

# **Hedge Funds: Origins and Evolution**

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If hedge funds keep growing as fast as they have been doing for the past five years, they could end up being transformed into mutual funds. That outcome would be tantamount to extinction and probably overstates the extent of hedge fund evolution. To understand the transformation that is occurring in the money management industry, it is important to understand what hedge funds are, how they have evolved, and the limits to their growth as consistently high-yielding assets.

### **Hedge Fund Antecedents and Origins**

Hedge funds have become the focus of a great deal of attention over the past five years—both from investors and regulators. For investors, hedge funds have become investment vehicles synonymous with high returns. Everyone wants to invest in a hedge fund once they are convinced that the term is synonymous with 25 percent-plus annual returns. Regulators sometimes act as if they believe that any investment vehicle earning extraordinarily high returns must either be extraordinarily risky or crooked. So, the reasoning goes, investors, especially the less wealthy ones particularly eager for high returns, must be protected from investing in hedge funds.

Few investors, not to mention pension fund managers and regulators, have stopped to ask themselves what is so special about hedge funds? How do they relate to mutual funds? Are hedge funds characterized by a unique approach to investing, the possession of special knowledge that enhances the rate of return on their investment activities, or simply by a unique fee structure?

“Hedge fund” is now a term covering what has come to be a far more heterogeneous collection of money managers than was the case even a decade ago. The growing and changing role of hedge funds in financial markets today is derived from the way in which the ongoing process of storing and enhancing wealth has been managed (largely in the United States) over the past seventy-five years. No doubt, the scope of the investigation of such a compelling process as the storage and enhancement of wealth could be expanded over a longer period of time and across a broader social spectrum. But an

examination of the process, in what has become the wealthiest country in the world, since just before the Great Depression, provides ample scope for an investigation of the origins and evolution of hedge funds. We shall begin our story with the Great Depression and the role of financial markets therein and end it with some thoughts on the future of hedge funds.

Among the “lessons” derived from the Great Depression was the firm conviction that unregulated financial markets led to rampant speculation, eventual market bubbles, and ruin for unprotected investors. The result was the imposition of strict government controls regulating the access of investors to investment vehicles. Financial institutions were constrained with regard to the types of investment activities they could undertake while being labeled for investors. Money managers could run stock funds or bond funds, but usually not both. And they could either invest in their primary investment vehicle (stocks), or hold “cash” (treasury bills) if they thought, as they seldom did or needed to do, that stock prices were going down.

What evolved after World War II was the mutual fund industry aimed at helping households that owned investable assets over and above owner-occupied real estate and normal savings to acquire the means to store and enhance wealth. The mutual fund industry was structured on a benchmark return basis. That means that mutual fund managers could offer to households various categories—stock funds, bond funds, growth funds, value funds—the performance of which was gauged by comparison with other funds in that category. Mutual fund managers collected a fee of 1–2 percent of the money under management and strove to outperform either the other funds in the industry, the overall stock market, and/or the benchmark return on riskless U.S. government securities. While some households chose to manage their own investments without the aid of intermediaries like mutual funds, the great bulk of U.S. household assets and pension fund assets held in trust for U.S. households were managed by a growing industry of mutual funds. The aim of mutual funds was to get as much money under management as possible thereby increasing the total fees available to the managers of the mutual fund

while maintaining a rate of return comparable to other funds and slightly superior to the return on what were viewed as less risky assets, like U.S. notes and bonds.

Another notable feature of mutual funds was a long-only orientation. That is, a typical mutual fund posted a sign that said, in effect, “we invest in stocks” or some subcategory of stocks, and were thereby constrained by Securities and Exchange Commission regulations to continue to do so. The managers of the fund had a simple choice. They either owned the class of assets they advertised as characterizing the fund or they went into “cash”—a somewhat misleading term used to describe short-term treasury securities. It is probably no accident that most mutual funds preferred to characterize the choice available to investors as either stocks or “cash,” leaving aside, for example, government or corporate bonds, another large category of wealth storage vehicles. The bond segment of the U.S. financial markets tended to be managed by professionals who usually earned a good living trading bonds in a market reserved for professionals by virtue of a fee structure that made it unattractive for individuals to participate.

The long-only-cash-benchmark structure of mutual fund investing characterized the wealth management strategy for most American households and/or pension funds during the 1950s and 1960s and into the early 1970s. Markets for commodities like oil, gold, silver, copper, currencies, and bonds were left to the professionals. Household access to the returns earned by those professionals was limited by custom and lack of information.

With the early 1970s came, first, the August 1971 breakdown of the Bretton Woods system, which meant that exchange rates could fluctuate, thereby providing another trading vehicle for investors with a trading orientation. Also, during the 1970s, options and futures markets developed to enable highly leveraged trading in financial instruments, currencies, and commodities. The breakdown of the Bretton Woods system and flexible exchange rates was followed by the first oil crisis in 1973–74, which sharply increased the volatility of the prices of many commodities.

As inflation persisted throughout the 1970s, the opportunities for individuals skilled in commodities trading rose exponentially. This was fertile ground for the first hedge fund managers—commodity traders who had a large and immensely profitable job to do. The skillful ones saw that getting to equilibrium prices in relatively thin currency and commodity markets at a time when the shocks hitting those markets were immense was a very profitable activity. Pools of capital began to emerge to exploit these opportunities and a class of “super traders” emerged that attracted funding, largely from wealthy investors anxious for the extraordinary 50 to 100 percent rates of return on a relatively small portion of their total wealth.

The performance of hedge fund managers wasn't measured relative to any benchmark, but in absolute terms. During bad years, mutual funds that lost money would report to investors that, although the fund was down by 5 percent for the year, the benchmark or the average return for that category of fund was down by 8 percent, thereby hoping to offer the investor some consolation. The biggest mutual fund winners during a bad year were the ones who held the most cash, since mutual funds didn't go short—that is, sell shares that they did not own in hopes of buying them back at a lower price.

In sharp contrast, the new class of hedge fund managers growing up trading largely in the commodities sphere was far less constrained than the typical mutual fund. First of all, they weren't limited to investing in or trading any particular category of asset. They traded currencies, commodities, stocks, bonds—whatever moved. Second, if they thought the price was going down, they sold. That is, they could be long or short any of the things they traded. Their default option was not cash (actually treasury bills) as was the case for mutual funds, but rather to sell something whose price was going down. In this sense, they were far less constrained than mutual funds, having a broader category of assets to trade and not being constrained by the cash-long choice faced by mutual funds. As a result of these lower constraints and of the high level of volatility in many of the commodity markets, the skillful traders made extraordinarily high returns and so were judged simply by the level of those returns rather than by comparing those returns with some other class of asset.

The early hedge fund managers were regulated not by the Securities and Exchange Commission, but rather by the markets. Highly volatile commodity and currency markets along with the leveraged access to trade those markets (available through options and futures contracts) required highly skillful, disciplined risk management and simple gut fortitude to be a successful manager. Many didn't make it, but those who emerged as successful became legendary.

By the early 1980s, wealthy investors pursued the most successful hedge fund managers to enhance their available capital in hopes of sharing in the extraordinary returns they were earning by trading volatile markets in an unconstrained manner. Traders like Bruce Kovner, George Soros, Julian Robertson, Paul Tudor Jones, and Louis Bacon set up companies to enable them to manage other people's money. Total funds under management at the largest hedge funds during the early 1980s tended to be, at the outset, around several hundreds of millions of dollars, extraordinarily small by today's standards. With the successful hedge funds earning 50 to 100 percent annually, funds under management rose extraordinarily rapidly through internal growth, but also as wealthy investors pressed hard for the most successful funds to manage more of their money. By the early 1990s, the largest hedge funds were managing over a billion dollars each and total money under management in the hedge fund industry totaled about 100 billion dollars.

With the remarkable returns earned by hedge fund managers, investors were willing to buy into the hedge fund fee structure. The hedge fund managers usually took a 2 percent fee, comparable to the fee charged by mutual funds, and then kept 20 percent of the profits. For a manager running a \$500 million fund, often with few employees and relatively little overhead, a 50 percent rate of return meant \$250 million in profits with \$50 million of that going to the manager. As the fund doubled in size, the relatively small number of highly successful hedge fund managers were clearing over \$100 million a year—far in excess of the compensation earned by the captains of industry and finance.

But simultaneously, their investors, even after fees, were earning 40 and 50 percent rates of return, extraordinary by any standard.

The elements of extraordinarily high returns for hedge fund managers and their investors were a combination of investment style unconstrained by the long-only cash benchmark approach of mutual funds, the introduction of leverage-enhancing vehicles in the futures and options markets, and the emergence of large markets in currencies, commodities, and financial instruments where prices moved enough to generate extraordinary profits for those on the right side of the trade.

The new trading style, the emergence of volatile prices, and the leverage-enhancing instruments were all necessary conditions to generate the high returns earned by the most successful hedge fund managers. However, they were not sufficient. Survival required the unique skills as traders and, more importantly, as risk managers that distinguished the most successful and resilient hedge fund managers. The more successful they became, the more people wanted them to manage their money and, as experience would prove, the more difficult it became to earn the extraordinary rates of return that characterized the early history of the hedge fund industry from the late 1970s to early 1990s.

As hedge funds reached the billion-dollar mark of funds under management, the most innovative hedge fund managers began to take steps to maintain high returns on a larger body of investable funds. They hired more traders and strategists and pursued alternative strategies hoping that the returns on such alternative strategies would not be highly correlated with one another, thereby easing the problem of managing risk as the size of the fund grew.

The evolution of hedge funds to larger entities able to manage multiple billions of dollars of funds was mixed during the 1990s. As all of the large hedge funds undertook alternative strategies, they all tended to move into the same collection of positions, meaning that any outside shock that forced an exit from those positions produced a highly

correlated movement of prices and that added to the volatility of returns thereby complicating the problem of managing risk in multi-strategy hedge funds.

The ability of hedge funds to grow was also constrained by the simple fact that great traders of volatile financial instruments, those able to earn a rate of return of 25 percent or more on half a billion dollars or more of tradable capital, proved to be rare indeed. A category of solid second-tier traders emerged who could manage between \$100 and \$300 billion a year, earning about 20 to 25 percent on that amount. That reality meant that it took about five traders, having consistently good years, to return 20 percent on a billion dollar fund. After fees, the 20 percent return on a billion-dollar fund yields investors a little bit less than 15 percent—fairly attractive, but not extraordinary when compared to the 8 percent long-run average available on equity investments with mutual funds. The 15 percent returns were also a far cry from the 40 and 50 percent rates of return earned during the early years by the most successful traders.

During the 1990s, the reality emerged that the hedge fund activity earning the remarkably high returns of the early phase of the industry was limited in scale. It was one thing to have an extraordinarily skillful hedge fund manager returning 50 or 60 percent annually on a billion-dollar fund. It was quite another to see such returns on substantially larger funds. Some of the hedge fund managers who had developed their skills trading equities were able to scale-up their activities somewhat more successfully through a combination of highly leveraged plays in large-scale equity markets, but even those activities reached their limits as fund size grew to above \$10 billion. Some funds elected to enhance their rate of return by reducing size and returning funds to investors. The reality that a fund structured to earn 40 to 50 percent rates of return was not infinitely scalable to the upside was disappointing to most investors, many of whom had to learn the hard way that all funds can't earn such extraordinary returns under all conditions.

### **Stocks Challenge Hedge Funds**

After 1995, hedge funds experienced another challenge. The U.S. stock market entered a period of extraordinary growth, which by the late 1990s, after the turmoil of the 1997–98 Asian/Russian debt crisis, saw investors move heavily into stocks and away from hedge funds. Why pay the hedge fund fee structure and earn 10 to 15 percent annually while putting unlimited amounts of money into the stock market that, according to the belief of many, was going to rise by 20 to 25 percent annually forever? Dow 36,000 was in reach according to the title of a widely read book published just before the NASDAQ market crash in March 2000.

Ironically, one of the most famous hedge funds, the Quantum Fund, founded by George Soros, fell victim to what, in retrospect, became the stock market bubble. Frustrated by missing out on the incessant rise in technology shares during 1999, the Quantum Fund elected to jump on the “tech” bandwagon late that year, earning an extra \$1 to \$2 billion for itself and its investors in the space of just a few months. The most successful portion of the Quantum Fund’s foray into tech stocks coincided with the end of its financial year in 1999. The result was that the fund’s managers enjoyed a substantial cash payout of 25 percent of the company’s earnings, thanks to the fee structure in place at the time. But, by March 2000, when the NASDAQ collapsed, the Quantum Fund lost heavily and elected, in essence, to close its doors, thereby leaving its investors with hefty losses and illustrating a moral hazard problem that has emerged in the hedge fund industry.

The label “hedge fund” continues to be a magnet for investable funds with investors behaving in a remarkably naïve fashion with regard to the prospects of new funds or existing funds for actual success. If a start-up hedge fund manager raises a half a billion dollars, with a fee structure of “two and 20,” he gets \$10 million to operate the fund for the first year plus 20 percent of the upside of anything he earns. A new manager with a short time horizon may, under such circumstances, be tempted to swing for the fences, perhaps shooting for a 25 or 30 percent return. Thirty percent on \$500 million is \$150 million of which a fee of \$30 million would go to the successful new manager for a year’s work. If, in the process, the manager bets incorrectly and loses, say 30 percent, the worst outcome for him is a zero return. His investors may lose 30 percent and therefore

withdraw their remaining \$350 million while the manager is left with only the \$10 million fee collected initially along with the search for a new job or a plan to start-up a new fund.

The moral of the moral hazard story with respect to hedge funds is for investors to check first to see how much of the manager's own money is under management alongside that of outside investors. The prospect of sharing losses as well as gains with one's investors exercises great discipline on risk management by hedge fund managers.

### **A New Growth Era for Hedge Funds**

The period after the NASDAQ market collapse in March 2000 witnessed the start of the largest growth era for hedge funds. With investors disillusioned with the stock market, real estate and hedge funds became the new darlings. For most middle-class American households, real estate dominated. U.S. tax laws had been changed in 1997 so that a household could keep, tax free, up to a half a million dollars of capital gains on the sale of a house. That process could be repeated every two years with the result that many American households have elected, with the help of favorable tax treatment not only on capital gains but interest expense on owner-occupied housing, to use real estate as their major vehicle of wealth building.

Outside of real estate, pension funds have been charged with building and preserving the wealth of a huge baby boom generation approaching retirement age. The financial assets of American households, or total assets excluding real estate and durable goods, stand at about \$38 trillion, having grown by a multiple of 2.6 at an annual rate of nearly 7 percent since 1990. While real estate assets have outstripped financial assets in terms of their rate of return over the past five years, there will probably be lower returns on real estate going forward in view of the fact that house prices relative to income are two to three standard deviations above normal in many real estate markets. With the U.S. stock market rising only at a moderate rate, managers of financial assets, including hedge funds, are seeking

ways to earn 8 to 10 percent returns on the huge \$38 trillion pool of financial assets owned by American households.

Unfortunately, hedge funds have been labeled by many as the vehicle that will provide high returns on this huge body of investable wealth. Yet hedge funds are limited in their ability to accommodate such large asset holdings while preserving higher returns. It is in this sense that the very existence of hedge funds, as originally constituted, has disappeared under the weight of their extraordinary growth over the past five years. Today, hedge funds are estimated to be managing about a total of \$1 trillion or about 7 percent of total U.S. financial net worth; less when it is recalled that many foreign investors are included in the \$1 trillion hedge fund total. Still, returns to large hedge funds, those with over \$3 billion under management, are averaging between 10 and 15 percent annually, still high relative to current low single-digit returns on U.S. equity markets, but really just a reflection of the hedge funds' aggressive inclination to invest in more rapidly rising foreign stock and bond markets.

### **Hedge Funds or Mutual Funds?**

Hedge funds can still pursue a more unconstrained investment approach than most mutual funds. They still can go short, and they still can pursue multiple strategies employing leverage. But this overlooks a number of facts that are causing hedge funds to evolve into mutual funds. First, many of the newer hedge funds that have appeared over the past several years are simply funds run by former mutual fund managers attracted by the hedge fund fee structure. For mutual fund managers able to assemble a billion-dollar hedge fund with a few of their colleagues in a relatively small, low overhead operation, the two-and-twenty fee structure is very attractive. A 20 percent annual return, or \$200 million, leaves \$40 million for the hedge fund manager—a figure far in excess of the several million dollars earned each year by the most successful mutual fund managers.

Beyond that, some hedge funds are beginning to be structured more like mutual funds. Long-only equity hedge funds have emerged, some of the quite successful in the hands of

competent managers but still closer in investment strategy to mutual funds than to hedge funds. Large financial institutions are bundling collections of hedge funds or fund of funds in a way that enables smaller investors to access the vehicle. However, the fees on such structures often leave the small investors with returns no greater than, or sometimes less than, returns on mutual funds. If a fund of hedge funds invests in a collection of hedge funds earning an average of 15 percent annually, a fund of funds nets around 11 or 12 percent with the typical two-and-twenty fee structure of the funds they invest in. If the fund of funds then charges a fee of 3 or 4 percent, the investor is left with returns in the 8 to 9 percent range during a good year, pretty close to the average long-run return for equity mutual funds. So, in the process of maturing, hedge funds have essentially been transformed back into an investment vehicle very much like the mutual funds they supplanted for wealthy investors during the 1970s and 1980s.

The term “hedge fund” has become more a marketing device than a description of the approach to investing being employed by the “fund.” There may be some potential for slightly higher returns at hedge funds managed by extraordinarily good risk managers that employ leverage and long-short strategies that distinguish the original hedge funds. But the successful application of some strategies appears difficult on a scale above \$10 billion.

Some of the most successful hedge fund managers (in the business since the 1980s) have reduced their overall funds to manage \$5 to \$10 billion. The result is that hedge fund managers are electing to earn a higher rate of return for themselves and their investors. Taking in more money essentially dilutes the returns available to hedge fund managers on their own accumulated wealth, which sometimes amounts to more than half of the money under management. In one case, James Simon, a remarkably successful hedge fund manager employing mathematical techniques, has returned all of his investors’ money, apparently believing that he can maximize his own wealth by applying his strategies only to the substantial amount of capital that he owns. The reason: the rate of return falls as the amount of money under management rises above some level, say \$5 billion. So, if you

have \$5 billion of your own money to invest in your own hedge fund, there is no reason to invest on behalf of other investors.

## **Regulation**

Of course financial regulators have pressed to increase their oversight of hedge fund activities as hedge funds have become more popular and more accessible to less wealthy investors. Most large hedge funds have elected to register with the SEC perceiving that the SEC's somewhat onerous regulatory requirements constitute a barrier to entry in an industry where such barriers are becoming increasingly desirable to the owners of existing successful hedge funds.

Ironically, the regulators have arrived to protect small investors from the hedge funds that no longer exist as vehicles yielding extraordinary returns. The typical small American investor wishes he could invest in a hedge fund because he has heard that they earn 25 percent a year rather than the 5 to 10 percent available annually from mutual funds. The truth is that most hedge funds no longer earn 25 percent a year and those that do have achieved that result by returning investor money rather than by seeking additional investors.

The hedge fund that most investors want to buy into doesn't want their money because they have enough of their own and taking in more would only drive down their return on capital. As more and more investors push more and more money into hedge funds through the fund of funds vehicle, they will learn that, thanks to lower returns on the underlying funds coupled with layers of high fees, returns to most investors on so-called hedge funds are nothing extraordinary. In reality, the best hedge funds have learned to manage long/short strategies employing leverage to earn relatively attractive absolute returns for their owners. Meanwhile, the marketers of hedge funds in general have taken for themselves the rents that accrue to employing long/short strategies with leverage that distinguish the hedge fund approach from the mutual fund approach.

Meanwhile, the pension fund managers and insurance companies with trillions of dollars of investable assets console themselves with the thought that the hedge funds will help them provide super-normal returns on a massive scale. The reality is, that with everyone chasing returns so hard, risky assets have been priced as nonrisky assets. Latin American countries with records of extraordinarily consistent default on their liabilities are able to borrow in their own currency at 8 percent, just a few hundred basis points over the 4.4 percent available on virtually riskless ten-year U.S. treasury notes.

In a world of long-duration liabilities faced by pension funds and insurance companies, the new “cash” asset has become ten-year U.S. treasury notes whose yield is now identical to the yield on the old cash—two-year U.S. treasury notes and six-month U.S. treasury bills. The incessant, building pressure upon the financial industry to restore and enhance the wealth of a growing and rapidly aging population worldwide has and will continue to push down returns on most assets. The rate of return on UK fifty-year inflation-protected gilts recently dropped below 0.5 percent as U.K. pension funds sought long-duration, low-risk yield. The frantic search for return has provided fertile ground to use the name “hedge fund” to describe large and unwieldy investment vehicles that are, today, almost indistinguishable from mutual funds.

The extraordinarily high returns earned by hedge funds during their golden age in the 1980s and early 1990s were not too good to be true. They were just too good to be true for everyone.

### **Looking Ahead**

The successful, large-scale money management vehicle of the future will probably manifest a blend of hedge fund and mutual fund features. Four attributes of money management pioneered by hedge funds will be incorporated into successful large-scale money management vehicles: simultaneous trading in a broad range of markets; utilizing long/short strategies; employing/developing the skills of traders in specific markets; and incentive-based fee structures along with owner/manager participation in fund performance.

The ability to successfully trade in a wide range of markets including stocks, bonds, commodities, and currencies will characterize future mutual/hedge funds. Exposure to a broader set of markets will help to smooth out performance over time so that funds can shift their emphasis as the opportunities across markets evolve. Such flexibility has been partly responsible for superior returns at some of the larger hedge funds.

Long/short strategies also help to increase the flexibility of managed funds to capitalize on changing market conditions. The more constrained long-only-or-cash approach that many equity-based mutual funds traditionally maintain is somewhat constraining, especially in a market where stocks usually rise but can, for short periods of time, fall sharply.

Hedge funds, of course, were built around the skills of superior traders able to deal with rapidly changing market conditions. Those skills will always be a part of the alpha, or above market, returns earned by the most successful large money management funds.

Finally, successful funds may have a less ambitious fee structure, such as a 1 percent service fee and 10 percent of profits going to managers instead of the usual “two and 20” structure that prevails today. There may be some variation around those figures with service charges ranging up to 2 percent and/or incentive fees ranging up to 20 percent of fund profits. Only the long-established, most successful hedge funds will earn higher fees. The critical aspect is to incentivize owner-managers by increasing their compensation as fund performance improves rather than linking their compensation simply to flat fees tied to the size of the fund as most mutual funds have done in the past. Investors will be looking for incentivized managers who have a substantial personal stake in the success of the fund in which they are planning to invest.

Broadly, the impact of hedge funds on the money management business has been and will continue to be substantial. The overall result will probably be to modestly increase long-term returns for most investors due largely to the additional effort by incentivized fund managers.

However, as more and more funds apply the less constrained hedge fund approach to money management, extraordinary returns will become less and less common.

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