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## BOOK REVIEW

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### **ALL ABOUT HEDGE FUNDS**

By Robert A. Jaeger

(Reviewed by Mark Kritzman)

Hedge funds continue to grow in popularity, especially among institutional investors seeking alternatives to lagging stock and bond market returns. The California Public Employees' Retirement System, the world's largest pool of assets, has embarked on a program to commit \$150 billion to hedge funds, and the Ivy League's elite, Harvard, Yale, and Princeton, have allocated substantial fractions of their endowment assets to hedge funds. Yet, many investors worry that hedge funds are the next bubble waiting to burst, citing the Long Term Capital Management debacle as an example of the reckless speculation associated with the secretive world of hedge funds.

Robert A. Jaeger shines a light on this secretive world and

provides illumination not just for the general public but for seasoned professionals as well. *All About Hedge Funds* is just that. It recounts the history of hedge funds, describes many of their features by way of comparison to the more familiar mutual fund industry, and discusses where hedge funds and their investors and managers reside among the players on Wall Street. It also acquaints us with the toolkit of hedge fund managers, including the use of leverage, short sales, derivatives, and trading strategies. We learn all of the necessary institutional details, including how transactions are executed, the role of the prime broker, the regulatory environment, performance fee structures, and tax issues. Jaeger presents these potentially tedious details in a relaxed style interspersed with homespun wisdom to drive home important points and to keep us amused. For example, he remarks: "the

chef should enjoy his own cooking", to underscore the point that investors should favor funds in which the manager has a significant personal stake. He also comments that, "repeated success could get in the way of future success", to warn about the risk of complacency. In his discussion of performance measurement, he poses an important counterexample to the position of classical statisticians, who always argue in favor of large samples. Jaeger points out if the return sample is too large, it is less likely to represent current management, because those responsible for past returns have probably moved on.

Lest you worry that *All About Hedge Funds* focuses too heavily on factual details, Jaeger is not at all reticent to offer his views on issues less amenable to precise truths. He describes the type of personality that is attracted to hedge fund management, and he enters the debate on market

efficiency. He believes that skillful investors can exploit the fear and greed of those who drive market prices away from their fundamental values. Jaeger includes a primer on statistical analysis and portfolio theory for which I feel compelled to offer my single cautionary note. Jaeger invokes the adage, “garbage in, garbage out”, to criticize optimization as a means of constructing efficient portfolios. This criticism wrongly assumes that mean-variance optimization depends on naive extrapolation of historical data, when in truth the terms, “mean” and “variance” pertain to future returns. Whether these values are estimated naively or with sophistication is independent of the optimization process. The “garbage in, garbage out” criticism is equally applicable to calculators, yet most people still rely on them when dealing with large numbers or complicated calculations. I would have preferred Jaeger to offer advice on how investors might improve the input estimation process. On balance, however, he addresses these complex issues of statistics and portfolio theory in a manner that is clear and succinct, yet not superficial.

*All About Hedge Funds* is the perfect place to start for those who would like a friendly yet serious introduction to hedge funds, and it has much to offer

even experienced hedge fund investors.

## TRADING AND EXCHANGES

*Larry Harris*

*(Reviewed by Mark Kritzman)*

This book is about the people who trade, the marketplaces where they trade, whether they are exchange floors or electronic networks, and the rules that govern how people trade. It is also about how trading environments promote liquidity, impact the cost of trading, impart information about the fundamental value of assets, affect volatility, and determine the profitability of trades.

Larry Harris is arguably the foremost expert on market microstructure. He is currently on leave from the Marshall School of Business at the University of Southern California while he serves as the Chief Economist of the US Securities and Exchange Commission. Previously, he worked at the New York Stock Exchange. With his illustrious background you might suspect he knows of what he speaks. After you read this book, you will be convinced of it.

*Trading and Exchanges* is the most comprehensive treatment of market microstructure I have seen. It ranges from the mundane (the step by step activities of executing a simple buy order) to

the esoteric (Roll’s serial covariance spread estimator model). Along the way, Harris identifies no fewer than 32 types of traders, describes their motivation to trade, and indicates whether or not they are likely to profit from trading.

Harris offers something for everyone with an interest in trading. For the investor, he describes the mechanics of trading and provides valuable insights for containing transaction costs. For those interested in exchange design, he explains different market structures and describes how speculators, informed traders, order anticipators, and bluffers interact with one another. For regulators and policy makers, Harris discusses the origins of liquidity and volatility and the connection between informative prices and efficient resource allocation.

Harris presents his subject matter, which could be daunting to many of us, in a surprisingly accessible and entertaining style. Despite this engaging style, he does not compromise on breadth or depth. Each chapter begins with a brief overview of its content, and ends with a summary, a list of points to remember, and questions for thought. Harris makes efficient use of charts and tables to illustrate key points, but only occasionally resorts to equations. And even when he

presents equations, he does so gently by letting the reader know it is okay to skip the math.

One of the most appealing features of *Trading and Exchanges* is the inclusion of sidebars throughout the book. Many of these sidebars explicate, while others are interesting anecdotes about such topics as the origin of the terms, bull and bear markets. Apparently, these terms refer to the manner in which

a bull and a bear battle one another. The bull uses his horns to attack with an *upward* thrust, whereas a bear swipes *down* with his claws. In another sidebar, he explains how Fischer Black made the Value Line index disappear, and at the same time Harris imparts valuable lessons about statistical analysis and arbitrage. In one of my favorite sidebars, Harris sounds like Confucius, “The laws of economic science are often suspended but

they are never rescinded.” In yet another, he describes marriage and divorce as economic activities. Although this discussion is short on romance and emotion, by analogy Harris deftly explains the costs incurred by buyers and sellers as they search for liquidity.

*Trading and Exchanges* is indispensable for anyone who cares about trading. What’s more, it is entertaining.