

Classifying Hedge Funds: What's in a Name?

Ted Caldwell

During the Summer Olympics of 1996, the U.S. track team produced eight gold medals with an average winning time of precisely 69.14 seconds. Of course the media didn't report this average time, because even sports novices would recognize it as an utterly useless statistic.

CATEGORY	TIME (SEC)
Women's 100 meter	10.94
Women's 4 x 100 Relay	41.95
Women's 4 x 400 Relay	200.91
Men's 4 x 400 Relay	175.99
Men's 110m Hurdles	12.95
Men's 400m Hurdles	47.54
Men's 200 meter	19.32
Men's 400 meter	43.49
Average Winning Time (seconds):	69.14

Track events, like all athletics, are segregated into appropriate peer groups. Statistics for each separate group tell us the relative achievements of the participants and provide useful averages, rankings, and comparative performance. But applying the same measures across distinctly different groups provides us with meaningless statistics.

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The major classes and subclasses of hedge funds, properly defined, are just as different from one another as the 100 meter sprint is from the 400 meter hurdles, and investors need to understand the differences before they enter the race. The classification system described in this article is unlike others in use today in that it distinguishes between hedge funds with different risk profiles, even when they may have identical legal structures and invest in the same asset classes. The system is based on the critical characteristics of strategy that most directly influence the risk and return patterns investors will likely encounter in their hedge fund investments.

SOME BACKGROUND

In 1949 Alfred Jones combined two risk-assumptive investing strategies (short selling and the use of leverage) into a *risk-averse* investing system. This is a concept that has eluded the financial media, most investors, and most investment advisors for the past half-century. It has also eluded many hedge fund managers.

Jones was not the first investor to maintain a basket of stocks sold short as a hedge against a general market decline, but he was the first to utilize this form of true hedging strategy in the legal structure of a private partnership and with performance-based compensation for the manager. Jones's "Fully Committed Fund" provided the original model from which the hedge fund industry has evolved.

The proliferation of hedge funds didn't begin until 17 years later, in early 1966, when in the midst of a major bull market the financial media finally discovered Jones's operation. But the fact that Jones conceived a *conservative* investing system was lost on most of the imitation funds that were established in the following years. They appear to have been set up primarily to invest with leverage in a bull market, and to keep 20% of their investors' profits. Most failed after the bull market turned in December of 1969.

One would think that the failure of so many of these first generation "hedge funds" would have compelled commentators to distinguish between funds that actually hedge and funds that don't. But the media and the investment world in general continued to miss the point. Funds structurally similar to Alfred Jones's have been called "hedge funds" ever since — with complete indifference as to whether or not they hedge.

This problem of misidentification has been reinforced over the

decades by the media's predictable focus on funds that utilize leverage without hedging. Such funds have predictably provided the most spectacular returns and the most spectacular failures — and they will continue to do so. Meanwhile, the less sensational but usually more attractive long-term performance of true hedge funds continues to be largely ignored.

Thus, common usage has come to characterize hedge funds as privately placed investments that use leverage and pay incentive fees to the portfolio managers, who usually have a significant portion of their own net worth in the pool. Remarkably, the use of true hedging strategies has essentially no bearing on this customary definition of hedge funds.

Structure, asset class, and strategy all play a part in hedge fund classification, but strategy is by far the most significant variable affecting the risk and return characteristics of a hedge fund. Thus the Unified Hedge Fund Classification System (pages 42–46), first published in 1996, departs from common practice by shifting the primary focus to the essential questions of strategy.

THE ESSENTIAL CONCEPTS OF HEDGE FUND STRATEGY

Modern portfolio theory argues that return is primarily a function of systemic (i.e., market) risk. This is true for market-based strategies, but long before modern portfolio theory was articulated and became widely accepted, Alfred Jones argued that his system for isolating skill would facilitate a significant increase in returns without a commensurate increase in risk, or it would facilitate equal returns with significantly less risk than is inherent in the markets.

Jones immersed himself in the concepts of how speculative tools could be combined into a conservative investing system. He measured and studied all aspects of his portfolio, and regularly quantified the separate contributions from skill and the market in detailed performance attribution studies.

No fund manager since Alfred Jones has studied this system of hedging in such depth, nor has it been necessary. The operation of a Jones model hedge fund is so intuitive for those who do it well that they have no need to conceptualize or articulate the mechanics of the system. Indeed, few Jones model managers have given much (if any) consideration to the concepts addressed by Jones. However, understanding the concepts that Jones pondered for circumventing the volatility of markets is central to understanding the proper classification of hedge funds.

In traditional investing, where securities are bought, held, and sold — but not sold short — the performance of the market is the primary determinant for the performance of the portfolio. The traditional portfolio manager's skill is relegated to the pursuit of incremental performance, relative to the performance of the appropriate market benchmark. Traditional, long-only investment strategies are *market-based strategies* because the dominant variable for performance is the market.

Jones sought to isolate skill from the directional force of the market, at least in the portion of his portfolio that he called the “fully-hedged” portion. By balancing long positions and short positions within this hedged portion of his portfolio, Jones created an approximately market neutral environment and thus succeeded in isolating the stock-picking skills of the portfolio manager. Such true hedging strategies that are designed to isolate investment skills by approximately neutralizing market volatility are *skill-based strategies*.

VALUE-ADDED VS. INSURANCE HEDGING

The advent of hedging with derivatives requires further clarification of the concept of true hedge strategies, by distinguishing between value-added hedging and insurance hedging. Buying insurance simply amounts to paying someone else to assume all or part of some risk that you don't want to retain. In the case of your home insurance, the entity that assumes the risk of loss is an insurance company that maintains sufficient reserves to cover the losses that may accrue from its aggregate assumption of homeowner risk.

Can you insure against a market decline that decimates your stock portfolio? While there is no “stockowners” insurance policy, you can acquire portfolio insurance quite easily in the derivatives markets. You simply buy a PUT option on the stock index that most closely resembles your portfolio, or you can buy a customized PUT to replicate your portfolio. Listed and unlisted derivatives offer the holder of virtually any securities portfolio the opportunity to insure against a decline in the value of those securities, while keeping the benefits of an increase in their value.

Buying portfolio insurance, like buying insurance on your home, is neither a skill-based nor a profitable venture. You are purchasing protection, and will collect only in the event of a loss, and only for the amount of loss you insured against. (The purchase of excess insurance for your home or your portfolio is not hedging, it's speculating.)

Value-added hedge strategies are forms of arbitrage that seek to profit from disparities in the value of related securities, usually baskets of related securities, regardless of the direction of the market. Value-added hedge strategies are true hedge strategies that approximately neutralize the directional force the market imposes on a given asset class. Again, with the market's influence effectively neutralized, the dominant factor in the performance of value-added (or true) hedge strategies becomes skill. Thus true hedge strategies are skill-based strategies.¹

Insurance hedging is the mitigation of market risk with *expensive strategies* that only pay off in the event of a loss in the value of securities held.

Value-added hedging is the mitigation of market risk with *skill-based strategies* that approximately neutralize the directional force of the market while pursuing profits within the hedge.

TRUE HEDGE FUNDS

The Unified Hedge Fund Classification System recognizes that the commonly accepted definition of hedge funds is based primarily on structure, and where structure is the predominant defining characteristic of a fund, such funds are called Nominal Hedge Funds. But prudence dictates shifting the focus immediately to strategy, by segregating True from Nominal hedge funds at the first level of classification. The following pages briefly review the structure and main classes of this more relevant system.

True Hedge Funds are defined as investment pools that employ value-added hedge strategies at all times with a significant portion of assets. Under this system, structural attributes are no longer defining characteristics, although they remain prevalent.

The question arises, where do we draw the line for the amount of value-added hedging that must be used before a fund is classified as a true hedge fund? I currently look for a minimum of 25% of fund assets (not capital) held "within the hedge" at all times, before recognizing a fund as a true hedge fund. Although this requirement is somewhat arbitrary, it's still quite low, and funds that don't meet this 25% hedge criterion in fact depend far more on the market than on skill for their performance and have substantially higher risk profiles than managers that comfortably fit the definition.

Actually, I chose such a low hedging requirement primarily to accommodate Alfred Jones. The requisite that only 25% of assets be held

within the hedge allows for true hedge funds to actually magnify market risk at times — which some do — while continuing to maintain a substantial portion of assets within the hedged structure. This will be explained later, but for now readers should note that this classification system does not define true hedge funds as funds that mitigate market risk at all times, although most do.

The difficulty in determining whether or not a hedge fund meets this criteria for significant value-added hedging probably explains why other classification systems avoid segregating true from nominal hedge funds. Nonetheless, from the viewpoint of hedge fund investors and advisors, this is the most important distinction to be made.

There are only three classes of true hedge funds: a) Jones model funds, b) Relative value funds, and c) Macro hedge funds. These will be examined in greater detail than the nominal hedge funds, because the nominal hedge fund classes are generally self-evident, market-based groupings.

JONES MODEL FUNDS

A number of different names have been used to describe the classic equity hedge fund based on Alfred Jones's original hedge fund model. For clarity, I began in 1995 advocating the term "Jones model funds" to describe this (numerically) largest primary class of true hedge funds.²

I define Jones model funds as simply equity funds that maintain no less than 25% of assets (not capital) within a hedged structure at all times, regardless of their legal or fee structure. Although they commonly employ leverage (long + short exposure in excess of capital) of less than 200%, leverage is not a defining characteristic, because there are a sizable minority of funds that do not use it. A small portion of Jones model funds exceed 200% leverage. Although most are privately placed investment pools, structured like Jones's to reallocate a portion of profits to the fund managers, these are no longer defining characteristics in the Unified Hedge Fund Classification System.

Most "equity hedge funds" are not Jones model funds, although this classification system is unique in making the distinction. Most equity hedge funds should be classified as nominal hedge funds under the system, because they fail to utilize significant value-added hedging.

Assets within a Jones model hedge are comprised of an equal dollar value of long and short stock positions, and thus are approximately market neutral. Although some managers use paired trading within the hedge,

it is more common for longs and shorts to be unpaired baskets of securities. Jones used the phrase “fully hedged” to describe his fund if, on rare occasions, all assets were within the hedge. Assets not within the hedge comprise net market exposure, which is expressed as a percent of capital.

Jones model funds that are always maintained as fully hedged funds (i.e., that have equal dollar amounts of long and short positions) are known as long/short funds. Although long/short funds fit well as a subclass under conservative Jones model funds, I show them as a subclass under relative value funds due to their goal of market neutrality. Many believe this is the way Alfred Jones ran his fund, but this notion is inaccurate. Jones rarely maintained a fully hedged portfolio.

CONSERVATIVE VS. AGGRESSIVE JONES MODEL FUNDS

There are two primary subclasses for the Jones model, mandated by two distinctly different sub-strategies and risk profiles.

Conservative Jones model funds always mitigate market risk by maintaining net market exposure from 0% to 100%, inclusive. Thus, any leverage employed in a conservative Jones model fund is invariably contained within the hedge. Although conservative managers have plenty of room to adjust market exposure within these parameters, the emphasis remains primarily on stock selection rather than market timing.

Aggressive Jones model funds may occasionally (or regularly) amplify market risk by exceeding 100% net market exposure, or by going net short. Thus, aggressive Jones model funds sometimes (or regularly) place greater emphasis on market timing than on stock selection. When net market exposure exceeds 100% in an aggressive Jones model fund, leverage has been utilized outside of the hedged structure.

Consider the example of a conservative and an aggressive Jones model fund, both utilizing small-cap value sub-strategies. They have the same legal and fee structures, and use the same amount of leverage, with gross market exposure (longs + shorts) at 160% of capital. The conservative fund is 100% long and 60% short, and thus has 75% of all bets within the hedge, and only 40% net market exposure. The aggressive fund is 140% long and 20% short, and thus has only 25% of its investments within the hedge, and 120% net market exposure. Whereas the conservative fund has eliminated most of the market’s influence, the aggressive fund has amplified the market. Prudence clearly dictates the segregation of these two Jones model funds into different subclasses, regardless

of their similar appearances and utilization of the same asset class.

More pointedly than in the above example, the different risk profiles of conservative and aggressive Jones model funds have been experienced by investors over the past half-century. I have searched but haven't yet discovered a single conservative Jones model fund that failed due to large investment losses (although many have faded away due to mediocre investment skills). On the other hand, numerous aggressive Jones model funds have suffered disastrous losses (as have many equity funds that don't qualify as Jones model funds). Indeed, Alfred Jones himself demonstrated the potential for enormous losses, by having more than 100% net market exposure when the bull market turned at the end of 1969.

The Unified Hedge Fund Classification System is the only classification system to recognize the distinction between conservative and aggressive Jones model funds. Making this distinction is imperative, if investment objectives and statistical benchmarks are to reflect the distinctly different risk characteristics of these two Jones model sub-strategies.

RELATIVE VALUE FUNDS

This class of true hedge funds is most often called "market neutral," but a growing number of advisors have substituted the names "relative value funds" or "arbitrage funds," for good reason. Market neutral refers to the *goal* (sometimes not achieved), whereas relative value and arbitrage describe the strategy of these funds. Because the Unified Hedge Fund Classification System is based primarily on strategy, I chose relative value as the banner head for this class of true hedge funds; the class contains numerous subclasses using different arbitrage strategies.

All relative value funds seek fully-hedged bets on the relative values of two or more securities. Many utilize dynamic models for maintaining the full hedge, and thus they are subject to model risk. Market neutrality, even when achieved, is never risk neutral, although many investors infer this.

Since the number of relative value strategies is endless, I have classified only strategies descriptive of a critical mass of funds. Each relative value strategy has its own set of risk characteristics. Because the strategies can become quite complex, and leverage plays a significantly greater role than in most other classes of hedge funds, manager selection is critical. Nonetheless, properly selected managers can provide remarkably consistent returns with no correlation to the equity markets.

Long/Short equity funds, as discussed above, are fully hedged conservative Jones model funds *having market neutrality as a goal*. This strategy demonstrates that subclasses are not necessarily mutually exclusive, because it fits under conservative Jones model funds, and also here under relative value funds.

Capital structure arbitrage only has one subclass, *convertible arbitrage*, with enough funds using the strategy to warrant classification. *Fixed income arbitrage* has two distinctly different subclasses, *mortgage arbitrage* and *non-mortgage arbitrage*.

The direction of performance (up or down) for convertible, fixed income, and mortgage arbitrage funds depends largely on the manager's ability to select and appropriately hedge the securities used. Leverage then takes over in expanding the magnitude of the performance. Broker-dealer fund managers may employ significantly more leverage in convertible arbitrage strategies than others using the strategy. The leverage employed in fixed-income and mortgage arbitrage can be enormous, and often must be to generate significant returns.

Merger arbitrage is another example of a more descriptive name replacing a common name. "Risk arbitrage" is the common name, ensconced in the nomenclature of the financial industry, but merger arbitrage is far more descriptive of this strategy. Again, the greater interest of investors prevails, and I follow the leadership of some other advisors who have adopted the name merger arbitrage for this classification.

Merger arbitrage involves the simultaneous purchase of stock in a company being acquired, and the short sale of the acquiring company, thus making a directional bet that the deal will go through. On occasion a manager may reverse the long and short positions, betting that a deal is falling apart.

MACRO HEDGE FUNDS

Macro hedge funds utilize numerous skill-based strategies to capitalize on the impact of regional and global economic change on securities, commodities, interest rates, and currency rates. Their use of leverage and derivatives tends to be enormous compared to most other classes, and the degree of hedging can vary significantly.

Some nominal hedge funds appear to operate as macro hedge funds, but fail to utilize value-added hedging at all times for a significant portion of assets, and thus they should not be recognized in this category.

The conceptual arbitrage in some macro plays (for instance, going long the dollar and short the yen) is so concentrated that it arguably does not fit the definition of value-added hedging. Such a concentrated bet would be akin to a Jones model arbitrage between just two stocks, which might very roughly neutralize the directional movements of the market. I take the position that a macro fund must contain significant allocations to strategies that clearly entail value-added hedging to be classified as a true hedge fund. The use of concentrated macro bets in addition to clear value-added hedge strategies generally creates higher levels of volatility for macro hedge funds, but can be very rewarding.

NOMINAL HEDGE FUNDS

Nominal hedge funds fit the customary, structural definition of hedge funds, but do not maintain value-added hedge strategies with a substantial portion of assets. Many of these funds can make a useful contribution to a diversified portfolio, due to their generally low correlation to the major equity markets.

The dominant factor in the performance of nominal hedge funds (as in traditional investing) is the performance of the market for the asset class in which the manager invests. This is not to imply that skill is not an important determinant in the performance of nominal hedge funds, but rather to assert that skill is rarely the *dominant* variable influencing performance. In nominal hedge funds, as in traditional investing, investment skill is relegated to the pursuit of *incremental* performance, relative to the performance of the asset class.

Short funds are classified as nominal hedge funds because value-added hedging is not central to their strategy. They seek to profit from the short sale of securities, predominantly equities. Although they have suffered in the low interest rate, bull market environment of the past five years, they may well return to favor. A short biased fund that is always net short, but always hedged with a significant basket of longs, would be a distinct subclass of aggressive Jones model funds, but one I have not shown due to insufficient numbers.

Special situation funds are often called "event driven funds." Both are reasonably descriptive terms and vague enough to apply to numerous other strategies, but special situations seems to be the less vague. *Distressed security funds* buy, and may occasionally short, the securities of companies under bankruptcy and/or reorganization. They usually have a low

correlation to the market. *Opportunistic fixed income funds* primarily acquire higher yielding debt issues, mispriced due to mitigating circumstances. *Activist investor funds* seek to raise the value of securities held (debt, equity, or other) by becoming activist shareholders.

The *emerging markets funds* classification is comprised of a broad and growing number of debt, equity, and mixed security subclasses for investing, primarily long, in the securities of developing countries. *Long equity funds* become classified as nominal hedge funds when they operate essentially as mutual funds structured to permit incentive fees and greater leverage.

USES AND LIMITING FACTORS

Although this classification system has been designed for use with hedge fund databases, the more common use will be for providing general guidance to hedge fund investors. Simply making the effort to determine how a given fund fits into the Unified Hedge Fund Classification System will help investors better understand the fund's risk characteristics.

Because fund managers sometimes lack the consistency of strategy conducive to useful classification (and investing), database managers should adopt one or more "relative fit" fields for describing how well a fund fits the system's categories. Each fund's data should be qualified and coded for whether its fit within the class is 1) statistically useful, 2) generally descriptive, or 3) roughly descriptive. Useful benchmarks for a class or subclass will necessarily exclude data from funds that are not coded as statistically useful, but benchmarks established without this effort are rendered irrelevant.

It's also important to recognize that the intent of this system is *descriptive, not prescriptive*. It was designed merely to best describe hedge fund peer groups for the benefit of investors and the utility of database managers. Managers are not expected to change what they do in order to fit a desired classification.

Determining the proper classification and relative fit of a fund rarely can be achieved by simply reviewing the offering documents. It is a labor-intensive process and, regrettably, cheap labor can't be relied upon to do it correctly. Proper classification is a process that requires familiarity with the actual operation of each fund, and as one might expect there is an inverse relationship between the quantity and the quality of data in most

hedge fund databases. The effort is rarely made to distinguish true from nominal hedge funds, and none of the published data on hedge funds has properly separated conservative from aggressive Jones model funds or both types of Jones model funds from nominal equity hedge funds. Given the enormous differences in the risk profiles of these appropriate peer groups, the effort is warranted.

The focus of different investors and advisors will require a variety of refinements at the subclass level, which further encourages the use of common classes at the higher levels. Consider the broad flexibility of our suggested equity subclasses: investment style (growth, value, mixed, trading oriented, etc.); market capitalization (large, medium, small, and micro-cap stocks); geographic (global, international, or regional); and industry sector. The information needs of different investors can be easily met by tailoring subclass data, so long as the subclasses are grouped in the context of the appropriate primary classes.

The Unified Hedge Fund Classification System is a work in progress, and suggestions are welcomed. Regardless of the difficulties in using the system, grasping the concepts utilized will better equip investors to recognize different types of hedge funds according to their different risk and reward characteristics. The benefits justify the effort.

NOTES

1. For this reason, I have argued that incentive fees for skill-based strategies are reasonable, but incentive fees for market-based strategies, and for any market-based portion of true hedge funds, should only come from the excess performance over the appropriate market benchmarks.
2. "The Jones Model," *Lookout Mountain Hedge Fund Review*, Fourth Quarter 1995, page 1.