

The Growth of Hedge Funds

Dallas is fertile ground for the often risky and sometimes wildly rewarding investments.

S O YOU'RE WONDERING WHETHER TO jump on the hedge fund bandwagon. You hate being the last one to the party, and already a number of your friends have sold stocks to buy hedge funds. You're not alone.

Hedge funds have grown from the first fund pioneered by A.W. Jones in 1949 to more than 6,000 today. Capital committed to these funds has increased more than 17 percent per year during the past five years with more than \$1 trillion invested today.

In the 1990s, it seemed that every one of my MBA students wanted to start a dot-com firm. Now, it seems that every one of my students wants to start a hedge fund. That should tell you something.

A HOTBED FOR HEDGE FUNDS

Your anxiety about what to do is no doubt compounded by the fact that Texas—and Dallas specifically—is one of the nation's hotbeds for hedge funds. According to Ed Easterling of Crestmont Research, a Dallas-based investment management and research firm that specializes in Texas-based hedge funds, "Texas has been home to a variety of hedge funds for decades and today has the largest concentration of hedge funds outside of the New York area and California."

In the Dallas-Fort Worth area, there are approximately 140 firms managing more than 175 hedge funds, with assets in excess of \$40 billion, according to data compiled by Crestmont Research. Almost 75 percent of the assets are managed by the top 10 firms, and more than half of the firms have less than \$30 million under management.

One significant trend in the overall growth of hedge funds is their penetration into the institutional investor market. In 1992, 81 percent of all hedge fund investors were individuals. Currently, this number has dipped to 53 percent. [See chart, p. 26.]

Top HEDGE FUND MANAGERS in Dallas-Fort Worth

Name	Assets Under Management (billions)	National Rank
MAVERICK CAPITAL	\$9.6	14TH
HBK INVESTMENTS	\$5.6	38TH
CARLSON CAPITAL	\$4.7	50TH



(Source: Alpha magazine, 2005)

» THE TAKEAWAY

- 1 Dot-coms were the '90s version of what hedge funds are today.
- 2 Individual investors still outnumber institutional ones—for now.
- 3 The Bass family has left a hedge fund legacy.

One reason hedge funds have grown is that they have a low barrier to entry. Anyone can quit his current job and open a hedge fund. Hedge funds require no real estate, little in the way of equipment (perhaps a couple of computers), and not much staff. It costs a lot more to open a McDonald's.

Hedge funds also have grown because generous compensation systems attract talent. Before the advent of hedge funds, fees had been falling in the institutional investment arena, driven by low-cost index funds with management fees of less than 0.15 percent a year. Then came the hedge fund, not only reversing this trend but also spurring fees to unprecedented levels. Hedge fund management fees today typically range from 1 percent to 2 percent annually, plus managers get a percentage of the profits—typically 20 percent, but sometimes as high as 50 percent.

In the June 2006 issue of *Vanity Fair*, one trader at a large hedge fund attested, "I can list a hundred people I know personally who made over \$100 million last year." This claim is almost certainly an exaggeration, but there are a significant number of well-paid hedge fund managers, as the average

take-home pay of *Alpha* magazine's best-paid hedge fund managers in 2005 was \$363 million.

What is it about the DFW economy that has attracted hedge funds?

Most people attribute this growth to the "Bass effect." The Bass family—beginning with Sid and Perry and later Perry's sons Sid, Lee, and Edward—has been involved in hedge fund-type investing for many years. When hedge funds became popular, many people who had worked with the Bass family had the skills and knowledge required to launch hedge funds. Their specialized knowledge and experience has served as a kind of incubator for the continued growth of hedge funds in North Texas.

As with any investment product, there are good funds and not-so-good funds. Dallas has been home to several funds that, in recent years, have done very well. Three of the 50 largest U.S. hedge funds are in Dallas [see table, p. 24] and manage billions of dollars each.

You may be curious what these firms do and how they invest their money. Unfortunately, hedge funds are not very forthcoming with information. Go to any mutual fund's Web site and you will find an abundance of investor information. But on most hedge fund sites, such information is hidden behind login screens for registered users. Hedge funds have frustrated the institutional investment community for years due to their lack of transparency (although the situation is improving). However, unlike mutual funds, many hedge funds still won't tell you what they hold.

PICKING A GOOD HEDGE FUND

This lack of transparency means you'll need to do a fair amount of research on any hedge fund before investing in it. Following are two steps to take, at a minimum, before pulling the trigger:

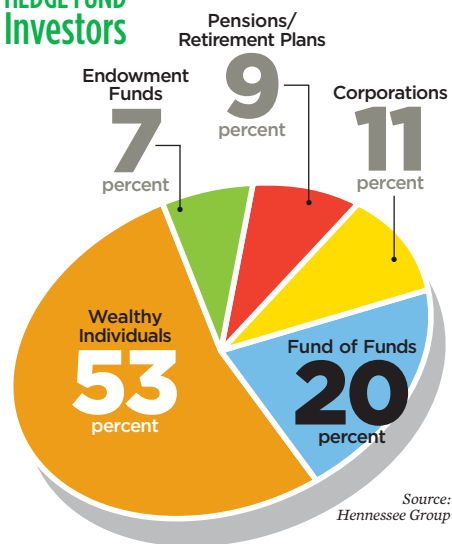
One, register with the firm and collect as much information on the firm and the fund as possible. (You may not be able to get holdings data, but any firm should be willing to explain the parameters of how they invest.)

Two, make sure you understand what type of strategy the fund follows and how much exposure the fund has to the market, as

many managers will claim that they have little market risk in their portfolio.

The most prevalent hedge funds follow equity hedge strategies that buy equities and also short them. (Shorting involves borrowing a security you do not own and selling it). These strategies can involve the use of leverage. The amount of market return in the portfolio depends on the strategy. A long/short strategy can range from 120 percent to 140 percent long and 20 percent to 40 percent short—giving 100

HEDGE FUND Investors



percent market exposure to a market neutral strategy that is 100 percent long and 100 percent short, thus offering no market exposure.

How does leverage and short-selling lower the market risk? The typical long/short hedge fund is dependent on stock selection, not the market, to make money.

Only after understanding these issues should you focus on returns. Look for funds that have produced consistent returns over time.

NOT WITHOUT RISK

Despite the fact that hedge funds offer little exposure to market risk, there are still a number of risks to consider before investing:

1. Lack of transparency. As mentioned before, unlike mutual funds, hedge funds are not required to report their holdings. You may never be able to find out what you actually are invested in.

2. Insufficient diversification. Many hedge funds take big bets. The only way George Soros was able to earn a billion dollars in his hedge fund was to take huge positions. On the flipside, Long-Term Capital Management lost more than \$2 billion in capital in 1998 alone.

3. Headline risk. A meltdown of Long-Term Capital Management proportion becomes very public, very fast. If your company pension plan has invested in a hedge fund that melts down, you may find yourself on page one of *The Dallas Morning News*.

4. Fees. Fees are guaranteed losses of your money. The higher the fee, the more your investments must earn in order for you to break even, let alone profit.

5. Liquidity. Unlike mutual funds, which can be sold any day the market is open, hedge funds may require you to tie up your funds for several years. Most require a minimum one-year "lockup" and provide only quarterly access to capital.

TAKING THE PLUNGE

If one thing is certain, it's that the hedge fund industry will continue to grow. Established New York funds like Reservoir Capital Group occasionally open offices in fertile markets like Dallas, and strong local firms like Vision Research Capital Management will undoubtedly launch every year. Like any burgeoning industry, the hedge fund industry will continue to mature.

If you're considering hedge funds as a component of your portfolio, the last thing you should do is rush to jump on the bandwagon. While the temptation to act swiftly is great, particularly if your friends are already flush with high double- or even triple-digit hedge fund returns, you're better off doing your homework and understanding the pros and cons of any one fund before investing in it. **D**



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