



## OPINION: SO YOU WANT TO BE A HEDGE FUND MANAGER

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"The best of times, the worst of times" means one thing to an English major and something else entirely to a manager entering the roiled waters of today's alternative asset market. Without a doubt, this is no time for the faint-hearted. However, for those determined to put money to work in today's market—whether a new or seasoned manager—the rules of the road have decidedly changed. The once familiar alternatives terrain has been recast in ways that seek to redefine the manner in which hedge funds have long operated. The new roadmap for running a hedge fund looks very different in a variety of critical areas.

**The Environment.** Today's challenging environment for hedge funds is different from previous economic setbacks in many, but not all, ways. While this financial crisis has outlasted any other in the memories of most active managers, impacting everything from regulatory oversight to fund structure, investor behavior has remained as predictable as ever. The fear and greed that we have seen over the past 36 months has greatly impacted the markets and hedge fund business models. Managers that offered investor-friendly terms and liquidity became the ATMs investors drew on to raise cash. The poorest performers with the most leverage and least liquidity put up gates, held onto assets and captured the violent rebound in asset prices. The manager sporting 2008 and 2009 returns that were down 14% and up 8%, respectively, is frowned upon by some when compared to the manager who is up 40% in 2009 following a dismal 50% loss in 2008. How can that be? Greed is returning, clouding memories of 2008. There is an investor for everyone. Whether you preserved capital and exhibited a controlled approach to risk and leverage or had to freeze redemptions and lock investors in, there's a good case to be made for the many investors focused on a big 2009.

**Liquidity.** Hedge fund investors today must manage a healthy preoccupation with liquidity. In many respects, liquidity has morphed into a proxy for strategy. The net effect of this transformation is that longer lockups have shrunk as investors over-value liquidity and under-invest in less liquid strategies. The irony, of course, is that some of those less-liquid strategies by definition will benefit from higher inefficiencies, wider spreads and bigger payoffs.

The lesson learned (at least one lesson) is that, going forward, so long as the most liquid strategies trade at a premium, certain less-liquid strategies stand to deliver the greatest opportunities. Investors' fixation on liquidity will force a convergence between portfolio liquidity and commensurate lockups. Why have more than a 30-day lockup period if you're heavy on equities? Look for

lockups to match the liquidity of underlying strategies in ways not seen before.

**Leverage and Risk.** The other L word, leverage, is inarguably the one common thread that strings together virtually every global crisis in recent history. It applied in the Crash of 1987 (leverage applied to portfolio insurance), Long-Term Capital Management (leverage applied to relative value) and the current crisis (leverage imposed on structured products). The only thing as egregious as the leverage pandemic was the inability of regulators to see it before it was too late. The torturous de-levering of the global capital markets was one of the most important contributors to the duration of the financial crisis. The fact is, leverage in the financial system has fueled excesses, including excessive economic growth—a lesson lost on no one. As an investor, I don't want a significant part of my hedge fund manager's strategy to rely on leverage. The bottom line: modest use of leverage will mean equally modest economic growth going forward.

That brings up the new risk paradigm. In the headlong rush leading to the financial collapse, managers and regulators alike confused measuring risk with managing it. Some of the blame falls on a preoccupation with technology, which is better than ever at capturing, aggregating and applying risk metrics and historical data at sub-millisecond speeds. An unchecked reliance on quantitative models to steer us through market ups and downs has only made matters worse. Unswerving faith in quantitative models turned out to be the slippery slope to ratcheting up the leverage. As we all discovered, quantitative models can't account for previously unobserved events. Managers in today's world must strike the right balance between applying quantitative measures (which frequently mis-value tail risk) and the human factor. Someone needs to be awake at the switch.

In an environment unlike any we've seen in recent times, unlocking the opportunities that uncertainty presents will require some important changes to how managers invest money and how they make it. Investors will demand nothing less. SkyBridge, which has raised \$2 billion since its 2006 launch, currently manages \$1.6 billion in assets.

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