funds developed hedge fund-like strategies. Traditional hedge funds are available to accredited investors while mutual funds with hedge fund-like strategies are available to anyone and typically have low minimums. “Many mutual-fund companies have

taken a page straight from the hedge-fund playbook and are offering funds that can profit when stocks and bonds fall. Others trade currencies and use complex derivatives.”<sup>30</sup> There are even some innovative ways to track the whole hedge fund universe. For instance, the IQ Hedge Multi-Strategy Tracker is a replication ETF that attempts to track the whole hedge fund universe.

Both mutual funds and ETFs are adding offerings that include various hedge fund strategies. “Hedged mutual funds, also known as long-short equity mutual funds, offer more liquidity and transparency than traditional hedge funds but their returns tend to be lower.”<sup>31</sup> The growing list of mutual funds that resemble hedge funds (alternative mutual funds) will likely continue because of investor demand. Instead of alternative mutual funds (mutual funds with similar objectives to a hedge fund), Fidelity Investments in a partnership with Arden Asset Management now offers a mutual fund of hedge funds. The objective is lower fees and liquidity. However, illiquidity is not a necessary evil, as evidenced by Harvard’s endowment not being able to sell alternative investments at the bottom of the Great Recession. Investors, when the market drops, tend to pull out like a rabbit that gets its foot caught in a trap. The rabbit will tear its foot off to get away and so will the average retail investor. Institutional investors can panic as well. Harvard had liquidity issues. Fortunately, they did not sell their alternative investments and the value went back up again. Hedge fund managers also can be adversely affected by large amounts of money leaving with no restrictions.

## ALTERNATIVE MUTUAL FUNDS

Alternative mutual funds are typically less expensive than the classic hedge fund. Investors also demanded more transparency and liquidity, paving the way for vehicles such as the Hybrid Hedge. A Hybrid Hedge resembles a hedge fund but has some of the positive attributes of mutual funds: liquidity, transparency, lower fees, and regulation. Investors, both institutional and retail, will likely seek the Hybrid Hedge model because its features essentially cover the best of both worlds from hedge funds and mutual funds. The Hybrid Hedge model also offers full transparency unlike a model with a number of hedge funds thrown in it. Transparency

will continue to be important to investors and hedge funds will most likely need to adopt. The Statement of Financial Accounting Standards No. 157 (SFAS 157) was introduced as a guide to measuring and reporting fair value of assets. The present structure causes some concern. “Their research shows valuations that hedge funds report for their stocks in quarterly filings with the Securities and Exchange Commission are sometimes at odds with actual share prices.”<sup>32</sup> The Hybrid Hedge model also is more diversified than a fund selecting a handful of hedge funds. Monitoring hedge funds is not easy. Just because they are thrown in a mutual fund does not reduce all the due diligence needed and ongoing monitoring.

Hedge fund replication strategies began to flourish and attract more interest since the Great Recession. Companies like Natixis, Goldman Sachs, Deutsche Bank, Credit Suisse, Rydex/SGI, Index IQ, and others offer a number of options for investors to examine. “These strategies rely on computer programs that essentially drive looking in the rear-view mirror. Computer models evaluate past returns of hedge funds, either across the entire industry or by specialty.”<sup>33</sup> Replication strategies for hedge funds are in essence passive or index-like strategies, as opposed to hedge funds that incorporate active management. While an investor can gain exposure to different types of hedge fund strategies, replication strategies are not perfect. “Replicator funds, unlike hedge funds, are essentially passive, index-based strategies.”<sup>34</sup> Following in a hedge fund’s footsteps (by assembling investments that would have produced similar returns or buying after they do) might not equal or beat the hedge fund’s performance. Hedge funds have a lot of resources. As a result, performance might not be the same, or worse, might suffer.

## BUYING RESEARCH OR TROUBLE

The settlement in 2003 that the New York Attorney General Eliot Spitzer forced with Wall Street to spend \$460 million on independent stock research for their clients led to more use with their hedge fund clients as opposed to retail investors: “Less than 2% of Goldman Sachs Group Inc.’s Private Wealth Management clients likely downloaded a report each month, according to data from the public reports.”<sup>35</sup> The US government

started prosecuting a number of hedge funds and employees in 2010 for obtaining research viewed as “insider trading.” Here lies a paradox. The US government changes research on Wall Street in order to help investors. Hedge funds seek investment knowledge outside of Wall Street research in order to earn higher rates for investors. Investors pay hedge funds a lot of money and expect the hedge fund manager to have a competitive advantage. Hedge funds were the biggest buyers of independent research, since they wanted to gain an edge and they paid for it. After a number of hedge funds produced stellar returns, the US government accused them of wrongdoing. There is a fine line of whether this should or should not be viewed as insider trading. In certain cases, there appears to be wrongdoing. But in others, it appears to be a witch hunt or political vendetta. “There is no insider-trading statute. Most modern-day, insider-trading prosecutions are brought under the general federal statute forbidding securities fraud. Fraud involves lying, deception, or trickery. But most stock sales occur over exchanges, where the buyer and seller never meet, let alone mislead each other.”<sup>36</sup>

As an investor in hedge funds, it is prudent to note trends such as government intervention. Is a given government favorable to hedge funds or anti-hedge fund? Is a government increasing taxes concerning hedge funds or lowering them? Is a government filing lawsuits against a particular hedge fund manager that it believes harmed investors or is there some other political agenda lurking in the background? For instance, a politician might be accused of being lax toward hedge funds. As a result, they take a hard line against hedge funds. There is the mentality of “shoot first, ask questions later.” Here are a number of hedge funds that the US government pursued: SAC Capital (Steve A. Cohen); Galleon Group (Raj Rajaratnam); Harbinger Capital (Philip Falcone); Millennium Global Emerging Credit Fund (Michael Balboa); and Magnetar Capital (Alec Litowitz/Ross Laser).

The US government attack on hedge funds was quite transparent. Rajaratnam was convicted and this also led to another conviction with a Goldman Sachs’ board member and former head of McKinsey, Rajat Gupta. Other investigations took place. Steve Cohen had his hedge fund, one of the largest in the world, destroyed because of insider trading

though there was never any evidence implicating Cohen personally. Falcone had his fund destroyed. After much struggling, Chapter 11 seemed the only option left for LightSquared. “Mr. Falcone’s LightSquared Inc., a wireless-networking venture, filed for Chapter 11 bankruptcy protection Monday. The move, which came after the company failed to reach an agreement with its lenders to avoid a default, further clouds the future for Mr. Falcone and his signature investment.”<sup>37</sup> Besides making every new hedge fund manager timid, the approach of finding bad guys through data analysis is completely and utterly unreliable. Multiple fraud cases were filed against hedge funds by the SEC during the later part of 2011 and in 2012, which appears to be a “shoot first then ask questions” mentality. The mentality that if you are successful, you must be doing something wrong, appears to prevail. Investors in hedge funds can be affected by these actions. For example, a hedge fund manager might likely be focused on defending himself as opposed to the performance of the fund.

Due diligence and diversification is essential for selecting hedge funds. Even the smart money or institutional investors such as hedge funds themselves can get burned. For example, quite a few hedge funds, including those in New York that employed the well-regarded detective firm Kroll, lost money with Scott Rothstein for discounted legal settlements.

Unlike Bernie Madoff or Allen Stanford, who mostly hurt individual investors, the 49-year-old Rothstein sucked in a billion dollars from sophisticated investors—including New York hedge funds that employed the well-known detective firm Kroll and an onsite inspector at Rothstein’s Fort Lauderdale law firm, from which he sold discounted legal settlements with annualized returns as high as 437%.

Sadly, the settlements didn’t exist.<sup>38</sup>

There is smart money but there is also what I call the “Foolish Money.” If an alternative investment sounds too good to be true, it usually is and one should walk. An interesting and peculiar trend occurred with a few hedge funds, despite the difficulty they had during the Great Recession. As the market picked up again in 2010–2011, a small minority of hedge funds started making investments in venture capital. Falcone, for

instance, invested in a start-up, LightSquared. His idea was not a bad one and likely would have worked if the Federal Communications Commission (FCC) did not take away his license rights after giving it to him. Historically, hedge funds have not put a lot into venture capital because of the illiquidity. When Falcone invested, his hedge fund was \$26 billion in 2008 but this dropped to less than \$5 billion in 2011. The investment in LightSquared was not excessive because of all the assets Falcone had under management at the time. Redemptions make it difficult to manage money regardless of the vehicle, which is why investors in alternative investments should pay attention if there is trouble. Mutual fund redemptions can also be problematic for a manager. What might have appeared to be a small investment at the time for Falcone soon became his largest by far. Falcone clearly was invested for the long haul and most likely allocated assets based on \$26 billion in assets.

### **HYBRID HEDGE MODEL**

The Hybrid Hedge model is a strategy that evolved to essentially combine both hedge fund and venture fund investments. Hedge funds can invest in venture capital through vehicles known as “side pockets.” Side pockets are used to separate and distinguish investor ownership of illiquid assets purchased by hedge funds. Historically, the alternative investment market was segregated. LBO funds did not invest in real estate, venture capital, commodities, or other alternative investments. They stuck to their knitting as firms grew and the market changed. Most of the large LBO funds are now firms that specialize in a variety of alternative investments. They have all sorts of offerings for alternative investments. In fact, they have expanded so much they are now investing or building capabilities in fixed income and equity. For example, Carlyle Group, which was originally a LBO fund, has morphed into a much larger publicly traded company with real estate, venture capital, and other alternative investments. Carlyle bought a controlling interest TCW, which is known for fixed income like corporate bonds, US Treasuries, municipals, etc. In a sense, the larger private equity firms are becoming similar to mutual fund companies, with huge menus or investment options. For instance, Crosslink offered a type of hybrid option. “Stark’s Carbonite investment is quintessential

Crosslink. The firm, with \$2.15 billion under management, tries to make money from a hybrid strategy of providing venture funding for private companies and hedge fund investments to profit from public ones.”<sup>39</sup> A hybrid model will most likely become more attractive to allow managers optimum flexibility and to make the best possible investments.

Consultants tend to favor cookie-cutter models for clients because it is easier to direct venture capital funds in one part of an allocation and hedge funds into another. However, this might not be the best method. It is the same nonsensical advice as the old style box that consultants stuck to, no matter what happened with the market. Years ago, a money manager that shifted assets was depicted as a “style drifter,” but things changed after the technology bubble and managers were allowed more flexibility. It is now acceptable to “drift.” There is no logical reason why one should not explore a hybrid model of investing for alternative investments.

After LinkedIn and Pandora went public, the race was on to find the next social media company to back, with the hopes of a quick exit strategy such as an IPO. “LinkedIn’s rather gargantuan valuation suggests that investors eager to play the stunning growth, popularity and near-ubiquity of Facebook are grabbing at anything that faintly resembles it, even if that means paying up for a far more limited opportunity in a site whose user aren’t remotely as engaged as Facebook’s.”<sup>40</sup> Bankers were delighted by the sky-high valuation of LinkedIn. LinkedIn went public at \$45 in May, quickly jumped to as high as \$122, and now trades at \$68, or 240 times projected 2011 profits, and 127 times 2012 estimates.<sup>41</sup> Hedge funds and investors sought a piece of this action. “Tiger Global Management LLC, a hedge fund founded by Chase Coleman, paid \$20 million for a stake in LinkedIn Corp., valuing the professional-networking website at more than \$2 billion, said two people familiar with the matter.”<sup>42</sup> A number of hedge funds backed a competitor of Groupon called LivingSocial. “When daily-coupon website LivingSocial Inc. said it raised \$400 million in April, the firms putting up cash included hedge funds Tiger Global Management, Lone Pine Capital, and Brookside Capital, people familiar with the matter say.”<sup>43</sup> It was almost as though one took a time machine and went back to the late 1990s when the Internet was the Wild West. LivingSocial, however, did not jump right into the public

market prematurely. “Asking for a huge valuation on a questionable business model proved troublesome for Groupon. Hopefully, by staying out of the public market for longer, LivingSocial will give itself time to mature.”<sup>44</sup> Ironically, Sarbanes-Oxley meant to help small investors but opened the door for hedge funds to buy venture capital. “Some call it ‘regulatory arbitrage’: well-meaning but inherently flawed laws such as Sarbanes-Oxley that were designed to protect small investors from the next Enron have imposed such heavy costs on public companies that many private ones are delaying their initial public offerings.”<sup>45</sup> Hedge funds by nature move in and out of investments. If they invest in venture capital, an investor needs to pay careful attention to what the hedge fund is doing. “It’s unusual for hedge funds to dabble in venture capital.”<sup>46</sup>

### **COMPETING WITH HEDGE FUNDS (VENTURE CAPITAL AND IPOS)**

High net worth and sometimes smaller institutional investors get the faulty idea that they can do what a hedge fund is doing and attempt to buy the same investments. In most cases, this is a disaster. Hedge funds are difficult to compete with and hard to follow. The amount and frequency of hedge funds buying venture capital has picked up quite a bit from being virtually nonexistent before Sarbanes-Oxley when hedge funds seldom invested in venture capital. “Hedge funds, private-equity firms and mutual-fund companies, facing a dearth of initial public offerings, are taking bigger stakes in private technology companies to benefit when they go public.”<sup>47</sup> Prudent investors in alternative investments will examine all the players when competing. Hypothetically, if one invests in LinkedIn while it was private, who are the other investors? Are they long- or short-term investors? Hedge funds can also set up numerous vehicles to invest like side pockets. Because of changes in the law, it is much more cumbersome for individual investors to understand who the other investors are or what their motives really are. Are they there to help the company or make a quick buck?

Another important question to ask is, “Who are the underwriters?” Do the underwriters have pre-existing relationships with any of the

institutional investors? Is there favoritism? Do they get preferential treatment? How much of the company do they own? Whether you are a retail investor, ultra high net worth investor, or another hedge fund, one might ask why a certain hedge fund was offered pre-IPO shares or IPO shares of a hot deal while others were excluded. Is the ownership buried in a massive prospectus? The new environment for investing in alternative investments, such as venture capital or hedge funds, requires a lot of due diligence. That is, an inordinate amount of due diligence is needed today. One almost needs to be a detective or forensic accountant. Jose Miguel Mendoza, a corporate law lecturer at Oxford University studying IPO investing, claimed in 2010 that venture capitalists were responsible for most of the stock changing hands in pre-IPO markets but last year hedge funds bought 70 percent.<sup>48</sup> There is a reason these shrewd investors are called the smart money. Are there conflicts that one should be aware of before making an investment that might have been disclosed by either the underwriters or the company? Buying IPOs shares is not the same as investing in the company while it is private. An individual investor needs to decide whether it is better or not for them to invest in private shares or public shares like an IPO. However, an investor can easily get burned if they are not paying attention. Investors that own private shares in a company might be selling shares in an IPO while some retail investors are buying.

If an investor is a retail investor, it is generally a good idea to take note of what institutional investors are doing. Buying IPO shares as well as stock in the aftermarket after a company just went public can be dangerous for a retail investor especially when lockups come off and large investors can dump shares. Hedge funds and other institutions buy percentages of a company with ease. It requires a lot of experience and know-how concerning IPOs and the purchase of shares in the aftermarket. For example, the hedge fund Tiger bought shares of LinkedIn. It is difficult if not impossible to follow what a hedge fund is doing. Discovering buyers before, during, and after an IPO can be a challenge. “While we knew Coleman was buying up shares of LinkedIn, we didn’t know it was to the tune of over \$75,000,000 and Coleman himself now owns a little

**Table 7.3** LinkedIn and Tiger Global

December 21, 2009–August 10, 2010	PIP V acquired shares of preferred and common stock of the Issuer (which were later exchanged for Class B Common Shares) in a number of secondary transactions, pursuant to which PIP V purchased 2,436,001 shares of preferred and common stock of the Issuer (which were later exchanged for 2,436,001 Class B Common Shares) for an aggregate amount of \$31,740,600.70.
August 10, 2010–April 15, 2011	LinkedIn Holdings acquired shares of common stock of the Issuer (which were later exchanged for Class B Common Shares) in a number of secondary transactions pursuant to which LinkedIn Holdings purchased 1,306,927 shares of common stock of the Issuer (which were later exchanged for 1,306,927 Class B Common Shares) for an aggregate amount of \$29,796,007.50.
May 24, 2011	Post-IPO, Tiger Global Management LLC reported a purchase of 300,000 Class A Common Shares at the IPO price of \$45.00 per share for an aggregate amount of \$13,500,000.

*Source:* Form 3 (Initial Statement of Beneficial Ownership), LinkedIn Corp, Reported by Coleman Charles P III, Securities and Exchange Commission, Edgar Online, June 3, 2011, 2.

over 4 percent of LinkedIn, according to the filing.”<sup>49</sup> Table 7.3 contains Tiger Global’s interest in pre-IPO and post-IPO LinkedIn shares:

Tiger did quite well with its various vehicles buying shares of LinkedIn. LinkedIn’s IPO was priced at \$45 per share but started trading at \$83 per share.

## THE FACEBOOK FIASCO

Institutional and individual investors are interested in alternative investments. However, rushing into these vehicles without proper due diligence can be a mistake. Facebook is a wonderful example of how things can go horribly wrong as well as how investors can easily get burned if they are not paying attention. Facebook involves two main types of alternative investments (venture capital and hedge funds) as well as other vehicles such as IPOs and mutual funds that invest in private companies as well as IPOs. Further, it involves mutual funds invested in IPOs. Lastly, Facebook illustrates both private and public exchanges. Early in 2011, Facebook hinted at going public in early 2012. A reporter called me and asked if there was a lot of upside to Facebook at \$100 to \$200 billion valuation. Facebook was private at the time. A number of institutions and investors were investing and valuations appeared excessive. I put the phone on mute and laughed. There are many finance books on the market that cover valuation but none of them have chapters called Hype.

The purpose behind venture capital is to invest early, not when values are in the stratosphere. For instance, Accel Partners invested a lofty \$12.7 million in Facebook in 2005 when the company was priced around \$100 million and could reap a 1,000 times return with its stake potentially worth as much as \$9 billion.<sup>50</sup> Accel did not invest at a \$100 billion valuation. Timing is important when investing in alternative investments such as venture capital. Are you investing early or are you late to the party? Many investors show up after the party. Likewise, the vehicle or means an investor selects to invest in a private company can be equally challenging. For instance, a number of funds that bought shares of Facebook as a private company bought at the wrong time. “As initial valuations go, \$100 billion is a big number to ask. But at least Facebook has a business model to buy into...Facebook collects loads of information about its users that can be used to target advertisements. That should help it capture a bigger share of advertising dollars.”<sup>51</sup> By the end of 2011, Facebook was planning an IPO in the first half of 2012.

The split of fees between banks for taking Facebook public was unusual. “Morgan Stanley got 38.5% of the fees, while J.P. Morgan got just over 20% and Goldman Sachs got 15%, not exactly the typical split for a deal with three underwriters.”<sup>52</sup> Further, Morgan Stanley increased both the amount of shares and the dollar price shortly before the Facebook IPO. “Facebook and Morgan Stanley, its lead underwriter, faced criticism for boosting the number of shares sold in the IPO by 25 percent to 421.2 million in the days before deal.”<sup>53</sup> The bigger the IPO deal, the more lucrative it is typically for a bank. The IPO for Facebook ended up being the second largest IPO ever and also held the record for most amount of venture capital ever raised for a company. “Facebook originally filed to sell 337 million shares at a price range of \$28 to \$35, but this week hiked that expected range to \$34–\$38.”<sup>54</sup> Prudent investors will examine the financial landscape and market before buying alternative investments. The landscape can quickly change.

Most CEOs or entrepreneurs elect not to sell on the IPO and cash out. It is viewed negatively by investors. The sentiment is, “Why should I buy shares if the person running the company is selling?” Similarly, many venture capital firms decide to hold as opposed to sell if they truly believe in

the company. With regard to Facebook, the well-known and respected venture capital firm, Greylock, did not sell as nearly as much percentage-wise as other sellers at the IPO price of \$38.00 despite the long-term investment and guidance they gave the company. “Other investors, including Tiger Global Management, Goldman Sachs, DST Global and Mail.ru group, all decided to sell significantly larger amounts of their holdings than they had previously indicated they would. In some cases it was almost double the amount and represented half their shares.”<sup>55</sup> Right before the IPO, it was announced that selling shareholders would sell more at \$36.00 per share (which ended up being \$38.00, with Morgan Stanley setting the price at the very high end of the range):

The company itself will not float extra stock, Facebook said in a Wednesday filing with the U.S. Securities and Exchange Commission. But early investors like venture capital firm Accel Partners; Tiger Global Management, the hedge fund; Goldman Sachs; PayPal co-founder Peter Thiel; and companies tied to Russian tycoon Yuri Milner are cashing out with additional sales to the tune of as much as \$3.8 billion... Milner’s Digital Sky Technologies Global Ltd will unload an additional 19 million shares, bringing the value of its sale to more than \$1.6 billion. Mail.ru, another firm controlled by the Russian mogul, will sell a stake worth \$705 million.<sup>56</sup>

Accel Partners, another venture capital firm, filed to sell more shares. Hedge funds, which historically do not invest in venture capital, might have a different objective from investors in an IPO. “But the most winning trade of the week, month, and no doubt the year, belongs to Charles “Chase” Coleman, the 36-year-old hedge fund manager who runs Tiger Global Management. Coleman on Wednesday indicated that he intends to sell a big chunk of his firm’s holdings in Facebook in the big social network IPO that is about to take place.”<sup>57</sup> Investors should always be observant of the smart money. A few of the funds and what their stakes are worth in Facebook are as follows: DST Global led by Yuri Milner had 131.3 million shares worth \$5 billion; Mail.ru Group (also run by Milner) had 56.3 million shares worth \$2.14 billion; and Tiger Global Management had 53.8 million shares worth \$2 billion (selling approximately 50 percent of its shares in the IPO).<sup>58</sup>

The majority of Facebook shares sold on the IPO came from existing shareholders, followed by the CEO. “Facebook Inc. sold 180 million of its shares in its initial public stock offering. Another 241.2 million came from existing stockholders, including the company’s earliest investors and CEO Mark Zuckerberg.”<sup>59</sup> The IPO enabled existing shareholders to cash out a staggering sum of money. Existing shareholders walked away with \$9.2 billion while the company received less. Facebook received only \$6.8 billion. With the green shoe, existing shareholders could cash out even more. “At the \$38 offer price, Facebook itself will raise nearly \$7 billion. Add cash already on its balance sheet, and it begins life as a public company with about \$11 billion total. If underwriters exercise their option to sell extra stock, about 60% of the cash raised in the IPO is going straight to selling shareholders, not to the company.”<sup>60</sup> Smart money tends to win over foolish money (frequently known as the retail investor), which is the loser. Competing with smart money is most difficult. For example, Tiger Global’s investment into Facebook: “Coleman is known to shy away from press and avoid discussing stakes in private companies, however, his investment in Facebook has gathered a lot of media attention as most believe his stake in the social networking site currently valued at \$50 billion gives him access to private information about the company financials.”<sup>61</sup> The importance for an investor is to be cognizant of what an institution or the smart money is doing. Are they buying or selling? Hedge funds have always sought hot IPOs to flip but primarily at the time of the offering because the shares are publicly traded and highly liquid; they can quickly sell them. However, hedge funds are now investing privately and then selling on the IPO:

The shareholders stepping up most aggressively to sell stock include Tiger, Thiel, Accel, but also DST Global and Mail.ru, according to the May 16 filing. Greylock Partners also modestly increased its allotment... Tiger Global Management sold 23.4 million shares, a 596% increase from the 3.4 million it anticipated selling as of the May 3 filing. The firm was the most aggressive seller. It still holds 30.4 million shares... Goldman Sachs sold 28.7 million shares, a 117% increase from the 13.2 million it expected to sell as of May 3. Goldman still holds 37.3 million shares.<sup>62</sup>

Since IPOs can frequently have an initial pop in price, it is essentially free money to buy and flip an IPO. Investors bought into the Facebook IPO to make money. Strangely, the CEO of Morgan Stanley, Jim Gorman, admonished investors in Morgan Stanley's Facebook IPO during an interview with CNBC: "The group of people that thought they were buying this stock so they could get an enormous pop were both naive and bought [shares] under the wrong pretenses."<sup>63</sup>

Rarely have hedge funds bought shares pre-IPO like Tiger; hedge funds typically buy liquid investments. Buying private companies has not been their bailiwick. Retail investors would be wise to proceed with caution when hedge funds start plowing large amounts of money into private deals. If the deal has strong demand they will wait to sell on the IPO. "Many institutional investors seek allocations of supposedly hot IPOs because they want to make money, not because they want to own the stocks. Access to hot IPOs is one way Wall Street rewards profitable clients. If the deals don't trade well initially, institutions often sell quickly to lock in whatever profits that they can."<sup>64</sup>

It is not easy for the average retail investor to outwit the smart money, especially an institutional investor that invested large amounts of money into a company far before a retail investor. "While the ability to allocate IPO shares is seen as a strength of so-called wirehouses like Morgan Stanley Smith Barney, the 'value proposition seems a bit weaker' following Facebook's disappointing debut."<sup>65</sup> Facebook changed its S-1 before going public. An S-1 that gets changed so quickly and last minute is difficult to evaluate. It would not enable an investors to find how the deal changed unless of course they were a securities attorney or an extremely sophisticated purchaser of IPOs. In other words, virtually no average investor would be able to piece together everything going on behind the scenes. The urgency by Morgan Stanley, the lead manager for the IPO, appears somewhat peculiar, especially considering the information disseminated as well as the details about the company which were not clearly explained. As reported by PrivCo, on "May 9, 2012: Facebook's underwriting team offers a bare minimum disclosure and amends its S-1 stating simply that daily active users are increasing at a faster rate than deliverable ads due to mobile and potentially decreasing revenues," and on "May 15–16,

2012: Underwriters encourage institutional and retail investors to request more shares than they may want. Investors are told demand for Facebook IPO shares is so robust that they will only receive a fraction of their allocation requests.”<sup>66</sup> It is doubtful that investors would have invested as much as they did in Facebook if they studied all the risks involved.

The Facebook IPO was pitched to many retail investors as a “gift” when in reality it was as far from a gift. “The Facebook IPO was supposed to be the kind of opportunity that customers of Wall Street wirehouses could look forward to receiving. Instead, it has turned out to be another blemish on Wall Street’s already tarnished image with retail investors.”<sup>67</sup> Increasing the amount of shares last minute can harm an IPO. “Facebook initially set out to sell 337.4 million shares to the public, according to an S-1 the company filed with the SEC on May 3. Two days before the IPO, it increased the amount to 421.2 million, with the additional shares coming from shareholders, not the company, according to the May 16 SEC filing. The company’s contribution to the offering—180 million shares—stayed unchanged.”<sup>68</sup>

One year before Facebook went public, reporters asked if the valuation for Facebook at \$100 billion was a good deal. “A group of Facebook shareholders is seeking to offload \$1 billion worth of shares on the secondary market, a sale that would value the company at more than \$70 billion, according to five sources with direct knowledge of the situation... It is questionable whether new investors would realize the exponential growth that early-stage investors got in Facebook.”<sup>69</sup> Interestingly enough, the IPO was priced at \$38.00, making the company worth in excess of \$100 billion. After the IPO, the share price came right back down to the valuation of \$70 billion. Valuing a private company is never easy. Private companies that set an IPO price too high, can run into a number of problems. Owing to the tens of billions of lost dollars in the Facebook IPO during its first two months, regulators are looking into the Facebook IPO’s disappointing results:

Regulators are looking into a report that Morgan Stanley, the lead underwriter for Facebook’s initial public offering last week, shared a negative assessment of the social network with major clients ahead of the IPO. Rick Ketchum, head of the Financial Industry Regulatory

Authority, an independent regulatory body, acknowledged an article from Reuters saying that a Morgan Stanley analyst reduced his revenue projections for Facebook shortly before the offering and shared this with institutional investors. The report has raised questions about whether certain investors received privileged information ahead of the offering that should have been disseminated more widely.<sup>70</sup>

During the road show for Facebook, certain investors appeared to get favoritism with regard to useful financial information. “Massachusetts Secretary of the Commonwealth William Galvin has subpoenaed Morgan Stanley over questionable actions surrounding its role as lead underwriter of Facebook’s IPO. The subpoena accuses Morgan Stanley of discussing Facebook’s lower revenue projections with certain institutional investors—a move which possibly violates Massachusetts state securities law.”<sup>71</sup>

## CONFLICTS OF INTEREST

Conflicts of interest can harm investors. For example, naïve investors jumped at the opportunity even though many had no idea what they were doing. For instance, Morgan Stanley mutual funds bought private shares of Facebook. A question then arises: how can the bank be objective when they were also an underwriter getting a fee for an IPO and representing the company? Investors bought Morgan Stanley funds, which received a lot of publicity that they were buying pre-IPO Facebook shares. Mutual funds appeared to be a viable way to gain access. “By getting in ahead of the crowd, the funds position themselves for potentially big gains if companies go public.”<sup>72</sup> Quite a few questions come to mind. Did those investors buying the Morgan Stanley funds ultimately get a good deal? Did they do better than the Morgan Stanley clients who bought the IPO shares? Did neither do well? Morgan Stanley made millions but what about the retail clients of the bank? What price did the fund pay for the pre-IPO shares and at what price did they sell? Were the shares bought in the funds just to land the Facebook deal at the expense of the fund shareholders? Did they sell on the IPO with other institutions or not? Either way, there is an

inherent conflict of interest when you sit on both sides of the table, on top of the table, and underneath it as well. Other mutual funds lost money—funds not even affiliated with Morgan Stanley. “Facebook’s disastrous stock-market debut sheds new light on the hazards of investing in funds that invest in private companies. GSV Capital and Firsthand Technology Value, two funds designed to give retail investors exposure to tech companies before their initial public offering, have lost 37% and 32% of their values, respectively, since Facebook went public.”<sup>73</sup>

Initial finger pointing was focused at Nasdaq, “In the wake of the botched offering—Facebook has shed \$22 billion in market value since the May 18 deal—much of the focus has been on the chaotic first day of trading, which was marred by technical problems on the Nasdaq Stock Market. But interviews with Wall Street bankers, brokers, investors and Silicon Valley executives reveal that Mr. Grimes, his firm and Facebook made several decisions in the weeks leading up to the offering that contributed to the rocky ride.”<sup>74</sup> No matter what the excuse is from an underwriter, when investors buy high such as retail investors purchasing Facebook IPO shares, they tend to take a dim view of it:

To anyone outside of Wall Street, this whole arrangement seems like a giant conflict of interest. Just days before the IPO, Morgan agreed to allow Facebook to sell more shares than it originally proposed. Morgan also set the IPO price higher than originally expected. That, in part, set the stock up for the fall, creating the trading gains for Morgan. Wall Street, of course, doesn’t see it that way. In fact, Facebook’s own prospectus says that the underwriters ‘may sell more shares than they are obligated to purchase under the underwriting agreement, creating a short position.’<sup>75</sup>

Billions of dollars were lost by individual investors with the Facebook flop. The Facebook IPO created mistrust. “Public perception seems to be that Morgan Stanley favored institutional customers rather than the retail clients who make up the bulk of business for its 17,000 advisers. Published accounts claimed that many of Morgan Stanley’s big clients got phone calls informing them that the firm’s technology analyst had reduced his estimates for the company.”<sup>76</sup> The question to ask is, “What next?” Facebook is

a well-known entity and was virtually impossible to have botched an IPO. After the Facebook IPO, the former CEO and chairman of Morgan Stanley, Phil Purcell, argued for big banks to be broken up including Morgan Stanley:

Right now the market valuation of too-big-to-fail institutions is too low because of the earnings volatility inherent in investment banking and trading. There is also a mismatch between the cultural values that infuse investment banking and those of asset management, retail banking, and private wealth management. The financial giants have mixed profitable and client-centric services with the higher risk, more volatile and opaque investment banking and trading.<sup>77</sup>

The bottom line is that the retail investor got annihilated with the Facebook IPO and the reason why is quite clear; the retail investor's interest seemed to be put last not first. "One reason Morgan Stanley got the Facebook mandate was its wide retail distribution network. Yet many of the firm's retail customers—who got an estimated 25% of the firm's allocation—are sitting with losses on their Facebook shares and steaming that some institutional customers were warned of problems with the deal while they were told nothing."<sup>78</sup>

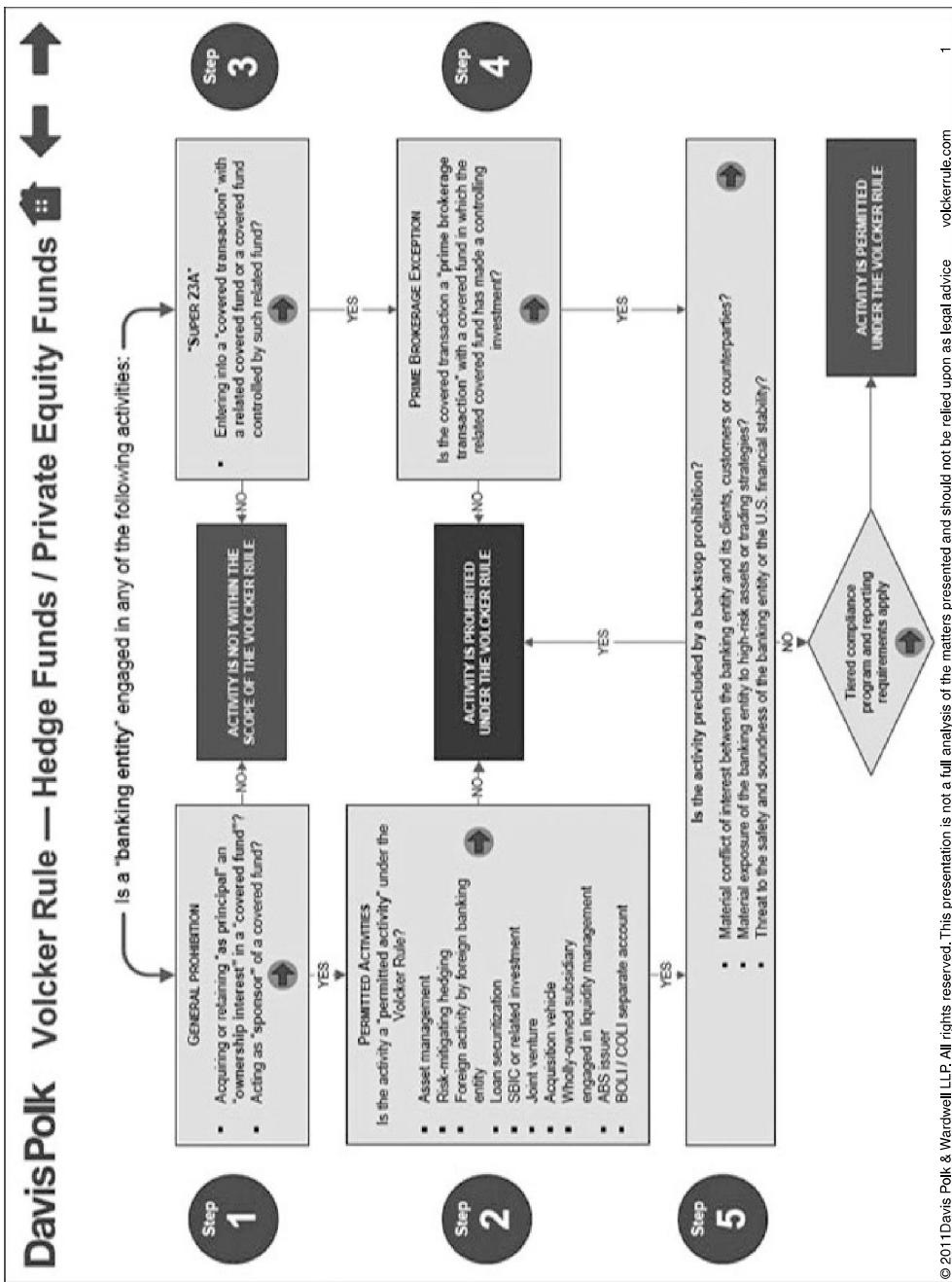
The poorly handled Facebook IPO might have an adverse effect on the entire IPO market, venture capital, alternative investments, and banks that offered these shares. Any IPO that craters will likely spook investors due to Facebook's size. It might adversely affect future IPOs. Venture capital moves in waves and the way that Facebook was handled could have severe repercussions for the whole market. "With just four IPOs on the calendar for next week, June 2012 US listed IPO activity could be the lowest since June 2003 (3 IPOs). Average June IPO activity since 1995 is 29 deals making it the third highest month on average over the 18 year period."<sup>79</sup> Regulators will examine Facebook and might impose more regulation. Rep. Darrell Issa, R.-California, on behalf of the House Oversight and Government Reform Committee, suggests the rules for pricing IPOs and disseminating information need to be updated: "The Facebook IPO taught us that, at a minimum, the IPO process suffers substantial flaws. In fact, it appears the

entire IPO regulatory framework, based on an outdated Securities Act of 1933, fails to provide a market-based solution to IPO pricing.”<sup>80</sup>

In December 2012, Morgan Stanley paid a \$5 million fine concerning Facebook. “Massachusetts said that Morgan Stanley’s senior investment banker on the deal ‘orchestrated’ phone calls from Facebook to analysts in a way that favored large investors over small ones and that violated restrictions on bankers’ role in the IPO process.”<sup>81</sup> With the M&As of many banks due to the Great Recession, the financial landscape has forever changed. For example, initial public offerings must be large enough now for banks to make money. This need can create conflicts and problems, especially for those investing in alternative investments.

## **HEDGE FUNDS IN THE FUTURE**

Hedge funds are not all evil. Granted, there have been quite a few standout nefarious characters, but this is the exception rather than the norm. There will be some rotten eggs out of ten thousand hedge fund managers. It is inevitable. The objective for every investor (including the banks, consultants, and other alleged experts that failed to guard clients against Bernie Madoff) is to perform proper due diligence. The experts clearly failed here. It is no use for an investor to realize after the fact when there is a blow-up or the manager is thrown in jail. Bernie Madoff is a learning lesson for everyone. When a fraud is discovered, investors typically lose money. What happened to all the investors who lost money with Bernie Madoff? Fortunately, it turns out that quite a bit of money is being recovered. “Irving Picard has collected \$7.6 billion for victims of Bernard Madoff’s Ponzi scheme, and he’s aiming much higher. Investors were lucky. The trustee liquidating Madoff’s firm, Picard has filed more than 1,000 lawsuits that he calculates would bring in \$100 billion, far more than the \$19 billion that he estimates disappeared.”<sup>82</sup> When the news broke about Madoff at the end of 2008, it could not have occurred at a worse time in the market, causing even more fear with hedge funds. In fact, Madoff ran a ponzi scheme rather than a hedge fund. There was so much deception, many investors thought they were investing in a hedge fund. As a result, virtually every investor questioned or examined any alternative investment.



**Figure 7.8** Volcker Rule Proposed Regulations for Hedge Funds / Private Equity Funds.

Source: Davis Polk & Wardwell LLP, "Volcker Rule Proposed Regulations: Hedge/PE Funds Summary" [http://www.davispolk.com/files/Publication/58f87d88-c7d7-4b7a-a2f8-e3ac51ed9143/Presentation/PublicationAttachment/6b3db65d-710f-41dd-98a9-05732dd284bc/101211\\_Davis\\_Polk\\_Volcker\\_Funds\\_Summary.pdf](http://www.davispolk.com/files/Publication/58f87d88-c7d7-4b7a-a2f8-e3ac51ed9143/Presentation/PublicationAttachment/6b3db65d-710f-41dd-98a9-05732dd284bc/101211_Davis_Polk_Volcker_Funds_Summary.pdf), April 12, 2013."

Despite the fact that there was extreme pessimism about investing and a negative sentiment about hedge funds, the circumstances in 2008 and 2009 were unusual. Wave Theory shows that if the hedge fund market keeps growing the way it has since the Great Recession, it is not inconceivable that the hedge fund market doubles by 2015. Hedge funds came roaring back dispelling all the naysayers. “We find that global sentiment is a statistically and economically significant contrarian predictor of market returns.”<sup>83</sup> Hedge funds are likely to continue attracting assets. It is predicted that U.S. allocation to hedge funds will increase 28 percent of total portfolio assets by the end of 2013.<sup>84</sup> Rogue waves or Black Swan events frequently distort value perceptions. Closed-end funds illustrate this point:

The problem of accounting for price changes on the basis of fundamental values is not confined to the overall stock market. Studies of price behavior in setting where fundamental values can be measured directly have similar trouble in explaining prices. The classic example is closed-end mutual funds, discussed by Malkiel and Firstenberg (1978). These funds have traded at both discounts and premiums relative to their net asset value during the last twenty years. At any moment, the cross-sectional dispersion in discounts is substantial and difficult to link fundamental factors.<sup>85</sup>

Closed-end funds can offer exceptional buying opportunities since investors tend to throw the baby out with the bath water. Unlike open-ended funds where there is no limit of shares, closed-end funds have a set amount of shares and trade on an exchange. Since they trade on an exchange, prices can fluctuate. Case in point, one can examine NAV or net asset value compared with the stock price of the closed-end fund to see how much above or below the price should actually be worth.