Review of *All About Hedge Funds: The Easy Way to Get Started*

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Until recently, hedge funds have been treated as if they were qualitatively different from the rest of the investment world. Perhaps because of their unique organization and pricing structure, the assumption carried over that hedge funds were immune from the principles and forces that governed traditional investment programs. One result has been a number of books that are largely categories and description of the predominant hedge fund styles and strategies with little attention paid to the body of investment management literature and concepts. Fortunately, this has been changing as more and more hedge funds and hedge fund strategies are closely linked to traditional investment organizations, strategies, and markets.

Robert Jaeger's new book, *All About Hedge Funds: The Easy Way to Get Started* (New York: McGraw Hill, 2003), places hedge funds squarely in their theoretical and historical context. This is to be expected from Mr. Jaeger, who is vice chairman and chief investment officer of Evaluation Associates Capital Markets, a leading asset management firm that invests in both traditional and alternative strategies. Mr. Jaeger rightly notes that "hedge funds are an essential part of the global financial system, not just a sideshow."

This well-written (unusual for investment books) and interesting book provides a host of insights not normally seen in the hedge fund literature. It also manages to be an interesting read with many relevant insights and anecdotes on a variety of subjects ranging from the motivation of hedge fund managers to the influence of size on performance and the construction of an ideal investment portfolio. While the book lives up to its name of providing an easy (and complete) way of getting started in hedge funds, it can also be usefully read by industry professionals and investment managers looking for an innovative way of presenting many of the hedge fund world's concepts.

The book is divided into five sections. The first is "The Historical and Institutional Context," which nicely describes the key players (investors, managers, brokers) and provides an interesting and not often told history of the hedge fund industry from its "start" with Alfred Winslow Jones in the 1940s to the industry's explosive growth that coincided (not coincidentally) with the great bull market of the past 20 years. This section also includes an interesting discussion of the influences of small size on hedge fund organization, management, portfolios, and investment strategies in comparison to larger investment management firms.

The second section, "Hedge Funds, Active Management, and Efficient Markets," provides a unique look at hedge funds from a traditional asset management framework. Specifically, Jaeger views hedge funds as a subcategory of *active investment management* in which the manager "tries to earn superior returns through a combination of diligent research, insightful analysis, savvy trading and intelligent risk management."

Jaeger evaluates hedge funds in light of the dominant frameworks of modern finance: modern portfolio theory and efficient market theory. These theories seem to preclude the types of returns shown by hedge funds, and Jaeger neatly shows their faults in excluding the emotional aspects of market behavior (fear and greed) and investment skill. He also provides an excellent and highly understandable analysis of "efficiently diversified portfolios" and the benefits of including hedge funds in a traditional portfolio mix. This section concludes with a discussion of the problems associated with cap-weighted indices, including the major problem that they are often not diversified, either in the familiar sense or in the technical sense of mean/variance optimization theory.

The third section, "The Tools of the Trade," is given over to clear-cut discussions of leverage, short selling, hedging, and futures and options strategies. One unique concept in this section is the concept of "AM/FM investing," to distinguish between "amplitude modulation strategies" (designed to win big on occasion) versus "frequency modulation strategies" (designed to win smaller amounts more often). The framework is nicely applied to discussions of long/short volatility, momentum-based strategies, and risk management.

The fourth section, "Some Operational Issues," provides a look at legal and regulatory issues and investment company structures; performance fees; and a detailed look at tax issues, a topic often neglected by writers in this area, but not by investors. This section includes discussions of the tax treatment of income and expenses, realized gain and loss, tax efficiency of hedge fund investments (a benefit that may offset the oft-cited tax drawbacks of investing in actively managed portfolios), and issues surrounding *unrelated business taxable income* (UBTI) for tax-exempt institutions.

The final section addresses the core issues in the "Menu of Hedge Fund Strategies." Individual chapters cover each of the hedge fund strategy groups and subgroups and include discussions that will prove useful to both industry professionals and educated individual investors. Even here Jaeger provides fresh insight along with excellent descriptions of the main hedge fund styles and strategies that include historical returns and extended risk analysis.

The book divides the hedge fund universe into four groups: equity hedge funds, global asset allocators, relative-value managers, and event-driven managers. Each group has several sub-strategies that are also covered in detail. This classification is intuitively appealing in differentiating hedge funds along important dimensions of trading approaches and volatility. Jaeger also uses the groups for an examination of the historical record of hedge funds compared to traditional asset classes. He shows that hedge funds do indeed provide superior risk and return characteristics compared to equity and fixed income investments over a sustained period of time. He also uses *downside volatility* (measured by average monthly loss and frequency of monthly loss) to highlight the fact that relative value and event driven strategies appear as the more risk-averse strategies.

The book includes an extensive discussion of the role of hedge funds in asset allocation portfolios, generating efficient frontiers for various combinations of hedge funds and the S&P 500 and showing that shifting money to hedge funds reduces portfolio volatility. However, Jaeger rightly points out that, while the analysis of risk is fairly robust, "the return question is more difficult," depending on how equities perform in the next few years. Jaeger takes this point and expands it into a major criticism of mean/variance optimization techniques, the favored financial tools for building diversified portfolios. He points out that these techniques make implicit assumptions about future performance that may or may not be valid, casting doubt on their conclusions.

This is characteristic of the book's tone throughout. Jaeger brings a calm, level-headed, and reasonable approach to a myriad of problematic issues in both hedge funds and general investment management. This approach will certainly help investors to sort out the inflated rhetoric (both pro and con) that surround hedge funds. It will also help finance professionals to take a more measured and reasonable approach to their function.

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