Chapter 2

Market gravity and hedge fund aerodynamics: the prudent approach to hedge fund classification

Ted Caldwell
Lookout Mountain Capital, Inc., Tennessee

Introduction

There is only one definitive attribute that yields a clear and concise definition for hedge funds, something you may never have encountered. This chapter presents the prudent approach to defining and classifying hedge funds, based on their original and unique triumph and the only characteristic that distinguishes hedge funds from other investment pools.

Most attempts to define hedge funds (and you have probably read hundreds) focus on descriptive traits common to many hedge funds, including the following. Hedge funds are lightly regulated, privately placed investments for the very rich or large institutions. They often borrow large sums to take big risks and they pay performance fees to managers that have most of their net worth invested in the fund.

Although these characteristics generally describe what most investors and the financial media consider a hedge fund to be, they are neither unique to, nor definitive for hedge funds. In fact, hedge funds are increasingly becoming available as registered, publicly offered products for multitudes of moderately wealthy individuals. They often borrow nothing, and take remarkably little risk. Sometimes they do not pay performance fees, and sometimes the managers do not have much of their net worth invested in the fund.

In short, none of the traits (individually or collectively) most commonly used to define hedge funds, tell us what a hedge fund really is. Hedge fund definitions using these characteristics are focused primarily on structural traits and continually mislead. So what really distinguishes hedge funds from all other managed investment pools?

The single, definitive characteristic that separates hedge funds from all other managed investment pools was central to the design of Alfred W. Jones' original hedge fund in 1949. Jones combined two conventional investing strategies normally associated with taking increased risk (short selling and leverage) into something counter-intuitive. He created a risk-averse investing system, designed to insulate investment skills from the gravity of the markets. Jones' system altered the relationship between risk and return, from that normally required to invest in a given market.

Alfred Jones told his investors: 'The conservative nature of our operation [stems from] how differently we relate ourselves to the risks inherent in the stock market. [Our] unique hedging operation is merely the means for greater profit with equal risk, or equal profit with less risk than in conventional investment programmes.'[1] To fashion a clear and concise definition for hedge funds, all we must do is paraphrase what Alfred Jones told his investors (in the context of how he ran his fund):

> A hedge fund is a diversified, managed investment pool designed to extract returns from a given market, with less risk than is inherently required of traditional investors participating in that same market.

Market gravity: systemic risk & return

In the half-century following the establishment of Jones's original hedge fund, Modern Portfolio Theory[2] (MPT) evolved to provide the blueprint for institutional investing. Among other things, MPT maintains that the dominant risk and return that diversified investors acquire when investing in a market, are the systemic risk and return inherent for that market. To achieve higher returns than the market, you must accept higher risk. To secure lower risk, you must accept lower returns. In addition, MPT accurately quantifies the historical sensitivity for individual securities and whole portfolios to the gravity of the market.

Market risk in a conventional portfolio can be reduced (by going to cash), enhanced (by using leverage), or insured against (by using derivatives). Regardless, the dominant factor in the performance of assets invested in a market remains the systemic gravity of the market. Since the relationship between risk and return in traditional portfolios remains fundamentally anchored to the risk and return of the market, all traditional investing should be recognised as market-based strategies.

Consequently, a huge disconnect separates what Alfred Jones told his investors from MPT's fundamental assertion (that to achieve higher returns than the market, you must accept higher risk; and to secure lower risk, you must accept lower returns). Indeed, Jones articulated the antithesis of this, when he said his system provides the same returns with less risk, or greater returns with the same risk. Despite MPT, Jones' system did just that, and continues to do so!

The only way to reconcile the general truth asserted by MPT, and the reality of what Jones (and others that followed) actually accomplished, is by recognising superior investment skill. Yet, MPT is absolutely correct in declaring that superior investment skill is a rare commodity. A hedge fund manager may or may not possess superior investment skills. This is why the word 'designed' is such an important qualifier in my definition for hedge funds.

Hedge fund aerodynamics: a fundamental change in the risk/return profile

Alfred Jones always maintained significant assets in what he called the 'fully hedged' portion of his portfolio, where long positions were balanced by an equal value of short positions. This systematic approach allowed him to remain fully invested in the market, without being fully exposed to the systemic risk from the gravity of the market. It also shifted the attribution of returns in the fully hedged portion of the portfolio from the gravity of the markets to the investment skills of the manager.

The balance of Jones's portfolio remained exposed to the market, where returns were primarily attributable to the performance of the market. Jones always held a large number of positions in order to diversify, but he varied the net market exposure of his fund depending on his market judgment and that of his portfolio managers. Jones did not run a market neutral fund, as many believe.

Jones was remarkably advanced in analysing his portfolio exposure and performance attribution, in the era before computers and the academic tools of MPT. He quantified the contributions from market-based returns, which he attributed to market judgment (market timing), and skill-based returns, which he attributed to superior stock picking in the fully hedged portion of his portfolio. Jones even hired assistants to algebraically calculate the 'velocity' of stocks in relation to the market, to assist him in adjusting the effective valuation of stocks held long or short in the fully hedged portion of his portfolio (this is done today using beta).

Jones was not the first investor to utilise a basket of stocks sold short as a hedge against a general market decline. He was, however, the first to systematically employ this type of value added hedging[3] at all times in a managed investment pool. He used the structure of a general partnership with performance-based compensation to establish his Fully Committed Fund in 1949 and then changed it to a limited partnership shortly thereafter. The limited partnership provided the original model from which the hedge fund industry has evolved.

So, what was the aerodynamic that allowed Jones to significantly overcome the gravity of markets? Jones fundamentally altered the relationship between risk and return in the fully hedged portion of his portfolio, simply by implementing an arbitrage. The related securities of his arbitrage were a basket of under-priced stocks (held long) and a basket of over-priced stocks (sold short).

Indeed, to extract returns from a given market with less risk than traditional investors have in the same markets, all hedge funds must employ some form of arbitrage for a significant portion of their assets. In addition, a system designed to extract returns from a given market with less risk than traditional investors is the only definitive characteristic that segregates hedge funds from conventional investment pools.

So, while the definition given above is sufficient and concise for general use, I expand on it a little for the classification system at the end of this chapter:

> A hedge fund is a diversified, managed investment pool designed to extract returns from a given market, with less risk than is inherently required of traditional investors participating in that same market, by systematically employing an arbitrage strategy (or strategies) to considerably insulate investment skills from the gravity of markets.

The rationale for perpetual confusion: true versus nominal hedge funds

Clearly, my definition for hedge funds excludes a large number of funds that call themselves hedge funds, and that are regularly called hedge funds by the financial media. There is a reasonable explanation why this misleading custom came into common use, however, it does not suffice as a reasonable excuse for failing to prudently classify hedge funds.

So, how did it become common practice to define hedge funds using mostly structural characteristics (discussed at the beginning of this chapter), while neglecting the unique, fundamental shift in the risk/return profile achieved by true hedge funds?

Jones's system for fundamentally altering the relationship between risk and return for a portion of assets invested in a given market is conceptually simple, yet it is notoriously difficult for many to grasp. It is a concept that (until the millennium bubble burst) almost totally eluded the financial commentary on funds structured similarly to Jones's, which have been called hedge funds since the late 1960s. The continuing failure of the media to recognise what really distinguishes true hedge funds perpetuates confusion among the investing public.

Had Alfred Jones been running a fully hedged portfolio in 1966, when the 'Fortune' magazine unveiled his 17-year-old operation, the financial media may have acquired and held a focus on the skill-based contribution of his hedged returns. However, in fact, Jones never ran a fully hedged portfolio. Although he always maintained a significant portion of assets within the hedged portion of his portfolio, the net market exposure of his fund varied considerably over the years, depending on the market judgement of his management team.

A single article in the spring of 1966, 'The Jones Nobody Keeps Up With'[4] by Carol Loomis, triggered the first great stampede into hedge funds. This article revealed the enormous success of Jones's fund, which had handily outperformed the best mutual funds over the prior five- and 10-year periods, after deducting an inconceivable 20 per cent profit reallocation to the fund manager.

Loomis's article also provided a virtual blueprint for how to set up and run a Jones-like fund. Although his concept of hedging was discussed, readers evidently focused more on the performance, the structure and the enormous incentive fees of Jones's operation. Aspiring hedge fund managers quickly calculated the impact of 20 per cent performance fees on their incomes, particularly when they could use leverage, and the rush to set up new funds was under way. The best information indicates several hundred hedge funds were established during the next three years, but Jones's notion of maintaining a conservative investing system within a significant portion of the portfolio was clearly lost on most of the imitation funds. Many funds appear to have been set up primarily to invest with leverage in a rising market, and to keep 20 per cent of the profits. Many failed after the market turned down in December 1968.

Funds structurally similar to Alfred Jones's have been called hedge funds ever since, with complete indifference to whether or not they significantly employ strategy to isolate investing skills from the gravity of the markets. In addition, there is an uncomplicated rationale for the financial media's failure to grasp the unique and extraordinary value of true hedge funds in the years since.

The media converge on exceptions, rather than the norm, because that is what their audience wants. Funds that utilise leverage with little or no hedging have quite predictably provided the most spectacular returns, and also the most spectacular failures, so these are the funds that predictably garner the most attention. Meanwhile, the generally more attractive (but less sensational) long-term performance of true hedge funds continues to be largely ignored. Indeed, during the millennium bear market, some excellent hedge funds were actually panned in the media for preserving capital rather than producing spectacular gains.

Furthermore, many in the hedge fund industry loathe to have investors focus on what sets true hedge funds apart because the perpetuation of vague and confusing definitions serves the industry well. The value of hedge fund intermediaries is perceived to be greater when investors are less well informed. The 'friction' (ie, fees raked off at different levels) for hedge funds is enormous, making them a most attractive profit centre for multiple branches of major brokerage firms, and other intermediaries. The best information for investors rarely takes priority over the best interests of the street.

Nominal hedge funds are not excited about being recognised as having market-based strategies because it might reasonably raise questions about outperforming appropriate benchmarks before performance fees are earned. Yet, even many true hedge funds are reluctant to have investors focus on the distinction between skill-based and market-based attribution because much of their performance (and performance fees) comes from the gravity of the markets, not skill. However, these are third-generation fee issues for another piece of writing. Enough heresy for now!

It is not my goal to reverse conventional use of the hedge fund moniker, but rather to provide investors with the appropriate template for distinguishing between true and nominal hedge funds. By recognising the distinction, investors will better understand the benefits and shortcomings of both true and nominal hedge funds, and their respective subclasses.

True versus nominal: reduced risk for returns versus non-correlating returns

To construct a truly useful blueprint for classifying hedge funds, the 'Unified hedge fund classification system' (see the Appendix to this chapter), begins by drawing a proverbial line in the sand. On one side of the line, true hedge funds are divided into three logical peer groups. On the other side of the line, nominal hedge funds are divided into logical peer groups.

It should not be inferred that the distinction between true and nominal hedge funds imparts a value judgment that discounts the benefits of nominal hedge funds. The line is drawn to make the crucial distinction between two fundamentally different investing systems. Investors will find compelling investment opportunities on both sides of the line. Likewise, they will find unworthy opportunities on both sides of the line.

The two essential concepts for correctly distinguishing between true and nominal hedge funds are: skill-based investment strategies vs. market-based investment strategies, and value added hedging vs. insurance hedging.

The distinguishing feature between skill-based and market-based investing systems is the source of expected returns, assuming the random selection of securities. Thus, the expected return for a market-based strategy is equal to the performance of the appropriate market benchmark for the portfolio.

While investment skill provides incremental performance for a market-based strategy, it provides essentially all of the performance for a skill-based strategy (that is, a fully hedged portfolio, or the hedged portion of a partially-hedged portfolio). In addition, since random selection provides no skill factor, the expected return for a skill-based strategy (or the hedged portion of partially-hedged portfolio), is equal to zero. Any performance is a value-added performance, attributable to skill.

A major benefit of many nominal hedge funds is that they provide investors with low or non-correlating returns for their portfolio mix, but non-correlating returns from nominal hedge funds are still market-based returns. The skill-based returns of true hedge funds are also non-correlating. However, they fundamentally alter the risk/return profile for participation in a given market.

The advent of hedging with derivatives requires further clarification. There must be a distinction between insurance hedging (which is market-based), and value-added hedging (which is skill-based).

Buying insurance simply amounts to paying someone else to assume all or part of a risk that you do not want. To insure against a market decline that could decimate your stock portfolio, you can buy a put option on the stock index that most closely resembles your portfolio, or you can buy a customised put to replicate your portfolio. Different strategies utilising listed or unlisted derivatives (at a cost, and assuming the viability of counterparties) 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 the loss you insured against (the purchase of excess insurance for your home or your portfolio is not hedging; it is speculating).

Insurance hedging is the mitigation of market risk with expensive, market-based 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 neutralise the gravity of the market while pursuing profits within the hedge.

All 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 neutralise the directional force the market imposes on a given asset class. Again, with the market's gravity effectively neutralised, the dominant factor in the performance of value-added hedge strategies is skill. Thus, true hedge strategies are skill-based strategies.

Over the past half century, most funds that have utilised skill-based investing systems (including Jones' fund), have done so for only a portion of their assets. To draw the proverbial line in the sand, we must decide how large a portion of assets invested in skill-based strategies qualifies as a 'significant portion' to meet the definition of true hedge funds. Somewhat arbitrarily, but with considerable insight into the historical use of the system, this author chose 25 per cent of invested assets (not capital) as the minimum that must be invested in skill-based strategies, at all times, to qualify a fund as a true hedge fund. This is a very low requirement, but enough to alter the risk/return characteristics.

Recognising the definitive characteristic that set Alfred Jones's original hedge fund apart from traditional investment programmes is absolutely essential in understanding hedge funds. Prudence dictates that it is the basis for properly classifying hedge funds.

The 'Unified hedge fund classification system' (see the Appendix to this chapter) is an imperfect peer grouping scheme for an imperfect world. Initially published in 1996, it remains the only classification system to distinguish between true and nominal hedge funds. This classification system is a work in progress, and the update outlined in the following pages (version 1.6) will surely raise questions not yet sufficiently addressed. Your comments and criticism are welcomed, and may well spawn improvements to future versions.

Appendix

Unified hedge fund classification version 1.6[5]

Traditional investments

Traditional investing is characterised by the purchase, holding or sale – but not short sale – of primarily stocks, bonds and cash. The dominant variable in the performance of traditional investment management is the performance of the market. Except in rare cases, investment skills of the portfolio manager are relegated to the pursuit of incremental performance, relative to the appropriate market benchmark. Trust companies, insurance companies, mutual funds, pension funds and investment advisory accounts are the primary structures for holding traditional investment portfolios. The primary attribute for classifying traditional investments is asset class.

Non-traditional (alternative) investments

Alternative investments include all non-traditional forms of securities investing. Some major categories are: private equity and venture capital funds, real estate partnerships, oil and gas partnerships, commodities trading pools, true hedge funds, and nominal hedge funds. The primary attributes for classifying non-traditional investments vary significantly.

True and nominal hedge funds share no definitive trait, and indeed they have fundamentally different risk-return characteristics. Though they often share structural and other characteristics customarily perceived (and frequently represented in the financial media) to be definitive for all hedge funds, these characteristics are only descriptive.

The primary attribute for classifying true hedge funds is strategy, whereas the primary attribute for classifying nominal hedge funds is structure.

True hedge funds

True hedge funds are diversified, managed investment pools designed to extract returns from given markets, with less risk than is inherently required of traditional investors participating in those same markets. They do this by systematically employing an arbitrage strategy (or strategies) with a significant portion of assets (at least 25 per cent of invested assets – not capital) to considerably insulate investment skills from the gravity of markets.

True hedge funds fundamentally alter the relationship between risk and return compared to traditional portfolios invested in the same markets. Like nominal hedge funds, true hedge funds are usually offered by private placement, they usually have performance-based fees for their managers, who usually have a significant personal stake in the fund – but none of these widespread characteristics are defining characteristics for true hedge funds.

There are only three major categories of true hedge funds: (a) Jones model funds, (b) relative value funds and (c) macro hedge funds.

Jones model funds

Jones model funds are true hedge funds that invest almost exclusively in equity markets. They maintain no less than 25 per cent of invested assets within a value-added hedge structure at all times.

This original hedge fund model seeks to profit from the arbitrage between a basket of long equities and an equal value basket of short equities, maintained within the hedge at all times, but not necessarily with all assets. Any assets not within the hedge comprise 'net market exposure', which is expressed as a percent of capital.

Net market exposure (%) = (Longs – Shorts)/Capital

Throughout the 1990s, a growing number of managers set up 'equity hedge funds' that did little or no hedging. Thus, in 1995, I coined the name 'Jones model fund'[6] (with aggressive and conservative subclasses) to distinguish equity funds that systematically and significantly hedge at all times from those that do not.

Conservative Jones model funds

Conservative Jones model funds mitigate market risk at all times by maintaining net market exposure from 0–100 per cent of capital inclusively, thus keeping any leverage within the hedge. This subclass allows tremendous manager flexibility, and includes numerous subclasses characterised by the use of different equity markets, sectors, regions, styles and exposure ranges.

- *Market neutral (or 'equal long/short') equity funds* constitute a subset of conservative Jones model funds that are 'fully hedged' (ie, they hold equal dollar long and short positions; some funds also balance by beta, sector and other variables). They normally have net market exposure of zero or stay within a narrow range around zero exposure.

Aggressive Jones model funds

Aggressive Jones model funds may occasionally or regularly amplify market risk by exceeding net market exposure of 100 per cent, thus using leverage outside of the hedged structure, or by going 'net short' with negative net market exposure. Nonetheless, they maintain no less than 25 per cent of invested assets within a value-added hedge structure at all times.

Alfred Jones' original hedge fund would have been classified in this peer group.

General equity subclasses

Whereas some of the following groups are primary classes for traditional investment classification, they are secondary or lower classes under this system. These are useful subclasses for Jones model funds, as well as for nominal equity hedge funds. The subclasses listed here are neither comprehensive nor mutually exclusive, and order is a matter of preference.

- *Investment style subclasses.* Growth, value, mixed, trading-oriented, etc.
- *Market capitalisation subclasses.* Large cap, mid cap, small cap, and micro cap.
- *Geographic subclasses.* Country specific, global, international, regional or emerging markets subclasses.
- *Industry sector subclasses.* Healthcare, energy, telecommunications, technology, etc.

Relative value funds

Relative value funds seek to profit from the arbitrage between closely-related securities. Most articulate a goal of market neutrality or very low market correlation, but not all seek to fully hedge the portfolio. Strategies range from the arbitrage between highly diversified baskets of related securities, to highly concentrated arbitrage bets on the spread between two related securities. Market risk is generally minimised, but other forms of risk (notably, model risk) can be substantial. The number of subclasses utilising arbitrage strategies is virtually unlimited.

Capital structure arbitrage funds

- *Convertible arbitrage funds* go long convertible securities and short the underlying common stock.
- *Other capital structure arbitrage funds.*
- *Fixed income arbitrage funds* exploit price differentials between related fixed-income securities and/or derivatives.
- *Mortgage arbitrage funds* are primarily long mortgage-backed securities while hedging interest rate, volatility, and prepayment risk.
- *Other fixed income arbitrage (non-mortgage) funds*.

Merger arbitrage funds (risk arb)

Merger arbitrage funds specialise in 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. They sometimes reverse this strategy.

Multiple strategy arbitrage funds

A substantial number of funds utilise multiple relative value strategies, which may include a combination of the above and/or a variety of index or other derivative arbitrage strategies.

Macro hedge funds

Macro hedge funds seek to capitalise on changes in the relative values of securities, interest rates and/or currencies affected by regional or global economic change. They tend to be aggressive asset allocators, the use of leverage and derivatives tends to be substantial, and the method and degree of hedging may be highly concentrated or vary significantly.

Historically, macro hedge funds looked essentially like diversified funds of funds, with multiple sub-managers, and typically derived a significant portion of their returns from Jones model allocations within.

Due to the extreme concentration utilised in some forms of macro arbitrage (for instance, going short one currency against another), macro funds that do not clearly utilise a significant level of other value-added hedge strategies, should arguably be classified as ‘broad mandate nominal hedge funds’.

Nominal hedge funds

Nominal hedge funds fit the customary, structural description for hedge funds, but fail to employ a significant level of value-added hedging at all times. They are privately placed investments with performance-based fees for managers who often hold a significant personal stake in the fund.

Nominal hedge funds utilise market-based strategies, thus the dominant variable in their expected performance is the performance of the appropriate market benchmark. However, nominal hedge funds often make attractive allocations, by contributing returns with little or no correlation to the portfolio mix.

Short funds

Short funds seek to profit from the short sale of securities, primarily the stock of overvalued, fundamentally flawed or fraudulent companies.

- *Short-only funds* focus exclusively on the short sale of securities.
- *Short-biased funds* seek to profit primarily from the short sale of securities, but may buy securities as a hedge.

Special situations funds

- *Distressed securities funds* buy, and may occasionally short, the securities of companies under bankruptcy and/or reorganisation.
- *Opportunistic fixed income funds* purchase debt securities that are undervalued due to mitigating circumstances.
- *Activist investing funds seek* to directly impact the value of securities held by influencing other securities holders, or by becoming activist shareholders.

Emerging markets funds

Emerging markets funds encompass a broad and growing classification with debt, equity, and mixed subclasses for investing, primarily long, in the securities of developing countries.

Nominal equity hedge funds

Equity nominal hedge funds are structured as traditional hedge funds, and they may use index options or some short selling, but they do not maintain a Jones model hedged structure.

- *Unleveraged equity funds.*
- *Leveraged equity funds.*

Broad mandate nominal hedge funds

Broad mandate funds are macro or mixed strategy funds that do not employ significant value-added hedging at all times.

Other alternative investments

- Private equity and venture capital funds.
- Real estate securities.
- Oil and gas partnerships, etc.
- Commodities trading pools.

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[1] Taken from a report from Jones to the investors in his 'Fully Committed Fund,' 1961.

[2] Inclusive of the Capital Asset Pricing Model (CAPM).

[3] As opposed to insurance hedging, addressed in commentary that follows.

[4] Carol Loomis. 'The Jones Nobody Keeps Up With'. *Fortune*, April 1966, 237–247.

[5] 'Unified Hedge Fund Classification', *Lookout Mountain Hedge Fund Review*, 3rd Quarter 1996, © Lookout Mountain Capital, Inc. Version 1.6 is the May 2003 revision. Subsequent updates to this classification may be

obtained from www.Jonesmodel.info. Comments or suggestions should be sent to lkt_mtn@bellsouth.net or faxed to Lookout Mountain Capital, Inc. at (423) 821–9485.

[6] 'Jones Model Funds' LMC's Recommended Classification Name', *Lookout Mountain Hedge Fund Review*, 4th Quarter 1995, © Lookout Mountain Capital, Inc.