# History of Hedge Funds

***In an investor survey published by a consultancy firm in March 2000, a European chief investment officer (CIO), asked whether his organisation currently invested in hedge funds, was quoted saying: 'No, we don't! It is completely obvious that hedge funds don't work. We are not a casino.'[1] The survey was published at the peak of the equity bull market. While this quote was symptomatic for hedge fund investing during the equity bull market, the perception has changed materially during the equity bear market that followed. As of 2004, hedge funds were managing around US$1 trillion.***

## The beginning[2]

The official (most often quoted) starting point for hedge funds was 1949 when Alfred Winslow Jones opened an equity fund that was organized as a general partnership to provide maximum latitude and flexibility in constructing a portfolio. Jones took both long and short positions in securities to increase returns while reducing net market exposure and used leverage to further enhance the performance. Today the term "hedge fund" takes on a much broader context, as different funds are exposed to different kinds of risks.

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Other incentive-based partnerships were set up in the mid-1950s, including Warren Buffett's Omaha-based Buffett Partners and Walter Schloss's WJS Partners, but their funds were styled with a long bias after Benjamin Graham's partnership (Graham-Newman). Under today's broadened definition, these funds would also be considered hedge funds, but regularly shorting shares to hedge market risk was not central to their investment strategies.[3]

Alfred W. Jones was a sociologist. He received his Ph.D. in sociology from Columbia University in 1938. During the 1940s Jones worked for *Fortune* and *Time* and wrote articles on nonfinancial subjects such as Atlantic convoys, farm cooperatives, and boys' prep schools. In March 1949 he wrote a freelance article for *Fortune* called "Fashions in Forecasting," which reported on various technical approaches to the stock market. His research for this story convinced him that he could make a living in the stock market, and early in 1949 he and four friends formed A. W. Jones & Co. as a general partnership. Their initial capital was $100,000, of which Jones himself put up $40,000. In its first year the partnership's gain on its capital came to a satisfactory 17.3 percent.

Jones generated very strong returns while managing to avoid significant attention from the general financial community until 1966, when an article in *Fortune* led to increased interest in hedge funds. The second hedge fund after A. W. Jones was City Associates founded by Carl Jones (not related to A. W. Jones) in 1964 after working for A. W. Jones.[4] A further notable entrant to the industry was Barton Biggs. He formed the third hedge fund, Fairfield Partners, with Dick Radcliffe in 1965.[5] Unlike in the 2000-2002 downturn, many funds perished during the market downturns of

1969–1970 and 1973–1974, having been unable to resist the temptation to be net long and leveraged during the prior bull run. Hedge funds lost their prior popularity, and did not recover it again until the mid-1980s. Fairfield Partners was among the victims as it suffered from an early market call of the top, selling short the Nifty Fifty leading stocks because their valuation multiples had climbed to what should have been an unsustainable level. The call was right, but too early. "We got killed," Mr. Biggs said. "The experience scared the hell out of me."[6] Morgan Stanley hired him away from Fairfield Partners in 1973. Note that around three decades later some hedge funds also folded for calling the market too early; that is, they were selling growth stocks and buying value stocks too early.

Jones merged two investment tools—short sales and leverage. Short selling was employed to take advantage of opportunities of stocks trading too expensive relative to fair value. Jones used leverage to obtain profits, but employed short selling through baskets of stocks to control risk. Jones' model was devised from the premise that performance depends more on stock selection than market direction. He believed that during a rising market, good stock selection will identify stocks that rise more than the market, while good short stock selection will identify stocks that rise less than the market. However, in a declining market, good long selections will fall less than the market, and good short stock selection will fall more than the market, yielding a net profit in all markets. To those investors who regarded short selling with suspicion, Jones would simply say that he was using "speculative techniques for conservative ends."[7]

Jones kept all of his own money in the fund, realizing early that he could not expect his investors to take risks with their money that he would not be willing to assume with his own capital. Curiously, Jones became uncomfortable with his own ability to pick stocks and, as a result, employed stock pickers to supplement his own stock-picking ability. Soon he had as many as eight stock pickers autonomously managing portions of the fund. In 1954, he had converted his partnership into the first multimanager hedge fund by bringing in Dick Radcliffe to run a portion of the portfolio.[8] By 1984, at the age of 82, he had created a fund of funds by amending his partnership agreement to reflect a formal fund of funds structure.

Caldwell (1995) points out that the motivational dynamics of Alfred Jones' original hedge fund model run straight to the core of capitalistic instinct in managers and investors. The critical motives for a manager are high incentives for superior performance, coupled with significant personal risk of loss. The balance between risk seeking and risk hedging is elementary in the hedge fund industry today. A manager who has nothing to lose has a strong incentive to "risk the bank."

### The 1950s and 1960s

In April 1966, Carol Loomis wrote the aforementioned article called "*The Jones Nobody Keeps Up With.*" Published in *Fortune,* Loomis' article shocked the investment community by describing something called a "hedge fund" run by an unknown sociologist named Alfred Jones.[9] Jones' fund was outperforming the best mutual funds even after a 20 percent incentive fee. Over the prior five years, the best mutual fund was the Fidelity Trend Fund; yet Jones outperformed it by 44 percent, after all fees and expenses. Over 10 years, the best mutual fund was the Dreyfus Fund; yet Jones outperformed it by 87 percent. The news of Jones' performance created excitement, and by 1968 approximately 200 hedge funds were in existence.

During the 1960s bull market, many of the new hedge fund managers found that selling short impaired absolute performance, while leveraging the long positions created exceptional returns. The so-called hedgers were, in fact, long, leveraged and totally exposed as they went into the bear market of the early 1970s. And during this time many of the new hedge fund managers were put out of business. Few managers have the ability to short the market, since most equity managers have a long-only mentality.

Caldwell (1995) argues that the combination of incentive fee and leverage in a bull market seduced most of the new hedge fund managers into using high margin with little hedging, if any at all. These unhedged managers were "swimming naked."[10] Between 1968 and 1974 there were two downturns, 1969–1970 and 1973–1974. The first was more damaging to the young hedge fund industry, because most of the new managers were swimming naked (i.e., were unhedged). For the 28 largest hedge funds in the Securities and Exchange Commission (SEC) survey at year-end 1968, assets under management declined 70 percent

(from losses as well as withdrawals) by year-end 1970, and five of them were shut down. From the spring of 1966 through the end of 1974, the hedge fund industry ballooned and burst, but a number of well-managed funds survived and quietly carried on. Among the managers who endured were Alfred Jones, George Soros, and Michael Steinhardt.[11]

## Hedge Funds—The Warren Buffett Way

An interesting aspect about the hedge funds industry's history is the involvement of Warren Buffett, which is not very well documented as Buffett is primarily associated with bottom-up company evaluation and great stock selection. He is often referred to as the best investor ever and an antithesis to the efficient market hypothesis (EMH). According to Hagstrom (1994), Warren Buffett started a partnership in 1956 with seven limited partners. The limited partners contributed $105,000 to the partnership. Buffett, then 25 years old, was the general partner and, apparently, started with $100. The fee structure was such that Buffett earned 25 percent of the profits above a six percent hurdle rate whereas the limited partners received six percent annually plus 75% on the profits above the hurdle rate. Between 1956 and 1969 Buffett compounded money at an annual rate of 29.5 percent despite the market falling in five out of 13 years. The fee arrangement and focus on absolute returns even when the stock market falls look very much like what absolute return managers set as their objective today. There are more similarities:

- Buffett mentioned early on that his approach was the contrarian/value-investor approach and that the preservation of principal is one of the major goals of the partnership.[12] Today, capital preservation is one of the main investment goals of all hedge fund managers who have a large portion of their own net wealth tied to that of their investors. Warren Buffett's partnership had a long bias after Benjamin Graham's partnership. Selling short was not central to the investment strategy.
- Buffetts' stellar performance attracted new money. More partnerships were founded. In 1962 Buffett consolidated all partnerships into a single partnership (and move the partnership office to Kiewit Plaza in Omaha). The fact that stellar performance attracts capital is not new. Superior performance attracts capital in retail mutual funds as well as hedge funds. However, with some absolute return strategies there is limited capacity. In addition, there are manager-specific capacity constraints next to strategy-specific capacity constraints. Skilled managers are flooded with capital and eventually close their funds to new money.
- As the Nifty Fifty stocks like Avon, IBM, Polaroid, and Xerox were trading at 50 to 100 times earnings Buffett had difficulties finding value. He ended his partnership in 1969. Buffett mailed a letter to his partners confessing that he was out of step with the current market environment:

*'On one point, however, I am clear. I will not abandon a previous approach whose logic I understand, although I find it difficult to apply, even though it may mean foregoing large and apparently easy profits to embrace an approach which I don't fully understand, have not practiced successfully and which possibly could lead to substantial permanent loss of capital."*[13]

These notions sound like an absolute return investment philosophy. There are two nice anecdotes with this notion: First, in recent years some market observers were claiming that Warren Buffett finally "lost it" as he refused to invest in the technology stocks of the 1990s as he had refused to invest in the Nifty Fifty stocks three decades earlier. The lesson to be learned is that absolute return managers do not pay 100 times prospective earnings, whereas relative return managers do.[14]

Shareholders of Berkshire Hathaway were also exposed to various forms of arbitrage, namely risk arbitrage and fixed income arbitrage. Over the past decades, Warren Buffett created the image of being a grandfatherly, down-to-earth, long-term, long-only investor, repeatedly saying he invested only in opportunities he understood and implying a lack of sophistication for more complex trading strategies and financial instruments. However, there is no lack of sophistication at all. According to Hagstrom (1994) Buffett was involved in risk arbitrage (aka merger arbitrage) in the early 1980s and left the scene in 1989 when the game became crowded and the arbitrage landscape was changing. In 1987 Berkshire Hathaway invested in $700 million of newly issued convertible preferred stocks of Salomon, Inc. Salomon was the most sophisticated and most profitable fixed income trading house of the time and the world's largest fixed income arbitrage operation. Note that Long Term Capital Management

(LTCM) was founded and built on the remains of Salomon staff after the 1991 bond scandal.[15] Warren Buffett became interim chairman of Salomon after chairman John Gutfreund resigned. Hagstrom (1994) argues that “Buffett’s presence and leadership during the investigation prevented Salomon from collapsing.” Had the board, led by Warren Buffett, not persuaded U.S. attorneys that it was prepared to take draconian steps to make things right, it seems highly likely that the firm would have been indicted and followed Drexel Burnham to investment banking’s burial ground.[16]

Warren Buffett’s Berkshire Hathaway was invested in Bermuda-based West End Capital during the turbulence caused by the Russian default crisis in 1998. Berkshire contributed 90 percent of the capital raised in July 1998 to West End Capital, which attempts to profit through bond convergence investing and uses less leverage (around 10 to 15 times) than comparable boutiques. However, the investment is not sizable when compared to long-only positions. In August 1998 John Meriwether approached Buffett about investing in LTCM. Buffett declined.[17] Later Buffett offered to bail out LTCM, an offer that was ultimately declined by LTCM.[18]

Throughout his extremely successful career, Warren Buffett has had some kind of involvement in what today is called the hedge fund industry, that is, money managers seeking absolute returns for their partners and themselves while controlling unwanted risk.

## The 1970s

Richard Elden (2001), founder and chairman of Chicago-based fund of (hedge) funds operator Grosvenor Partners, estimates that by 1971 there were no more than 30 hedge funds in existence, the largest having $50 million under management. The aggregate capital of all hedge funds combined was probably less than $300 million. The first fund of hedge funds, Leveraged Capital Holdings, was created by Georges Karlweis in 1969 in Geneva and the second by Richard Elden, founder of Grosvenor Partners in 1971. The idea, back then as well as today, was to invest in the best managers that could be found, who, at the time, were concentrated in New York and included the likes of George Soros and Michael Steinhardt. Given that even the best managers had erratic swings in their performance, the idea was to smooth returns through diversification. Most industry observers classify these vehicles as the first formal fund of hedge funds structure. However, the first multi-manager programme had its origin in the United States, when Alfred Jones started allocating assets to external managers in 1954.

In the years following the 1974 market bottom, hedge funds returned to operating in relative obscurity, as they had prior to 1966. The investment community largely forgot about them. Hedge funds of the 1970s were different from the institutions of today. They were small and lean. Typically, each fund consisted of two or three general partners, a secretary, and no analysts or back-office staff.[19] The main characteristic was that every hedge fund specialized in one strategy. (This, too, is different from today.) Most managers focused on the Alfred Jones model, long/short equity. Because hedge funds represented such a small part of the asset management industry they went unnoticed. This resulted in relatively little competition for investment opportunities and exploitable market inefficiencies. In the early 1970s there were probably more than 100 hedge funds. However, conditions eliminated most.

## The 1980s

Only a modest number of hedge funds were established during the 1980s. Most of these funds had raised assets to manage on a word-of-mouth basis from wealthy individuals. Julian Robertson’s Jaguar fund, George Soros’ Quantum Fund, Jack Nash from Odyssey, and Michael Steinhardt Partners were compounding at 40 percent levels. Not only were they outperforming in bull markets, but they outperformed in bear markets as well. In 1990, for example, Quantum was up 30 percent and Jaguar was up 20 percent, while the S&P 500 was down 3 percent and the Morgan Stanley Capital International (MSCI) World index was down 16 percent. The press began to write articles and profiles drawing attention to these remarkable funds and their extraordinary managers.

During the 1980s, most of the hedge fund managers in the United States were not registered with the SEC. Because of this, they were prohibited from advertising, and instead relied on word-of-mouth references to grow their assets. The majority of funds were organized as limited partnerships, allowing only 99 investors. The hedge fund managers, therefore, required high minimum investments. European investors were quick to see the advantages of this new breed of

managers, which fueled the development of the more tax-efficient offshore funds.

Caldwell (1995) puts the date where hedge funds re-entered the investment community at May 1986, when *Institutional Investor* ran a story about Julian Robertson.[20] The article, by Julie Rohrer, reported that Robertson's Tiger Fund had been compounding at 43 percent during its first six years, net of expenses and incentive fees. This compared to 18.7 percent for the S&P 500 during the same period. The article established Robertson as an investor, not a trader, and said that he always hedged his portfolio with short sales. One of the successful trades the article mentioned was a bet on a falling U.S. dollar against other major currencies in 1985. Robertson had bought an option, limiting downside risk by putting only a fraction of the fund's capital at risk. Rohrer showed the difference between a well-managed hedge fund and traditional equity management.

Another fund worth mentioning was Princeton/Newport Trading Partners. Princeton/Newport was a little-known but very successful (convertible) arbitrage fund with offices in Princeton, New Jersey, and Newport Beach, California. Some practitioners credit the firm with having the first proper option pricing model and making money by arbitraging securities; this included optionality that other market participants were not able to price properly. For two decades to 1988, Princeton/Newport had achieved a remarkable track record with returns in the high teens and extremely few negative months. Unfortunately, Princeton/Newport was hit by overzealous government action that lead to an abrupt cessation of operations in 1988.

### The 1990s

During the 1990s, the flight of money managers from large institutions accelerated, with a resulting surge in the number of hedge funds. Their operations were funded primarily by the new wealth that had been created by the unprecedented bull run in the equity markets. The managers' objectives were not purely financial. Many established their own businesses for lifestyle and control reasons. Almost all hedge fund managers invested a substantial portion of their own net worth in the fund alongside their investors.

One of the characteristics of the 1990s was that the hedge fund industry became extremely heterogeneous. In 1990, two-thirds of hedge fund managers were macro managers, that is, absolute return managers with a rather loose mandate. Throughout the decade, more strategies became available for investors to invest in. Some of the strategies were new; most of them were not. By the end of 2001, more than 50 percent of the assets under management were somehow related to a variant of the Jones model, long/short equity. However, even the subgroup of long/short equity became heterogeneous. This diversity results in low correlation among different managers, despite the managers trading the same asset class. Low correlation among portfolio constituents then allows construction of low-risk portfolios.

The 1990s saw another interesting phenomenon. A number of the established money managers stopped accepting new money to manage. Some even returned money to their investors. Limiting assets in many investment styles is one of the most basic tenets of hedge fund investing if the performance expectations are going to continue to be met. This reflects the fact that managers make much more money from performance fees and investment income than they do from management fees. Due to increasing investor demand in the 1990s, many funds established higher minimum investment levels ($50 million in some cases) and set long lock-up periods (three to five years).

Both Julian Robertson's Tiger Management and George Soros' Soros Fund Management reached $22 billion in assets in 1998, setting a record for funds under management.[21] Both organizations subsequently shrunk in size, and Tiger ultimately was liquidated. Today, there are dozens of organizations managing more than $1 billion. Based on data from Hedge Fund Research, Inc. (HFRI) the hedge fund industry grew in terms of unleveraged assets under management of $38.9 billion in 1990 to $456.4 billion in 1999 and $889.8 billion at the end of Q3 2004.

### Hedge Funds today

There is little evidence to suggest that absolute return investing (hedge funds) is not a growth story. Growth in absolute return space is a mix of capital inflow and capital gains. It has been high over the past decade, and accelerated since equity markets peaked in 2000 and spiked in 2003 and Q1 of 2004. Three important questions are whether the stark growth is 'healthy',

whether there is a potential problem in the making, and whether the nature of growth is cyclical or structural.

In 2001 and 2002, there was the fear that money would be pulled from the hedge fund industry as soon as the equity market started to rise again. However, in 2003 we experienced a first indication that this is in fact unlikely to happen. Not only did large parts of the 2001-02 inflows remain in absolute return space, new money followed, eventually, resulting in the spike of capital inflow in 2003. This was despite equity markets rallying (temporarily). In the author's view, large parts of this capital buys into the absolute return investment philosophy and not, or to a lesser extent, into historical returns. If investors were buying historical returns, the argument is that the growth is more cyclical and less structural. However, that the main driver of the growth is a sustainable change in the perception of risk. In other words, short-term volatility matters to the long-term investor.

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## Notes

1. Ludgate Communications (2000) "The Future Role of Hedge Funds in European Institutional Asset Management".
2. Sources for hedge fund history: Peltz (1994, 2001), Caldwell and Kirkpatrick (1995), Caldwell (1995), Elden (2001), Anson (2002), and Ineichen (2003).
3. From Caldwell and Kirkpatrick (1995).
4. From Caldwell and Kirkpatrick (1995).
5. From Financial Times (2002).
6. From Financial Times (2002).
7. From Caldwell and Kirkpatrick (1995).
8. From Caldwell and Kirkpatrick (1995).
9. From Caldwell (1995), p.9
10. From Caldwell (1995), p.10
11. From Caldwell (1995), p.11
12. From Hagstrom (1994), p.3
13. From Hagstrom (1994), p.4 quoting from Train (1981), p.11
14. Assuming the stock is in the benchmark portfolio and the contribution to active risk is not negligible.
15. In August 1991, Salomon controlled 95 percent of the two-year Treasuyry notes market despite rules only permitting 35 percent of the total offering. Salomon had exceeded this limit by a wide margin and admitted to violating Treasury auction rules. From Hagstrom (1994), p. 171.
16. From Smith and Walter (1997), p.10.
17. Bloomberg News (1998).
18. Warren Buffett is the ultimate value investor. Acquiring LTCM's positions at a discount would have been a great trade, since most positions turned profitable after the '100-year flood' had settled.
19. From Elden (2001), p.48.
20. From Rohrer (1986).
21. From Elden (2001), p.49.

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