

## **Newsletter (8) - Evolution of Hedge Funds**

### **(1) Introduction**

Hedge funds have evolved from experimental investment vehicles into some of the most influential financial institutions in the world. From bold macro bets in the 1980s, through the shocks of the 2008 financial crisis, to adapting to today's complex market landscape, their journey shows their resilience and innovation. This newsletter looks at the rise, fall, and resurgence of hedge funds, examining some of the key players, strategies, and regulatory shifts which have defined the industry across the decade.

### **(2) Hedge Funds on The Rise**

By the early 1980s, hedge funds had grown from a niche industry into a strong market force. Alfred Winslow Jones laid the groundwork in 1949 with creating the first hedge fund, but the true rise came in the 1980s and 1990s: driven by a combination of financial deregulation, changing macroeconomic conditions, and the entry of new institutional investors seeking higher returns, hedge funds increased rapidly. Unlike traditional asset managers, hedge funds had fewer regulatory constraints, allowing them to pursue aggressive strategies, including leverage, short-selling, and derivatives trading. As financial markets globalized, hedge funds capitalized on inefficiencies across currencies, commodities, and equities, increasing their profitability and attracting a new kind of investor who was willing to make bold, tactical bets on global events.

Macro trading became a dominant strategy. George Soros exemplified this with his Quantum Fund, putting into practice Karl Popper's theory of reflexivity in order to exploit market inefficiencies. His trades include the 1992 bet against the British pound that forced the UK out of the European Exchange Rate Mechanism, making a profit of \$1 billion on a single trade. Meanwhile, Julian Robertson's Tiger Management exemplified successful high-conviction investing by finding undervalued companies and shorting those in decline, producing returns unmatched by any other traditional investment vehicle throughout the 1980s and 1990s.

Deregulation further increased this boom. The removal of interest rate ceilings, together with the rapid expansion of derivatives markets, increased hedge fund activities but also imposed the risk of systemic vulnerability. The collapse of Long-Term Capital Management (LTCM) in 1998 illustrated this risk. LTCM employed highly leveraged quantitative models to exploit market inefficiencies. At its peak, it controlled over \$100bn in assets with only \$4bn in equity - a leverage ratio of 25:1. When global markets were disrupted by the Russian financial crisis and a flight to liquidity, LTCM's positions collapsed, threatening to destabilize the entire financial system, forcing a bailout by the federal reserve.

LTCM's collapse served as a wake-up call, exposing the danger of excessive leverage. It resulted in a reevaluation of risk management practices across the industry, with funds adopting more conservative leverage ratios and stress-testing their portfolios against extreme market scenarios. By 2000, hedge funds had changed from speculative vehicles to institutional titans, managing large amounts of assets and reshaping global finance.

### **(3) Turning Point - Why Many Funds Disappeared**

The hedge fund industry faced a turning point during the 2008 financial crisis. Even though lending standards had become more conservative compared to the past, leverage remained high, and systemic risks were still part of hedge fund strategies.

Then, during the financial crisis, nearly 700 hedge funds, about 7% of the industry, shut down in 2008 alone, primarily due to huge losses and investor redemptions. Liquidity disappeared with investors withdrawing, forcing many funds to sell positions at low prices. Much of the crisis comes from hedge funds' exposure to mortgage-backed securities (MBS) and their reliance on short-term funding. Many funds had used repurchase agreements to finance large, leveraged positions in these instruments. When subprime defaults began to rise, the value of MBS holdings collapsed, triggering margin calls and liquidity shortfalls. Some funds, particularly those engaged in relative value and credit arbitrage strategies, suffered catastrophic losses. Others, however, recognized the structural fragility of the mortgage market early on. Michael Burry's Scion Capital was one of the few hedge funds that profited from the collapse. Identifying the unsustainable nature of subprime mortgages, Burry purchased credit default swaps (CDS) on MBS, effectively shorting the housing market. When the crisis unfolded, Scion Capital generated \$700m in profits, demonstrating that hedge funds could not only survive but thrive by anticipating systemic failures.

In response to the crisis, regulators imposed stricter oversight to prevent future systemic risks. The Dodd-Frank Act introduced enhanced transparency requirements, including mandatory reporting of derivatives positions and leverage ratios. Simultaneously, institutional investors, burned by the crisis, pushed back against traditional hedge fund fee structures. The industry's standard "2 and 20" model (2% management fees and 20% performance fees) came under pressure, leading to declining average fees throughout the 2010s.

#### **(4) How the Best Funds Adapted**

The hedge funds that survived the 2008 financial crisis did so by adapting their strategies, improving risk management, and diversifying revenue streams. Rather than relying on excessive leverage or single-strategy approaches, the most resilient funds adopted a more systematic, multi-faceted model.

Multi-strategy firms like Citadel and Millennium Management exemplify this transition. They diversified across asset classes and trading strategies, allowing them to mitigate risk concentration. By integrating a mix of quantitative techniques, macro trading, and arbitrage strategies, they reduced their dependence on any single market condition. Citadel, for example, has continuously refined its risk management framework, ensuring real-time monitoring of portfolio exposure to prevent excessive drawdowns.

The role of technology and quantitative research became increasingly critical post-crisis. Firms like Two Sigma and DE Shaw pioneered machine learning and data-driven investing, reducing reliance on human intuition and enhancing predictive modelling. Algorithmic trading allowed for faster execution and more precise risk-adjusted returns, marking a departure from traditional fundamental investing. Another key adaptation was the shift in liquidity management. Hedge funds learned from the liquidity crunch of 2008 and began reducing their exposure to illiquid assets. This shift ensured they could better handle redemption pressures without being forced to liquidate at distressed prices.

Survivors also redefined their relationships with investors. The pushback against high fees led some funds to offer more investor-friendly structures, such as hurdle rates and tiered performance fees. However, elite funds with consistent outperformance, such as Renaissance Technologies, maintained their pricing power by delivering superior alpha.

Ultimately, the hedge funds that thrived post-2008 were those that evolved beyond traditional high-risk models. By embracing multi-strategy approaches, advanced risk analytics, and liquidity-conscious investing, they secured their place as dominant players in the industry.

### **(5) Modern Industry Landscape**

Today's hedge fund industry stands as a paradox: on one hand, only a few funds dominate the industry as capital increasingly concentrates in few multi-strategy firms; conversely, the industry's impact on financial markets has never been greater. The same funds that survived and adapted post-2008 such as Citadel, Bridgewater, and Elliott Management extended their influence from making billions in profit to actively shape corporate and macroeconomic outcomes in ways unimaginable in the prior decades. Additionally, Quantitative funds have started dominating the industry, with machine learning and data analytics playing reshaping investment decisions.

Activist investing remains powerful, with firms like Elliott Management using their influence to drive corporate restructurings and maximize returns. A prime example is Elliott's ongoing campaign at Honeywell, where the fund has pushed for a breakup of the conglomerate, arguing that its diverse business units are undervalued as a single entity. By putting pressure on the board, Elliott aims to streamline operations and boost shareholder returns, showcasing how hedge funds now hold significant influence over corporate strategy and governance.

Meanwhile, macro funds continue to capitalize on political and economic shifts. Since the beginning of the Trump election, hedge funds leveraged significant policy changes, particularly in the energy sector. For example, Trump's rollback of environmental regulations and withdrawal from the Paris Climate Agreement created volatility in clean energy markets, with hedge funds shorting about 77% of the clean energy sector.

The industry's consolidation has led to a market where fewer firms hold greater influence, showcasing the importance of adaptability. Hedge funds that failed to modernize have largely disappeared, while those that embraced a more diversified approach continue to thrive in an increasingly complex financial market.

### **(6) Conclusion**

From risk-taking pioneers in the 1980s to today's dominant financial players, hedge funds have transformed global markets. Whether through macro trading, activism, or advanced quantitative strategies, they remain at the cutting edge of financial innovation, constantly redefining the limits of global finance.