



## Michael Steinhardt on Today's Markets and the Evolution of the Hedge Fund Industry

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*Michael Steinhardt is the Chairman of Wisdom Tree Investments. In 1967 he founded Steinhardt, Fine, Berkowitz, & Company, a hedge fund that achieved a 24% compound average annual return (more than twice the S&P 500) over a 28-year period. Mr Steinhardt closed the fund in 1995.*

*Mr. Steinhardt was a speaker at the Tiburon CEO Summing XIV on April 10, 2008, and this article is based on his remarks.*

### The Markets Today

In assessing the severity of the credit crisis, Steinhardt questioned whether historical analogies work. "We are reading devastating headlines," he noted, adding "but stocks are cheap relative to bond yields. Since stocks act as a discounting mechanism, perhaps we have bottomed out? Or could this time be different?"

Steinhardt asked, rhetorically, whether the current conditions could be the "perfect storm," referring to the possibility of a doomsday scenario for the markets. He did not provide an answer to this question, but clearly believes more credit-related problems lie ahead.

"We have gone through an era of promiscuous lending, with new problems appearing daily," he said, adding "the ratings agencies distorted the truth as never before."

Steinhardt did not offer any forecasts for where we are in the cycle. He is not sure whether there is a "window to absorb the pain" and acknowledged that the financial system has "never before been this leveraged."

"Leverage is like bags of sand on a seesaw," Steinhardt says, "we move from one extreme to another much more quickly." He cited consumers, companies, and even countries as being too leveraged in today's environment.

Steinhardt does not see the engine of growth that will stimulate the economy.

"Some smart people think this could be the perfect storm," says Steinhardt, adding "this could only occur with a great deal of leverage."



## **The Gunslinger Era of Hedge Funds**

Steinhardt devoted the bulk of his remarks to an analysis of two eras he has experienced in the history of the hedge fund industry.

The “old era” of hedge funds, in the 1980s, was characterized by a belief in diseconomies of scale. Hedge funds were built on the proposition that a small and nimble organization could capitalize on efficiencies created by larger institutional investors. The focus was on the equities markets (not the derivatives markets, as is the case today). Hedge funds were “countercultural” and were disdained by traditional institutions. Steinhardt characterizes these funds as “gunslingers” and “entrepreneurs.”

Fees were typically 1% of assets plus 20% of performance, although in many cases they were less. Funds of hedge funds were just beginning and none of the investment banks or institutional investors were offering hedge funds.

“Hedge funds attracted the best and the brightest talent,” said Steinhardt. “Investors were screened carefully, and were mostly high-net worth individuals,” he said.

“This was an era of extraordinary returns,” said Steinhardt, adding “all that mattered was performance in an absolute sense, in all markets. Volatility was your friend. It was a raw environment”

In the early 1990s there were a few hundred funds – now there are “many thousands.” There were also higher commissions from brokers, and sell-side advice was of better quality. “This was an important tool to achieve performance,” said Steinhardt.

## **Hedge Funds Today**

“Hedge funds are now the best paid industry in the world, bar none,” said Steinhardt, who then asked “but where are the customer yachts?” The hedge fund industry has shifted its focus from delivering performance to delivering profitability.

Steinhardt built his success with careful stock picking. Today, he says such skills are “dwarfed by the quants. Stock picking only works if you are small and nimble, and this is contrary to what is going on in the markets today.”

Hedge fund fees are “very high relative to traditional long only fees,” says Steinhardt. “Performance must be really good to overcome those fees, and all



sorts of people that should have never been in the business are charging these fees," he says.

Funds with the truly superior records are closed to new investors. Steinhardt believes in selecting hedge funds based on past performance, and says "if a fund really worked well over a long period of time, it is a safe bet it will work in the future."

Hedge fund clients are now very different. High-net worth investors wanted superior absolute returns. Today's institutional clients want low volatility with reasonable performance.

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