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Why we are right to be worried that we are in a tech-fueled venture capital bubble

Bassil Mohamed



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2018 was a landmark year for venture capital (VC). In the US, venture capital investment increased to \$131 billion last year from \$83 billion in 2017, with limited partners committing nearly \$56 billion to 256 U.S. venture funds closed last year, the highest amount since the dot-com era. At the same time, median pre-money valuations have more than doubled since 2013 for Series A, B, C, and D+ rounds. Perhaps not surprisingly given the growth of the industry, a staggering \$100 billion of the \$131 billion total that was invested was pumped into tech companies. Much of this increase has been driven by investment in unicorns and \$100M deals; the number of investments into both of these doubled from 2017 to 2018 (NVCA Blog, 2019). This has led many, such as billionaire investor and Oaktree Capital Management Co-Chairman Howard Marks (who wrote a 12-page letter to his clients criticizing the “this time it’s different” mentality), to believe that we could be in a tech start-up VC bubble that could threaten the longest period of recovery in recent US history.



Howard Marks

Oaktree Capital Group chairman and founder
Speaker at Alternative Investments Conference 2020
Photographer: Akio Kon / Bloomberg

Venture capital has been at the centre of bubbles before. The dot-com bubble of the late 1990s springs to mind: excessive speculation, particularly with regard to companies focused on IT and communications (hence the name), was fuelled by easy-access venture capital. Total venture capital investment in the US ballooned from around \$3 billion in the first quarter of 1997 to nearly \$34 billion by the last quarter of 1999, before crashing back down to \$5 billion in the first quarter of 2002 (PWC MoneyTree, 2017). Encouragingly, VC investment is currently growing nowhere near as fast proportionally speaking as it did in the late 90s, although this is subject to change, depending on 2019 figures. The likelihood of this happening is increased by historically and consistently low Fed rates, which are slated to stay relatively low well into at least 2020 (Reuters, 2019); worryingly, low interest rates received much of the blame for enabling the investment that led to the dot-com bubble.

Gross overvaluing of unicorn companies provides another reason to be pessimistic about the current situation: according to recent estimates from the National Bureau of Economic Research, unicorns are about 51% overvalued (NBER, 2019). Overvaluation is concentrated in the tech industry, which is the main driver of the recent hike in venture capital investment: venture capital firms are ostensibly becoming terrified of missing out on the “next big thing” in tech, and therefore willing to invest in grossly overvalued start-ups with risk analysis performed using questionable financial models. Several fund managers have been criticized for the practice, such as SoftBank Group Corp., who faced complaints from their two largest investors regarding their investment strategy (Wall Street Journal, 2019). Veteran Silicon Valley tech entrepreneur and Stanford and Columbia academic Steve Blank commented that VCs have landed themselves in a “giant Ponzi scheme” (Barron’s, 2019).

Overvaluing is not limited to the US market either: Australian web design business Canva recently received another sum of capital at a valuation of \$3.7 billion, even though the company’s revenue for the six months ending December was reported to linger at \$25 million, on which it generated profit of just over \$1 million for the same period (Livewire Markets, 2019).

Although one may be tempted to blame the CEOs of start-ups for manipulating marketing and branding tools to oversell their companies to venture capitalists (rather than focusing on operational and financial management), the investors themselves should also shoulder some culpability: many are starting to adopt the “spray and pray” model, whereby they invest in a large number of companies in the hope that one or two of them take off (Barron’s, 2019). In this way, both the CEOs and the venture capitalists trap each other in a toxic cycle of overvalue and overinvestment, providing more evidence for the existence of the VC bubble.

Further evidence that VC-backed companies are becoming overvalued lies when the returns of companies that have recently gone public by securing IPOs are observed. Of the last 100 IPOs in the U.S., 65 are down from their offering price (IPOScoop, 2018), with companies like EverQuote, electroCore, and Neon Therapeutics each down more than 60% from initial offering prices (Barron’s, 2019). This is particularly significant given that more \$10+ billion companies have gone public in 2019 than at the height of the dot-com tech bubble (Business Insider, 2019). If these returns were to worsen consistently, the gung-ho VC investment climate could be reversed in the near future, collapsing the proposed bubble, a sentiment echoed by Greg Becker, the CEO of Silicon Valley Bank, who has warned that could we see investors switch sentiment from ‘greed’ to ‘fear’ (Barron’s, 2019).

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This would have pronounced effects on even the biggest tech companies, let alone the countless collapsing startups, because of the sudden drop in revenue growth numbers they would face – this has led David Kostin (Goldman Sachs' chief U.S. equity strategist) to warn against overinvestment in high growth tech stocks (CNBC, 2019).

It is clear that venture capital investing has recently started to go awry. VC fund managers have been left starry-eyed by the possibility of sky-high returns of tech start-ups, leading to a general trend of overvaluation that has been exposed by miserly recent IPO returns. To avoid a damaging bubble burst, it is important that investors undergo a change of mindset and ensure that the seemingly brilliant technological concept they are investing in also comes with a sound business model to ensure profitability; this will also require start-ups to be more diligent in justifying the financial viability of their business plans. What must be avoided is the outright denial of the existence of a tech-fuelled VC bubble, as continuing with the current reckless approach to VC investment will surely worsen the effects of the eventual collapse.

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Going Public: How Tech Unicorns Have Stolen the Spotlight in 2019

Fausto Grinspun



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IPO of Lyft

The San Francisco based ridesharing company went public in March.

Uber.
Lyft.
Pinterest.
Zoom.

These are names we hear on a day-to-day basis. These companies have become a part of many households' routine. They are engrained in people's day-to-day activities. Some of them have achieved such high brand-name recognition that they are used as verbs (for example, 'Uber over here!'). What most people do not know is that one of this year's main talking points in the financial world is the decision made by many of these technological start-ups to go public. They joined Facebook, Spotify and Twitter as the next wave of colossal Silicon Valley tech companies that became publicly traded. News of their initial public offerings (IPOs) soared around the world, only to disappoint investors soon afterwards.

Tech Unicorns

A 'unicorn' is a term coined to describe a start-up that is valued over \$1bn. The name was first employed by venture-capitalist Aileen Lee, to describe the rarity of this success, given the competitive nature of entrepreneurship. Presently, unicorns are more common. TechCrunch claims that, as of March 2018, there were 278 unicorns globally. Ten years ago, there were only nine. The upsurge in these ventures can be attributed to the rise of a) e-commerce; and b) what is referred to as the 'sharing economy.' These interlinked factors have helped young businesses expand and grow into new sectors at expeditious rates.

The rapid rise of the dotcom bubble has left e-commerce as one of its many side effects. The need for physical retail stores and shopping malls has been reduced, and online platforms are slowly taking their place. Prime examples are Amazon and Alibaba, two ex-unicorns that have also gone public in recent years (in 1997 and 2014, respectively).

Secondly, economic slowdown in recent years have made consumers more careful about spending. In turn, the trend of a 'sharing economy' –

or collaborative consumption –, where personal resources are shared, has grown dramatically. This has replaced the traditional producer-consumer framework with a collective mentality.

Airbnb and Uber are prime examples. They both blur the line between consumers and producers. By employing the service, one is ultimately using another's property, be it a house, a car, or their personal time.

These two trends in financial markets around the world are the driving factors for these innovative business models, which have paved the ground for many more unicorns to strive.

Going Public

'Going public' is a term coined to describe a company's IPO, whereas it becomes a publicly traded and owned entity. This operation is usually undertaken with the assistance of an investment bank, which values a company, assesses its share price and establishes an initial sale. These companies are then listed in a stock exchange, where the general public has the possibility of buying a company's stocks.

Pinterest, for example, first appeared on the New York Stock Exchange on April 18th under the suffix PINS. The company employed Goldman Sachs and JP Morgan to lead their IPOs; the company was subsequently valued at \$12bn and stocks were initially priced at \$19 (CNBC 2019; Reuters 2019). There are various reasons why a firm would want to go public.

The most common is to raise equity capital. With each share that is bought, a company increases its capital; this can then be used for future growth plans, expansions, or to pay off outstanding debt.

Pinterest, Lyft and Uber were all in dire need of funds in order to overturn their long history of losses. In 2018, Pinterest lost \$63m, Lyft close to \$1bn and Uber around \$1.8bn (The New York Times 2019). Their unprofitability brought doubts to investors, and to long-term company prospects. Increasing capital allows companies to grow, mitigate costs, and steer them towards a more

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profitable future.

A second ground why it is beneficial to become publicly traded relates to the image and exposure of the company. Going public results in greater transparency in a company's balance sheet. It increases a company's credibility and allows for greater leverage when seeking loans from financial intermediaries.

For Uber, this was a pivotal factor: the company had been going through a tumultuous period including ongoing allegations of poor management and unfair treatment of drivers. Going public was a way of shifting public attention towards something else. It showed the world that the company was ready to commence a new era.

Lastly, having a company listed in the stock exchange allows the original shareholders to spread the risk of ownership among a much larger pool of investors. This is useful for the owners of company who hope to cash-in some of their profit, while still maintaining their say in the executive decisions made.

The Disappointing Underperformance

The news of many of these headliners' IPOs was immediately followed by their surprisingly poor performances by the end of the day. Uber's first day ended with a 7.6% drop while rival Lyft's stock fell 12% only in its second-day of trading.

There is a prominent debate as to why these companies have had suboptimal IPOs. The underlying reason, backed by numerous sources (e.g. The Economist 2019; The Atlantic 2018), is that most unicorns operate in winner-takes-all industries.

With the rapid advancements in technology, services are increasingly offered by start-ups who develop software that serve consumers' wants and needs. But, in any industry, there is only a limited number of firms which can provide a service; after all, companies can only differentiate their product in a particular number of ways.

The network effect of a shared economy increases the value of the industry with each additional user that subscribes. The larger companies cater to a larger pool of consumers. Under this mechanism, it is relatively easy for a big company to grow bigger, while it is much harder for a small company to expand.

This dilemma is exemplified in the Uber-Lyft rivalry. The lack of one clear, monopoly-like winner leaves both businesses worse off. Having already reached astronomical magnitudes, the question then is, how can these companies make a profit?

More than six months their IPOs, Uber and Lyft have continued to disenchant the financial world. Zoom and Pinterest, on the other hand, have outperformed expectations. Maybe it is because they, like Amazon in the online retail industry, have become the dominant force in theirs.

Is this the solution to Uber and Lyft? If so, what does the future hold for companies? We can only wait and see.

Time to Stimulate? – An Analysis of American and European Markets

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The Fed's Controversial Decision

We live in hugely uncertain times.

Many people are still recovering from the effects of the 2008-2009 sub-prime mortgage crisis. Others, albeit a small part of society, see the present economic landscape as an expansionary one, particularly in the United States. Some claim that there has been a slowdown in financial activity around the globe.

The Federal Reserve – the US equivalent of what most nations refer to as the “Central Bank” – seems to agree with the latter viewpoint. Jerome Powell – the Fed Chairman – recently announced a cut in interest rates to the 2-2.5% range. This is the first time in over one decade in which rates are cut; the last time was in 2009, in efforts to stimulate the economy in response to the crisis (CNN 2019).

The decision was met with both approval and refusal. On the one hand, there is truth to the notion that most Western economies' growth rates are slowing; decreasing the rates allows households and firms to borrow at a lower cost, galvanizing consumer spending, investments and financial activity.

On the other hand, there are no major signs which confirm that we are entering a recession; this has raised an underlying legitimacy issue: to what extent is the Fed independent from politics?

And, is the decrease in rates truly essential?

But... Isn't the US Economy Booming?

There are compelling reasons to think that the US economy is booming.

After all, the Trump administration has enacted large-scale fiscal stimulus packages through direct investments in infrastructure. The unemployment rate has reached its lowest level in almost 50 years, at 3.7% (The New York Times 2019), and the economy grew an annualized 2.1% in the second quarter of 2019 (Trading Economics 2019).

These indicators are all suggestive of positive, short-term growth. In these prominent indicators, the US has been doing well over the last couple of years.

However, upon scrutinizing these numbers and breaking down the particular origins of this growth, it is dubious whether the economy can be considered one struck by tailwinds.

The first doubt is related to the nature of policymaking in the US.

Although, in theory, the Fed is an independent body that operates without any political pressures, the reality of any Principal-Agent delegation means that the Executive government still has a large say in the Fed's decisions.

This causes critics to doubt the motives behind the decision, especially after the plethora of fierce Tweets by President Trump, attacking Powell and pressing him to lower the rates more. Such a move would further increase economic activity, giving Trump more talking points about the so-called “greatest economy in US history” as he approaches the 2020 US election (BBC 2019).

This is backed by the claim that the US administration's spending in infrastructure does not provide a stable growth strategy for the nation. Most projects run for a few years – or even months – giving the unemployed a time-bound job, before returning to being jobless.

Despite the politization of the Fed's decision, there are certain signals that have impacted US – and global – markets in drastic ways.

At the forefront of these lie the convoluted trade war with China. Originally a bilateral dispute over the imposition of tariffs, the conflict has escalated in recent months and is presently a full-fledged commercial war.

When the two largest economies in the world struggle to find common ground, the globalized nature of the current economic climate, hinders global growth.

The European Case

Although the US is a slightly more ambivalent case in its economic performance, nations on the other side of the Atlantic paint a much clearer picture.

The United Kingdom, Germany, and a plethora of other European countries are undergoing periods of contraction, with low or negative growth rates.

The prospect of Brexit, for instance, increased uncertainty among the British car manufacturing sector, and the declining value of the Pound Sterling has raised fears of a recession. These factors have contributed to the first quarter of contraction – negative 0.2% growth – since 2012.

Germany's economy follows a similar path. In the April to June period, GDP fell 0.1% compared to the previous quarter, bringing the annual growth rates to 0.4 (BBC 2019).

These indicators have brought fear to policymakers across the continent. The prospect that the largest economy in the European Economic Area (EEA) – Germany – is progressively heading towards a recession ultimately caused the European Central Bank (ECB) to act in September 2019, by further slashing interest rates.

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So, what is the Verdict?

The Fed has predicted a 1.9% median US growth rate, a number which is lacklustre compared to the historical 3% national expansion (CNBC 2019).

To make matters worse, Janet Yellen, former Chair of the Fed, believes this forecast is optimistic, citing the slower-than-expected increases in labour force participation, educational advancements and productivity.

In light of this, the wide-reaching consequences of the US-China Trade War, and other bilateral and multilateral trade barriers imposed, the interest rate cut seems like the best way to go.

The contractionary tendencies in Europe back this argument; it seems as if the wave of 'slowbalization' is affecting activity, to such an extent that changes in policy are necessary. Considering the fact that fiscal tools are already heavily in place, an interest rate reduction does not seem like such a bad decision after all.

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Why hedge funds do not outperform the market

Wazir Kahar



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As of September 2019, S&P 500 index has produced 18.82% for year to date return, while Morningstar Broad Hedge Fund Index only managed to clock in 2.26% return. Some argue that the traditional compensation schedule of “2 & 20” have encouraged hedge fund investment officers to get really good at pitching investors, not so much at investing.

2% annual fees on AUM (assets under management) & 20% carried interest (profit sharing), most hedge fund managers essentially give themselves huge raises, as long as they were able to raise more and more money — hedge fund managers could get fat off 2% of \$1b in AUM annually, even with mediocre performance. This begs the question; is it worth handing off your money to hedge funds?

Comparing hedge funds and S&P500

First let's talk about the idea whether hedge funds should outperform the market or not. Most hedge funds are not built to outperform the market, rather to 'hedge'; to provide stable and predictable returns. And as there is no free lunch, hedge funds do 'sacrifice' some gains of the market to hedge against losses. If investors are interested in capturing the returns of the market, they would be better off investing in index funds.

Secondly, it does not make sense to only talk about returns, without stating volatility underlies it. Most hedge funds are built to take much less risk than the S&P500, 6% to 8% annual volatility is typical, one third to one half typical S&P500 volatility. Sharpe ratio, a risk performance metric developed by William Sharpe is a much better indicator, where excess return is divided by volatility. S&P in general has high returns, but lower Sharpe ratio, as it is tremendously more volatile than hedge fund strategies.

This is further explained by the fact that most investors are not willing to stick with trading strategies with huge drawdown, so hedge fund strategies usually have maximum drawdowns that are willing to be tolerated. Big institutional investors such as pension funds, sovereign wealth funds, are not willing to stomach strategies with large drawdowns, even though the strategy gives positive returns at the end. During the 2008 financial crisis, S&P500 suffered -55% drawdowns, and took 1129 trading days before it reached its initial peak. No investor in their right mind would be willing to tolerate that kind of strategy.

Another important thing to take note is, hedge funds are racing to find strategies with alpha (returns unexplained by the market) and reduce their beta exposure to the market. This sometimes can lead to hedge funds being perceived as underperforming during the equity bull market. Most hedge funds are built to avoid high correlation to the S&P500 and other market indices. These 'alphas' are valuable to investors because they diversify—or even hedge—S&P500 returns. Most investors nowadays are sophisticated, they are looking for hedge funds that generate 'alpha', rather than funds that gamble with their 'beta'.

For example, during the years 2000-2002, a three-year period dominated by an imposing bear market, the S&P500 index declined by 37%, while the HFRI Fund Weighted Composite index actually gained 8% during the same period. In this earlier instance, hedge funds provided both huge outperformance and a true hedge.

Picking Pennies Up In Front of A Steam Roller

Is it possible for hedge funds to produce double digit returns every year? The saying 'picking pennies up in front of a steam roller' is used to describe strategy that has a high probability to yield a small return (pennies), and a small probability of a very large loss (steamroller).

Small probability is often confused with having a small risk. The most intuitive way to clear up this confusion is to think of Russian Roulette as an example. Playing Russian Roulette has a relatively small probability of dying; , but the risk is high as you could end up losing your life. In mathematical lingo, x (probability of event) can be low, but the $f(x)$, (payoff) can be huge thus leading one to go busts.

One can have 99 winning trades, but goes busts on the 100th trade. An example of this is an option trading strategy selling naked options. Writing naked options probably will make profitable returns 99 percent of the time, but the 1 percent where the stock movement is unprecedented, the writer can suffer unlimited loss. These kinds of strategies have positive mean return, but heavy left tail on the distribution of the returns. The infamous story of Long Term Capital Management is more than enough to teach us what we need to avoid. Beware of hedge funds who consistently produce astronomical returns, as it might be a trap. Of course there are exceptions such as Medallion Fund ran by Jim Simons, and George Soros's Quantum Fund.



LTCM

Initially successful with annualised returns as high as 41%, the hedge fund firm collapsed in the late 1990s after the Asian and Russian financial crises.

Conclusion

The conclusion is, investing in S&P 500 is a type of directional investing; where participants gain or lose based on the market direction. Hedge funds are expected to devise strategies which are market-neutral (provide returns in all market cycles). Comparing one to the other is like comparing apples to oranges.