Bears should have had a fine time in the 1969 market. But some followers of the hedge concept got clobbered on their shorts while being murdered on their longs. Worse than that, the SEC is moving in as

HARD TIMES COME TO THE HEDGE FUNDS

by Carol J. Loomis

Atalanta Partners, Takara Partners, August Associates, Icarus Partners, Grasshopper Fund, Lincoln Partners, Sage Associates, Rudman Associates, Tamarack Associates, Hawthorn Partners. Most investors would not find a single familiar name in that collection or in a list of more than a hundred similar firms that could follow. Yet, all together, these firms represent an investment force capable of moving more than $1 billion in and out of the stock market. They are private "hedge funds," those unique investment partnerships which operate almost completely out of public view.

Some 3,000 investors, however, can claim a special view, for there are now that many who are limited partners in one or more hedge funds. Most of those investors are wealthy, many are important businessmen, and some today are troubled about their hedge-fund investments. Their misgivings are something new, for until lately the hedge funds looked like an investor's dream. The records they produced were consistently lustrous, and it seemed as if their structure was ideally geared to success.

That structure has three main features: first, the partnership arrangement itself, through which the managers of a fund can be compensated in such a way as to leave them highly motivated to do well; second, the use of borrowed money to obtain "leverage," a technique permitting the fund to take maximum advantage of a bull market; and third, the use of short selling as a "hedge," or protection against a bear market. The trouble that has now arisen is with the hedge, which simply did not meet last year's stern test. In general, the hedge funds were clobbered by the 1969 bear market, ending up in many cases with records that were worse than those put together by aggressive mutual funds denied the luxury of short sales.

The 1969 experience has been a rude awakening for many hedge-fund investors, and has left some of them with strong reservations about the whole concept. For the first time in their relatively short history, the funds are not growing; in fact, some have suffered large withdrawals of capital and a few have actually folded.

What remains, however, is still a big business, for in the last few years the hedge funds have both proliferated in number and exploded in size. They are still, it is true, dwarfed by their public cousins, the mutual funds, whose assets are in the $50-billion range. But the more than $1 billion the hedge funds command is of quite special interest, since it is money that is inclined to gravitate toward the more speculative stocks and, in steady pursuit of "performance," to move in and out of them with exceptional speed. Furthermore, the last couple of years have seen the formation of some twenty-odd mutual funds that are patterned after the private funds and that are commonly also identified as "hedge funds." Their presence in the market substantially extends the impact of the hedge concept.

The most interested spectator of all of this growth has been the Securities and Exchange Commission, under whose yoke the investment partnerships, because of their private character, do not now fall. For about a year, the SEC has been giving the funds a close new look, and while the commissioners have reached no conclusions, certain SEC staff members have made it supremely clear that they believe the funds should be brought under some form of regulation. The managers of the hedge funds dislike that thought in every respect, but what they most dread is the prospect of an SEC move that would prevent them from earning their compensation in the traditional way —i.e., by taking a share, usually 20 percent, of the profits earned on their limited partners' money. The glories of this arrangement, given a reasonably good stock market, explain why so many money managers have been inspired to start hedge funds. But right now the threat of SEC action—and the threat must be judged very real —is another deterrent to growth.

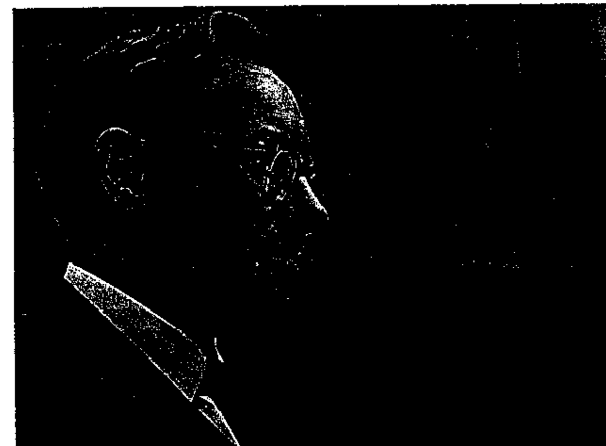
Why the crowds gathered

One man who never really wanted the growth to get this far is Alfred W. Jones, who started the first hedge funds and for years had the business to himself. Jones, after a career as a sociologist and a stretch as a FORTUNE writer in the early 1940's, established his first limited partnership, A. W. Jones & Co., in 1952. He started a second one, A. W. Jones Associates, in 1961, by which time he was celebrated among his investors for having compounded their money, over his nine-year history, at a 21 percent annual rate. Because he was running private partnerships, Jones was able to keep the dimensions of his success very quiet, and he had no imitators of any consequence until 1964, when one of his general partners—the first of several to do so—peeled off to start his own fund. Today three of the largest hedge funds, City Associates

TWO PIONEERS AND A HOT NEW TEAM

The patriarch of the hedge-fund business, Alfred W. Jones (right), sixty-nine, had his worst year ever in 1969. He says the two Jones funds misread the market and will be run more conservatively from now on. Jones himself is conservative and has done little to capitalize on his considerable fame. Some people feel he missed the boat by not building a financial empire, but he says, "That's one boat I never wanted to be on."

A standout newcomer among hedge funds is Steinhardt, Fine, Berkowitz, whose $30 million is run by (from left) Howard P. Berkowitz, twenty-nine, Jerrold N. Fine, twenty-seven, and Michael H. Steinhardt, twenty-nine. In the fund's first fourteen months, its investors realized a gain of 139 percent. In the year since, they have just broken even.



After thirteen years of outstanding success in "value" situations, Warren E. Buffett (right), thirty-nine, is closing down his $100-million Omaha operation, Buffett Partnership, Ltd. He wants to pursue other interests, and has suggested that in the current market his investors may want to retreat to municipal bonds.

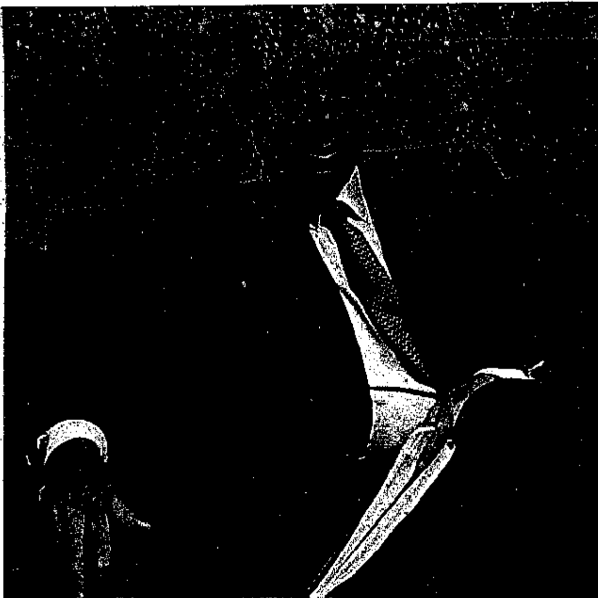
Fairfield Partners, and Cerberus Associates, each upwards of $30 million in size, are run by former Jones men. These funds are sometimes jokingly referred to as "Jones's children," though Jones apparently feels no paternal affection toward the defectors from his organization.

The real growth of the hedge funds did not begin until 1966, and it came then in the wake of a FORTUNE article on Jones ("The Jones Nobody Keeps Up With," Personal Investing, April, 1966). That article pointed out that Jones's long-term record was better than that of any mutual fund, that he had shown profits in most bear markets and pulled through even the 1962 collapse with only a small loss, and that Jones himself had become rich. These items of news were enough to create almost overnight a raft of would-be hedge fund managers, most of whom were convinced that Jones had discovered the millennium. Some who then went on to start funds now acknowledge that they paved their way into business by using the article about Jones as a sort of prospectus, relying on it for help in explaining, and selling, the hedge-fund concept to investors.

In the four years since, the number of hedge funds has grown to an estimated 150. The estimate is FORTUNE's, and it is at best wobbly, for counting hedge funds is one of the harder jobs around. Indeed, a look at some of the complications involved reveals a lot about the intriguing character of these funds.

First of all, there is some disagreement these days as to the definition of a hedge fund. Once it was not so. Alfred Jones invented the hedge fund, and therefore his style of operation provided the definition. Thus, a hedge fund was a limited partnership organized to invest in securities, with the partnership structured in such a way as to give the general partners—the managers of the fund—a share of the profits earned on the limited partners' money. Furthermore, Jones said—and still says—that a hedge fund is *always* leveraged and *always* carries at least some short positions.

Fine, except that there are all sorts of limited partnerships around these days that have obviously borrowed most of Jones's ideas, but not quite all. For instance, there are some partnerships that feel no obligation to be leveraged, or to be short. In fact, some have actually renounced one or both techniques, either because they have never felt them necessary or wise, or because they have tried them out and bombed. On the other hand, there are also partnerships around that *are* leveraged and *do* make short sales, but that have no provision for the general



SOME STARS AMONG THE LIMITED PARTNERS

With money in eight funds, Laurence Tisch, chairman of Loew's, thinks the managers learned a lesson last year. "The market," he says, "is a humbling thing."

The unquestioned champ of hedge-fund investors is Daniel J. Bernstein (below) who also heads a brokerage firm bearing his name. He, his family, and clients have around $15 million in four funds, half of it in Steinhardt, Fine, Berkowitz. Bernstein prefers his own investment judgment to that of the hedge funds, but says he farms out part of his money "to make life a little easier."

Decorating the list of investors in geles' Taurus Partners are actress Turner (top), with a $50,000 investm Deborah Kerr, with $200,000.

partners to share in the limited partners' profits. The question, then, is which of these partnerships, if any, should be thought of as "hedge funds"?

The question is plainly arguable, but it would appear that the key feature of a hedge fund is neither the hedge nor the leverage, but instead the method by which the general partners are compensated. Certainly it is this characteristic that has spurred the funds' growth and also helped arouse the interest of the SEC. Therefore it seems reasonable to count as hedge funds those limited partnerships that do not necessarily hedge and/or use leverage, but that otherwise are constructed in the Jones mold.

This definition would exclude, for example, the funds set up by brokerage houses as vehicles for commingling the accounts of several clients into a single account; the general partner, who is typically a representative of the firm, runs the account on a discretionary basis, getting his compensation from the commissions that it generates, not out of investment profits. It is not unusual, furthermore, for a family to set up an investment partnership. Last year around twenty members of the Rockefeller family and certain members of the Rockefeller staff organized the Pocantico Fund, capitalized with around $4 million. Since the general partners, however, will get no part o the limited partners' profits, this fund—and others sim ilar to it—is not under discussion here. Nor are the so called venture-capital partnerships, whose emphasis o long-term investments in new nonpublic companies make them far different from the typical hedge fund.

A beacon in Manhattan

Armed with some definition of a hedge fund, the censu taker next comes up against the enormous problem of di covering the partnerships that might fit the pattern. Suc help as there is comes from certain state laws applyin to partnerships. Typically, these laws stipulate that eve new limited partnership must file a body of informatio about itself, including the names of the partners and th amount of their investments, at some specified county o state office.

The great bulk of the country's hedge funds are l cated in New York's borough of Manhattan, and, than to a provision of the New York partnership law, can b flushed out there with relative ease. This provision r quires every new partnership to publish the substan of its official filing in two newspapers; in Manhattan, o of these is by custom always the *New York Law Journ*

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which thus provides the beacon by which essentially every Manhattan hedge fund can be located.

What the records show is that, since early 1966, when there were only a handful of hedge funds in existence, about a hundred new ones have been formed in Manhattan. Some of these have folded, but their numbers are probably roughly balanced by the funds set up in certain New York suburban areas. Inquiries in around twenty other major cities uncovered about thirty more funds, and there can be no doubt that some were missed. In total then, an estimate of around 150 hedge funds seems reasonable.

These 150 vary substantially in size and make-up. The largest are Jones's two partnerships, each around $40 million in size (for a list of some other leaders, see page 139). At the opposite end of the spectrum are a few funds capitalized with less than $100,000. Some funds have more than sixty limited partners, but the average is closer to twenty. There are even a few with only one limited partner. The most interesting of these solo acts are funds in which the limited partner is a corporation, or an arm of a corporation. For example, the NuTone division of Scovill Manufacturing Co. has invested $2,670,000 from its pension fund, of all places, in Waterbury Associates, a one-year-old venture run out of New York.

Like the funds themselves, the 3,000 or so investors who populate them come in many varieties. Their average investment works out to better than $300,000, and as the magnitude of that amount might suggest, many have names that are immediately recognizable. A good number are corporate executives: e.g., Laurence Tisch, of Loew's; Keith Funston, of Olin Mathieson; Leonard Goldenson, of American Broadcasting; Daniel Searle, of G. D. Searle; H. Smith Richardson Jr., of Richardson-Merrell; Louis "Bo" Polk, formerly of M-G-M. Another well-known businessman, Nathan Cummings, of Consolidated Foods, once held limited-partnership interests, but has recently given them up. So has actor Jimmy Stewart. However, a passel of other movie stars—Deborah Kerr, Lana Turner, Rod Steiger, Jack Palance—remain bunched in one California fund, Taurus Partners. Gregor Piatigorsky, the cellist, Pete Gogolak, the pro-football place kicker, and Thomas and William Hitchcock, scions of the Mellon family, are other examples of the diversity that is to be found among hedge-fund investors.

A watchdog for Mr. Phipps

It becomes apparent, in discussions with limited partners, that many never had any idea that their names, much less the size of their investments, were on file in some courthouse or state office building. A lot are appalled at that news. Probably out of a desire to keep what information they can confidential, the managers of some hedge funds have made their partnership filings very difficult to find. For instance, though the managing partner of Cerberus Associates, Ronald LaBow, has his office in downtown Manhattan and runs the partnership's portfolio from there, the partnership's papers are filed in suburban Westchester County, where the partnership keeps an address. In neither locality does Cerberus have a listed phone. When one finally lifts this veil, a number of prominent names turn up on the fund's list of investors, including Howard Phipps Jr., of the well-known Long Island family.

Limited partnerships are required to amend their filings whenever important changes, such as the admission of new partners, take place. The latest partnership filing by Cerberus gives mid-1968 data and shows Phipps's investment to be $2,500,000. Cerberus' record since then has been more up than down (it has been a star performer among the hedge funds) so it is likely that this investment is now larger. As a footnote, it may be recalled that in mythology, Cerberus was the three-headed dog who guarded the gates of Hell; the name, one dictionary says, also connotes "a watchful and formidable or surly keeper or guard."

The comfortless cushion

After last year's bear market the words "watchful" and "surly" might also have been used to describe certain hedge-fund investors. FORTUNE has been able to find only a very few funds—most of them under $10 million in assets—that were in the plus column for the year. Many of the larger funds had dismal records: on the first of October, when the New York Stock Exchange composite average was down by some 13 percent for the year, the two Jones funds and City Associates were down between 30 and 40 percent.

Figures compiled by John M. Hartwell, who runs a large investment-counseling firm and who has been managing two private hedge funds himself, also suggest the extent of the destruction. During the month of June, when the market, as measured by the Big Board's composite average, dropped by 6.9 percent, eight hedge funds on which Hartwell collected data (his own two were included) dropped on the average by 15.3 percent. In July, when the market fell 6.4 percent, the funds were down by an average of 10 percent. And in August, when the market bounced back briefly, the seven funds for which Hartwell had data averaged only a 4.2 percent gain, compared to a 4.5 percent gain for the composite average.

Despite the weight of this and other evidence, some hedge-fund managers have attempted to persuade their investors that 1969 wasn't really as deplorable as it might have seemed. Charles E. Hurwitz, who runs three private hedge funds in Texas and also one of the largest public hedge funds, Hedge Fund of America, reminded the shareholders of that fund a few months ago that "the hedging feature is designed to reduce losses in a downturn, not eliminate them." He also referred to the "cushioning" effect of the hedge concept during 1969. Some stockholders must have shuddered to think where they would have been without the cushion. For at the end of November, in a tabulation of 379 mutual funds prepared by Arthur Lipper Corp., Hedge Fund of America's 24 percent decline for the year left it sitting in the 340th spot. Even then, it was some distance ahead of the oldest public hedge fund, the Hubshman Fund, whose cushion had not prevented it from losing 47 percent for the year and taking firm possession of the 379th spot.

Euphoric at sixty-nine

Alfred Jones, a candid and likable man, is one hedge-fund operator who has not taken 1969 lightly. He has brooded about the year's catastrophes, and believes he can trace their causes. The trouble began, he says, in the 1966-68 period when the craze for performance swept the investment world and when all sorts of money managers, including those in his own shop, got overconfident about their ability to make money. Jones's record for this period was excellent: during his three fiscal years ending May 31, 1966, through 1968, the limited partners in A. W.

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Change Begins in the Doctor's Office *continued*

Consideration is seldom given to innovations in the system or forms of practice. Thus it is difficult for most practicing physicians to appreciate the arguments of their critical colleagues —or even to understand what they are talking about.

During their training period, doctors go through what Dr. Lewis of Harvard calls "a greater socializing process than even the priesthood." For at least seven years they spend almost all of their waking hours with other doctors or would-be doctors, not only absorbing medical information but, in Dr. Lewis' words, "learning how to act and think as well." Consciously or otherwise, most pattern themselves after the role models set by their instructors.

Humane, but also human

When they are accused of "making too much money," doctors can with some justice point to the fact that medical education is tremendously expensive—even allowing for the fact that so much of it is government-subsidized. The Association of American Medical Colleges estimates the average bill for four years of medical school at $20,000. After they get their degree, moreover, most doctors spend three or more years as interns and residents. More than 90 percent of interns and residents still receive salaries under $6,000, although some hospitals pay far more. According to a 1968 study sponsored by the Department of Health, Education, and Welfare, doctors below the age of thirty-five typically earn less than other professionals except clergymen. And this is at a time when many are still saddled with debt from their medical-school days.

Later, not surprisingly, doctors make up for the lean years with a vengeance. According to *Medical Economics*, the median net income of self-employed doctors below the age of sixty-five in 1967 was $34,700. The figure understates the income of the well-established man. For, while it excludes interns and residents, it includes young doctors just entering private practice—and many of them report net losses for a year or two. Between 1955 and 1967 physicians' median income rose a startling 117 percent—20 percent in the last two years, as medicare and medicaid poured new money into the medical marketplace. Certainly one important consideration that makes doctors oppose a reorganization of the health-care system is the fear that it may threaten their financial position. As Dr. Rashi Fein, the medical economist, recently told a congressional subcommittee, "Doctors may be humane, but they are also human."

With few exceptions, physicians are conscientious and dedicated to providing the best possible care *for their own patients*. But preoccupied with this demanding one-to-one responsibility, and limited by background and training, most are unwilling to recognize the flaws in the general system, and the unmet needs of many of their fellow citizens. The flaws, however, are now showing up everywhere—in the waiting rooms, in the hospital corridors, and in the figures on the cost of care. Change has to come. If they want to guide its direction, physicians must quickly begin to supply some leadership. As Dr. Knowles warns, "If we want to keep our profession free, we have to control ourselves, and act in the public interest." END

HARD TIMES COME TO THE HEDGE FUNDS *continued from page 108*

Jones & Co. realized gains—*after* deduction of the general partners' 20 percent of profits—of 29 percent, 22 percent, and 45 percent. In all three years, these gains (as well as those recorded by Jones's other partnership) were far superior to those made by the broad market averages. As the new fiscal year began in mid-1968, the profits continued to build up. Even Jones himself, despite his sixty-nine years, was caught up in what he describes as the "euphoria" of the times. He says he began to wonder—for him, the very thought was heretical—whether his hedging strategies, which had always been aimed at softening the effects of a potential market decline and which had therefore held back his gains in bull markets, might not have been misguided; perhaps it would have been smarter, he told himself, to have run at full risk all the time, thus taking maximum advantage of the general upward trend of the market.

It was in this frame of mind that Jones and his organization came into late 1968 and into a market top, which, of course, could not at the time be easily recognized as such. As the market slid, Jones and his portfolio managers gradually cut back their risk by building up short positions—but as he says, it was "too little, too late." By May 31, all of the early gains of the fiscal year had been wiped out. The break-even performance that Jones was obliged to report to his investors compared to a 4.3 percent gain for the Exchange's composite average, and so, for the first time in his history, Jones had finished second to the market.

Jones's reaction, other than dismay, was to involve himself more closely with the business, which in recent years had occupied less and less of his time. Included in his immediate problems was some unrest among his limited partners. One of them, in fact, had written to complain that the standard of living to which he had become accustomed was incompatible with break-even years. Jones, while he can hardly view his limited partners as on the verge of destitution—their average investment is even now around $500,000—is nevertheless sympathetic to such problems; for his funds, more than most in existence, include a large number of investors who had very little to start with and whose partnership interests now represent virtually their entire wealth. Acknowledging this, Jones now says that his funds will not in the future be trying for the big swings, but will instead aim for moderate, steady growth. ("Moderate," to Jones, if not to most people, seems to mean gains of 20 to 30 percent a year.) In his annual letter to his partners last July, Jones spelled out his thoughts a little further: "Each money manager is now fully aware of the necessity of running his segment as though the typical Limited Partner were retired and had all of his capital, say $500,000, invested in our business."

Crowding up on the short side

Jones's midyear decision to keep his short positions high, though it came at a time when the market was still heading down, did not get him out of the woods. For, as almost any hedge-fund operator can testify, it is one thing to assume short positions and another to make money on them, even in a bear market. The alleged difficulties are numerous and have been recited so often by battered short sellers that they are by now fairly well known. One is a procedural difficulty: by an SEC rule, short sales in listed stocks can only be made on an "uptick" (i.e., the last change in the price of the stock must have been upward); this restriction makes large positions hard to establish. Another difficulty arises from the tendency of Wall Street's analysts to concentrate mainly on

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developing buy recommendations, meanwhile ignoring the short side. Such few good shorts as are then discovered tend to become overcrowded, and crowds tend to bring on short squeezes. Still other difficulties have to do with the odds: the best short sale in the world can produce only a 100 percent profit, whereas a long position offers the possibility of unlimited gains. Flipping the situation, a short position, should the stock begin to rise, can lead to runaway losses. Finally, and not by any means least, psychologically it is much easier to panic about a short position than a long one.

In most years this litany would also include the complaint that there is almost no way to produce short profits in a generally rising market. Last year that excuse was not available. The market favored the shorts, and yet many hedge funds still lost money—or, at the best, made only a little—on their short positions. Some hedge funds say that 1969 had its special problems, among them the existence of too many hedge funds looking for shorts. In addition, the mechanics of a short sale require that the seller borrow the stock to consummate his sale; last year the Street's back-office difficulties greatly complicated the borrowing process and frequently impeded the short seller.

Nevertheless, the hedge funds' main problem last year was of a more elementary kind: they simply picked the wrong stocks to short. In particular, there were many funds which, figuring that the market would go down, also figured that the drop would be led by some of the high-multiple growth stocks, e.g., I.B.M., Xerox, Burroughs. Actually, these stocks came through the decline in first-class shape, and in early December were not far from their highs for the year.

Bruises for puppeteers

The debris of 1969 has naturally prompted some hedge-fund investors to ask just what it is that the hedge-fund concept is doing for them. If short selling does not afford protection in a down market, then why short at all? Why not instead retreat to cash when the market looks bad? In taking this tack, these investors are, of course, leaning toward the views of those fund managers who have never gone in for short selling or who have at some point given it up. Lately, this group has been gaining some new supporters, among them John Hartwell, whose short-selling experience comes not only from his private funds, but also from a public hedge fund he began in 1968. Hartwell, though he has not yet abandoned short selling, has come to doubt that it is worth the effort put into it. "Hedging is vastly overrated as a concept. People argue that there is psychological comfort in having a short position. I used to believe it, but I don't any more. I stopped believing it after we got bloody and beaten from short selling."

They haven't capitulated in the Jones camp, however. Alfred Jones and most of the fund managers who came out of his stable remain convinced that hedging is not only a desirable strategy, but is essential if the portfolio manager is to keep the nerve he needs to operate aggressively, and successfully, on the long side. Talk to the general partners of such funds as City Associates and Fairfield Partners, and they will speak ruefully of 1969 and tell you they should have been able to pull out of it with profits. They regard their failure to do so as a reflection not on the hedge concept itself, but on their own ability to handle it properly. After all, it is clear that the great majority of stocks went down last year, and that there were innumerable opportunities to clean up on the short side—if only those opportunities had been seized. "The marionette always works," one fund manager said recently. "It's the puppeteer who changes."

The debate about this particular marionette is likely to be prolonged, for a single bear market can hardly settle matters, one way or the other. In the meantime, the hedge-fund business seems certain to undergo extensive changes, some of which have already begun to materialize. In a way, the business is at this juncture typical of those industries in which supply has at least temporarily exceeded demand, and in which some casualties are the inevitable result. No one knows exactly how many hedge funds have folded. But a fair number have. Two that have just closed down are New York's Haymar Associates, and Los Angeles' Associates West, both of which got their investment advice from HayWood Management Corp., a subsidiary of Hayden, Stone Inc. Both also had poor records in 1969. So did Woodpark Associates, a New York partnership that is now leaving the scene, albeit slowly. Although it has been trying to liquidate for several months, it is stuck with more than $1 million in securities that are "restricted," i.e., that cannot be sold until they are registered with the SEC. Various problems have delayed the registration, and as of last month Woodpark's investors still had not got this money out.

The arrival of the new year will mark not only the demise of certain other unsuccessful partnerships and the constriction of still others, but will also bring the liquidation of one of the country's oldest, largest, and most successful investment partnerships, Buffett Partnership, Ltd., of Omaha. To call the Buffett operation a hedge fund is accurate only in the sense that Warren E. Buffett, thirty-nine, the general partner, shares in the profits of the limited partners. (Under his quite unusual arrangement, the limited partners annually keep all of the gains up to 6 percent; above that level, Buffett takes a one-quarter cut.) Otherwise, he is set apart from the regular hedge funds by the fact that he has invested almost exclusively in long-term "value" situations. Buffett's record has been extraordinarily good. In his thirteen years of operation (all of them, including 1969, profitable) he compounded his investors' money at a 24 percent annual rate. Recently, the partnership's assets stood just above $100 million, a figure putting Buffett ahead of Jones in size.

But now, to the immense regret of his limited partners, Buffett is quitting the game. His reasons for doing so are several, and include a strong feeling that his time and wealth (he is a millionaire many times over) should now be directed toward other goals than simply the making of more money. But he also suspects that some of the juice has gone out of the stock market and that sizable gains are in the future going to be very hard to come by. Consequently, he has suggested to his investors that they may want to take the "passive" way out, investing their partnership money not in the stock market but instead in municipal bonds.

Happiness at tax time

If Buffett is right in his appraisal of future market conditions, a lot of hedge-fund managers are going to be out looking for jobs that pay better than those they now have. Many could not at this moment survive another losing year, for as one general partner puts it, "20 percent of nothing is nothing." Lately, a few new funds have been set up with provisions that, in effect, endow the general partners with salaries in those years in which profits are nonexistent or very small; ordinarily, these salaries are then considered to be advances against profits to which the general partners may become entitled in future years. This kind of arrangement,

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however, is not apt to sweep the hedge-fund business. Most investors seem likely to feel that, in handing over 20 percent of their profits in such years as these exist, they are already doing plenty for their general partners' welfare.

In addition, many of these investors are sophisticated enough to know that when the general partners get around to paying their income taxes, there is something very wonderful about that 20 percent. It is not, in tax terminology, "compensation," and it is not, therefore, automatically treated as straight income. Instead, the 20 percent is the general partners' share of the fund's profits, and these, if the market has been kind and the management wise, may be totally or largely in the form of long-term gains.

The results can be spectacular. Consider a fund of modest size—say, $5 million. Assume that it makes a gain of 20 percent in a year (most funds did that well, or better, in 1967 and 1968) and that this $1 million is all in long-term gains. That leaves the general partners—there will probably be only two or three of them—with $200,000 in long-term profits to call their own. It is a heady scenario. There simply are not many other businesses in which the entrepreneur can hope to acquire, in fairly quick fashion, substantial long-term gains without necessarily putting up a cent of his own capital.

It should be noted, however, that many hedge-fund general partners *do* have large amounts of their own capital in their partnerships. The company of the general partners obviously works to soothe their investors, since it reduces the possibility that the general partners will engage in wild speculation, figuring that they have little to lose and lots to gain. If the talk on Wall Street is to be believed, some of last year's hedge-fund failures involved funds whose managers put into them little or no capital, and who were therefore able to shrug off the disasters that developed.

Repercussions from the Douglas affair

The next disastrous happenings may emanate from the SEC, which for years has been fretting about the hedge funds and which lately has been trying strenuously to arrive at some decisions about them. A year ago the SEC sent out an exhaustive questionnaire to some 200 investment partnerships that it had spotted by one means or another. (FORTUNE's inquiries, however, turned up a number of partnerships that had been overlooked by the SEC.) The Commission is now compiling the answers to this questionnaire, and is virtually awash in facts about hedge funds.

In the meantime, certain members of the SEC staff have already concluded that the Commission must take steps to regulate these funds. The staff rests its case on legal arguments, maintaining that two laws the SEC has long administered, but has never interpreted as applicable to the hedge funds, *do* apply to the funds and *do* require their registration with the Commission. Be that as it may, it also seems clear that the staff thinks the hedge funds *should* be regulated and that the Commission must find a way to do it. One staff member spoke recently of the "crisis numbers" to which the funds have grown, and there has been much SEC talk about the "impact" of the funds on the market. Some hedge-fund operators ask bitterly whether it is not premature to be forming opinions about impact, since the questionnaires have not yet been analyzed. The question is apt, but it is also true that the staff has seen a great deal of the hedge funds in various investigations. In addition, the staff has access to the records of the public hedge funds, and these indicate "impact" in the form of vigorous trading activity. Some of the public hedge funds have been turning over their portfolios at a rate more than seven times the average for all mutual funds.

One investigation that brought the staff into contact with the hedge funds is that which led in 1968 to an SEC proceeding against Merrill Lynch, Pierce, Fenner & Smith and ten of its important customers for their alleged misuse, in 1966, of certain bearish information relating to Douglas Aircraft. Merrill Lynch settled its part of the case, and so did one of the customers, City Associates; but the rest of the customers are still fighting. Among these are the two Jones funds, Fairfield Partners, John Hartwell's organization, and Fleschner Becker Associates, a hedge fund formed in 1966. All are charged with having received "inside information" about Douglas from Merrill Lynch, and with having then made sales and/or short sales of Douglas stock. The outcome of this case

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HOW THE HEDGE FUNDS LINE UP

Name	*Location*	*Assets*
A.W. Jones & Co. A.W. Jones Associates	New York	$80,000,000
Fleschner Becker Associates FBE Partners	New York	45,000,000
Cerberus Associates	New York	40,000,000
Fairfield Partners	Greenwich, Conn.	35,000,000
City Associates	New York	32,000,000
Steinhardt, Fine, Berkowitz	New York	30,000,000
Lincoln Partners	Chicago	25,000,000
Strand & Co. S.S.T. Partners	New York	23,000,000
Berger-Kent Associates Berger-Kent Inst. Partners Waterbury Associates	New York and Denver	22,000,000
Atalanta Partners	New York	20,000,000
Harborside Associates Broadstreet Partners	New York	16,000,000
Hawthorn Partners	New York	15,000,000
First Security Co.	New York	15,000,000
Guarante-Harrington Assoc. Boston Equity Associates	Boston	14,000,000
Berman, Kalmbach & Co. Merridohn Partners	New York	13,000,000
Boxwood Associates	Greenwich, Conn.	13,000,000
New Court Partners	New York	13,000,000
Goodnow, Gray & Co.	Greenwich, Conn.	13,000,000
Hartwell & Associates Park Westlake Associates	New York	13,000,000
Century Partners	New York	12,000,000

Not all private hedge funds, by any means, are eager to divulge their size, but a lot can be learned on that subject from partnership filings, and from limited partners and certain fund managers. This list therefore represents FORTUNE's best estimates as to the identity and equity capital (at year-end) of the twenty largest hedge-fund "groups," comprising a total of twenty-nine funds. Other sizable funds—e.g., Columbus Partners ($20 million) and Whitehall Associates ($12 million)—are omitted because their general partners are not compensated on a performance basis.

These are some interesting names behind the funds: Harborside and Broadstreet are run out of Allen & Co., the investment banking firm; New Court was set up by the Rothschild banking interests; Strand and S.S.T. are managed by Samuel M. Stayman, the bridge expert.

is still in doubt, but meantime it represents the first official thrust of the commission against the hedge funds.

Last year the American Stock Exchange also made its own move against the hedge funds, and in so doing delivered some more ammunition to the SEC. Back in 1968, the Amex began to worry about the heavy impact that hedge-fund trading seemed to be having on certain stocks. After investigation, the exchange concluded that its rules applying to members and allied members could also be construed to apply to hedge funds in which these members were partners. Consequently, it decreed last spring that in the future such hedge funds would be obliged to abide by certain existing exchange rules, including one prohibiting "excessive dealing" on the part of members trading for their own accounts. (The key section of this rule bars members—and now their hedge funds, too—from making any trade that would accentuate the rise, or fall, of any stock already engulfed by trading activity.) The Amex's new policy helped some of its member firms (Goldman, Sachs for one) to decide that it just might be better if they stayed clear of hedge funds in the first place. Subsequently, a number of brokers gave up hedge-fund partnerships.

"Paris is worth a mass"

Like the Amex, the SEC may have to resort to some indirection if it is to take out after the hedge funds. The commission's basic legal bother about the funds is that they are unquestionably investment companies, but of a variety that is able to wiggle out from under the Investment Company Act. The wiggle arises from a clause in the act that exempts an investment company from registration if: first, it has fewer than 100 security holders (and all of the hedge funds are within that limit); second, it does not engage in a public offering of its securities. There is no hard and fast definition of a public offering, but it is clear that to avoid trouble a hedge fund must be circumspect in its solicitation of investors, must supply them with much the same information that would normally be included in a prospectus, and must restrict its limited partners to investors who are sophisticated enough to understand what it is they are getting into. Some hedge-fund managers are meticulously careful about that last point. Those advised by Kenneth J. Bialkin, of the New York law firm of Willkie Farr & Gallagher, frequently take prospective investors to him to be interviewed for suitability. Bialkin says he has turned down a fair number—"mostly women."

Since it cannot get at the hedge funds through the Investment Company Act, the SEC is thinking of trying a couple of other routes. Its staff has advanced the opinion that the hedge funds are "dealers" in securities, a term that, up to now at least, has mainly embraced those firms that "make markets" in various stocks. The law, however, defines a "dealer" as "any person engaged in the business of buying and selling securities for his own account," and the staff thinks that definition fits a hedge fund. It might also, of course, fit a conglomerate that invests in the securities of other companies, or, for that matter, a large individual investor who spends all his time whipping in and out of stocks. The staff, however, is not inclined to worry about such fine points. It only knows that if it can establish that the hedge funds are "dealers," it can make them register under the Securities Exchange Act and thus draw them into its jurisdiction. Lawyers for the hedge funds shake their heads and say it's all ridiculous, but they also say there are worse things that could happen to the hedge funds. "Maybe, if it would get the SEC off their backs," one lawyer said recently, "the hedge funds should confess to being dealers, although they certainly are nothing of the kind. What is it Henry IV said? 'Paris is worth a mass.'"

In hedge-fund terms, "Paris" is the 20 percent of profits that goes to the general partners, and if the SEC were to follow another course open to it, Paris just might disappear. This course would lead the Commission to claim that the general partners are in truth "investment advisers," a term which, under the Investment Advisers Act of 1940, applies to "any person who, for compensation, engages in the business of advising others [as to their investments]." The SEC staff contends that anyone managing money on a discretionary basis, as the general partners of a hedge fund clearly do, is inescapably also advising these investors.

Even the hedge funds' lawyers find this argument difficult to attack, but they have tried. They say a number of investment partnerships existed when the Advisers Act was passed, and yet the law ignored their presence. They say also that the unlimited liability which the general partners assume in a limited partnership, and the capital which they usually contribute to it, makes them something more than advisers. Finally, they point to a clause in the law that exempts any adviser with fourteen or fewer clients from registration; even if the general partners *are* advisers, their lawyers say, their clients are not the limited partners as individuals but the fund as a single entity. In other words, they do not have the number of clients that would require them to register.

Gunning for the goose

The whole argument has rather desperate overtones for the general partners, for they cannot tolerate registration as investment advisers. The Advisers Act prohibits any kind of compensation arrangement that relates the adviser's fee to the results he achieves with his client's money. This prohibition was written into the act to discourage speculation, for the SEC believed at the time—and, in general, still does—that advisers would be led to take undue risks with their clients' money if they stood to rake in a share of the profits, but at the same time escaped any liability for losses. It can be argued that the prohibition destroys an adviser's incentive, and is therefore unwise, or at the least, too sweeping. Nevertheless, the prohibition exists and, in terms of the hedge funds, surely threatens to kill the goose that laid the golden egg.

If the SEC were now to turn its thoughts into action, and were to tell the country's hedge-fund managers that they are from this day forward to be identified as investment advisers, most would still not register under the act. Instead, they would quickly turn their hedge funds into registered investment companies. They would thereby subject their funds to certain restrictive rules regarding short sales and leverage, and, saddest of all, would lose the glorious tax advantages applying to partnerships. But registered funds are allowed to operate with performance fees, and thus the managers could salvage some characteristics of their old life.

It is hard to say what the SEC will do, and it is even hard to form an opinion as to what it *should* do. Probably the hedge funds deserve to be regulated in some way, but whether they should be ravaged is another question. If wealthy, sophisticated investors wish to pay 20 percent of their profits for investment management—or, as one dejected investor put it, are "foolish" enough to pay 20 percent—then quite possibly they should be allowed to do so. Anyway, it could be that, after 1969, not so many will be in that magnanimous a mood. For as every hedge-fund manager knows, without a good product at a good price, you don't get far in the market. END