

## **Hedge Funds: What's the Debate About?**

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We have been investing in hedge funds since the late 1970s, so we have had a front-row seat as hedge funds have moved from the fringes of the investment community to a position much closer to the mainstream. This movement accelerated dramatically in 2000 as the bursting of the tech bubble forced investors to look for new sources of positive investment returns. The net result was an explosion both in the demand for hedge funds and in the supply of hedge funds. According to various commonly accepted estimates, there is now about \$1 trillion invested across a universe of 10,000 hedge funds.

The demand side of the equation is easy to explain. Hedge funds offer the potential for attractive returns, tolerable levels of volatility, and low levels of correlation with the standard stock and bond markets, especially when the standard markets are experiencing negative returns. The last attribute is particularly important, since hedge funds use short selling and other specialized strategies in the pursuit of returns that are not linked to rising markets.

Although hedge funds are often perceived as highly risky, the level of directional market risk in a hedge fund is often less than what you would find in a more traditional investment fund. Hedge fund investors are trying to avoid market-related directional risk, so they wind up assuming much higher levels of manager-specific risk. The main risk is simply the risk of disappointing results. But there are also more extreme risks, such as the risk of a “blow-up” due to investment mistakes, or the risk of fraud, theft, and related crimes. One way to mitigate these manager-specific risks is to create a “fund of funds”: a diversified portfolio of hedge funds representing a broad array of investment styles and strategies. The number of funds of funds has also increased dramatically since 2000, with many observers estimating that there may be as many as 1,000 funds of funds...