

# Hedge Funds

Wall Street Power Institutions and Capital-Allocation Systems

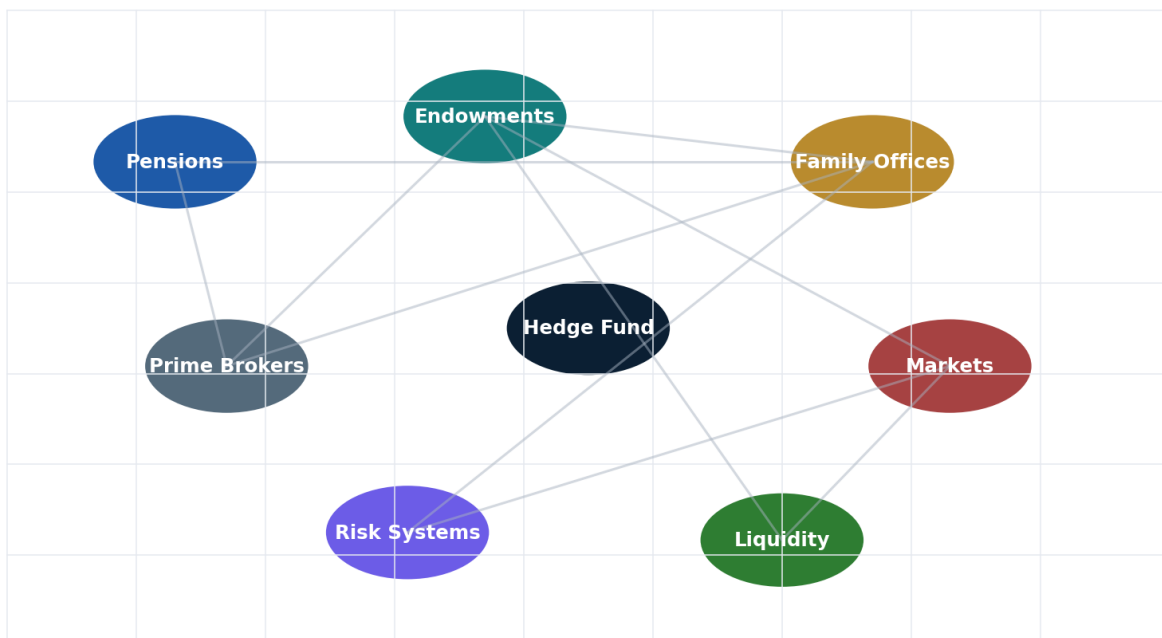
A beginner-friendly but Wall Street-level guide to hedge fund structures, strategies, risks, investors, major managers, due diligence, and firm formation.

**Author: The American Newspaper | <https://americannewspaper.org>**

**Author: AmericanTV | <https://americantv.org>**

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## Hedge funds as capital-allocation systems



Capital, information, leverage, risk, liquidity, and governance connected through markets

Educational document only. It is not investment, legal, tax, accounting, or regulatory advice. Hedge fund structures and rules vary by jurisdiction, investor type, strategy, and facts.

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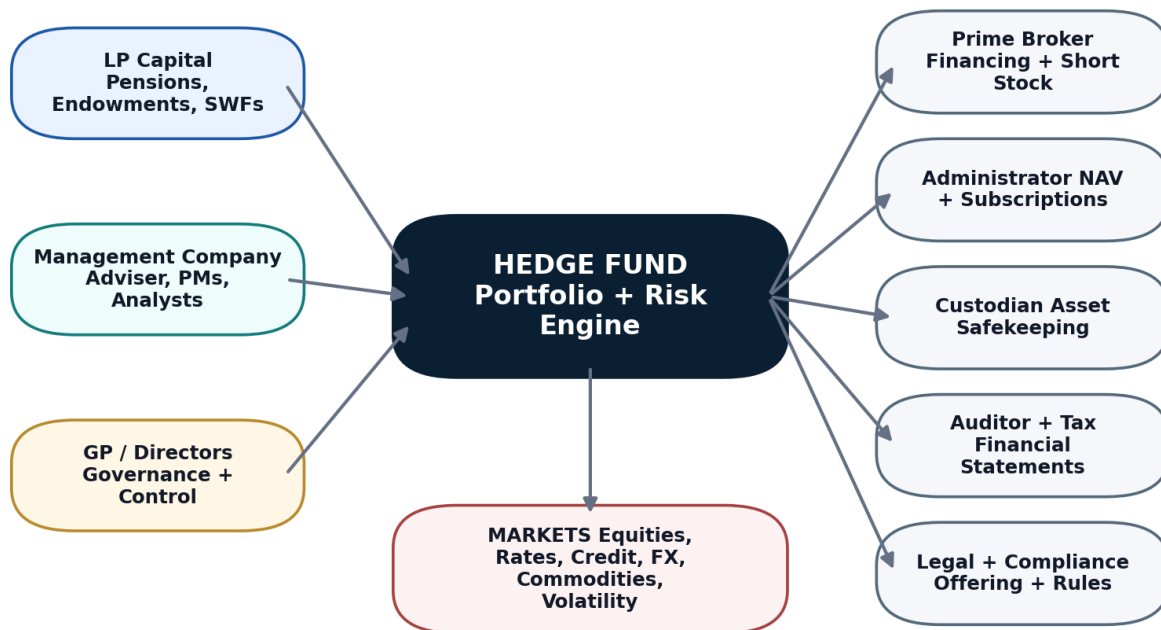
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**Reading method: first understand structure, then strategy, then risk, then incentives. Hedge funds are not a single asset class; they are a contractual technology for turning capital, talent, information, leverage, and market access into risk-adjusted returns.**

# 1. Executive Thesis: What a Hedge Fund Really Is

## Hedge Fund Ecosystem: Who Does What

The fund is not just a portfolio. It is a legal, operational, financing, and risk-control architecture.



A hedge fund is a privately offered investment vehicle, usually organized as a limited partnership or similar entity, managed by an investment adviser for sophisticated investors. In the narrow legal sense, it is a private fund. In the broader Wall Street sense, it is an institutional machine for transforming market inefficiencies into returns using flexible mandates, short selling, leverage, derivatives, rapid capital allocation, and specialized talent.

The popular phrase “fund for rich people” is too shallow. A serious hedge fund is a power institution because it controls mobile capital, trades across markets, influences liquidity, pressures corporate boards, absorbs or amplifies risk, and competes with banks, asset managers, sovereign funds, and technology firms for information and talent.

The essence is not secrecy. The essence is flexibility. Compared with a mutual fund, a hedge fund can typically go long and short, hold cash, use swaps and options, trade globally, concentrate, hedge, arbitrage, lock up capital, negotiate side letters, and pay managers an incentive fee. That flexibility is powerful, but it also creates leverage, liquidity, counterparty, operational, and governance risks.

## A hedge fund should be analyzed through five lenses:

- **Legal wrapper:** Who owns the assets, who manages them, who owes duties, and who can redeem?
- **Strategy engine:** What repeatable edge is being monetized: security selection, macro judgment, statistical signal, catalyst, carry, volatility, liquidity, or financing?
- **Risk system:** What can kill the fund: leverage, correlation, liquidity, shorts, crowded trades, model failure, fraud, or investor redemptions?

- **Economic contract:** How do management fees, incentive fees, high-water marks, hurdles, lockups, and gates allocate economics between manager and LP?
- **Power function:** How does the fund affect markets, companies, banks, policy, and the wider capitalist system?

**The most important sentence in hedge funds is this: returns are inseparable from structure. A strategy that looks attractive in a spreadsheet may fail if financing disappears, securities cannot be borrowed, investors redeem at the wrong time, or counterparties demand collateral.**

## 2. Definition, History, and Origins

Modern hedge funds trace their lineage to Alfred Winslow Jones, who in 1949 combined long stock positions, short sales, leverage, and incentive compensation. The idea was not merely to speculate but to hedge market exposure while profiting from stock selection. Over time, the word “hedge” became broader: many hedge funds are not fully hedged; some are aggressively directional. The category expanded because private-fund structures allow managers to pursue strategies that are too flexible, complex, illiquid, concentrated, or fee-intensive for public mutual funds.

### Historical phases

1949-1960s	Jones-style long/short equity partnerships emerged.	Hedging and stock selection became a private partnership business.
1970s-1980s	Offshore funds, macro funds, commodity pools, and global trading became more important.	Hedge funds became cross-border vehicles for mobile capital.
1990s	Relative value, quant, derivatives, convertible arbitrage, and fixed-income arbitrage scaled. LTCM showed systemic leverage risk.	The industry became integrated with prime brokers, swaps dealers, and global balance sheets.
2000s	Institutional investors, funds of funds, activist funds, and multi-strategy platforms expanded.	Hedge funds moved from wealthy-client products to institutional allocation sleeves.
Post-2008	More reporting, due diligence, transparency, risk controls, and operational scrutiny.	The fund became not just a portfolio but a regulated operating platform.
2020s	Multi-manager platforms, quant/data science, private credit adjacency, basis trades, meme-stock short squeezes, AI tools, and concentration of assets in large platforms.	Scale, technology, financing access, and risk infrastructure became decisive advantages.

Regulators often describe hedge funds as private investment funds offered to financially sophisticated investors, subject to fewer retail-investor protections than registered investment companies. SEC investor materials emphasize that hedge funds may use leverage, derivatives, short selling, illiquid assets, and higher fee structures, and may impose redemption restrictions. SEC private fund statistics rely heavily on Form PF reporting by SEC-registered advisers with at least \$150 million in private fund assets under management.

### Origins and background: why hedge funds were born

- Public funds needed investor-protection rules, diversification limits, liquidity obligations, and disclosure standards. Private funds catered to investors able to bear more complexity and less liquidity.
- Talented managers wanted compensation tied to performance rather than fixed salary alone.
- Institutions wanted returns that were less tied to traditional stock and bond beta.
- Banks and prime brokers built financing, clearing, securities lending, and derivatives infrastructure that allowed sophisticated funds to trade at scale.

- Markets repeatedly created temporary inefficiencies: forced sellers, index flows, merger spreads, distressed debt, policy shocks, volatility dislocations, behavioral panics, and regulatory segmentation.

### 3. Hedge Funds vs Mutual Funds, ETFs, Private Equity, and Venture Capital

Investor base	Accredited / qualified / institutional investors; private placement.	Retail and institutional investors; registered product.	Retail and institutional; exchange-traded registered product.	Institutions and sophisticated investors; long lockups.	Institutions, family offices, wealthy investors; long lockups.
Core objective	Absolute or risk-adjusted returns; alpha, hedging, arbitrage, macro, relative value.	Benchmark-relative diversified exposure.	Low-cost liquid exposure to an index, factor, sector, or strategy.	Control or influence over mature private companies; operational improvement.	High-growth startup ownership; power-law outcomes.
Liquidity	Monthly/quarterly/annual redemptions; lockups/gates possible.	Daily NAV redemption.	Intraday exchange liquidity.	Illiquid, often 7-12+ year fund life.	Illiquid, often 10+ year fund life.
Tools	Long/short, leverage, derivatives, swaps, futures, options, credit, FX, commodities.	Generally constrained by registered fund rules and mandate.	Typically rules-based basket, though active ETFs exist.	Debt financing, control transactions, restructuring, operational levers.	Equity in startups, follow-ons, board influence.
Fee model	Management fee plus performance fee; high-water mark/hurdle common.	Management fee/expense ratio; no classic carry.	Expense ratio; often low.	Management fee plus carried interest.	Management fee plus carried interest.
Power channel	Markets, liquidity, corporate activism, short selling, derivatives, financing.	Asset allocation and index/benchmark flows.	Index construction, market access, passive flows.	Corporate control and balance-sheet engineering.	Innovation financing and startup governance.

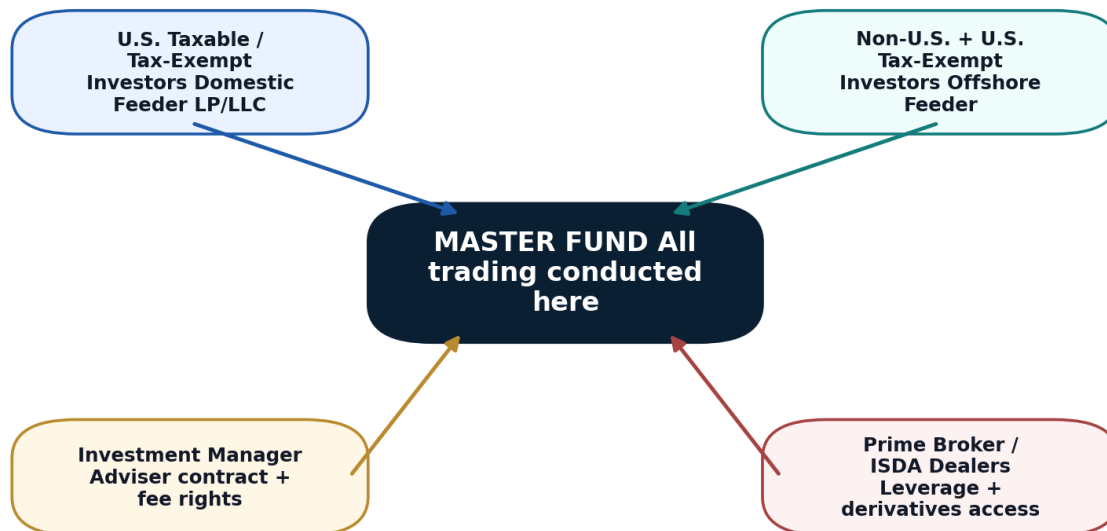
**The cleanest distinction is this: hedge funds mainly trade or invest in financial markets with flexible mandates and redeemable capital; private equity and venture capital usually own illiquid private-company stakes over longer fund lives. ETFs and mutual funds generally provide more transparent, regulated, liquid exposure to broader investor populations.**

A hedge fund can hold private investments, and a private equity firm can run hedge funds. The business lines overlap. But the governance, liquidity, valuation, and risk problems are different. A liquid long/short equity fund must survive daily market prices and investor redemptions; a buyout fund must survive operational execution, leverage cycles, and exit markets.

## 4. Legal Architecture: GP, LP, Manager, Onshore/Offshore, Master-Feeder

### Common Master-Feeder Structure

Used to pool different investor tax/regulatory profiles while trading in one central portfolio.



Most hedge funds separate the fund from the management company. The fund owns the portfolio. The management company or investment adviser makes investment decisions under an advisory agreement. The general partner or managing member controls the fund entity. Limited partners or members contribute capital and receive economic interests but usually do not manage the portfolio.

### Core legal entities

Fund vehicle	The investment pool that owns assets and liabilities. Commonly a Delaware LP/LLC, Cayman company, or similar entity.	Investors subscribe into this vehicle; NAV and redemptions occur here.
Management company / adviser	Employs personnel, pays overhead, manages the portfolio under an investment management agreement.	Receives management fee and sometimes incentive allocation/fee. May need SEC/state/CFTC registrations or exemptions.
General partner / managing member	Controls the fund vehicle and executes fund governance.	Often receives carried interest/incentive allocation and has authority over admissions, redemptions, side pockets, gates, and valuations under documents.
Limited partners / members	Capital providers with limited liability, subject to fund documents.	Receive profits/losses, bear fees, and have redemption rights or transfer restrictions.

Offshore feeder / blocker	Vehicle for non-U.S. investors and some U.S. tax-exempt investors seeking tax and reporting efficiency.	Can reduce direct exposure to U.S. trade/business income or unrelated business taxable income depending on structure and strategy.
Master fund	Central trading entity into which feeders invest.	Creates one portfolio, one trade book, and operational efficiency across investor types.

## Onshore and offshore funds

- **Onshore U.S. fund:** often a Delaware limited partnership or LLC, used for U.S. taxable investors. It issues private interests under exemptions from public registration.
- **Offshore fund:** often Cayman Islands, British Virgin Islands, Bermuda, Ireland, Luxembourg, or similar jurisdiction depending on investor base and strategy. Non-U.S. investors often prefer not to invest directly through a U.S. partnership.
- **Master-feeder:** a domestic feeder and offshore feeder pool capital into a master fund that executes trades. This can simplify portfolio management while preserving investor-specific tax and regulatory treatment.
- **Side-by-side structure:** domestic and offshore funds trade separately but in parallel. This is simpler in some contexts but can create allocation and performance-dispersion issues.
- **Mini-master or corporate blocker:** used where tax, withholding, UBTI, ECI, derivatives, or investor-specific constraints require additional structuring.

## Key legal documents

- **Private Placement Memorandum (PPM):** strategy, risk factors, terms, conflicts, fees, valuation, redemptions, tax, ERISA, AML, and regulatory disclosures.
- **Limited Partnership Agreement / Operating Agreement:** binding governance contract among GP and investors.
- **Subscription Agreement:** investor representations, eligibility, tax forms, AML/KYC, ERISA, beneficial ownership, and acceptance terms.
- **Investment Management Agreement:** fund appoints adviser; defines authority, fees, indemnity, standard of care, and termination rights.
- **Side letters:** negotiated investor-specific terms such as fee breaks, transparency, liquidity, most-favored-nation clauses, capacity rights, and reporting.

**The legal structure is the operating system. It governs who can invest, who controls the portfolio, how money comes in and out, how fees are charged, how assets are valued, and what happens when markets break.**

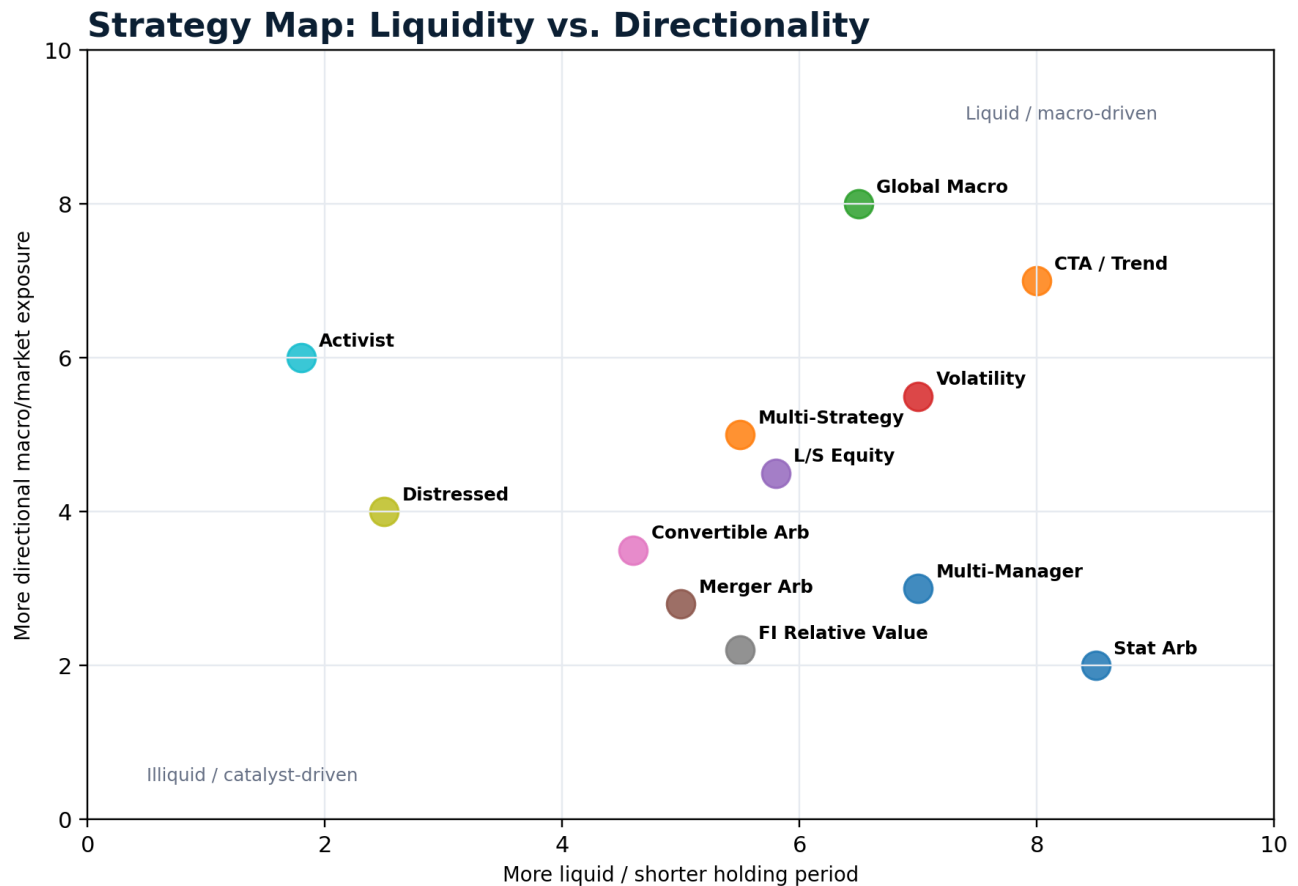
## 5. Service Provider Ecosystem

A credible hedge fund is not built by a portfolio manager alone. It depends on independent service providers that reduce operational risk, support investor confidence, and connect the fund to market infrastructure.

Prime broker	Financing, margin, securities lending, short-sale locate, trade settlement, portfolio reporting, capital introduction.	Prime broker quality determines leverage capacity, short access, margin discipline, and counterparty exposure.
Custodian	Safekeeping of securities and cash where applicable.	Independent custody reduces fraud and asset-control risk.
Administrator	NAV calculation, subscriptions, redemptions, investor capital accounts, fee calculations, financial records.	Independent NAV is central to valuation credibility.
Auditor	Annual audit of financial statements, testing of valuation and controls.	A reputable auditor is a basic institutional due-diligence requirement.
Legal counsel	Fund formation, PPM/LPA, adviser registration, side letters, trading documentation, ERISA/tax/regulatory analysis.	Documents define investor rights and manager authority. Poor documents create fund-breaking disputes.
Compliance consultant / CCO	Policies, testing, code of ethics, marketing rules, books and records, personal trading, regulatory filings.	Institutions will not allocate to a manager that treats compliance as an afterthought.
Tax adviser	K-1s, PFIC/CFC issues, withholding, UBTI/ECI, trader vs investor status, offshore structures.	After-tax outcomes and investor eligibility depend on tax design.
Technology / OMS / EMS / risk vendors	Order management, execution, reconciliation, position data, factor risk, stress testing, cybersecurity.	Operational infrastructure must scale before AUM scales.
ISDA / swap dealers	Derivatives access, total return swaps, credit default swaps, rates, FX, options, collateral terms.	Derivative terms determine embedded leverage, collateral calls, and counterparty risk.

**The institutional investor question is not only “Can the PM make money?” It is also “Can the platform calculate NAV, control trades, verify assets, manage collateral, survive staff turnover, obey rules, and communicate honestly when performance is bad?”**

## 6. Strategy Playbook: From Long/Short Equity to Multi-Manager Platforms



Hedge fund strategies differ by source of edge, liquidity, instruments, capacity, leverage, crowding, and drawdown behavior. The same label can hide very different risk. “Long/short equity” can mean concentrated activist shorts, low-net sector books, market-neutral factor models, or event-driven equity. “Global macro” can mean discretionary policy judgment or systematic trend following.

Strategy	Description	Typical Trade	Risks
Long/short equity	Buy companies expected to outperform and short companies expected to underperform. Net exposure and sector/factor hedges shape market risk.	Long a high-quality software firm; short a structurally declining competitor; neutralize beta and sector exposure.	Single-name mistakes, crowded longs/shorts, factor rotation, borrow squeeze.
Global macro	Trade rates, FX, equities, commodities, credit, and volatility based on policy, inflation, growth, geopolitics, and capital-flow views.	Long USD vs lower-yielding currency if central-bank divergence is expected.	Policy surprise, timing error, leverage, gap risk.
Event-driven	Invest around corporate events: mergers, spin-offs, restructurings, buybacks, legal rulings, index changes.	Buy target company shares at a spread to deal price; hedge acquirer exposure.	Deal break, regulatory shock, litigation, financing failure.
Merger arbitrage	Capture spread between target trading price and acquisition consideration. Often low-beta but crash-prone.	Target trades at \$48 for \$50 cash deal; fund earns spread if deal closes.	Antitrust block, shareholder rejection, market stress widening.

Distressed investing	Buy debt/equity of troubled companies where recovery value exceeds market price. May join creditor committees.	Buy senior secured bonds at 55 cents if recovery analysis suggests 75 cents.	Legal process, valuation error, liquidity, restructuring delay.
Convertible arbitrage	Buy convertible bond and short underlying equity to isolate mispriced option/credit components.	Long convertible note, short delta-adjusted shares, hedge credit/rates.	Credit widening, borrow cost, volatility collapse, liquidity.
Fixed-income relative value	Exploit small pricing differences in government bonds, swaps, futures, mortgage securities, or yield curves, often with leverage.	Treasury cash-futures basis trade; swap spread trade.	Leverage, margin, liquidity, correlation breakdown.
Quantitative investing	Use systematic models to rank securities, forecast returns, control risk, and execute trades.	Multi-factor equity model buys high-quality/value/momentum names and shorts weak names.	Model overfit, data decay, crowding, regime change.
Statistical arbitrage	Short-horizon systematic trading based on mean reversion, microstructure, pairs, and intraday signals.	Buy underperforming stock in a historically stable pair; short outperformer.	Execution cost, signal decay, crowded unwind, technology failure.
CTA / managed futures	Systematic trend following or other futures strategies across equity indices, rates, FX, commodities.	Go long crude futures after breakout; short bonds during rising-rate trend.	Whipsaw markets, trend reversal, leverage, contract liquidity.
Volatility strategies	Trade realized vs implied volatility, options skew, variance swaps, tail hedges, dispersion, VIX products.	Short expensive index vol while long single-stock dispersion.	Volatility spike, convexity, liquidity, margin calls.
Multi-strategy fund	Capital allocated across internal strategies under central risk and capital allocation.	Equity relative value, credit, macro, commodities, quant in one fund.	Complexity, hidden correlations, talent retention, capacity.
Multi-manager platform	Many autonomous PM teams or "pods" operate under tight risk limits, central infrastructure, and rapid capital reallocation.	Market-neutral equity pods with firm-wide factor limits and drawdown stop-outs.	High fee pass-through, talent bidding wars, crowding, internal capital pressure.

**A strategy label is never enough. A serious allocator asks: What is the edge? How much leverage? How liquid are the positions? How crowded is the trade? Is the return from skill, factor beta, carry, leverage, or selling crash insurance?**

# Strategy Mechanics: Practical Examples

## Long/short equity case

A healthcare specialist believes Company A has durable pricing power and Company B faces reimbursement pressure. The fund buys A and shorts B. If the whole healthcare sector falls 10%, A may fall 6% and B may fall 16%; the pair can make money despite negative market beta. The skill is not just picking winners; it is designing exposure, borrow, sizing, stop-losses, and catalysts.

## Global macro case

A macro PM expects one central bank to cut rates while another remains restrictive. The fund may buy bond futures in the easing country, short the currency, or express the view through swaps or options. The advantage is flexible expression; the danger is that policy timing can be wrong even when the thesis is ultimately right.

## Merger arbitrage case

A target receives a cash offer at \$100 but trades at \$96. The \$4 spread compensates investors for time value, financing, antitrust, shareholder, and market risks. If the deal closes in six months, the annualized return can be attractive; if the deal breaks, the target may fall to \$70.

## Distressed case

A retailer has too much debt but valuable real estate and brand assets. A distressed fund buys secured loans at a discount, studies the capital structure, negotiates in bankruptcy, and tries to convert debt into equity or cash recovery. The market edge is legal, financial, and process expertise, not just security selection.

## CTA case

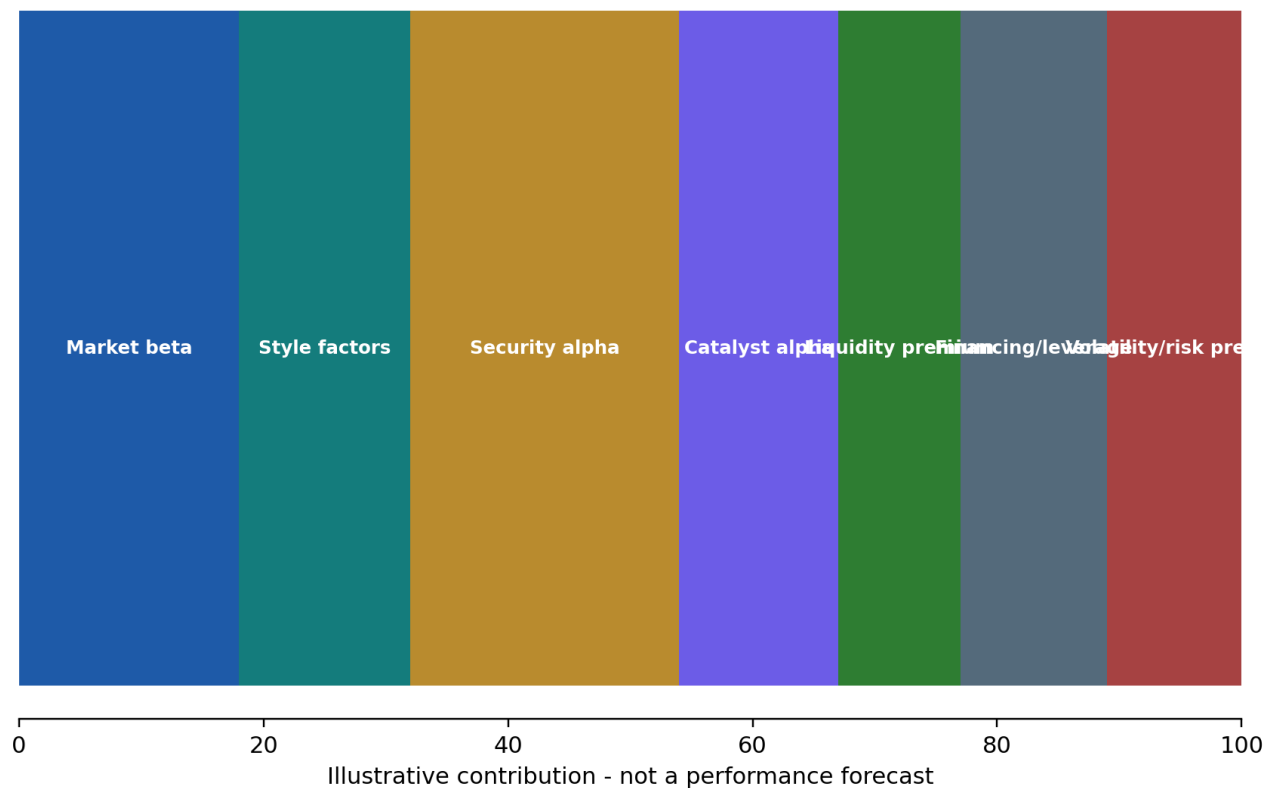
A trend follower does not need to forecast inflation. It follows price trends across futures markets. When inflation shocks produce persistent moves in commodities, rates, and currencies, CTA models can profit. In choppy markets, repeated false breakouts can produce losses.

## Volatility case

A volatility fund may sell expensive implied volatility when realized volatility is expected to be lower, or buy tail protection when the market underprices crash risk. The trade can look stable for long periods and then lose sharply if convex risk is not controlled.

# 7. Return Engines: Alpha, Beta, Leverage, Derivatives, Liquidity, and Behavior

## How Hedge Funds Convert Market Structure into Return Sources



A hedge fund return stream is a mixture. Investors often pay for “alpha,” but realized returns may include market beta, factor beta, liquidity premium, volatility risk premium, credit carry, leverage, timing luck, and hidden tail risk. The due-diligence task is to decompose the return before paying premium fees.

Alpha	Return from manager skill after adjusting for relevant risks.	Security selection, superior catalyst analysis, better execution, unique data, legal/restructuring expertise.
Beta	Exposure to broad market movement.	Long equity net exposure, duration exposure, credit spread exposure, commodity beta.
Style/factor beta	Exposure to value, momentum, quality, size, carry, defensive, volatility, liquidity, or trend factors.	A “stock picker” may simply be long quality/momentum and short junk/value without recognizing it.
Leverage	Borrowed money or embedded notional exposure magnifies gains and losses.	Margin borrowing, futures notional, swaps, repo, options, securities lending.
Short selling	Selling borrowed securities to profit from decline or hedge long exposure.	Generates negative beta or relative-value exposure but creates unlimited-loss and borrow risk.
Derivatives	Contracts whose value derives from securities, rates, currencies, commodities, volatility, or credit.	Options, futures, swaps, CDS, variance swaps, total return swaps.
Liquidity premium	Compensation for holding assets others cannot or will not hold.	Distressed debt, small-cap positions, complex credit, off-the-run bonds.

Information advantage	Better processing of public, alternative, expert, legal, or channel data within compliance rules.	Supply-chain checks, satellite data, NLP of filings, court-docket analysis, credit-card data.
Structural inefficiency	Market rules or constraints force non-economic flows.	Index rebalances, rating downgrades, mutual-fund redemptions, bank balance-sheet constraints.
Behavioral distortion	Human herding, panic, overreaction, forced selling, euphoria, career risk.	Buying forced-sold credit, shorting promotional equities, fading panic dislocations.

## Alpha versus beta in plain language

If a fund is up 15% because the S&P; 500 is up 25% and the fund was net long growth stocks, that is not pure alpha. If a fund is up 8% with low market exposure because it correctly identified merger spreads, relative-value dislocations, or mispriced credit recoveries, that is closer to alpha. Investors should not pay “2 and 20” for disguised beta that can be bought cheaply through ETFs.

**Leverage is not automatically bad. It is a tool. The danger is using short-term, mark-to-market financing to hold positions whose liquidity disappears precisely when margin calls arrive. LTCM and Archegos were not destroyed simply by being wrong; they were destroyed by being wrong, leveraged, and dependent on counterparties under stress.**

## 8. Economics and Fund Terms: 2 and 20, High-Water Marks, Lockups, Gates

Hedge fund terms are an economic constitution. They determine how profits, losses, liquidity, information, and control are shared between the manager and investors.

2 and 20	Classic fee model: 2% annual management fee plus 20% performance fee or incentive allocation. Many modern funds charge lower or more customized terms; top platforms may also pass through expenses.	Fees can consume large portions of gross return; alignment depends on true alpha.
Management fee	Fee on assets under management or net asset value, usually paid regardless of performance.	Keeps the business alive but can reduce urgency if too high.
Performance fee / incentive allocation	Share of profits paid to manager.	Aligns upside but can encourage risk-taking if not balanced by high-water marks, hurdles, clawbacks, or manager investment.
High-water mark	Manager earns incentive fees only on new profits above the investor's prior peak NAV.	Prevents charging twice for recovery from losses.
Hurdle rate	Minimum return before performance fee applies, sometimes hard or soft hurdle.	Protects investors from paying incentive fees for low or cash-like returns.
Lockup	Period during which investors cannot redeem.	Gives manager stable capital but reduces investor liquidity.
Gate	Limit on fund-level or investor-level redemptions in a period.	Prevents fire sales but can trap investors.
Redemption notice	Advance notice required before withdrawal.	Allows liquidity planning; affects investor cash management.
Side pocket	Separate account for illiquid or hard-to-value assets, often redeemable only when realized.	Protects remaining investors from forced-sale valuation but reduces liquidity and transparency.
AUM	Assets under management. Can mean regulatory AUM, net AUM, gross assets, or firmwide assets depending on context.	Bigger AUM can mean stability and resources but also capacity limits and diluted alpha.
Most-favored-nation clause	Investor may receive certain favorable terms granted to other investors.	Can improve fairness but complicates administration.
Founder share class	Early investors receive lower fees or better terms.	Useful for fundraising; can create long-term fee dispersion.

### Numerical example: high-water mark

Assume an investor subscribes \$10 million. Year 1 NAV falls to \$8 million. Year 2 NAV recovers to \$9.5 million. With a high-water mark at \$10 million, the manager earns no performance fee on the recovery. Only gains above \$10 million generate a new incentive fee. This mechanism reduces the asymmetry of “heads I win, tails you wait.”

**The most investor-friendly fee is not always the lowest fee. A lower fee with poor risk control is worse than a higher fee for true capacity-constrained alpha. The correct question is: What net return, after all fees, taxes, liquidity costs, and tail risks, does the investor actually receive?**

# People Inside a Hedge Fund

Portfolio Manager (PM)	Owns P&L; constructs positions, sizes trades, manages catalysts, communicates thesis.	Good PMs combine conviction with risk discipline and know when the thesis is invalidated.
Analyst	Researches companies, securities, macro data, legal events, models, channels, and valuation.	Analysts are the idea factory; weak research creates false alpha.
Chief Investment Officer (CIO)	Sets investment philosophy, capital allocation, risk appetite, hiring, and portfolio architecture.	CIO converts multiple ideas into a coherent risk-adjusted book.
Risk Manager	Monitors exposures, stress tests, liquidity, leverage, factor risk, drawdowns, and counterparty concentration.	Independent risk prevents a good strategy from becoming a fatal position.
Trader / Execution	Implements orders, manages market impact, borrow, derivatives, and liquidity.	Execution quality can be the difference between alpha captured and alpha leaked.
COO / CFO	Operations, finance, service providers, cash, margin, investor reporting, budgets.	Institutional credibility often depends more on COO/CFO discipline than PM charisma.
CCO / Legal	Regulatory compliance, marketing review, personal trading, filings, conflicts, policies.	Compliance protects the franchise from existential errors.
Investor Relations / Capital Development	Fundraising, DDQs, reporting, allocator communication.	Investors allocate to trust, process, repeatability, and clarity - not only past returns.

In a small emerging manager, one person may wear several hats. In an institutional platform, these functions are separated. The transition from “good investor” to “fund manager” is the transition from generating ideas to running an operating company under fiduciary, regulatory, operational, and reputational constraints.

## 9. Investors: Why Institutions and Family Offices Allocate to Hedge Funds

Institutions do not allocate to hedge funds merely because they seek high returns. They allocate because hedge funds can provide portfolio functions that traditional assets may not: diversification, downside control, crisis alpha, inflation/rates/FX exposure, access to specialized talent, event/catalyst returns, and opportunistic capital deployment.

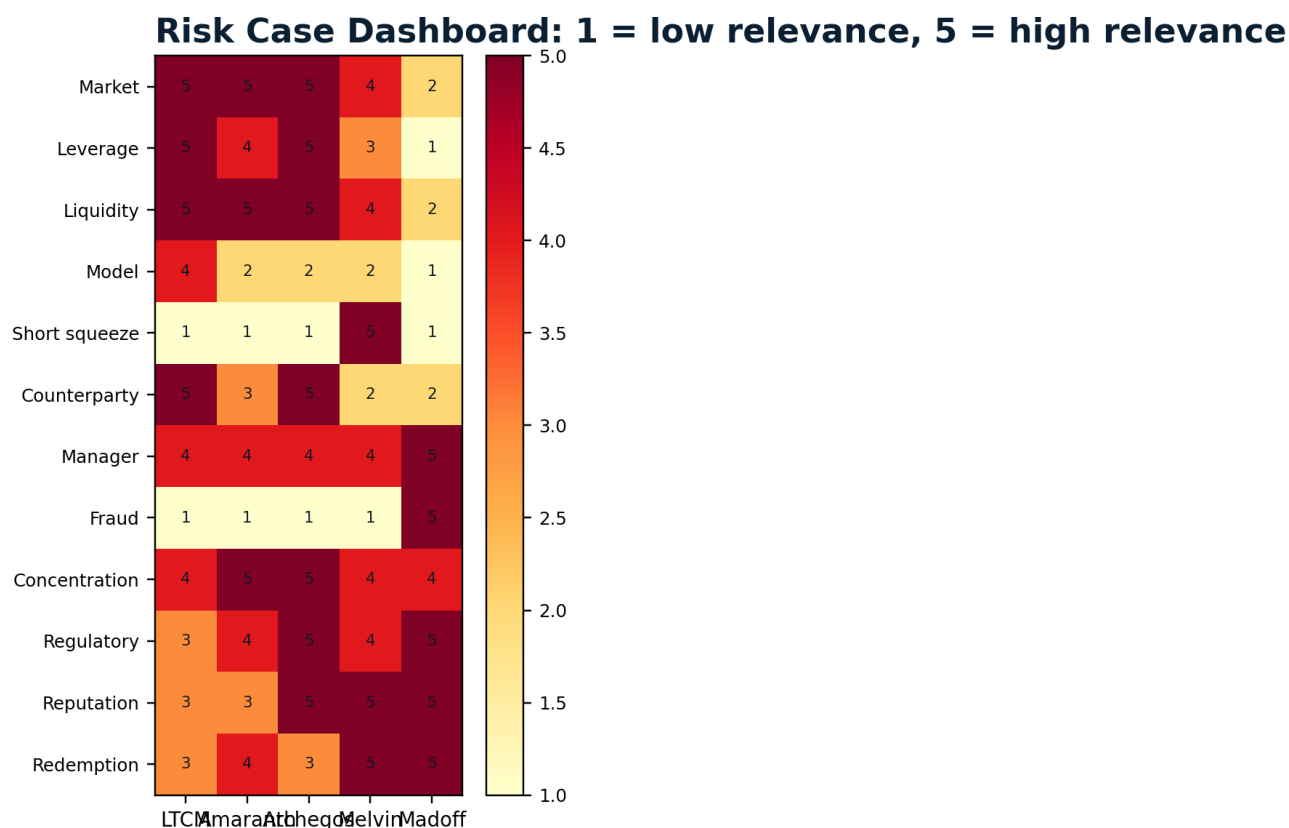
Pension funds	Diversification, lower correlation, absolute-return sleeve, liability-aware risk management.	Fees, transparency, political scrutiny, liquidity, headline risk.
University endowments	Long horizon, tolerance for illiquidity, pursuit of differentiated alpha, manager access.	Capacity, governance, manager selection, drawdown optics.
Insurance companies	Capital preservation, credit/rates expertise, low-correlation returns, asset-liability matching.	Regulatory capital, liquidity, valuation, downside risk.
Sovereign wealth funds	Global diversification, access to top managers, tactical macro and market dislocation exposure.	Scale, geopolitical risk, transparency, governance.
Family offices	Capital preservation, flexible mandates, tax-aware structures, access to niche managers.	Fraud, key-person risk, lack of institutional ops, liquidity.
Ultra-high-net-worth individuals	Alternative return streams, prestige/access, downside hedging, concentrated wealth diversification.	Complexity, suitability, taxes, fees, lockups.
Funds of funds	Manager selection, diversification, access, due diligence, portfolio construction.	Double fees, mediocre manager selection, liquidity mismatch.

### Allocator logic

- **Return enhancement:** access skill that cannot be replicated through passive public markets.
- **Diversification:** add sources of return that behave differently from equities and bonds.
- **Risk control:** use hedging, shorts, options, and macro strategies to reduce drawdown severity.
- **Crisis response:** certain macro, CTA, relative-value, and volatility strategies can profit from stress or provide liquidity after selloffs.
- **Specialization:** distressed, merger arb, structured credit, commodities, and statistical arbitrage require dedicated expertise and infrastructure.
- **Access:** some elite managers are capacity-constrained and available only to large or early investors.

**The investor mistake is to buy a hedge fund for “high return” without knowing what portfolio problem it solves. A hedge fund allocation should have a job description: reduce equity beta, provide crisis convexity, monetize spreads, access macro, harvest relative value, or compound capital through idiosyncratic alpha.**

## 10. Risk Framework and Case Studies



The hedge fund industry is built around risk taking, but professional risk taking differs from uncontrolled fragility. A fund can have a correct thesis and still fail because its financing, liquidity, collateral, redemption terms, or operational controls are wrong.

Market risk	Loss from price movements in equities, rates, credit, FX, commodities, volatility.	Limits, hedges, stress tests, VaR plus scenario analysis.
Leverage risk	Borrowed or embedded notional exposure magnifies losses.	Gross/net limits, margin buffers, financing tenor, independent risk authority.
Liquidity risk	Cannot exit positions without severe price impact or cannot meet redemptions/margin.	Liquidity buckets, gates, lockups, stress liquidity, position sizing.
Model risk	Quant or valuation model fails due to overfit, wrong assumptions, bad data, or regime change.	Out-of-sample testing, model governance, human challenge, kill switches.
Short-squeeze risk	Shorted security rises sharply, forcing buy-ins and loss acceleration.	Borrow monitoring, position caps, catalyst discipline, options hedges.
Counterparty risk	Prime broker, swap dealer, custodian, or financing counterparty fails or changes terms.	Diversification, collateral control, ISDA terms, exposure reports.
Manager risk	Key person, style drift, poor judgment, bad culture, or weak controls.	Key-person clauses, governance, transparency, background checks.
Fraud risk	False reporting, fictitious trades, misappropriation, Ponzi activity.	Independent admin/custody/audit, trade verification, no self-custody.
Concentration risk	Too much exposure to one trade, sector, factor, counterparty, or theme.	Position limits, factor analysis, risk aggregation.

Regulatory risk	Rule changes, enforcement, registration failures, sanctions, short-sale rules.	Compliance program, counsel, monitoring, training.
Reputational risk	Loss of investor, counterparty, regulator, or public trust.	Governance, communication, ethics, crisis management.
Redemption risk	Investor withdrawals force sales at bad prices or destabilize strategy.	Appropriate lockups, gates, investor-base diversification, cash planning.

## Five Case Studies: What Failed

LTCM (1998)	Highly leveraged relative-value fund suffered large losses after market stress and correlation breakdown. A private-sector recapitalization of \$3.6 billion by 14 banks and brokerages was organized with Federal Reserve Bank of New York facilitation, with no Fed funds at risk.	Small spreads plus high leverage can become systemic when positions are crowded and counterparties are interconnected.
Amaranth (2006)	Large natural gas positions produced severe losses; CFTC later announced a \$7.5 million civil monetary penalty settlement related to attempted manipulation charges.	Commodity liquidity, concentration, and calendar-spread risk can overwhelm diversified-looking portfolios.
Archegos (2021)	Family office used total return swaps to build large equity exposures across banks; margin calls triggered forced liquidation and major bank losses. SEC alleged billions of dollars in margin-financed total return swaps.	Synthetic leverage can hide concentration. Counterparties may each see only part of the risk.
Melvin Capital / GameStop (2021)	A crowded short thesis collided with retail-flow coordination, social media, options activity, and short-squeeze dynamics.	Shorts require liquidity, borrow discipline, position sizing, and awareness of social/flow risk.
Madoff (2008)	Fraudulent investment advisory operation represented fabricated trading and returns; SEC OIG later faulted failures to verify trading through independent third parties.	Operational due diligence is not optional. Independent custody, admin, audit, and trade verification are existential protections.

### The shared pattern

**These failures were different, but they share a core logic: trust without verification, leverage without liquidity, complexity without transparency, concentration without humility, or strategy without structural resilience. Serious allocators study blowups not as gossip but as engineering failures.**

# 11. Major Hedge Fund Managers: Comparative Profiles

The following profiles are educational snapshots, not investment recommendations. AUM, leadership, product mix, and performance change frequently; investors should verify current Form ADV filings, audited financials, investor letters, and official disclosures before making decisions.

Bridgewater Associates	Founded by Ray Dalio; institutional global macro and total-portfolio thinking.	Macro, risk parity heritage, systematic economic frameworks, institutional mandates.	Deep macro research, portfolio-construction culture, institutional relationships.	Macro cycles can be difficult; culture and succession have been heavily scrutinized; capacity constraints.
Citadel	Founded by Ken Griffin; global multi-strategy powerhouse.	Equities, fixed income/macro, commodities, credit, quantitative strategies.	Scale, technology, risk systems, talent, rapid capital allocation.	High complexity, expensive talent model, crowding risk, strong dependency on platform execution.
Millennium Management	Founded by Israel Englander; decentralized multi-manager platform.	Many independent PM teams across fundamental equity, arbitrage, macro, systematic, commodities/credit.	Diversification across teams, strict risk limits, institutional process; official site reports \$87B+ AUM and 330+ teams.	High pass-through expense model, pod turnover, capacity and crowding.
AQR Capital Management	Founded by Clifford Asness and partners; quant/systematic investing.	Systematic value, momentum, quality, carry, trend, alternative risk premia.	Academic rigor, factor research, scalable disciplined process.	Factor drawdowns can be long; models can become crowded or regime-sensitive.
Renaissance Technologies	Founded by Jim Simons; quantitative pioneer.	Mathematical/statistical models, systematic trading.	Exceptional quant reputation, scientific culture, data/technology intensity.	Opaque, capacity constrained, employee-only flagship history; public products may differ from legend.
Two Sigma	Founded by John Overdeck and David Siegel; data science-driven investment firm.	Quantitative research, machine learning, data engineering, systematic strategies.	Scientific method, technology, alternative data, engineering culture.	Model governance, leadership/culture risk, crowding and signal decay.
Elliott Investment Management	Founded by Paul Singer; activist and multi-strategy manager.	Activism, distressed, credit, equity-oriented, arbitrage, commodities, volatility protection.	Legal/credit expertise, activism playbook, long operating history.	Public controversy, long timelines, political/reputational risk, concentrated campaigns.
D. E. Shaw	Founded by David E. Shaw; quantamental investment firm.	Systematic to discretionary strategies across public and private markets.	Research infrastructure, quant roots, diversified approaches; official site reports over \$90B in investment and committed capital as of Mar. 1, 2026.	Opaque, complexity, talent competition, strategy capacity.
Point72	Led by Steven A. Cohen; successor platform after SAC history.	Fundamental equities, systematic, macro, private credit, venture.	Large analyst training ecosystem, 200+ teams, official AUM around \$50.7B as of Apr. 1, 2026.	Reputational legacy, platform complexity, PM retention.
Man Group	Publicly listed global alternative manager with long trading history.	Quant, discretionary, multi-strategy, long-only and alternatives.	Scale, transparency as public company, data-led quantitative heritage; official site reports \$228.7B AUM as of Mar. 31, 2026.	Public-market pressure, product breadth can dilute identity, flows can be cyclical.

Baupost Group	Founded by Seth Klarman; value-oriented private investment partnership.	Value investing, event-driven bias, distressed debt, private/public equities, real estate.	Margin-of-safety discipline, patient capital, conservative reputation.	Cash drag, underperformance in momentum markets, limited transparency.
Pershing Square	Founded by Bill Ackman; concentrated activist/value investor.	Concentrated large-cap positions, activism, public holding-company structure.	High-conviction research, public communication, corporate influence.	Concentration, public-persona/reputation risk, activist timing risk.
Third Point	Founded by Daniel Loeb.	Activist/event-driven equities, credit, venture capital.	Flexible mandate, catalyst orientation, credit/equity mix.	Activism can be cyclical; style shifts require close monitoring.
Tiger Global	Founded by Chase Coleman; public/private growth investing.	Long/short and long-focused public growth equities; early to late-stage private equity/venture.	Global technology/growth network, crossover capability.	Growth factor cyclicity, private valuation risk, drawdown sensitivity.
Soros Fund Management	Founded by George Soros; now a leading global asset manager/family-office style platform.	Equities, credit, macro; unconstrained capital allocation.	Macro heritage, concentrated conviction, dynamic allocation.	Founder-era returns are not necessarily repeatable; mandate and governance have evolved.

## Platform versus personality

A key industry shift is from star-manager personality to platform architecture. The old model was a brilliant founder with a concentrated book. The newer model is an industrial platform with hundreds of teams, centralized risk, data, financing, compliance, and capital allocation. Both can work. The platform model may be more resilient to individual error, but it is expensive and can create crowded, fast-moving capital flows.

## 12. How Investors Should Evaluate Hedge Funds

Due diligence has two halves: investment due diligence and operational due diligence. Many investors obsess over performance charts and underweight operations. Madoff showed why that is fatal. LTCM and Archegos showed that even sophisticated market participants can misjudge leverage, liquidity, and counterparty concentration.

What is the edge?	Specific, repeatable, capacity-aware source of return, explained in plain language.	Vague “proprietary process” with no falsifiable thesis.
What risk is being sold?	Clear distinction between alpha, beta, carry, volatility, liquidity, and leverage.	Returns look smooth but tail risk is hidden.
What is the drawdown history?	Explains worst months, recovery, mistakes, and process changes.	Blames markets without learning.
How is leverage controlled?	Gross/net limits, stress tests, financing terms, margin buffers, independent risk.	Leverage shown only in accounting terms, not notional/economic exposure.
How liquid are positions?	Liquidity buckets matched to investor redemption terms.	Monthly liquidity offered for assets that need months to sell.
Who calculates NAV?	Independent administrator and reputable auditor.	Manager self-calculates hard-to-value NAV without independent checks.
Where are assets held?	Recognized custodians/prime brokers; statements reconciled.	Self-custody or unclear asset verification.
How are fees calculated?	Transparent management/performance fees, high-water marks, hurdles, expenses.	Complex pass-through costs with limited reporting.
What is capacity?	Manager can explain when AUM hurts returns.	Always willing to take more capital regardless of strategy liquidity.
What is alignment?	Meaningful GP capital, fair terms, disciplined growth.	Manager gets rich from fees while investors wait for performance.
What happens in a crisis?	Written liquidity, valuation, communication, and risk-reduction protocols.	Ad hoc decision making and defensive communication.
What is the compliance culture?	CCO authority, tested policies, marketing review, personal trading controls.	Compliance outsourced psychologically even if documents exist.

### Investor scoring framework

- **Strategy score:** Is the edge real, understandable, persistent, and scalable?
- **People score:** Are PMs, analysts, risk, operations, and compliance credible and stable?
- **Process score:** Is portfolio construction repeatable or dependent on intuition alone?
- **Risk score:** Can the fund survive wrong-way markets, margin calls, redemptions, and crowded unwinds?
- **Operations score:** Are valuation, custody, admin, audit, cyber, trade reconciliation, and legal controls institutional?
- **Terms score:** Do fees, liquidity, transparency, and governance match the strategy?
- **Portfolio role score:** Does the fund solve a specific problem in the investor’s total portfolio?

**The best investor question is: “What would make this strategy lose 25%, and how would we know before it happened?” A manager who cannot answer that question clearly is not ready for institutional capital.**

# 13. How Managers Should Design and Operate Hedge Funds

A hedge fund manager is building two products at once: an investment strategy and an institutional operating company. The first may attract attention. The second keeps capital.

Investment mandate	Define instruments, geographies, liquidity, leverage, concentration, net/gross limits, expected volatility, and capacity.	Mandate creep and investor misunderstanding.
Research process	Document idea generation, variant perception, thesis, catalyst, downside, sizing, exit rules.	Narrative investing without falsifiable process.
Risk architecture	Independent risk dashboard, scenario tests, factor exposures, stress liquidity, counterparty map.	PM controls risk only when things are calm.
Operations	Daily reconciliation, trade capture, cash controls, NAV process, vendor oversight, cyber controls.	Operational error becomes investment loss or fraud suspicion.
Compliance	Code of ethics, marketing rule review, personal trading, MNPI policy, Form ADV/Form PF where applicable, CFTC/CPO/CTA analysis where relevant.	Regulatory surprise or enforcement risk.
Investor communication	Monthly/quarterly letters, exposure summaries, drawdown explanation, honest mistakes review.	Marketing spin replaces trust.
Capital strategy	Choose target investors, minimum check size, founder terms, seed economics, capacity plan.	Raising mismatched capital that exits during drawdowns.
Talent model	Clear PM economics, analyst development, retention, culture, succession.	Star culture with no bench or controls.
Technology	OMS/EMS, portfolio accounting, risk, data lake, research reproducibility, disaster recovery.	Spreadsheets become infrastructure until they break.
Governance	Valuation committee, conflicts policy, side-letter log, expense policy, board/directors if offshore.	Conflicts managed informally.

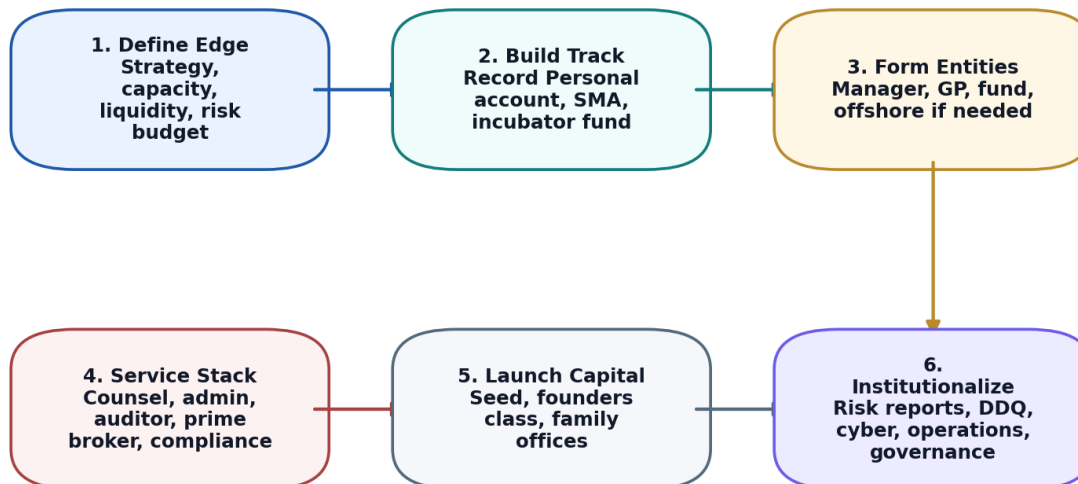
## Emerging manager discipline

- Start with a strategy narrow enough to be credible and broad enough to survive changing opportunity sets.
- Do not overpromise liquidity. Match redemption terms to the time needed to exit positions in stress, not normal markets.
- Create institutional-quality monthly reporting before institutions ask for it.
- Write down the risk limits before the first trade. Limits created after losses are usually politics, not risk management.
- Separate investment brilliance from operational authority: valuation, cash movement, and compliance should not depend on the PM's mood.
- Protect reputation like capital. One regulatory, valuation, or investor-communication failure can end fundraising for years.

# 14. Roadmap for Launching a Hedge Fund Management Firm

## Roadmap for Launching a Hedge Fund Management Firm

The launch is less about a fund name and more about edge, controls, service providers, capital, and credibility.



Launching a hedge fund is not a single filing event. It is a sequence: define an investable edge, produce a credible track record, build legal entities and documents, assemble service providers, raise capital, launch with controls, and then institutionalize.

0. Personal preparation	Convert investment skill into a business thesis.	Write strategy memo; identify edge, target markets, capacity, liquidity, expected volatility, drawdown tolerance, and investor fit.
1. Track record	Create evidence that the edge exists.	Trade personal account, SMA, or incubator vehicle; document returns net/gross of fees; show exposures, risk, and drawdown attribution.
2. Formation design	Choose structure aligned with investors and strategy.	Select domestic/offshore/master-feeder; hire counsel; draft PPM, LPA, subscription docs, adviser agreement; analyze SEC/state/CFTC/CPO/CTA requirements.
3. Service-provider build	Institutionalize operations before fundraising scale.	Prime broker, admin, auditor, tax, compliance, bank, OMS/accounting/risk systems, cyber policies.
4. Fundraising preparation	Make the fund investable, not merely impressive.	Pitch deck, DDQ, tear sheet, risk reports, sample investor letter, model portfolio, founder share class, data room.
5. Launch capital	Raise aligned early capital.	Friends/family, family offices, seed investors, strategic LPs; negotiate terms carefully; avoid investors whose liquidity needs mismatch strategy.
6. First year operation	Prove process under real capital.	Monthly NAV, investor letters, risk meetings, compliance testing, audit preparation, tax reporting, drawdown communication.
7. Institutional scaling	Move from boutique fund to durable firm.	Hire COO/CFO/CCO depth, expand research, refine capacity, add share classes, build consultant relationships, improve cyber and governance.

## Minimum viable launch checklist

- A one-sentence strategy that a sophisticated investor can repeat accurately.
- A track record with position-level attribution and risk exposures, not only monthly returns.
- A fund structure matched to investor tax/regulatory needs.
- A reputable administrator and auditor identified before launch.
- A prime broker or financing arrangement suitable for shorts, derivatives, and margin needs.
- A compliance manual, code of ethics, marketing-review process, cybersecurity policy, and books-and-records system.
- A realistic budget: legal, audit, admin, compliance, data, rent, salaries, technology, insurance, and travel.
- A capital pipeline that distinguishes soft interest from signed subscriptions.
- A drawdown communication plan before the drawdown occurs.

**The first institutional investor rarely funds a dream. They fund a credible process, a verified track record, a strong operating base, and a manager who knows exactly how the fund can fail.**

## 15. Hedge Funds and Financial Power in Capitalism

Hedge funds sit at the intersection of capital allocation, market liquidity, corporate governance, and financial engineering. They are not the largest pools of global capital compared with pension funds, sovereign wealth funds, insurers, mutual funds, or banks, but they are among the most mobile and opportunistic pools of capital. Their power comes from speed, mandate flexibility, leverage access, analytical specialization, and willingness to take controversial positions.

### Constructive functions

- **Price discovery:** hedge funds search for mispricing and force markets to incorporate information faster.
- **Liquidity provision:** they buy when others are forced to sell and sell/short when others are euphoric.
- **Risk transfer:** through derivatives, credit, macro, and volatility strategies, they absorb or redistribute risks that other institutions do not want.
- **Corporate discipline:** activist funds can pressure boards to improve capital allocation, governance, margins, or strategic focus.
- **Innovation in capital markets:** they help develop new trading, hedging, data, and portfolio-construction techniques.

### Critical concerns

- **Opacity:** private structures can hide leverage, concentration, and counterparty exposure.
- **Systemic leverage:** crowded trades financed by short-term credit can amplify stress.
- **Fee extraction:** high fees can transfer wealth from beneficiaries to managers if alpha is weak.
- **Short-termism:** activist pressure can improve discipline but may also push companies toward near-term metrics.
- **Inequality and access:** the best funds are often accessible only to large institutions and wealthy investors.
- **Regulatory arbitrage:** complex cross-border structures can challenge public oversight.

### The balanced view

Hedge funds are neither heroes nor villains by category. They are financial technologies. They can expose fraud, discipline management, provide liquidity, and diversify portfolios. They can also create crowded leverage, destabilize markets, extract fees, and hide risks. Their social value depends on whether they allocate capital better than alternatives after fees, risk, liquidity costs, and externalities.

**From a financial-power perspective, a hedge fund is a private command center that converts research, legal structure, market access, and risk appetite into capital movement. It is capitalism's special forces: smaller than the regular army of passive capital, but faster, more flexible, and often closer to the point of market stress.**

## 16. Key Terminology

Alpha	Return attributable to manager skill after adjusting for relevant risk exposures.
Beta	Exposure to broad market movements.
Gross exposure	Long exposure plus short exposure, measuring total market involvement.
Net exposure	Long exposure minus short exposure, measuring directional bias.
Sharpe ratio	Return per unit of volatility, often using excess return over cash.
Drawdown	Peak-to-trough decline in capital.
Prime broker	Brokerage/financing platform providing margin, securities lending, settlement, and reporting.
Borrow	Availability and cost of borrowing a security for short sale.
ISDA	Standard documentation framework for OTC derivatives.
Total return swap	Derivative that provides economic exposure to an asset without directly owning it.
Repo	Repurchase agreement; financing tool often used in fixed income.
Side letter	Investor-specific agreement modifying or adding terms.
ERISA	U.S. pension law relevant to benefit-plan investors and plan-assets analysis.
Form ADV	SEC/state adviser registration/disclosure form.
Form PF	Private fund systemic-risk reporting form for certain SEC-registered advisers.
CPO / CTA	Commodity pool operator / commodity trading advisor categories relevant to futures, options on futures, swaps, and certain commodity interests.
Capacity	Maximum capital a strategy can manage before returns degrade.
Crowded trade	A position held by many similar investors, vulnerable to forced unwind.
Convexity	Nonlinear payoff pattern; losses or gains accelerate as market moves.
Tail risk	Rare but severe loss event.

# Selected Sources and Further Reading

The report uses public regulatory, official firm, and reputable market sources. This source list is for orientation, not a substitute for live due diligence, audited financial statements, Form ADV, Form PF, investor letters, offering documents, or legal advice.

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End of report.