FOREWORD BY MICHAEL NOVOGRATZ

CEO OF GALAXY INVESTMENT PARTNERS



HEDGE FUNDS

What You Need to Know About Hedge Funds
But the Managers Won't Tell You

SECOND EDITION

ANTHONY SCARAMUCCI

SkyBridge Capital



OF HEDGE FUNDS

Second Edition

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ANTHONY SCARAMUCCI

WILEY

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As always to Deidre, AJ, Amelia, Anthony, Nick, and James

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Foreword

As a veteran of the hedge fund industry with over three decades of experience, I've witnessed firsthand the evolution of alternative investments. From my early days trading currencies at Goldman Sachs to running Fortress Investment Group's macro fund, and now leading Galaxy Digital in the exciting world of digital assets, I've seen the landscape transform dramatically. That's why I'm thrilled to introduce this updated edition of Anthony Scaramucci's insightful book on hedge funds and the broader world of alternative assets. When Anthony first published this book in 2012, the industry was still finding its footing after the 2008 financial crisis. Fast-forward to today, and we're navigating a completely different terrain.

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The hedge fund world has expanded far beyond its traditional boundaries, embracing new strategies, technologies, and asset classes that were barely on the radar a decade ago. Anthony brings his trademark wit and candor to demystify this complex industry. Drawing on his extensive experience, he offers an insider's perspective on what it really takes to succeed in the high-stakes world of hedge funds and alternative investments. What I appreciate most about Anthony's approach is how he breaks down key strategies, from long/short equity to global macro, while also delving into newer frontiers such as private credit, digital assets, and ESG investing.

One of the most significant changes since the book's first edition is the explosive growth of private markets. As Anthony details, private equity and private credit have become major players in the alternative investment space. The industry has evolved from simply buying distressed assets to actively shaping entire sectors of the economy. This shift has blurred the lines between hedge funds and private equity, with many firms now operating across both domains.

Another crucial development is the rise of quantitative strategies and artificial intelligence in investment management. Anthony does an excellent job explaining how these technologies are reshaping the industry, from high-frequency trading to machine learning—driven portfolio optimization.

As someone who's embraced technology in my own ventures, I can attest to the transformative power of these tools.

But this book isn't just about making money or leveraging the latest tech. Anthony also explores the human side of hedge funds—the drive, ambition, and relentless work ethic required to succeed in this competitive field. He doesn't shy away from discussing both the triumphs and pitfalls, something I've experienced firsthand throughout my career.

I particularly appreciate Anthony's insights on the changing regulatory landscape and its impact on the industry. From the Dodd-Frank Act to more recent developments, he provides a clear-eyed view of how hedge funds are adapting to increased scrutiny and compliance requirements.

As hedge funds continue to evolve in today's rapidly changing financial landscape, Anthony's book provides a timely examination of where the industry has been and where it's headed. His passion for this business shines through on every page, as does his commitment to educating investors on the potential benefits and risks of alternative investments.

Whether you're a seasoned pro or just starting out, you'll gain valuable knowledge from Anthony's analysis. He covers everything from the basics of hedge fund structures to advanced topics such as risk management and due diligence. I particularly enjoyed his case studies, which bring abstract concepts to life through real-world examples.

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In an era of unprecedented economic uncertainty, with challenges ranging from geopolitical tensions to climate change, understanding alternative investments has never been more crucial. Anthony's book provides a road map for navigating these complex waters, offering insights that are relevant to individual investors and institutional allocators alike.

I've known Anthony for years, and I can attest to his deep knowledge of the industry and his commitment to investor education. This book is a testament to that commitment, offering a comprehensive yet accessible guide to the world of hedge funds and alternative investments. I highly recommend this book to anyone looking to better understand the inner workings of hedge funds and the broader alternative investment landscape. Whether you're considering investing in these strategies or simply want to expand your financial knowledge, Anthony's insights will prove invaluable.

-Michael Novogratz

Introduction: Goin' through Changes

Hedge funds are the ultimate in today's stock market—the logical extension of the current gun-slinging, go-go cult of success.

—Peter Landau, "Hedge Funds: Wall Street's New Way to Make Money" (*New York Magazine*, 1968)

A lot can change in 12 years.

In the winter of 2012, when I first sat down to write a beginner's guide to the world of alternative assets, things were different. The top song in the world was *Rolling in the Deep* by Adele. The last Harry Potter movie was still in theaters. President Barack Obama, a former law school classmate of mine, was running for a second term in the White House, and I had just made headlines by asking him during

a town hall when he and his administration were going to "stop beating up on Wall Street."

(Google that if you ever want to see me get smacked around a little.)

Since then, we've lived through dozens of big market swings and a global pandemic. The guy from The Apprentice was president for four years. For a minute there, interest rates were as close to zero as they'd ever been, and as of this writing, they're higher than Snoop Dogg and Willie Nelson on top of Mount Everest. Drake and Kendrick Lamar are beefing. SkyBridge's AUM (assets under management) is down from its peak, which is fine with me, by the way. As we'll discuss in the pages to come, adaptability is key in the world of hedge funds, often referred to as "Wall Street's last bastion of secrecy, mystery, exclusivity, and privilege." Managers like me design strategies meant to provide returns no matter the market environment. Sometimes, those strategies—such as the big stake I've taken in Bitcoin and other cryptocurrencies these past few years, which you can read all about in several premature obituaries of my career—take a long time to pay off.

But when we hit, we hit big. For example, in 2021, TCI Fund Management posted returns of 23.3%, significantly outperforming the market. Citadel also had a standout year, with returns of 26.3%. Unlike more traditional investment vehicles, which tend to provide steady, predictable returns that go up and down with the market, hedge funds strive to

deliver superior returns with less volatility. Using complex strategies such as short selling, leverage, and derivatives, hedge funds can better adapt to bear markets than their counterparts in the mutual fund space. We tend to invest for the long term, using a big bag of financial tricks in an effort to help our clients make money no matter what is happening in the market at large.

What's in that bag, you ask?

In this fully updated and expanded edition of *The Little Book of Hedge Funds* (a book that was hailed upon its initial publication as "visionary," "wonderful," and "ahead of its time"), ¹ I'll tell you. I'll also discuss the changes that have occurred in the world of hedge funds over the past decade, a period that has included the rise of algorithmic trading, the COVID-19 pandemic and the lockdowns that followed, and major geopolitical events such as Brexit and the US-China trade war. Most importantly, we'll discuss how hedge funds can adapt to this new high-interest-rate environment, providing value to clients even as the market continues to deliver huge shocks to the industry.

In the 2012 edition of this book, I stuck with hedge funds. This time around, I'm going to branch out a little, delving into a few asset classes that have grown massively in the years since I published the first edition. We'll discuss the strange, secretive world of private equity, which involves high-net-worth individuals pooling their money to buy and

restructure companies. We'll also touch on other alternative assets such as venture capital, real estate investment trusts (REITs), infrastructure investments, and many others.

Along the way, I'll fix (and sometimes examine) some of the bad predictions I made in the first edition, and I'll include some updated wisdom from luminaries in the world of alternative assets: Leon Cooperman of Omega Advisors, Theo Phanos of Capeview Capital, and Steve Tananbaum of GoldenTree Capital Management. I'll also update all my old references and tell some fresh stories about the wild worlds of Wall Street, Washington, and a few places in between.

If you're a college student interested in the world of alternative assets, you'll find key knowledge here. The same is true if you're a beginning analyst at a financial firm, or a mid-level executive looking for pearls of wisdom you can pretend you've known for years. Even if you're a civilian who just finished binging Showtime's *Billions*, or you've always liked those fun, technical parts of Adam McKay's hilarious film *The Big Short*, you're apt to find a great deal in these pages that piques your interest.

For the next two hundred pages or so, I'll be your host—or, more accurately, your trusted resident advisor. For those of you who don't know, my name is Anthony Scaramucci, or just "Mooch" to my friends (which, if you've just purchased this book, now includes you). In 2005, I cofounded SkyBridge Capital Management, an alternative

asset management firm, which, as mentioned previously, is running approximately \$2.5 billion in total assets under management by investing in more than 20 different hedge fund managers. In 2008, at the height of the financial crisis, my partners and I founded the SkyBridge Alternatives (SALT) Conference, which has grown to become one of the premier conferences in the industry.

As the head of that conference, I have been privy to cloaked conversations among some of the most successful managers in the world of alternative assets. Some have become good friends. One of those people, Joe Dowling of the alternative investments behemoth Blackstone, was kind enough to write the foreword to this book, and several others will be quoted at length in the pages to come. Over the years, I have listened carefully to their views on the industry, observed how they have ironed out market inefficiencies through their dynamic use of alternative investment strategies, and studied the ancillary literature written on all manner of alternative assets.

What I've learned, primarily, is that some things never change. My beloved New York Mets will probably always struggle (and I'll always watch them play anyway). The smell of a nice pot of sauce cooking on Sunday will always fill me with joy. And hedge funds, my bread and butter for the past two decades, will, in my opinion, always provide a dynamic, lucrative complement to many investors' portfolios. To find out why, sit back and enjoy this newly updated *Little Book*.

After reading it, you will no longer have to shy away from conversations about *accredited* investors who allocate capital to hedge fund managers who take *two-and-twenty* by *exploiting market inefficiencies* through investment strategies (*short, hedge, leverage—oh my!*) that minimize *risk* while generating *absolute returns* ... all in the quest for *alpha*. (Don't worry, you'll learn what all of this means in this book—just keep reading.)

Seeing the Forest from the Trees

Before we can delve into the money-making secrets of hedge funds, we must first define the term. And yet, in keeping with the mysterious nature of hedge funds, there doesn't seem to be a universally accepted definition. Perhaps the reason why many experts differ on the exact definition stems back to the origins. Although we will have a detailed history lesson in Chapter Two, hedge funds earned their name because traditionally they literally hedged. Once upon a time in a faraway land, a journalist named Alfred Winslow (better known as A.W.) Jones began managing his portfolio by selecting securities to be both long and short through leverage, thus, creating a hedged portfolio.

Although some managers still hedge, many hedge funds do not. So what do they do? What do they all have in common?

There is no magic formula for defining the term, but since this is the hedge fund industry, I want you to imagine that you are back in biology or anatomy class, peering over a pig—the capitalist kind. That's right. It's time to travel back to high school. Picture it. Freshman year. Biology lab. Pig dissection day.

You are sitting on some uncomfortable wooden stool, trying to look all macho and act all cool in front of your hot lab partner, who is deathly afraid of dissecting the small, fetal pig that lies before you. You strap on your boxy goggles, pick up the scalpel, and open up the pig (of course all the while smiling at your attractive lab partner). As you make careful incision after incision, you begin to extrapolate vital components of the pig's anatomy. With every piece you discover, you are learning the sum of the pig's parts, which will ultimately provide you with a better understanding of the overall makeup of the animal.

The same technique is needed to define *hedge funds*. But instead of dissecting an animal, we are going to dissect the colloquial and controversial definitions presented over time by the experts.

Let's start with a technical definition provided by Jack Gain, president of the Managed Funds Association:

A pragmatic definition would be a private investment pool with a limited number of highnet-worth individual and institutional investors on the one hand and, on the other, a manager with the utmost flexibility. Hmm ... that definition doesn't say much, now does it? Besides, I've never been one for pragmatism. Let's keep moving.

According to the Alternative Investment Management Association's Roadmap to Hedge Funds:

A hedge fund constitutes an investment program whereby the managers or partners seek absolute returns by exploiting investment opportunities (taking risk) while protecting principal from financial loss. The first hedge fund was indeed a hedged fund.

Sounds like a good definition to me ... but let's take it further. Let's push the scalpel around a bit more. In *All About Hedge Funds*, Robert A. Jaeger defines a hedge fund as:

An actively managed investment fund that seeks attractive absolute return. In pursuit of their absolute return objective, hedge funds use a wide variety of investment strategies and tools. Hedge funds are designed for a small number of large investors, and the manager of the fund receives a percentage of the profits earned by the fund.

Now we're getting somewhere, but this extrapolation is still missing something—firsthand knowledge from a legend in the industry. As such, we need to move our scalpel over the supercapitalist's heart so that we can see the following definition from legendary hedge fund manager Cliff Asness of AQR Capital. According to him, hedge funds are:

Investment pools that are relatively unconstrained in what they do. They are relatively unregulated (for now), charge very high fees, will not necessarily give you your money back when you want it, and will generally not tell you what they do. They are supposed to make money all the time, and when they fail at this, their investors redeem and go to someone else who has recently been making money. Every three or four years, they deliver a one-in-a-hundred-year flood.

Although I may be biased toward my talented friend Cliff—who, if he weren't running AQR, might be writing comedy sketches for Jimmy Fallon or, better yet, could replace Colin Jost on *Saturday Night Live*'s "Weekend Update"—his humorous definition is chock-full of vital information about hedge funds that completes the discovery process and enables us to fully learn the sum of a hedge fund's parts.

Now, although we may never agree on a universal definition of *hedge fund*, you will notice that all four of these definitions have a few terms in common. So let's put down that scalpel and start examining the extrapolated components so that we can form our own definition.

- Alternative Asset Classification: Hedge funds live in the unique world of alternative assets, which—as the name implies—are investment vehicles other than the traditional investments of stocks, bonds, cash, or real estate. Alternative assets include other kinds of assets such as commodities, options, currencies, collectibles, convertible bonds, and emerging market debt. Just as the term *hedge fund* lacks a clear definition, so do its alternative asset parents. So when you hear the words *alternative investments* just think of anything in the investment world that is an alternative to stocks, bonds, and real estate and that utilizes alternative trading strategies such as hedging and shorting (don't worry ... we'll get to those terms a bit later).
- Absolute Returns: As an alternative investment that
 uses alternatives to stocks and bonds, the returns that
 hedge funds seek are different. Unlike mutual funds,
 which strive to outperform a relative index or benchmark such as the S&P 500 or Dow Jones, hedge funds

utilize a bevy of alternative investment strategies in order to produce positive returns regardless of market conditions and fluctuations.² In other words, the goal of hedge funds is to deliver long-term growth of capital and achieve positive returns. Hedge funds produce these "absolute returns" by investing in alternative assets (explained in a previous section) with alternative investment strategies (explained in the following section).

- Alternative Investment Strategies: In order to produce these absolute returns that are disconnected from the stock and bond markets, hedge funds rely on a wide range of diverse alternative investment strategies that seek to mitigate risk while protecting capital and maximizing returns. Although we will discuss these strategies in detail in Chapter Seven, they are classified into the following categories:
 - Long/short equity
 - Relative value
 - Event driven
 - Directional
- Managers/Partners: Just who are these magicians who employ these alternative investment strategies in the quest for absolute returns and how do they structure their funds? Primarily, hedge funds are legally

organized as limited partnerships, trusts, or limited liability companies (LLCs). Under this arrangement, there is one general partner who is equipped by the private placement memorandum to have discretion over the assets of the fund. The limited partners are the investors in the fund who are not fully liable—they are only liable for any losses that relate to their investment amounts. As such, many hedge fund managers "operate as general partners through another company as a way to avoid the unlimited personal liability, thus only exposing themselves to limited liability given the company serving as the general partner."

Oftentimes, the general partner has his own money invested in the fund. In theory, this arrangement incentivizes and motivates the manager, while comforting the weary investor, because any investment decisions and/or results will affect the manager's personal pocketbook.

A word of caution—don't invest in a manager who doesn't "eat their own cooking" and doesn't put his money alongside that of his clients or limited partners. There is nothing that concentrates the mind better than the fear of capital losses.

- Fees: How do these managers make money? Hedge fund managers typically charge two types of fees: a management fee and a performance fee. Infamously known as "two and twenty," the fees that a general partner typically makes are between 1.0% and 2.0% of the fund's assets under management *plus* 20% of the profits. Translation: if you put a million dollars into the fund, assuming the fund charges 1.5%, the annual management fee will be \$15,000. The manager is then entitled to a percentage of the profits. So let's say that the group has a gross return after the management fee of 20%. In this example, the manager gets \$40,000 and the investor gets to keep \$160,000. (We'll discuss this structure in more detail in Chapters One and Four.)
- Accredited Investors: Unlike mutual funds in which any Tom, Dick, or Harry can invest, hedge funds have historically only been available to "accredited" investors. To meet this criterion, individuals must have a minimum of \$1 million net worth (excluding the value of the primary residence) and/or make more than \$200,000 a year, while entities must have a minimum of \$5 million in total assets (or entities the owners of which are all accredited investors).

- SEC Regulation: As of the writing of this book in April 2024, hedge funds are now subject to more comprehensive regulation by the US Securities and Exchange Commission (SEC), a financial industry oversight entity. Over the past decade, regulators have intensified their scrutiny of these alternative investment vehicles to enhance transparency and protect investors. Despite the increased regulation, hedge funds still have the flexibility to invest in a broad range of traditional and nontraditional securities using diverse investing techniques. Many funds in the industry—including SkyBridge—have adapted to the regulatory environment and are working closely with regulators to ensure compliance and adopt best practices. As I've often said, my number one priority at SkyBridge—before anything else, even my morning coffee—is compliance. Without that, everything else goes out the window.
- Now let's bring the pieces all together to form a definition—a hedge fund is an alternative investment vehicle that seeks to produce absolute returns by utilizing a wide range of traditional and untraditional investment strategies that exploit market opportunities while protecting principal, preserving capital, and maximizing returns. These private investment pools are actively run by managers who typically invest