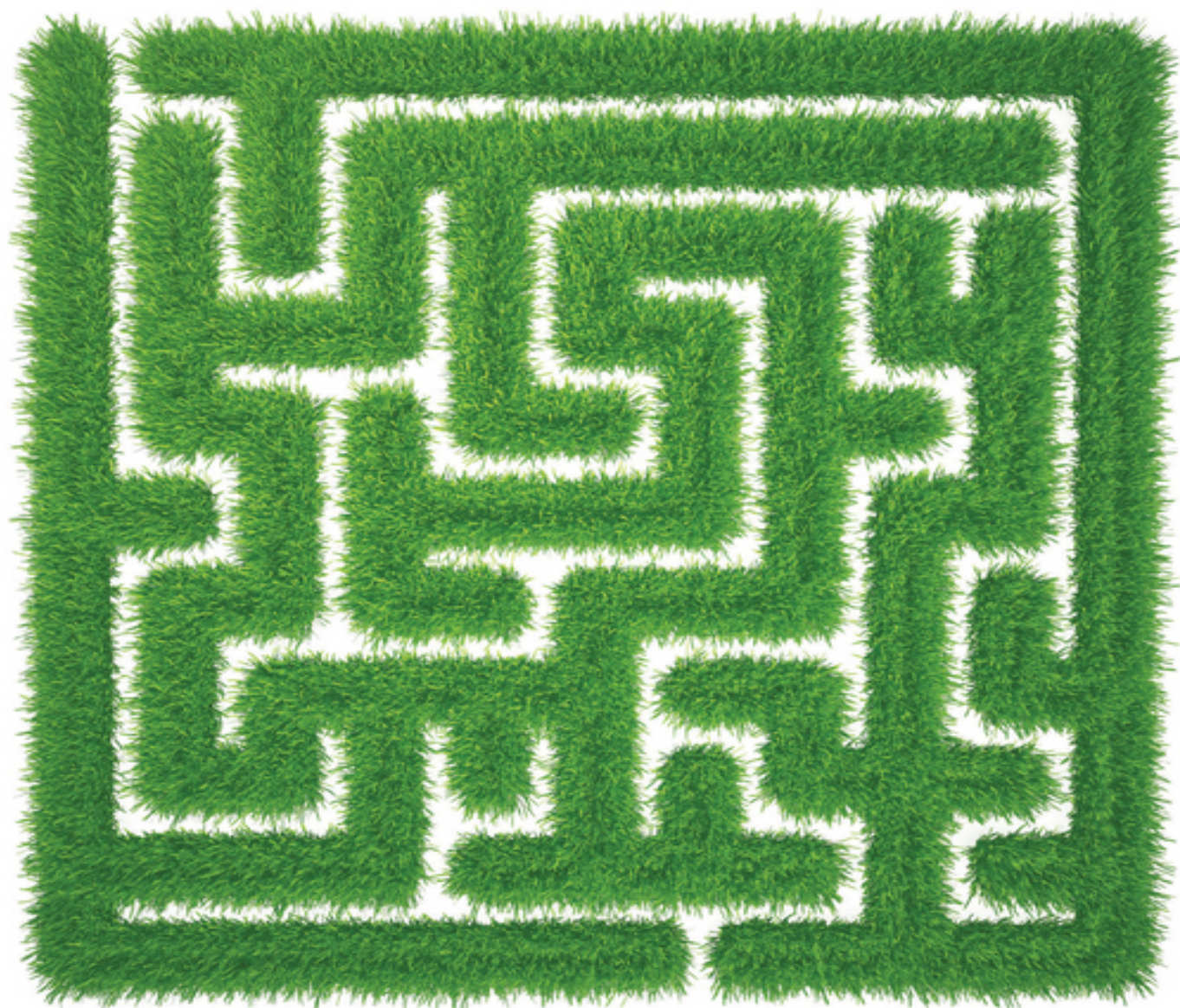


Erik Serrano Berntsen and John P Thompson



a Guide
to starting your
Hedge Fund

WILEY

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A Guide to Starting Your Hedge Fund

Erik Serrano Berntsen and John Thompson

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To Ada and Mary Grace

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their first pre-order to final delivery, thank you for not cancelling the orders. We hope to confirm that good things come to those who wait.

PART I

WHY THIS BOOK?

Chapter 1

Introduction

Beginning is half the journey.

Traditional Korean proverb

Why This Book?

When we launched our first hedge fund in 2006 we needed guidance. As a firm we had over three decades of experience in all facets of the energy industry as well as a background in management consulting and private equity. This rooted our approach in developing detailed business strategies and understanding the best practices for both young and mature businesses. What we did not have was an understanding of what it took to start and manage a hedge fund, especially a hedge fund focused on investing in energy and related commodities markets. As we looked for resources to help us fill our knowledge gap, we realized there was nothing out there.

Since those early days we have partnered with some of the best commodity traders and commodity investors to launch institutional quality asset managers. It has been a fascinating journey filled with a rollercoaster of events as varied as the 2008 Global Financial Crisis (GFC), the Bernard Madoff scandal, a day when we thought our investment bank clearers would go under, the end of Swiss banking secrecy, a deluge of new regulations, the exit of most banks from commodity trading, and a bunch of fantastic colleagues. We have also been blessed with great investors who we feel privileged to serve. Of course, along the way we have learned many lessons. Though some of

these lessons came from success (or perhaps more accurately, serendipity), the majority of the lessons we have learned were the result of mistakes we made along the way.

As we reflected back on those days of perusing bookshelves for books to help us with launching our first hedge fund, we thought it might be worthwhile to distil some of the lessons that we had learned over the years and record them. We wanted to create the book that we wished we had when we started down this path.

It was a great idea. Unfortunately, like many projects of any worth, it took much longer than we had anticipated. Thankfully, after many years, we are grateful that we can finally present this book to you.

We do not pretend that this book is exhaustive. That said, we feel it will be a useful reference tool for hedge fund practitioners. Specifically both energy commodity hedge fund managers as well as investors in such hedge funds should find it particularly useful. At least that is our hope.

The Big Picture and Energy Commodities

The amount of capital invested in hedge funds is approaching USD 3 trillion. To put that in context, the amount of capital invested in hedge funds is greater than the individual nominal 2012 GDP of France (USD 2.6 trillion), the UK (USD 2.5 trillion), and Russia (USD 2 trillion). Even the combined nominal 2012 GDP of countries like Australia (USD 1.5 trillion) and South Korea (USD 1.1 trillion) does not equal the amount of capital invested in hedge funds. In fact, the USA, China, Japan, and Germany are the only countries that on an individual basis have a nominal 2012 GDP that surpasses the amount of capital invested in hedge funds. It is anticipated that more capital

will flow to hedge funds, with total hedge fund assets under management to nearly double and hit USD 6 trillion by 2018.¹

Undoubtedly, it is an interesting time to be involved in the alternative investments industry. From the end of World War II until the present day, we have seen the growth and institutionalization of corporate and national pensions, endowments, foundations, family offices, and other similar entities responsible for directing much of the approximately USD 3 trillion that is invested in hedge funds.

With the spectre of underfunded pension liabilities looming over many developed economies, alternative investments have emerged as a preferred asset class to help generate attractive, risk-adjusted returns that ideally have minimal correlation to traditional asset classes. Indeed, for many large pensions and other large pools of capital that are under liabilities pressure, 'alternative investments' have become an increasingly important part of portfolio construction.

Within this milieu, many investors in alternatives are looking to commodities and especially energy commodities to provide attractive, uncorrelated - if sometimes volatile - returns that form one component of a larger, diversified portfolio that likely includes both traditional and alternative investments. Oil has long been traded by hedge funds and other speculative capital pools. Electricity, the fuels for generating electricity, and so-called environmental products such as emissions credits and weather derivatives have become high-profile investment strategies offering the promise of potentially high uncorrelated returns.

These high returns, however, are accompanied by volatility and risk. Additionally, few investors have experience in evaluating these investment opportunities and few

prospective hedge fund managers understand the market fundamentals and their associated risks. Many financial institutions and service providers have only begun to dedicate financial and intellectual capital to these rapidly growing investment strategies.

Case Study: Amaranth Advisors

For better or worse, the hedge fund that has become virtually synonymous with the volatility and risk related to energy commodities investing is Amaranth Advisors ('Amaranth'). Amaranth's spectacular demise in 2006, however, belied its more modest beginnings as a multi-strategy hedge fund launched in Greenwich, CT, in 2000 that was focused on convertible arbitrage opportunities. As convertible arbitrage opportunities and related profits began declining, Amaranth transitioned to an investment strategy that focused on energy commodities. Eventually, energy investing accounted for approximately 80% of Amaranth's profits, with its main fund growing to over USD 9 billion dollars by August 2006. Unfortunately, that would be the peak of Amaranth's success.

In 2004, about two years before its implosion, Amaranth hired a natural gas trader named Brian Hunter. Hunter had worked as a natural gas futures trader for both a pipeline company and then for Deutsche Bank before joining Amaranth. In 2005, Hunter was so instrumental in helping generate USD 1 billion of profits for Amaranth that it was expected his bonus might be as high as USD 100 million. Hunter's natural gas trading strategy focused on spread trades using natural gas futures. In this strategy, traders enter into long and short positions in the same underlying and benefit from the difference in pricing over time, or the *spread*. In addition to natural gas futures, Hunter overlaid call and put options on the underlying natural gas future

contracts as well as natural gas swap contracts that enhanced his core spread trade strategy using natural gas futures.

In early 2006, Hunter continued his spread trading strategy by buying natural gas futures contracts, options, and swaps for winter delivery, shorting non-winter-month gas futures, and entering similar positions via options and swaps. The maturity of these contracts ranged from 2006 until 2010. This strategy served Hunter and Amaranth well through the spring of 2006, when Amaranth's energy investments were up approximately USD 2 billion by April. In May, the long-dated natural gas future positions entered a period of volatility, although trouble was not immediately apparent.

After peaking at over USD 9 billion in August, Amaranth's main fund experienced a significant drawdown in September 2006 as the natural gas positions Hunter had taken started moving against him. By the middle of September, the fund had experienced a 50% drawdown and had a single day loss in September of USD 560 million. As the fund had difficulties meeting the ever-increasing size of margin calls, eventually market participants purchased large stakes of Amaranth's natural gas positions. The natural gas markets eventually stabilized towards the end of September 2006. Unfortunately, Amaranth's loss led to the closing of its doors and Amaranth and Hunter have been involved in a variety of regulatory investigations and legal actions since then. Amaranth, named after a flower meaning 'unfading' or 'eternal' in Greek, appears as though it will live up to its namesake, albeit for the wrong reasons.

Layout

With the hope of helping you launch a fund or invest in an energy commodities hedge fund that becomes an institutional quality asset manager and not another

Amaranth, we have organized this book in a way that we think will allow it to be used as a reference guide as different issues or topics arise. Beyond this Introduction, comprising [Part I](#), the book has four further parts and a series of appendices.

[Part II](#) provides the basics and background of hedge funds, energy commodities, and trading energy commodities. [Part III](#) delves into the key areas of starting a hedge fund with the focus on a sound business plan, the legal requirements of starting a hedge fund, and working with service providers such as prime brokers and administrators. [Part IV](#) focuses on the nuts and bolts of running an investment management firm by exploring topics of fundraising and operations. [Part V](#) concludes with points that hedge fund investors should consider when adding an energy commodity hedge fund to their portfolio, as well as thoughts we have had on the future of energy commodity hedge funds. The appendices include outlines of a sample business plan, an offering memorandum (also referred to as a private placement memorandum or PPM), and a due diligence questionnaire.

The Beginning

We have come a long way since trying to figure out how to launch our first energy commodities hedge fund almost a decade ago. Like us, the alternative investments industry, and hedge funds in particular, have come a long way in the last few years. We hope the beginning of this journey for you ends up being as rewarding as it has been for us. It is an incredible time to be part of an exciting and dynamic industry. Although the hedge fund industry has matured considerably since Alfred Winslow Jones started the first hedge fund in 1949, perhaps a review of the past is the best place to begin your journey.

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¹ Citi Investor Services, *Opportunities and Challenges for Hedge Funds in the Coming Era of Optimization, Part 1: Changes Driven by the Investor Audience*, 2014.

PART II

THE BASICS

Chapter 2

What Is a Hedge Fund?

Ever wonder why fund managers can't beat the S&P 500? Cause they're sheep and the sheep get slaughtered.

Michael Douglas as Gordon Gecko, *Wall Street*

I Already Know What a Hedge Fund Is

If you are reading this book, you are likely already familiar with hedge funds. Accordingly, you might wonder why this chapter was included. At one level, this chapter was written for those new to the hedge fund universe who may find themselves reading this book. For these readers, this chapter can serve as an informative standalone section, or as a foundation for the more technical topics that will be covered later.

We think this chapter is also important for readers with more experience in dealing with hedge funds. Although the factual information itself may not be new to you, we try to present the information in a way that conveys the importance of perspective, which is a theme throughout this book.

Depending on your perspective, a hedge fund can represent different things. For the trader that recently started a hedge fund, it is more than just a technical definition. It represents a new business venture where very likely a large portion of a hedge fund founder's personal wealth and all of their personal reputation is invested. For the university endowment or asset manager who has placed money with a hedge fund, it can represent an investment in an asset class. To a lawmaker or regulator, a

hedge fund is a nebulous, sometimes polemical component of the financial ecosystem. Of course, the general public's perception of hedge funds probably lies somewhere between a complete unawareness of them or and believing that hedge funds are populated by the likes of Gordon Gecko, the 'greed is good' character featured in the movie *Wall Street*.

A Little Bit of History

To the average person, hedge funds occupy the rarefied air of high finance populated by brash 'masters of the universe' whiz kids and erstwhile rocket scientists more interested in plying their numeric genius chasing dollars than conquering space. The glamour associated with hedge funds belies their more humble roots.

In 1949, at the age of 48, Alfred Winslow Jones launched what would become known as the first hedge fund by raising \$60,000 to supplement the \$40,000 he personally invested. With the princely sum of \$100,000, Jones launched his investment firm, eponymously named A.W. Jones & Co. In terms of 2012 dollars, A.W. Jones & Co. was launched with slightly less than \$1 million. Six decades later, A.W. Jones & Co. still exists, having evolved into a fund of hedge funds, now managing close to \$300 million.

In terms of age, background, and interests, Jones does not fit the image that most have when thinking of the modern-day hedge fund manager. He started in finance at a late age and his background does not suggest any extraordinary quantitative aptitude. Indeed, for much of his life it seems that Jones was not motivated by making money, but was more focused on trying to understand the world and make it a bit better.

Jones was born to American parents in Melbourne, Australia. His family returned to the USA when he was four. After graduating from Harvard in 1923, Jones worked on a tramp steamer sailing all over the world before becoming a diplomat with the US Department of State. He eventually left the State Department and returned to school, receiving a PhD in sociology from Columbia in 1941. An article based on his PhD dissertation examining the zeitgeist of 1930s industrial workers in Akron, OH, was published in *Fortune*, eventually leading to a job there.

For most of the 1940s, Jones was a journalist at *Fortune* where he wrote on a wide variety of topics that largely had nothing to do with finance. In the first nearly 50 years of his life, the father of the hedge fund industry had been a student, sailor, diplomat, and journalist. Until this point, nothing in Jones' life indicated any special interest in the world of finance. This would change in 1949.

In early 1949, Jones wrote an article for *Fortune* entitled 'Fashions in Forecasting', where he profiled a number of investors and their respective investment methodologies. The process of researching and writing the article (available on the A.W. Jones & Co. website) seemingly inspired Jones, and with the aforementioned \$100,000 he formed A.W. Jones & Co., an investment partnership that returned 17.3% in its first year. Not bad for a near 50-year-old journalist with a PhD in sociology.

But Jones' journey did not stop there. During the latter part of his life Jones worked with the Peace Corps, and at one point attempted to start a programme where young people from developing countries would come to the USA and serve as a cadre of Peace Corp-type volunteers working in the neediest areas of the country. The ethos of the curious, idealistic student who walked from Harvard Yard on to a

freighter seemingly never faded, even after his years as an investor on Wall Street.

So What Is a Hedge Fund?

In her 1966 *Fortune* article 'The Jones Nobody Keeps Up With', Carol Loomis, a near-legendary figure at *Fortune*, wrote a profile on Jones and his firm. Her article describes Jones' path from sociology to Wall Street and the unique characteristics of his firm that have come to shape modern-day hedge funds. Indeed, it was Loomis' article that initially coined the phrase 'hedge fund'.

The management and investment practices employed by Jones served as the original template for other hedge funds that followed. Though today's hedge funds may only subscribe to the following in varying degrees, the below factors are still worth noting.

1. **Organizational structure.** A.W. Jones & Co. was formed as a partnership composed of general partners (GPs) and limited partners (LPs). Most hedge funds are constructed the same way today. GPs serve as managers of the fund and are responsible for investing its capital. Additionally, like Jones, GPs often invest a substantial amount of their own personal wealth in their funds. Depending on jurisdiction, GPs can be personally and severally liable for any debts or expenses incurred by the fund.

In contrast, LPs act solely as investors in the fund and generally do not have any direct responsibility for the management of the fund or decision-making responsibility regarding how the fund deploys its capital. Unlike GPs, LP liability only extends to the amount of their investment in the fund.

2. **Fees.** Besides the use of a partnership structure for his firm, Jones introduced a performance-based incentive fee of 20%. This practice of receiving a performance fee has become ubiquitous among hedge funds, evolving to be embodied in the phrase '2 and 20'. The '2' refers to the management fee (2% of all invested capital that the fund manager uses to cover administrative and operational costs such as office space, computers, and salary); '20' indicates the performance fee (20% of all profits that the fund generates). Sometimes the performance fee is taken only after a specified hurdle rate has been achieved and frequently only when a high-water mark has been surpassed.

Although '2 and 20' is standard in the hedge fund industry, fee structure has become an important point of negotiation when investors place their capital with a fund. Different management and performance fees can be negotiated. For example, a fund may take a smaller management fee in return for a performance fee higher than 20%, or if an investor is willing to agree to a longer lock-up period for their capital. That said, '2 and 20' is considered an industry standard fee structure from which to commence bargaining, if any.

3. **Leverage.** Jones employed leverage to purchase a greater number of shares for companies he was optimistic about. Though using leverage was not completely unique at the time, using leverage to magnify returns was not a common practice among long-only mutual funds. Depending on investment strategy, leverage is still commonly used by hedge funds today.
4. **Short selling.** Jones used short selling to decrease the risk implicit in his portfolio. By selling shares, Jones helped manage his portfolio against the vagaries of the market, that the performance of his portfolio was driven

by the stocks he had picked. This allowed him to protect, or 'hedge', his portfolio. Jones focused his hedging efforts on reducing market exposure with the aim of making the performance of his fund more correlated to his selection of equities, and less a function of overall market performance.

The short selling practiced by Jones underlies what is commonly referred to as a long/short strategy, which describes the approach of many hedge funds today. There are funds, however, that choose not to hedge their positions at all, either through short selling or otherwise, and no longer follow Jones' footsteps on this point. Additionally, some funds use short selling to take risk as opposed to mitigating risk. For example, short selling is used by funds to profit when they feel a company will decline in value.

Jones coined his newfound concept as a 'hedged fund' all those years ago denoting some protection from the overall market. Today, some hedge funds are not actually hedged, although many of their investors may think they are and so they benefit from the original nomenclature.

As noted previously, modern-day hedge funds may differ on some of the points listed above, although these four factors originally found in A.W. Jones & Co. served as the archetype for hedge funds as the industry evolved post-1949. Additionally, many hedge funds share the following three characteristics that have emerged as hedge funds have matured.

1. **Hedge funds are considered alternative investments.** Compared with traditional investments such as equities or bonds, hedge fund investments belong to the universe of so-called 'alternative' investments. This world is also home to private equity

and venture capital investments. The main features of alternative investments include:

- they are not traded on a public market, which decreases their liquidity and increases their valuation complexity;
- they have inflexible redemption policies with longer lock-ups;
- the use of leverage to magnify returns often plays an important role in their strategy;
- there are regulatory restrictions around their eligible investor base and the nature of their advertising;² and
- there is still generally little regulation around fee levels and structures, which tend to be performance rather than asset-based.

2. **Hedge funds are focused on absolute returns.** As we saw in our review of the origin of hedge funds, one of the original objectives of their distinct investment strategy was to decrease exposure to the general market. A major selling point of hedge funds is their promise of absolute returns – positive returns independent of market performance.

This objective – and promise – is in stark contrast to the relative return objectives of traditional investments. A relative return measures how well an investment has performed against a benchmark, and the investment is deemed to have met its goal if it has performed better relative to that benchmark. For example, if a fund aims to deliver higher relative returns than the stock market, fund performance of -5% in a year when the stock market drops 10% is deemed successful by only having lost 5% of its value relative to its benchmark. Many would argue that relative return objectives are not

particularly compelling. As a well-known industry saying goes, you can't eat relative returns.

It is worthwhile to point out that although hedge funds are focused on absolute returns, hedge funds are frequently included in investor portfolios for diversification purposes. In particular, energy commodity hedge funds can serve a diversifying role in a balanced portfolio.

- 3. Hedge funds value information.** Hedge funds are typically very secretive about their operations. The financial press has sometimes interpreted this behaviour as Machiavellian. This is not entirely justified, however, as it is reasonable that hedge funds are reluctant to share information about their investors, size of assets under management, and trading and investment strategies. It is logical to protect one's edge, bearing in mind that diffusion of proprietary information could erode it.

Hedge Funds (Un)Defined

Thus far, we have listed some important characteristics that describe aspects of many hedge funds. We realize, however, that a definition has not been offered. This is because a universally accepted definition of a hedge fund does not exist. Indeed, if one were to ask a group of hedge fund managers to define what a hedge fund is, a series of similar, partially overlapping answers would emerge, but it would be unlikely any were exactly the same.

This is partly because there are various types of hedge funds that use different types of investment strategies. These experiences shape how these individual fund managers define the term 'hedge fund'. Perhaps more importantly, however, is that hedge funds remain relatively

unregulated and, as such, a formal, legal definition has not emerged. Although there are restrictions on the number of investors and the types of investors that invest in hedge funds, these rules were not crafted to apply only to hedge funds. [Chapter 6](#) contains an in-depth discussion on the legal aspects of hedge fund formation and management.

Indeed, the very term 'hedge fund' may actually be a misnomer. The hedging nature of the original hedge funds was a defining characteristic for naming purposes, but probably not appropriate from a descriptive point of view. Jones' contemporary 'hedge funds' were not focused on hedging risk; they were more focused on employing leverage.

Although a legal definition does not yet exist, government agencies and regulators have tried to describe hedge funds. In 2003, the US Securities and Exchange Commission's (SEC's) Staff Report on hedge funds defined a hedge fund as '...an entity that holds a pool of securities and perhaps other assets, whose interests are not sold in a registered public offering and which is not registered as an investment company under the Investment Company Act'.³

Those who detect the distinctly nebulous tone of the SEC will not be surprised to find that the definition has not advanced much since the SEC's 35th Annual Report in 1969. The imprecise nature of the SEC definition is part of what hedge funds are, namely investment vehicles lacking concrete classification. The SEC definition does, however, capture some of the key defining features of hedge funds. There are a number of high-level features, many of which were highlighted earlier, that most hedge funds share, and it is through these shared qualities that one can most accurately and practically define what a hedge fund is.

Unfortunately, to date, securities laws do not have an exact definition of the term 'hedge fund'. Admittedly, there has

been increased regulatory focus on hedge funds following the 2008 GFC. For example, in response to the crisis, the US government passed the Dodd-Frank Wall Street Reform and Consumer Protection Act ('Dodd-Frank').

Title IV of Dodd-Frank is called 'Regulation Of Advisers To Hedge Funds And Others'. Unhelpfully, the term 'hedge funds' is only mentioned in the title but never mentioned again in the body of Title IV. This section, *inter alia*, imposes a registration requirement for hedge funds that meet certain criteria. This registration requirement did not exist before, which contributed to the perception that hedge funds operated in secrecy. For better or worse, hedge funds continue to fall under the generic definition of 'private fund' found in the Investment Advisers Act of 1940, the same Act that Jones referenced when he started his firm.

So, returning to the SEC's 2003 Staff Report on hedge funds, the report offered the following hedge fund definition. A hedge fund is:

...an entity that holds a pool of securities and perhaps other assets, whose interests are not sold in a registered public offering and which is not registered as an investment company under the Investment Company Act...

Hedge fund strategies may include short selling, arbitrage, hedging, leverage, concentration, investing in distressed or bankrupt companies, investing in derivatives, investing in privately issued securities, or investing in volatile international markets.

Perhaps the broad definition offered by the SEC is apropos given the diversity of hedge funds employing varied strategies that exist today. Jones likely could not have imagined that his 1949 article on different investment