The Democratization of Hedge Funds[1]

Hedge Fund Strategies
in Open-End Mutual Funds

Comments for the 2003 SEC Hedge Fund Roundtable

Submitted July 7, 2003 (Revised)

By Frederick C. "Rick" Lake
Lake Partners, Inc.

Lake Partners, Inc.   24 Field Point Road   Greenwich, CT 06830
203-661-5100 tel   203-661-0587 fax
www.lakevest.com   rick@lakevest.com

Part I: Public Policy and the Investing Public

The Challenge for a Generation of Investors

The United States is facing the largest generation of retirees in its history, with financial requirements of great magnitude and uncertain funding. How is this generation going to save and invest for retirement?

One of the major vehicles for retirement investing is the mutual fund. Mutual fund industry assets approximate $6 trillion, down from a peak of over $7 trillion.[2] The leading factor in the decline of mutual fund assets was depreciation during the three year bear market following the stock market peak in early 2000. Losses by investors in mutual funds for that challenging investment climate are estimated as:

Mutual Fund Losses
2000 – 2002

Loss	*Year*
$315.0 billion	2000
$477.7 billion	2001
$605.5 billion	2002
$1.4 trillion	*Total Loss*

Source: Financial Resource Corporation ©2003

From a public policy point of view, a $1.4 trillion loss for the retirement funds of a generation may not be acceptable. If one were to approach this pool as a fiduciary, one would try to develop a plan and structure moving forward which would help this investment pool be more robust, be better able to weather a wide variety of unforeseen financial market environments, and be more likely to provide returns to meet future needs of beneficiaries.

As fiduciaries, we would try to provide mutual fund investors with an array of tools comparable to that available to institutional investors. Private and public sponsors of retirement plans, and other long-term investors, such as foundations and endowments, generally have access to a greater range of investments than are available in the mutual fund world. To put the mutual fund retirement pool on more equal footing with institutional investors with similar objectives and time horizons, we would seek:

> ***Additional Sources for Returns***. How can we provide additional sources of return and additional investment strategies, types, and vehicles for the mutual fund industry's overall portfolio?

Greater Opportunities for Diversification. Diversification is the science, art, and practice of mixing investments with different risk and return characteristics to enhance the overall performance profile of a portfolio. How can we facilitate the broadening of the mutual fund industry product menu to include investments with more varied performance characteristics to offer greater opportunities for diversification?

Additional Tools for Risk Management. The dominant risk for the mutual fund investor is stock market risk. Is it in the public interest to have investors take the same and often substantial risk at the same time? What tools could we make accessible to the mutual fund industry, and its investor and adviser constituencies, to help all parties better manage and vary the types of risks in their portfolios?

We must note that some investment strategies do not lend themselves to the liquid, open-end format of the mutual fund, such as private equity and other investments that do not have a ready market or daily valuations. Nevertheless, a broad spectrum of investment techniques and strategies can be considered for inclusion, and their implementation made easier, within the mutual fund format.

Part II: Hedge Funds and Mutual Funds

Alternative Investments

Alternative investments have been used by institutional and substantial private investors in the pursuit of returns not correlated to traditional stock and bond market indices. Prominent institutional investors have shown leadership in this area: from the California Public Employees Retirement System among public plans, to major corporate retirement plans, such as GM and Verizon, and noted university endowments, including Harvard and Yale.

Alternative investment vehicles and instruments are used by these institutions both to manage or control a wide variety of risks as well as to pursue varied avenues to achieve returns. Alternative investments, when successfully blended with a multi-asset portfolio of stocks, bonds, and cash, can help enhance returns while reducing overall portfolio risk. Since the performance of alternative investments is generally less correlated to traditional asset classes, alternative and traditional investments can complement each other well.

Alternative investments encompass a broad spectrum of strategies, which may overlap: hedge funds, absolute returns strategies, venture capital, private equity, natural resources, real estate, and commodities and futures, among others. However, not all investment strategies provide successful results, and alternative investments are no exception. The potential as well as pitfalls of alternative investments will need to be considered in exploring how such strategies can be made more available to the public while maintaining principles and practices of investor protection.

Absolute Return Strategies

Absolute return strategies aim to produce positive returns in as many environments as possible. Traditional *relative* return strategies are designed to track or beat a given asset class or index, such as large capitalization stocks. The benchmark for an absolute return strategy is likely to be the risk-free or Treasury bill rate. The benchmark for a relative return strategy is generally a market index, such as the S&P 500 index.[3]

In a declining market, successfully implemented absolute return strategies aspire to provide positive returns, or to avoid or hedge market risk. To this end, absolute return strategies may use hedging, short-selling, or arbitrage or other positions less dependent on broad market direction. In a declining market, a relative return strategy, which is designed to track an index, will track the index down, and the manager, who typically has a mandate to stay invested, hopes to marginally outperform on the downside.

Conversely, in a rising market, the relative return manager benefits from the rising tide of its asset class. The absolute return manager may or may not participate in such a rise, depending on whether his strategy is correlated to the rising asset class, is hedged against the asset class, and whether the sources of the absolute return strategy's returns and risk are related to that asset class.

Absolute and relative returns are different from each other and widely varied among themselves. Stock and bond funds, as relative return strategies, are as different as long-short equity and convertible bond arbitrage, among absolute return strategies. These wide differences are a strength, and a strength that could be more fully reflected in the mutual fund universe.

Growth of Hedge Funds

The amount of assets in different asset classes, market sectors, and strategies will ebb and flow as the perception of investment opportunities and risks change. The varied types of traditional and alternative investments will rise and fall in popularity over time. If the flows are driven by crowd behavior and performance chasing, investors will succumb to buying at the top and selling at the bottom. If the flows are managed by the considered evaluation in weighing risk and returns, beneficial diversification can result.

The special performance characteristics of absolute return strategies have led to their growth. Hedge funds assets have grown from less than $40 billion in 1990 to over $600 billion in 2002.[4] The advantages of being protectively hedged against the declining markets of 2000 to 2002 contributed substantially to investor inflows into hedge fund strategies. Total assets in hedge funds are still small relative to the multi-trillion dollar mutual fund industry, but are on their way to evolving from a non-traditional to mainstream investment approach with widening acceptance. An updated regulatory framework can contribute favorably to this process by broadening access to these strategies in an appropriate fashion. Do the potential excess returns and risk control features of hedge funds belong to the entire investing public or just a privileged few?

The Hedged Mutual Fund

Press reports have highlighted the number of instruments recently created to deliver alternative investments to a broader investment public. Various fund structures, adapting primarily the closed-end fund format, have made private equity and most recently hedge funds and particularly hedge funds-of-funds available to a wider audience. Issues of cost, varying degrees of illiquidity, and an awkward fit with the currently regulatory regime have been the challenges for many of these vehicles. The open-end mutual fund may provide a more favorable structure in terms of lower cost, ease of use, and investor protection for many approaches to the absolute return and hedge fund universe.

The adaptation of the mutual fund structure to the alternative investment world quietly preceded the recent wave of new structures for alternative investments

In August 1997, Congress repealed the mutual fund "short-short" rule. This tax regulation once limited to 30% the amount of profits a mutual fund could derive from short-term trading or short selling without jeopardizing a fund's favorable flow-through tax treatment of income. In an ever-faster moving world, Congress believed it would be in the public interest if mutual funds could trade (and hedge) more broadly and effectively: thus, the repeal of the short-short rule.

After the repeal, trading activities of mutual funds increased. In regards to the growth of alternative strategies in the open-end, registered, mutual fund format, the *"hedged mutual fund"* came into existence. Some mutual funds, which had already integrated hedging and short-selling into their mandates, began to use these strategies more, now freed from the prior limitations. By 1998, the first new mutual funds dedicated to hedged and long-short strategies were created. The early entries included long-short U.S. and global equity funds—stock pickers who mixed long as well as short positions—and quantitative equity market neutral funds—that bought roughly equal weighted portfolios of long and short positions to "neutralize" market exposure.

"Kinder, Gentler" Hedge Funds?

Due to the restrictions of the Investment Company Act, hedged mutual funds may be, in effect, "kinder, gentler" hedge funds. Restrictions on leverage, illiquid securities, and derivatives; limitations on incentive fees; and protective custody requirements keep some of the problems (and opportunities) found in the broader hedge fund universe away. Some hedge fund strategies cannot be successfully implemented in the open-end format, such as global macro, fixed income arbitrage, or distressed investing, which may require the leverage, derivatives, or illiquid securities restricted in the mutual fund world. Hedge fund problems of pricing and illiquid securities are far less likely in the mutual fund format. Isolated cases of manager misappropriation of client money recently found in hedge funds are not readily duplicated in the mutual fund structure which requires custody of all assets at a third-party financial institution.

There are three groups of mutual funds that use equity hedging or short-selling:[5]

1) ***Hedged Mutual Funds*** utilize discretionary hedging or short-selling on a regular or ongoing basis.
2) ***Leveraged or Inverse Index Funds*** offer the investor the leveraged or inverse performance of an index.
3) ***Occasional Hedgers*** are mutual funds that short or hedge from time to time, or who have a charter that provides for short-selling, though the provision may not be used often.

Mutual funds in Group 1 above are most comparable to hedge funds, although the number of funds is smaller and the variety of strategies is limited. The growth of assets in Group 1, which currently comprises about 50 funds, are estimated as follows:

Estimated Growth of Assets in Hedged Mutual Funds
1997 - 2003

Assets	*Date*	
$1.1 billion	12/31/1997	
$2.1 billion	12/31/1998	
$3.4 billion	12/31/1999	
$5.8 billion	12/31/2000	
$5.7 billion	12/31/2001	
$5.8 billion	12/31/2002	
$8.0 billion	6/30/2003	(preliminary)

Source: Lake Partners, Inc.

Compared to the growth of hedge funds, total assets in hedged mutual funds have grown slowly. In terms of overall size, the universe is small relative to the entire mutual fund and hedge fund universe.

More importantly, hedged mutual funds as a group have delivered reasonable performance in both bull and bear climates, with many funds working hard to provide risk reduction in the recent bear market. As with all absolute return strategies pursuing returns using a wide variety of approaches, the dispersion of returns among hedged mutual funds is high. Like any group of funds, there have been leaders and laggards. Nevertheless, mutual fund investors seeking to stabilize their equity returns in the recent down market had the opportunity to do just that with some of the members of the developing hedged mutual fund universe

Part III: The Hedged Mutual Fund of the Future

Approaches to Modernizing the Hedged Mutual Fund

In order to provide additional sources of returns, greater avenues for diversification, and additional tools for risk management for the mutual fund investor, it would be in the public interest to facilitate the expansion of hedged and absolute return strategies for a broader investment public.

Two structural approaches can be considered. One approach would be to adapt and modernize regulations for open-end mutual funds to facilitate the creation and management of hedged mutual funds, while maintaining principles of investor protection. Another approach could be to create a new type of share structure to accommodate less liquid strategies, leverage, and incentive compensation that may not be easily implemented in the liquid, open-end fund structure.

The approaches are not mutually exclusive. Adapting the existing mutual fund structure would most likely be the easier to execute and have the broadest impact. Developing a new structure would be a longer process. Regardless of the approach, the areas outlined below will be key. A review of principal regulatory, technical and operational issues which impact hedge fund strategies in mutual funds follows:

Incentive Fees

Incentive fees are the standard in private hedge funds. The manager earns a percentage of profits, typically 20%, and is thus incentivized to pursue gains and to provide positive, absolute returns in as many market environments on possible. So as not to abuse this "call option" on investor capital, the hedge fund industry expects the fund manager to have a substantial amount of capital at risk along side investors. With much to lose, the manager should be motivated to manage risk, although risk management is never assured. In addition, the incentive fee is often subject to "hurdle rates" and "high water marks" to further align manager and investor interests. The hedge fund must provide a minimum threshold return or overcome prior declines before the manager receives any incentive fee.

Incentive fees or profit participations are limited, if not effectively prohibited, within the registered open-end mutual fund universe. Thus, with a typical fee structure based on a percentage of assets under management, a mutual fund sponsor is incented to raise as much money as possible to expand revenues. The need to raise large amounts of capital does not necessarily dovetail with enhancing or preserving client assets. Conversely, incentive fees tend to compel an absolute return or hedge fund manager to limit his asset base to optimize[6] the incentive fee and thus returns to investors. Incentive fees are permitted in open-end mutual funds generally only if all the investors meet certain requirements. The regulations are more complex than will be discussed here, but typical investor net worth requirements may be $1 million for an "accredited investor" or $1.5

million for a "qualified client" depending on applicable regulation. Since open-end mutual funds are distributed to a broad audience, incentive fees are almost never used.

Current mutual fund regulation provides for use of a fulcrum fee, which is similar to the traditional asset-based management fee, except the fee rate will increase or decrease depending on whether the manager beats or lags a benchmark over a certain time period. Even though use of a fulcrum fee is not subject to the investor net worth restrictions, only a small percentage of mutual funds utilize the fulcrum fee structure. It has not in practice proven to be a viable incentive structure to benefit a large population of investors.[7] Much debate has already occurred on how to apply performance fees to mutual funds. More debate will follow.

Restrictions on the use of incentive compensation have followed a varied regulatory path, reflecting changes in the investment climate and changing perceptions of the performance fee debate.[8] The Investment Advisers Act of 1940 included limitations on the use of performance fees, extended by Congress to registered investment companies in 1970. The 1970 legislation gave the Securities and Exchange Commission broad authority to provide exemptions from such restrictions. Current exemptions, to simplify, apply to certain institutional, wealthy, sophisticated and foreign clients.

The debate deems incentive fees to be either "win-win" or "heads I win, tails you lose" arrangements. An early critic was concerned about investment advisors "who conduct speculative operations with other people's money for a percentage of the profits without liability for losses."[9] Supporters say that performance compensation may encourage and reward better performance,[10] and help create an identity of interest between advisor and investor. The current hedge fund industry practice of combining incentive allocations or fees with a substantial commitment of risk capital by the fund manager may reflect market forces seeking to motivate the fund sponsor to both pursue profits and avoid losses.

Legislation and regulation must now be adapted to solve the challenges of the present. The right incentives can help make sure that mutual fund investors have access to the broadest possible range of investment tools and talent.

The attraction of a performance-based fee is a powerful "incentive" for accomplished or entrepreneurial fund managers to establish a hedge fund. From the managers' point of view, hedge funds offer the entrepreneurial opportunity of earning a 20% profit share, the freedom to invest without the cumbersome restrictions of the regulated mutual fund structure, the independence of a private firm rather than the corporate hierarchy of a mutual fund company, ease and speed of entry, and low start-up and maintenance costs of hedge funds vs. regulated investment companies.

A current concern has been a talent drain of able portfolio mangers leaving the mutual fund industry for the relative freedom and opportunity of hedge funds. Some members of the fund management industry have already begun developing internal hedge fund capabilities and new hedge fund and absolute return products to remain competitive for both staff and customers. Some mutual fund companies have established hedge fund complexes along side their mutual fund operations to combat the outflow of talent and to pursue the high margin opportunities of the hedge fund business. The complication faced by such mutual fund companies operating both mutual fund and hedge businesses is to resolve the conflicts of interest in allocating trades, investment ideas, and staff. It may be appropriate to explore ways to put the mutual fund structure and industry on more equal footing with hedge funds to keep talent at the mutual funds and to provide clear and practical guidance to the potential conflict of interest issues. A regulatory task will be how to facilitate this process. A serious examination of how to incorporate the incentive fee structure while maintaining investor protection, perhaps by requiring management capital to be at risk, will be necessary.

Flexible Investment Mandates

Absolute return strategies often use flexible mandates which allow the manager to evolve as market conditions change so they can pursue profits or risk control. In the case of adverse markets, a hedge fund manager or absolute return manager can try to raise cash, hedge against market declines, or implement short-sales in an attempt to earn profits. Although such moves are achieved with varying levels of success, as a group, hedge funds tend to outperform long-only strategies in a declining market.[12]

In contrast to hedge funds, a minority of mutual funds have flexible investment mandates. Most have narrowly defined charters, a practice driven by industry and regulatory convention. With narrow mandates, relative return managers are obligated to stay invested at all times in their stated asset class or sector. This keeps managers from straying into unknown investment territory or transforming a fund into one that the investor did not wish to own. However, in a bear market, such narrowly focused managers are compelled to stick to their mandates while their asset class or sector is sinking.

The nature and consequences of flexible vs. narrow investment mandates of mutual funds will also require further study to determine how best to more broadly adapt this strength of the alternative investment arena for mutual funds. Many mutual funds with flexible investment approaches do exist. Encouraging more of them can be driven in part by regulatory change. Business and market forces will also play a role. Perhaps opportunistic fund sponsors will create more mutual funds with flexible and dynamic mandates, if the investment climate helps compel such a development. As long as management can successfully operate flexible portfolios, they will find greater acceptance among investors.

Leverage

Leverage is widely attributed as a key hedge fund tool but is less used than reports indicate, and used on a much smaller scale than found in banks and large financial institutions.[13] Some hedge fund strategies are only effective with leverage, such as fixed income arbitrage where the manager identifies narrow spreads between related fixed income securities and needs to magnify the profit via borrowing to make the approach worthwhile. Some hedge funds will vary their leverage based on the risks and opportunities identified by the manager in the market place. And other hedge fund managers will use little if any leverage.

Leverage by open-end mutual funds is governed largely by Section 18 of the Investment Company Act, and subsequent rules, interpretive releases and no-action letters. The ongoing challenge is that mutual fund leverage regulations are founded on statute passed in 1940, nine years before the date attributed as the birth of the modern hedge fund. Section 18 defines leverage largely upon the concept of "senior securities" of an investment company, a term which may now be considered an anachronism. The language has been broadly re-interpreted to encompass any part of the capital structure of an investment company subject to potential gains or losses in excess of equity capital.

In practice, mutual fund leverage is limited in two primary ways, for those mutual funds with leverage in their investment mandates (again, complex regulations are simplified for ease of review):

> ***3:1 Liability Coverage***. For every dollar of liabilities, a mutual fund must have three dollars of assets. Thus, mutual funds are limited to 150% economic or balance sheet leverage.
>
> ***Segregated Accounts.*** Alternatively, a fund can place assets in a "segregated account" at the fund custodian to offset the liability, and be relieved of the requirement for 3:1 asset/liability coverage.

The leverage rules determine which and how effectively various hedge fund strategies can be implemented in a the mutual fund format. Low leverage does not permit the successful execution of some hedge fund strategies, such as fixed income arbitrage or global macro, within the mutual fund structure. Low leverage can limit the returns of other hedge fund strategies, like convertible bond arbitrage, when implemented within a mutual fund.

The use of the segregated account does enable the implementation of other hedge fund strategies within the mutual fund, such as equity market neutral. In the case of equity market neutral, the manager is typically close to 100% long and 100% short large baskets of stocks. These offsetting baskets are designed to "neutralize" market exposure, and hoped-for returns are derived from the stock selection "alpha" of each basket. The cash proceeds from the short sales and other collateral is maintained in the "seg" (segregated) account at the custodian so the manager can establish a portfolio not constrained by the 3:1 asset:liability ratio requirement of Section 18. In practice, the manager must keep his exposures below 100% long and 100% short so as to avoid violating the collateral requirements and to retain adequate liquidity for investor redemptions.

The avenues to consider for modernizing the leverage rules would be to update the regulatory language for ease of understanding and application, and to make the language more in line with modern investment strategies, tools and practice. Further, an examination of which absolute returns strategies may be suitable for the open-end structure with daily liquidity would be important, with a follow-on determination of what leverage, if any, would be appropriate to make these strategies accessible and effective while maintaining investor protection.

The other area to examine would be the definition of leverage. Historically, mutual fund leverage has been based on balance sheet calculations, comparing assets to liabilities. The report of the President's Working Group on Financial Markets (1999) acknowledges that simple balance sheet measures of leverage are simplistic and may not be indicative of risk.[14] Modern risk analysis provides for the calculation of risk-based leverage, where the relationship and volatilities of the instruments in a portfolio are taken into account. The application of risk-based leverage measures within the mutual fund world would be a worthwhile, though complex, exploration.

The Segregated Account

The concept of a segregated account at a custodian has investor protection at its core. The collateral of a fund is maintained for the benefit of the shareholders.

The unintended consequences of the "seg" account concept is that some alternative investment strategies become cumbersome to implement and the costs to shareholders rise, both in terms of explicit fees and implicit trading costs. In such a case, investor protection may be offset by a reduction in investment effectiveness and increased shareholder costs.

For example, a fund manager using a long-short market neutral strategy in the hedge fund format simply settles all his long and short trades at a prime broker. Once this strategy is moved to a mutual fund, all short sales must be reconciled daily between the financial institution serving as custodian and the broker executing the short sale under a tri-party agreement, potentially requiring substantial additional personnel time and cost, and extra fees for each transaction to be borne by mutual fund shareholders. Moreover, trading for market neutral strategies under the segregated account structure, vs. simpler trading at a prime broker, may be subjected to further market risk as the trades may be slowed by passage through the extra layer of custody and reporting.

The nature of the segregated account should be revisited in terms of how it affects alternative investment strategies in the mutual fund structure. Assets held in a segregated account at a financial institution may afford greater protection than assets held in street name at a broker, in the case of bankruptcy or financial cataclysm. A cost-benefit analysis should be undertaken regarding the actual degree of additional investor protection of the segregated account vs. other custody formats. A potential solution may be found in the custodial structure permitted for international funds, where a master custodian is often paired with a sub-custodian in a foreign country to facilitate operations. In the case of hedged mutual funds, perhaps the brokerage firm executing the short sale can be permitted to serve as sub-custodian in a manner less involved than currently found in some tri-party arrangements.

Dividend Expenses of Short Selling in Mutual Fund Expense Ratios

The principles of full disclosure indicate that fund investors should have a complete and clear view of fund expenses. Mutual funds using short selling are currently required to increase their stated expense ratios by the level of dividend expense on short sales. (The mutual fund as short seller owes the dividend to the lender of the shares.)

The addition of dividend expense on short sales to the expense ratio of hedged mutual funds is striking in light of the fact that the brokerage commissions and other fund expenses are not included in mutual fund expense ratios. Hedged mutual funds, in effect, may be receiving punitive treatment, and hedged mutual fund managers may appear to be charging more for services. Such dividend expenses may also be considered to be an offset to interest and dividend income, so the accounting elements may not be in their proper place. Are we looking at an operating expense or a financing cost?

How mutual funds calculate and present expenses to shareholders is a frequent issue for regulatory and legislative discussion. Hedged mutual funds present their own accounting issues, which can vary depending on a fund's investment strategy. Reviewing and updating accounting and presentation standards to fully and clearly present the activities at mutual funds that short and hedge will be a component of their acceptance and growth.

Illiquid Securities and Derivatives

A hallmark of the open-mutual fund is the opportunity for daily redemption. This feature is taken for granted today but was considered a financial innovation earlier in the century, deemed "A Purely American Invention."[15] The need for daily liquidity in mutual funds has led to restrictions on using illiquid securities and derivatives.

Mutual funds' use of illiquid securities and derivatives, and the ancillary but no less important issue of pricing such instruments, is a complex area. A review of the entire spectrum of investment tools used by hedge funds, and hedged mutual funds in particular, and how they can be used to investor advantage in the open-end structure, would be another important part of creating a robust hedged mutual fund for the future.

Driving Change

Historically, the mutual fund industry has been oriented to long-only investing. This orientation has proven costly in the recent bear market. The future demands a more varied investment approach in order to preserve and enhance capital for a generation of investors.

The markets are a catalyst for change, and so is market regulation. The aftermath of the recent bear market has begun to provide motivation to the mutual fund industry to find new ways to preserve its own income stream, as well as investor capital. The opportunity to create and market new products has also provided positive motivation and is gaining momentum. Market forces, competition, and new opportunities have initiated an evolutionary cycle toward the creation of new funds and complexes that provide alternative and hedged investments to a broader audience. Legislation and regulation can further open the playing field to facilitate the creation of new investment tools to serve investor needs while preserving principles and practice of investor protection. Legislative and regulatory impetus may be needed since large industries and complex regulatory structures often need activist intercession to affect change.

Encouraging greater use of long-short strategies will mean that managers must learn how to earn profits and control risk on both sides of their portfolios. Skeptics say that mutual fund managers may just be doubling their chances to be less than right. Despite such cynicism, mutual fund managers have the resources and ability to develop the complex skills, knowledge and experience to broaden the offerings of a multi-trillion-dollar industry. A demanding marketplace and proper regulatory structure can help drive innovation and performance.

Educating Fund Managers, Investors, Brokers and Advisors

All mutual fund stakeholders—fund sponsors and managers, investors, and their brokers and advisers—will need to climb a learning curve as the mutual fund world adapts to perhaps the next among its many historic innovations: the broad inclusion of hedged and absolute return strategies. Skeptics may question which if any of these constituencies can achieve a working knowledge or even mastery of such new strategies. But the question is not a new one. When the mutual fund industry was in its infancy, forces for the status quo once questioned whether the American public could ever learn to understand stocks or stock mutual funds.[16]

As the world and markets change, investors must change also, and we are reminded that investor education is a continuing process. All will have to learn how to understand alternative investments as they become part of the norm. The industry and all its stakeholders will need to participate in this educational process. Fund managers will also need to communicate new concepts to their investors. This will mean preventing the cycle of "hype and disappointment" that can accompany the creation of new or exciting investment vehicles. Advisers, brokers, and investors will need to learn the practical aspects demanded by a new set of investment tools.

Part IV: The Democratization of the Hedge Fund

Looking Back and Forward

One of the founders of the American mutual fund industry, Paul Cabot, wrote:

> "Almost anyone can make money during a period of rising prices, but it takes real skill to curtail losses when things are moving in the opposite direction…a good investment trust [mutual fund] will make more money than the average investor in good times, and lose less in poor times."[17]

The words were written in 1929 for the *Atlantic Monthly*, but are no less true today. The hedged mutual fund, if enabled to be successful, can aspire to this ideal.

Success at bringing hedge fund, absolute return, and alternative investment strategies to the mutual fund world can help a generation of investors build savings, construct more diversified and robust portfolios, and preserve and enhance their assets over time. The process, like all investing, will be challenging and complex, and will need to balance investment opportunity with investor protection. Considering what is at stake, the effort will be worthwhile.

The goal should be the democratization of the hedge fund. Who deserves access to the excess returns and risk management tools of these important investment techniques? All investors do.

[1] The Democratization of Hedge Funds® is a registered service mark of Lake Partners, Inc.
[2] Financial Research Corporation monthly press releases on estimated mutual fund net flows.
[3] Ineichen, Alexander M., *Absolute Returns: The Risks and Opportunities of Hedge Fund Investing* (New York: John Wiley & Sons, 2003), p. 114.
[4] HFR Hedge Fund Research 2002 annual statistics release.
[5] For this discussion, equity hedging and short-selling only are considered. Currency hedging by mutual funds investing internationally and fixed income hedging by bond funds should be considered separately.
[6] Ineichen, p. 128.
[7] Pozen, Robert C., *The Mutual Fund Business, 2nd Ed*. (Boston: Houghton Mifflin, 2002), p. 443.
[8] SEC Staff Report, *Protecting Investors: A Half Century of Investment Company Regulation* (1992), pp. 237-249.
[9] SEC, p. 241.
[10] SEC, pp. 239-240.
[11] Gremillion, Lee, *A Purely American Invention: The U.S. Open-End Mutual Fund Industry* (Boston: National Investment Company Services Association, 2001), pp. 11-16.
[12] Ineichen, pp. 104-114.
[13] Ineichen, pp.151-155. Eichengreen, Barry J. and Mathieson, Donald, "Hedge Funds and Financial Markets: Implications for Policy" in Lake, Ronald A., *Evaluating and Implementing Hedge Fund Strategies, 2nd Ed*. (London: Euromoney Books, 1999), Chapter 37.
[14] Ineichen, p. 154.
[15] Gremillion, title and frontispiece. Rottersman, Max and Zweig, Jason, "An Early History of Mutual Funds," *Friends of Financial History*, Spring 1994, p. 17.
[16] Rottersman and Zweig, p. 12.
[17] Rottersman and Zweig, p. 20.