Hedge Funds: Past, Present, and Future

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The author examines the history of hedge funds, outlines their structure and various styles, and analyzes past performance. Looking to the future, he believes that increased competition, institutional participation, and regulation will cause the performance of hedge funds to be lower than it has been in the past.

Hedge funds are mostly unregulated investment pools that can only issue securities privately to qualified investors. Alfred W. Jones is generally believed to have started the first hedge fund in 1949, pursuing a strategy of buying stocks and hedging the positions with short sales. Almost all hedge funds use an asymmetrical compensation structure under which the managing partner keeps 20 percent of the fund returns above a predetermined benchmark in addition to a 1–2 percent management fee. Such a fee structure makes it possible to receive extremely high compensation—in 2005, at least two hedge fund managers earned more than $1 billion each. Although funds must generate returns above the highest past value for the manager to earn additional performance fees, many underperforming funds are simply closed. Because of the high minimum investment, the limited liquidity, and the limited visibility of the strategies, due diligence can be as high as $50,000 for an investor trying to choose a hedge fund. Funds of funds have become popular as a means of diversifying those risks and sharing the costs.

Hedge funds seek inefficiencies in the market and attempt to correct them. The four most popular types of hedge funds are long–short equity, event driven, macro, and fixed-income arbitrage. Because the inefficiencies that are exploited are often small, many hedge funds use leverage to amplify the return on each decision.

Based on the CSFB/Tremont Hedge Fund Index, since 1994, hedge funds have delivered returns similar to S&P 500 Index returns but

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with lower (approximately half as much) volatility. However, investing in such a hedge fund index would have been extremely difficult. The results are based on samples that are biased by voluntary reporting and would need to be adjusted for market exposure because many funds are not fully hedged. Furthermore, many hedge funds have steady returns in normal times but can become volatile in others. Past performance can be especially misleading as a result. Finally, many illiquid securities are valued based on subjective values rather than on prices observed in the market. Despite these difficulties, the author concludes that, on average, hedge funds exhibit nonnegative alpha net of fees.

Risks associated with hedge funds include investor protection, risks to financial institutions, liquidity, and volatility. These risks are causing many regulators to call for increased scrutiny. A regulatory response must be thought through carefully, however, because all risk is not created equal. Specifically, investor protection should not be a driver of increased regulation because small investors (the main focus of the U.S. SEC) are already prohibited from investing in hedge funds. In contrast, the author believes that the risks that banking regulators are concerned about—the impact hedge funds can have on financial institutions (and on the larger economy)—although real, are exaggerated.

Furthermore, the industry itself has grown to a point that competition is eroding the ability to find profitable opportunities. As a result of these trends, the author expects the average performance to be lower and institutional investors to push for less risky positions and for greater regulation.

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