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CHAPTER TWENTY-SEVEN

Hedge funds as phantastic objects: a psychoanalytic perspective on financial innovations

Richard Taffler and Arman Eshraghi

"We start with a *blank canvass*. We are trying to *sketch out* a global macro view of the world for the next two years. And we are looking for *wealthy patrons* that want to buy that *piece of art*."
Hugh Hendry, Founder and Chief Investment Officer of the Eclectica Hedge Fund, interviewed in the *Financial Times* (Williams, 2015, italics added)

Overview

Hedge funds are the "darlings" of the investment industry, with currently almost $3 trillion invested in them. These opaque, predominantly unregulated and exclusive investment products, which are only open to wealthy individuals and large investing institutions, possess a mystique and allure that renders them enormously attractive to investors. This is despite their less than stellar performance in recent years. Whereas the large majority of hedge funds are properly constituted and appropriately managed investment vehicles, some are less so, and the important implications of this are expanded upon in the chapter. Specifically in our analysis we draw on psychoanalytic theory, and especially the work of Klein and Bion, to explain the magical appeal of hedge funds to investors, and why they are willing to put so much of their funds and, by extension, their trust into such "exotic" and secretive investment vehicles. In particular, we explain the rapid growth in aggregate hedge fund assets under management until June 2008, followed by their subsequent dramatic collapse, in terms of the

conflicting emotions such investments evoke, and, from this, consider the implications of the excitement-generating potential underlying all financial innovations.

Adopting the methodological approach of critical discourse analysis, this chapter explores how hedge funds were represented in the financial press, interviews with hedge fund managers, investor comments, and Congress hearings, before and after the burst of the hedge fund "bubble". In particular, we frame the human need for excitement in this discourse. Our study finds evidence demonstrating how hedge funds can be transformed in the minds of investors into objects of fascination and desire, with their unconscious representation dominating their original investment purpose. Drawing on the insights of the psychoanalytic understanding of unconscious fantasies, needs, and drives as these relate to financial markets, and parallels with dot.com mania, we show how hedge fund investors' search for "phantastic objects" (Tuckett & Taffler, 2008) and the associated excitement of being invested in them can become dominant, resulting in risk being ignored.

We suggest that financial regulators need to recognise explicitly the key role powerful unconscious processes play in all financial activity at both individual and market levels, and the adverse consequences if such understanding is ignored. Public policy implications are that investors need to be protected from the encouragement to act out their unconscious fantasies to their financial detriment via appropriate regulation, and that stricter ethical guidelines for the hedge fund industry may be required. *Caveat emptor* is not an adequate basis on which parts of the financial services sector should be allowed to operate, however "sophisticated" investors might be thought to be. We also argue that the financial and public media need to contain, rather than spread, the excitement associated with innovative financial products, and the individuals behind them. This is one of very few studies concerning investors' emotional attachment to financial innovations, and builds on the emerging field of emotional finance. The conclusions and implications discussed in the chapter go beyond any single financial market or product.

Introduction

Although the first hedge fund was established in 1949 they are a relatively recent but very high profile financial innovation. There is no clear definition of what a hedge fund is.

However, broadly speaking, such investment vehicles are loosely regulated and secretive in nature. They are designed for sophisticated and wealthy investors, and aim to earn higher returns while protecting investor capital from downside risk using a wide range of different investment strategies. Importantly, their managers, many of whom become very rich and are celebrated in the financial media, are incentivised by the high fees paid them. Hedge fund assets under management grew at the rate of twenty-five per cent per annum from 1990 to June 2008, peaking at almost $2 trillion, and with the industry then consisting of no fewer than 10,000 hedge funds and funds of hedge funds (funds that invest in hedge funds) (HFR, 2009). In the following six months, however, assets under management collapsed by almost a third following investment losses of around twenty per cent, associated investor withdrawals, and fund closures. Interestingly, despite the hedge fund industry underperforming the Standard & Poor's 500 Index (S&P 500) by almost ten per cent a year in the five years to the end of 2015 (Preqin, 2016), assets under management had by then increased to over $3 trillion (Preqin, 2016). We will return to this apparent paradox in our discussion section.

This chapter helps to explain the rise and dramatic fall in hedge fund assets under management from 1990 to 2008 by addressing, among other factors, how the unconscious needs and beliefs of market participants may have come to dominate normal investment considerations. We hypothesise that the fascination with investment vehicles such as hedge funds, and associated unrealistic expectations and wishful thinking, may at least partially be explained in terms of the collective psyche of market participants and their unconscious fantasies (phantasies).

Specifically, we describe how hedge funds came to assume a very different meaning in investor's unconscious reality to their stated aim of providing investment returns less correlated with more traditional asset classes. Based on a psychoanalytic reading of financial markets, we explain how before the hedge fund "bubble" burst, the excitement of investing in what hedge funds represented became divorced from the anxiety associated with the potential consequences of taking on excessive investment risk. Against this backdrop of collective euphoria, all such doubts were dismissed or rationalised away (Tuckett & Taffler, 2008).

However, any such euphoric state is likely to be unsustainable, leading to widespread denial, anger, blame, and panic when reality ultimately intrudes. The emotional trajectory experienced by market participants in this process is a common feature of most asset-pricing

bubbles (Kindleberger & Aliber, 2011, pp. 26-33). We argue that the rapid growth and then dramatic collapse of hedge fund assets under management followed a similar trajectory. Hedge funds can be easily represented in the minds of market participants as highly desirable "phantastic objects" due to the financial innovations that many of them claim to represent, the potential opaqueness of their investment strategies, their implicit promise of wealth, their often exclusive nature, and their portrayal in the financial media.

In this chapter we draw parallels between hedge funds as phantastic objects and investors' perceptions of dot.com stocks both during dot.com mania, and after the bubble burst. We suggest many hedge fund investors become emotionally involved with their investments in a similar way, with associated unrealistic expectations and unintended consequences. In particular, we demonstrate the anger and blame felt by investors who had again to relinquish their unconscious desires when ultimately confronted with underlying reality, and to acknowledge that hedge funds are, in principle, just like any other investment vehicle. Finally, we argue that almost any type of investment has the potential to become phantastic in the investor's unconscious. It is therefore important to understand properly the vital role the unconscious plays in investment decision-making, the domain of the emerging field in finance, emotional finance (e.g., Taffler & Tuckett, 2010; Tuckett, 2011; Tuckett and Taffler, 2012). Emotional finance seeks to describe how unconscious processes can drive investment decisions and market behaviour more generally. It studies how the inherently unpredictable nature of financial markets generates powerful feelings of excitement and anxiety leading investors to being caught up emotionally with consequences often not recognised.

We believe that the psychoanalytic understanding of the human mind constitutes a helpful epistemology to explore the issues addressed in this paper. The manner in which hedge funds are perceived by many investors and the media, as demonstrated below, provides implicit evidence that unconscious processes are being acted out in the market for hedge fund investments, with the consequential need for greater regulation to protect investors and stricter ethical codes of behaviour. Whereas most hedge funds seek to act in their clients' best interests, a number, whether consciously or not, may well be exploiting the highly seductive nature of these investment vehicles to investors for their own purposes. It is these cases that are the particular concern of this chapter.

Hedge funds

There is no universally accepted definition of what a hedge fund is. According to a US Securities and Exchange Commission (SEC) definition, "hedge fund" is a "general, non-legal term used to describe private, unregistered investment pools that traditionally have been limited to sophisticated, wealthy investors." The Alternative Investment Management Association stresses their absolute return focus, using a definition based on Ineichen (2003): "A hedge fund constitutes an investment program whereby the managers or partners seek absolute returns by exploiting investment opportunities while protecting principal from potential financial loss."

Essentially, being largely unregulated, hedge funds are able to undertake a wider range of activities than, for example, conventional mutual funds (professionally managed and regulated investment funds that pool money from many investors, and are sold to the general public). They are open to a limited number of typically wealthy individuals and their representatives or investing institutions such as pension funds, endowments, insurance companies, sovereign wealth funds, and banks. Investment processes are determined by each fund's particular strategy and investment approach, which may change from time to time. Their investable universe can, in some cases, be viewed as just that – the universe – ranging from conventional equities and bonds to commodities, currencies, and other financial instruments, etc. They are able to take short positions (i.e., bet against the fall in value of an asset) and use leverage (borrowing) and derivatives (artificially constructed financial instruments deriving their value from the real assets than underpin them) to increase returns at the cost of greater risk, and invest in illiquid (i.e., difficult to sell) assets. They may also tie up their investors' funds for a significant period, imposing restrictions on withdrawals with clear consequences, for example, when investors sought to get their money out in 2008 but could not.

In theory, hedge funds should play an important role in the management of diversified investment portfolios (Stulz, 2007) and improve risk-adjusted portfolio returns. Nevertheless, measuring the performance of hedge funds is difficult. First, hedge funds, being largely unregulated, are not required by law to report their investment returns to any single publicly available database, unlike mutual funds. Although the majority do self-report to one or more

of the commercial hedge fund databases available, many do not, making it difficult to measure overall industry performance and managerial skill. Also, because voluntary reporting is often done for marketing purposes, this leads to positive selection bias in commercial database coverage (e.g., Aiken et al., 2013; Jorion & Schwarz, 2014) resulting in a serious overstating of average hedge fund returns (Getmansky et al., 2015). In addition, there is a high attrition rate among hedge funds reporting to commercial databases (Getmansky et al., 2015). It is therefore not possible to measure hedge fund performance accurately, as in the case of mutual funds.

Nonetheless, there is some evidence that a significant percentage of hedge fund managers do have skill. For example, Ibbotson and Chen (2011) find that even after correcting for data biases, returns earned are significantly positive. In addition, a number of authors (e.g., Jagannathan et al., 2010; Jame, 2015; Kosowski et al., 2007) demonstrate top hedge fund performance cannot be explained by luck and can persist; that is, prior returns can help predict future returns.

On the other hand, other authors (e.g., Dichev & Yu, 2011; Gregoriou, 2006; Griffin & Xu, 2009; Malkiel & Saha, 2005) argue hedge fund returns are lower than is commonly supposed. In particular, Dichev and Yu (2011) show that investors tend to invest in such funds well after their inception, and in widely uneven bursts of capital often chasing past returns. As a result, the *actual* returns they earn are three to seven per cent below conventionally reported ones with real returns close to zero, and much lower than the return on the S&P 500 Index. Also, Chan et al. (2006) demonstrate that a hedge fund manager may be able to report strong and consistent returns over ninety-six months but still be at risk of sudden implosion. Similarly, Stulz (2007) comments that "hedge funds may have strategies that yield payoffs similar to those of a company selling earthquake insurance … [and thus] will have a significant positive alpha [return] – until the quake hits." Indeed, the lack of consistent results across various studies further confirms the difficulties and biases inherent in the measurement and evaluation of hedge fund performance, and the real contribution of hedge fund managers. In addition, most, but not all, empirical studies cover historic periods, not the more recent ones when reported hedge fund returns are very much lower than prior to 2008.

Investors and the allure of hedge funds

In parallel with the remarkable growth in hedge fund assets under management until June 2008, the level of attention paid to hedge funds, both in absolute terms and relative to comparable investment vehicles, rose dramatically. For example, a search in the entire Factiva database of newspaper stories, magazine articles, and the like between 1998 and 2008 for the terms “hedge fund” and “mutual fund” yields an increase of 115 per cent in the frequency of mentions of “hedge fund” compared to only a twenty per cent increase for “mutual fund”. Similarly, a simple search in Google Trends shows a forty-six per cent increase in “hedge fund” mentions from 2004 to 2008 in US-based sources, which compares with a twenty-six per cent decline in occurrences of the term “mutual fund” during the same period.

We argue that the rapid increase in the amount invested in hedge fund assets, followed by its sudden collapse in the second half of 2008, may be explained by the unconscious meaning hedge funds have in the minds of investors. To start with, such investment vehicles are conventionally believed to be able to deliver higher returns because of the often complex, sophisticated, and wide range of investment strategies and asset classes available to them. We suggest this implicit promise of wealth can become a key driver of investor fascination with hedge funds whether or not such performance is actually realised. Gregoriou (2006, p. 139) also points out that the lottery-like nature of hedge fund returns and the increased chance of doing very well or very badly, compared, for example, with mutual funds, can further enhance their appeal to investors and lead them to “expect a more thrilling investment ride”. In addition, since hedge funds are unconstrained in what they do and able to change their investment strategy freely, investors can easily fantasise, imagining them to be whatever they want them to be.

Another distinctive feature of hedge funds is that a number of prominent funds are run by enormously wealthy managers who are hero-worshipped by the financial media. It is a basic human need to always search for champions that can be cherished and with which to identify. “Star” hedge fund managers, particularly when portrayed in exaggerated and unrealistic ways, can become represented in the minds of market participants as investment gods or gurus, further disconnecting investors from their underlying anxiety about the possibility of loss. That many hedge fund managers are reluctant to disclose their investment rationale for proprietary reasons or to maintain a “mystique” again adds to the attraction of their funds.

Hedge funds' exclusivity also contributes to their magical appeal. Being accredited to invest in a high-profile hedge fund represents membership of an exclusive, elite society of rich and sophisticated individuals. Lowenstein (2000, p. 24) describes the mania associated with Long-Term Capital Management (LTCM) with the observation that "hedge funds became symbols of the richest and the best." (LTCM was a celebrated hedge fund with two Nobel prize winners in economics and the Vice Chairman at the Federal Reserve Bank as principals, as well as employing no fewer than twenty-four PhDs, which collapsed within a month in 1998 and had to be bailed out to avoid bringing down the US financial system.)

> The real appeal of hedge funds, however, was financial snobbery. Investing with one of these titans meant membership in a discreet, truly exclusive private club. Imagine the cachet that came from standing at a reception in Midtown Manhattan in the '90s and listening to other people discuss their mutual funds, dot.com investments, and stock options, and being able to quietly murmur that your money was invested with Soros, (Farrell, 2002)

The role of the investment environment in the transformation of hedge funds to magical and immensely attractive vehicles must also be highlighted. A psychoanalytic reading of dot.com mania demonstrates that investors are always searching for exceptional returns with no downside (Taffler & Tuckett, 2005; Tuckett & Taffler, 2008). Highly leveraged hedge fund structures became attractive in the post-2000 investment environment of low interest rates and abundant capital (Geithner, 2008). Hence, many investors employed splitting, a common mental process whereby they were able to "split off" their knowledge of underlying risk from the excitement of the potential to earn extraordinary returns, thereby avoiding anxieties they would have felt had they brought the two together.

Hedge funds as phantastic objects

The concept of phantasy derives mostly from the writings of Freud (1911b) and Melanie Klein (Spillius, 2001). In his paper "Formulations on the two principles of mental functioning", Freud defines phantasy as a "wish-fulfilling activity that can arise when an

instinctual wish is frustrated". Klein, however, regards phantasy as more central and argues that phantasies are not only the constituents of dreams but of all forms of thought and activity.

The term "object" in psychoanalysis refers to the mental image of something or someone in the real world, that is, objective reality. As the object points to the image rather than the actual thing or person, multiple versions of the same object can exist in the minds of different individuals. The phantastic object is thus defined as "a mental representation of something or someone which in an imagined scene fulfils the protagonist's deepest desires to have exactly what she wants exactly when she wants it" (Tuckett & Taffler, 2008). Hence, when discussing phantastic objects, the term "phantasy" suggests the potential of the object for transformation into an exceptionally exciting and desirable mental image. We argue that the thrill, and sometimes euphoria, associated with a successful investment may be explained by the unconscious role the phantastic object plays, be it a winning stock, a top-performing mutual fund, or, as in this paper, a celebrated hedge fund or hedge fund manager.

Freud, in his later thinking, together with Klein, views object relations as central to psychic development. In particular, Klein maintains that object relations arise at the outset, and there is no psychology without object relations (Klein, 1952a). Further, individuals are more susceptible to the phantastic object when a particular sense of reality dominates their thinking. According to Klein (1952b), people make decisions in one of the two basic oscillating states of mind, the depressive (D) state of mind, and the paranoid-schizoid (PS) state of mind. In the D state, we see ourselves and the others more or less as we are, both good and bad. In the PS state of mind, the psychic pain of dealing with undesirable reality is avoided by mentally splitting off the good from the bad. The unconscious search for the phantastic object triumphs over "realistic" judgments when a PS state of mind dominates. In such settings, hedge funds can readily be transformed in the minds of investors into investment vehicles that promise, much like Aladdin's lamp, to fulfil their investors' deepest unconscious desires.

Importantly, once an investor comes to "believe" that a particular hedge fund can earn exceptional returns, he is likely to repress any doubts associated with investing in it. Hence, in the investor's unconscious search for the phantastic object, the hedge fund's stated purpose may well be ignored. When the excitement of investing in the phantastic object takes over, the normal capacity to judge risk breaks down, unless sufficiently large losses literally wake the investor up from his reverie.

Information processing takes on a different purpose when a phantastic object is unconsciously believed to exist. The phantastic object “appears to offer the opportunity to break the rules of usual life and so turn ‘normal’ reality on its head” (Tuckett & Taffler, 2008), which creates the impression that what was previously considered impossible can, in fact, happen after all. In this respect, there are interesting parallels between hedge funds and internet stocks in the late 1990s. Taffler and Tuckett (2005) describe what happened in the dot.com bubble:

> Conventional firm valuation models based on discountable future cash flows and/or earnings broke down not just in the absence of meaningful historic accounting numbers and realistic forecasts but, crucially, because of the unconscious psychic meanings dot.com stocks possessed as phantastic objects.

Likewise, some hedge funds could have been viewed as latter day dot.com stocks, with their innovative investment strategies, implicit promise of exceptional returns, and media portrayal of their managers changing the rules of business (Taffler & Tuckett, 2005). The anxiety associated with investment risk is thus split off from the excitement, and underlying reality is similarly suspended. In such settings, market participants essentially become a “basic assumption group” that share the same strong belief in the phantastic object. In contrast to the “work group” whose members co-operate in the performance of a task, are clear about their purpose, and act in a rational and constructive manner, individuals in a basic assumption group do not think for themselves (Bion, 1952). Rather, they operate in a particular sense of reality, a PS state of mind, which blocks any attempt to think clearly and independently. Basic assumption group members collectively adopt unconscious defences against anxiety. Their activities, which look chaotic at first, “are given a certain cohesion if it is assumed that they spring from basic assumptions common to all the group” (Bion, 1961, p. 146).

Splitting and projection are evident in basic assumption groups but, according to Bion (1952, 1961), these take the form of one of three “basic assumptions”: fight/flight, pairing, and dependence. “All basic assumption groups include the existence of a leader, although in the pairing group … the leader is ‘non-existent’, i.e., unborn. … [The leader] need not be a

person at all but may be identified with an idea or an inanimate object" (1961, p. 155); in our case perhaps the idea of investment outperformance?

In the dependency mode, "one person is always felt to be in a position to supply the needs of the group, and the rest in a position in which their needs are supplied ... the basic assumption seems to be that an external object exists whose function is to provide security for the immature organism" (Bion, 1961, p. 74). Clearly, the dependency basic assumption might help explain the interdependence between superstar hedge fund managers and investors relying on them for their own phantasy fulfilment. In such settings, infatuation with the phantastic object accompanies wishful thinking. However, it is important to recognise that any investment in a phantastic object must eventually lead to disappointment. This is both because hedge fund managers are required on one level to live up to their investors' needs to be phantastic objects, and the way they may equally be caught up unconsciously in the same basic assumption group thinking. Hedge fund managers may also be driven to take uncalculated risks due to investors' demands for magic in the form of extraordinary returns. In fact, the real problem may be "not [so much] out-of-control hedge fund managers, but rather overaggressive marketing and overeager investors" (Cramer, 2006).

Fight/flight refers to the tendency of groups to either attack an object directly or to run away from it in a state of panic. Bion (1952) describes situations of panic that can sweep through crowds, causing people to run away from an unknown, possibly non-existent threat. In this scenario flight offers instant satisfaction of impulses. These types of behaviour are evident in financial markets in the contagious excitement of asset price bubbles where investors simply have to have the phantastic object (Tuckett & Taffler, 2008) and then turn against it in panic when reality intrudes and their idealised phantasy is shown to be just this. In fact, we may view the dramatic collapse in investment in hedge funds in 2008 as directly reflecting how investors turned from fight for possession of the phantastic object to flight, and the attempt to withdraw their funds as quickly as possible.

Pairing is the basic assumption least talked about by Bion but relates primarily to the libidinal, reproductive instincts of groups. In the pairing basic assumption group the feeling of hope is key, based on the collective phantasy of a notional pairing producing a "messiah", although he can never be born. Bion (1961, p. 151) comments: "… the feeling of hope itself … is characteristic of the pairing group and must be taken by itself as evidence the pairing

group is in existence, even when other evidence appears to be lacking." The key role collective unconscious wishful thinking or hope of a never to be realised investment jackpot plays in all investment activity is a clear manifestation of pairing basic assumption group behaviour.

The psychoanalytically informed theory of the phantastic object can also explain why, despite the level of competition in the market, hedge fund fees (commonly two per cent of assets and twenty per cent of profits) have remained so high for so long. Once hedge funds become phantastic objects in the minds of investors, they and their managers are consequently deemed infallible, and hence, immensely valuable. Just as one would not wish to be operated on by a heart surgeon who competes on price, so one is not likely to invest with a cut-price hedge fund manager.

When reality finally intrudes, investors feel cheated, and the once dominant feeling of desire for the phantastic object changes to anger and blame. The blame emanating from investors is rarely directed towards themselves. Instead, it is projected outwards at their managers, and more generally at hedge funds as an investment class with all their associated elements of marketing, including the media that helped to spread the investment phantasy. Conversely, hedge fund managers tend to blame overeager investors, regulators, rating agencies, and the financial system as a whole (Sender & Kirchgaessner, 2008). This culture of blame is often intertwined with a hatred of reality, which can destroy the functions of perception such that objective, external reality may not be appropriately acknowledged. When investors in a PS state of mind are eventually let down, this is inevitably associated with the avoidance of feelings of guilt and shame, and the wish to learn from the experience, which would be the appropriate emotional response in a D state of mind.

Hedge funds and their managers in the media: spreading the phantasy

The exciting depiction of hedge funds in the media as money-making machines, and their managers as financial alchemists, can play a key role in their transformation into phantastic objects. Through disseminating cover stories that are "often new, complex, always rather vague and appear clever" (Tuckett, 2009), the media can help eliminate any legitimate doubts that investors might initially have about the phantastic object, and thus further spread the

phantasy. Whether this hidden power of media is manipulative has been debated by, for example, Fairclough (2001, pp. 45-46), who cites the professional beliefs and assumptions of media workers as the main factor in "keeping the power of the media discourse hidden from the mass of the population." In the context of hedge funds, however, it is not only the phantasy-provoking nature of the media stories surrounding these investment vehicles, but also their investors' often unconscious search for excitement, and the symbiotic link between these two forces, that contributes to a psychic retreat from underlying reality.

Hedge funds' potential to deliver spectacular performance, as well as the distinctive features of some hedge fund managers, among other factors, contribute to the willingness by the media to cover the individuals running these investment vehicles. Indeed, the media often treat high-performing and exceptionally rich hedge fund managers as celebrities, which, in turn, can attract more investors to hedge funds through unconscious identification and the expectation of earning similar exceptional returns.

Media portrayal of hedge funds in the form of movies (such as *Wall Street* and its 2010 sequel, *Pretty Woman*, *Bonfire of the Vanities*, *The Wolf of Wall Street*, and, most recently, *The Big Short*) and TV broadcasts can further consolidate this phantasy element. Many of these depict very rich and glamorous investment managers who can virtually get anything or anyone they wish for, conveying a sense of their omnipotence to the audience. The depiction of hedge funds and the people associated with them in the press involves similar themes. The media coverage of the Noel sisters, the five daughters of Walter Noel, the founder of Fairfield Greenwich Group – Madoff's largest feeder fund investing $7.6 billion with him, and earning $500 million in the process – provides a good example. With three of their husbands being partners in Fairfield and another running a hedge fund of his own, they were regularly showcased in newspaper and magazine articles with glossy photographs as the *perfect* girls who happen to be "well educated [Harvard, Yale, Brown, Georgetown], well married, and raising a pack of well-behaved, multi-lingual children ..." (Stewart, 2002). Needless to say, Fairfield Greenwich went bankrupt when Madoff's fraud (see below) was exposed, losing its investors a large part of their investments.

Despite the secrecy of many hedge funds, there is often little reticence about the wealth of their managers. According to the annual survey by *Alpha* magazine, the world's twenty-five highest-earning hedge fund managers in 2009, after hedge fund returns recovered, earned an

average $1,013 million each, up from $464 million apiece in 2008, and $892 million in 2007, for the equivalent but different sets of top twenty-five managers. However, it is not only the exceptional wealth of some hedge fund managers that attracts attention, but also how it is commonly displayed and reported on in the media. For example, Steve Cohen, former owner of the eponymous hedge fund SAC Capital, with personal net worth of $12 billion in 2015 according to *Forbes*, is generally regarded as owning "one of the best privately owned art collections in America". This has over 300 works by Impressionist and contemporary artists including Picasso, Cezanne, Van Gogh, Warhol, and Francis Bacon (Burrough, 2010). He also owns Damien Hirst's celebrated thirteen-foot shark in a tank of formaldehyde with which he is often photographed. (SAC Capital was closed down in 2013 after being fined $1.2 billion to resolve criminal wrongdoing charges and paying $600 million civil penalties for insider trading.)

Ironically, the personal lifestyles of hedge fund managers may often be more carefully scrutinised than their investment strategies. For example, they are often well represented in the wedding announcements of *The New York Times* (Anderson, 2005). The hedge fund industry's unofficial 2006 annual conference, Hedgestock, which took place at a stately home just north of London with the slogan "Peace, love and higher returns", consciously sought to appropriate the trappings of the generation of Woodstock (Timmons, 2006). Similarly, in a 2007 charity fund-raising dinner hosted by Arpad Busson, a high-profile hedge fund manager, Bill Clinton flew in to make a speech, and the celebrity guest list included the likes of popular music icons Madonna and Prince, top fashion designer Valentino, and British actress Elizabeth Hurley (Cadwalladr, 2007):

> Arpad Busson, for example, who manages £5bn through his company EIM, dated Farrah Fawcett [actress] before having two children by Elle Macpherson [model and actress] (they recently parted), while Nat Rothschild, of Atticus Capital, the 46th richest person on this year's *Sunday Times* Rich List, has dated Petrina Khashoggi [model], Ivanka Trump [model] and Natalie Portman [actress], and is good friends with Roman Abramovich [the Russian oligarch and owner of Chelsea Football Club]. According to *Tatler*, Busson is the seventh "most wanted man at a party", while Rothschild is "Britain's most eligible bachelor".

Critical discourse analysis holds on to the underlying assumption that power and language are interlinked (Fairclough & Holes, 1995; Fairclough, 2001). In particular, Fairclough (2001, p. 1) argues that the role of language in producing, maintaining, and changing social relations of power is widely underestimated, hence the importance of analysing discourse in a systematic way. From this vantage point, we suggest that the language used to describe hedge funds and their managers in the media bears witness to their assumed power and mystique. Phrases such as “masters of the new universe”, “this generation’s robber barons”, and “Delphic oracles of finance” are only a few examples of how hedge fund managers used to be portrayed before June 2008 (Anderson & Creswell, 2007; Niederhoffer, 1998). Such exaggerated representations of some hedge fund managers as omnipotent and omniscient beings is typical of the phantastic object, and serves further to dismiss any anxiety related to investing with them. Media portrayal of hedge funds and their managers in this spirit not only adds to the mystique associated with these investment vehicles, but also serves to enhance the hubristic self-perceptions of their high-profile hedge fund managers and, as such, turns them into (human) phantastic objects for their investors. This is consistent with the inherent reflexivity of language, that is, language both mirrors reality and constructs (construes) it in a desired way (Fairclough & Holes, 1995).

For example, James Simons, the president of Renaissance Technologies, and number one in *Alpha’s* list of twenty-five highest-earning hedge fund managers in 2008, is described in a *Financial Times* article (White, 2007) as:

> ... the most successful hedge fund manager ever… [who] does just about everything a little differently ... a prize-winning mathematician and former code-breaking cryptologist ... the king of the quants ... spent $600 million on computers ... [has] an army of PhD’s ranging from astrophysics to linguistics.

Another example, an eight-page *Business Week* cover story, describes Philip Falcone, the co-founder of Harbinger Capital Partners who ranked fourth in *Alpha’s* list in 2008, as “the Midas of Misery” belonging to a group of vulture investors with “more clout and more imagination … [who] just might kick-start the economy” (Thornton, 2008). However,

following heavy investment losses, by September 2009 Harbinger Capital Partners funds under management were seventy per cent down on their peak of $26 billion a year earlier. Nonetheless, Falcone subsequently invested $2.9 billion of his remaining funds in a speculative satellite communications network that went bankrupt, and in 2013 was banned from the securities industry for five years by the SEC, *inter alia* for market manipulation and misuse of client monies.

A similarly eloquent tone and admiring language is used in *Fortune's* nine-page hagiography of Ken Heebner, a widely-acclaimed hedge fund manager:

> Spend some time with [him] and it becomes clear why. His brain is wired differently. His ideas come faster, his focus is more intense, and his ability to sift through massive quantities of information and zero in on what matters is downright spooky… Basically, he's the last of the gunslingers – a go-anywhere manager who can be investing in left-for-dead US value stocks one day and red-hot Brazilian growth stocks the next. (Birger, 2008)

Eulogising high-performing hedge fund managers in this way only helps to consolidate the investment phantasy. In the case of Heebner, after producing an unmatched record of outperformance, including a gain of eighty per cent in 2007, his main fund (CGM Focus) fell by over fifty per cent in the second half of 2008, and he had underperformed ninety-five per cent of his peer group in the five years to 2012 (Stein, 2012).

The marketing of hedge funds to potential investors is similarly conducted in a variety of attractive and enticing ways that trigger the (unconscious) need for belonging to an exclusive group. Within this context, it is not surprising that hedge funds can bear singular names such as Dragonback, Eclectica, Richland, Matador, Maverick, Atticus (variously an Ancient Greek philosopher, a Christian martyr, or Atticus Finch, the upstanding and noble hero of *To Kill a Mockingbird* by Harper Lee), Valinor (the Undying Lands in Tolkien's world of fantasy), Kynikos ("dog-like" in Ancient Greek from which the English word "cynic" is derived), Helios (the ancient Greek god of the Sun), Farallon (radioactive islands), Cerberus (three-headed mythological creature), and Appaloosa (a horse breed known for its distinctive physical characteristics) among others.

Hedge funds and the intrusion of reality

The bursting of financial bubbles is not driven by the emergence of new information, rather by the fact that "what people have always known becomes salient in such a way that it can no longer be ignored" (Tuckett, 2009). Once reality intrudes, a strikingly different series of emotions is triggered, which highlights the prototypical emotional reactions to the intrusion of the real world.

With the unfolding of the global financial crisis, and the drying up of liquidity in financial markets in 2008, hedge fund returns collapsed, which, together with investor withdrawals, forced many funds out of business. As hedge fund closures and implosions increased, so did the blame-driven accusations against almost all parties involved, partly fuelled by comments from politicians, regulators, and investment bankers who held hedge funds accountable for the disruptions witnessed in the financial sector. A strong denial of reality, a universal search for scapegoats, and an abundance of anger and blame was a common thread in the range of reactions by investors, hedge fund managers, regulators, and the public.

Denial is an immediate defence mechanism that allows the individual to "avoid awareness of some painful aspect of reality and so diminish anxiety or other unpleasant affects" (Moore & Fine, 1990, p. 50). Such denials of one's involvement with reality are often intertwined with blame and projection, a process whereby "a personally unacceptable impulse or idea is attributed to the external world" (ibid.). When the belief in the existence of the phantastic object is confronted with objective reality, denial can be of the reality itself, or of any personal involvement with it.

An abundance of blaming others, in the absence of any noticeable self-blame, is commonly observed upon the intrusion of reality. For example, in the US Congress hearing on hedge funds, George Soros, ranked fourth in 2008 and second in 2009 in *Alpha's* list of twenty-five highest-earning hedge fund managers, blamed "the financial system itself" for the global financial crisis (Soros, 2008). John Paulson, ranked first in 2007, second in 2008, and fourth in 2009 in the same annual ranking, showed no embarrassment in his testimony by claiming his wealth reflected returns to investors (Paulson, 2008). Likewise, Philip Falcone emphasised he had tried hard to earn his wealth and had not always been fabulously rich:

> By 1994, I was so "financially challenged" that the power in my apartment was shut off because I could not afford to pay the electricity bill. That experience, as painful as it was, stayed with me over the years ... It is important for the committee and the public to know that not everyone who runs a hedge fund was born on 5th Avenue – that is the beauty of America. (Falcone, 2008).

At the same hearing, James Simons blamed the Securities and Exchange Commission (SEC), the Federal Reserve System (Fed), and credit rating agencies in particular, arguing they did not warn early enough of the dangers ahead:

> There is much blame to be shared: the SEC and perhaps the Federal Reserve for taking such a hands-off position ... the players all along the chain of creation and distribution of the paper, each of whom should have blown a whistle rather than passing the problem on to the next guy; and finally, and in my opinion the most culpable, the rating agencies, which failed in their duty and allowed sows' ears to be sold as silk purses. (Simons, 2008).

A study of letters to investors written by hedge fund managers to explain their unsatisfactory performance provides further evidence of blame by revealing common patterns. They usually opened with a brief apology, then moved swiftly on to blame other market factors, while working on emotions as well as creating a feeling of human warmth and optimism in the process (Kellaway, 2008). Arguably, the abundance of anger and blame expressed in such letters is consistent with what happens when the phantastic object eventually has to confront reality.

The Madoff fraud: The *perfect* phantastic object

The $65 billion fraud by Bernie Madoff – who did not actually claim to run a hedge fund, but used feeder funds that were mostly hedge funds or funds of hedge funds – clearly illustrates the seductiveness and power of the phantastic object. First, Madoff successfully exploited

investors' unconscious search for the investment phantasy by showcasing the exclusivity of his funds. Investment with Madoff was by invitation only, and considered a great privilege. He would usually emphasise that his funds were closed, which made potential investors even more eager to get in. Investors were "hypnotised by the perceived exclusivity of investing with Madoff and believed that not investing would be foolish" (Arvedlund, 2009, p. 85). Occasionally, Madoff would admit some individuals, claiming "they came from the same world or were related through an uncle of his accountant" (Sender, 2008). One of Madoff's closest investors describes how being initially rejected made investors more willing to part with their money:

> In November, I invited a friend and longtime Madoff investor to dinner and literally begged him to get me in. He listened politely, then shook his head slowly. "Forget it", he said. Bernie was closed; Bernie had a multimillion dollar minimum; Bernie didn't need my money. His discouraging response only made me want Bernie all the more. (Seal, 2009).

Second, the language used by Madoff to describe his business and his stated investment strategy (the so-called "split-strike conversion" strategy) further enhanced his image of an omnipotent fund manager. While there was no detailed explanation of what he was doing, Madoff's use of such terminology led to plenty of discussion in internet forums and elsewhere about how it worked and how to replicate it (Caldwell, 2009).

Third, Madoff's apparent extraordinary returns, as well as his reputation in the industry and personal attributes, allowed him to enjoy a perceived edge with both friends and investors. His close friends always had a high opinion of him – one even referring to him as "the most honorable, smart person" – while his investors described him as pleasant and charming (Seal, 2009), and "the benchmark for investors seeking stable returns" (Sender, 2008). His longtime secretary thought there was "a mystique about him – the money, the power, the legend" (Seal & Squillari, 2009). All this, together with Madoff's background and charitable donations, his history of Nasdaq chairmanship, and the SEC's continued approval of his operations, served as cover-ups that led people to trust Madoff as a fund manager. It was not just Madoff who became a phantastic figure, but also the managers of the main feeder

funds who invested heavily with him, and who effectively opened the door for more investors to enjoy the privilege of being invested with Madoff.

Fourth, the strength of the Madoff phantasy was such that any attempt to disassociate with it became futile. True Madoff believers increasingly referred to him as “the miracle worker” and wished to see him living happily and well as they felt he deserved it (Seal, 2009). Very little effort was made to question Madoff’s investment methods. For example, Madoff’s largest investors, such as Fairfield Greenwich, viewed themselves equally as victims in his fraud, despite having apparently failed to notice red flags or reportedly perform required due diligence. However, various studies argue that Madoff investors could easily have discovered the fraudulent nature of the returns series by performing operational due diligence or quantitative analysis (e.g., Bernard and Boyle, 2009; Clauss et al., 2009; Gregoriou & Lhabitant, 2009). The same point is made in the many lawsuits filed by the court-appointed trustee, Irving Picard, charged with recovering money for Madoff’s victims *inter alia* against even such large and reputable banking institutions as HSBC and J P Morgan (Masters, 2010; Masters et al., 2011).

The Madoff case illustrates how belief in the phantastic object can lead to such basic assumption group dependency pressure that individuals wishing to warn others against the phantasy are repeatedly ignored, or accused of just not “getting it”. Harry Markopolos attempted many times to warn regulators about the Ponzi scheme (earlier investors are paid out with money from later ones) being orchestrated by Madoff, but no one, including the SEC, took appropriate action (Markopolos & Casey, 2010). Likewise, a 2001 article appearing in a hedge fund publication wondered how Madoff’s strategy worked by raising some key concerns:

> Skeptics who express a mixture of amazement, fascination and curiosity about the program wonder, first, about the relative complete lack of volatility in the reported monthly returns. But among other things, they also marvel at the seemingly astonishing ability to time the market and move to cash in the underlying securities before market conditions turn negative; and the related ability to buy and sell the underlying stocks without noticeably affecting the market. (Ocrant, 2001).

However, the desirability of investing with Madoff was so strong that any signs of doubt were inevitably repressed. Only when reality intruded on 11 December 2008, did his investors recognise how they had been caught up in phantasy. The unconscious irony of Madoff's favourite sculpture, the four-foot rubber screw behind his desk where he met investors (Seal & Squillari, 2009), can also be noted in this context.

Discussion

On one level, investment is always associated with excitement (Taffler & Tuckett, 2010), and the search for excitement is a universal human activity. In volatile markets, when hedge fund strategies are considered most effective, this excitement is heightened. On this basis, it is not only the intrinsic nature of hedge funds as alternative investment vehicles that explains the apparent investor fascination with them, but also the excitement generated by investing in them. Hedge funds' exclusivity and perceived secrecy, the lottery-like nature of their investment returns, and the often exaggerated media portrayal of their managers and their performance also contribute to such sentiments. Hedge funds as phantastic objects can therefore become a source of emotional attachment for all investors.

Since the end of 2008 the amount invested in hedge funds has almost doubled to over $3 trillion despite the underperformance of the sector compared with the S&P 500 of getting on for ten per cent per annum over the past few years. What is very interesting, also, is how high net worth individuals now account for only a third of hedge fund assets under management compared with two thirds ten years ago, and even then most of their investment is managed professionally on their behalf by "family offices" and private wealth advisors. Institutions such as public and private pension funds, foundations, sovereign wealth funds, asset managers, banks, and insurance companies are now the dominant clients and invest a significant amount of their total assets in this investment class (Preqin, 2016). So, it seems not only wealthy and arguably less financially knowledgeable individual investors, but also prudent and sophisticated institutional investors, may be susceptible to the unconscious lure of the phantastic object and dependency basic assumption group phantasy.

Also, given the lack of regulation, investors need to be able to guard themselves against hedge fund managers being susceptible to acting in their own rather than their clients'

interests (Foley, 2015; SEC, 2013). They have the ability and, in principle, the incentive, to overvalue their portfolios, and avoid reporting losses to attract and retain investors (Bollen & Poll, 2009) as well as routinely revising their previous returns history, thereby altering their performance record (Patton et al., 2015). By studying a comprehensive sample of hedge fund due diligence reports Brown et al. (2012), in fact, show how hedge funds frequently misrepresent past legal and regulatory problems. However, the costs of commissioning such reports are prohibitive for smaller investors.

Unlike with carefully regulated mutual funds, where audited information on strategies and performance is readily available, in the case of hedge funds investors are dependent on past performance and associated information self-reported to public databases (Patton et al., 2015), as well as media coverage. This makes responsible reporting even more important and the need to avoid being carried away by the excitement-generating potential of such investment vehicles. Given the tendency of media coverage to generate investment flows (Ozik and Sadka, 2013), the importance of the financial media following appropriate ethical practices in the reporting of hedge fund activities, and likewise avoiding being caught up in the collective excitement, can also not be emphasised enough.

Had there been stricter regulations and ethical standards in force governing professional conduct in the hedge fund industry, Madoff, for example, could not have so easily orchestrated a fraud of such dramatic proportions. In the post-Madoff era, it is clear that even the most respected firms should not get a pass on the required checks, and investors should not have to tolerate any level of manager obfuscation.

It is, however, important to observe that the transformation of investment vehicles into phantastic objects is not exclusive to hedge funds. Dot.com stocks, house prices, Chinese shares, and the exotic financial instruments purveyed by investment banks designed by their "rocket scientist" PhDs, which were believed to have banished risk forever through magical sleight of hand, and helped stoke the global financial crisis, are other recent examples. In fact, the risks posed by phantastic objects go well beyond financial markets. All technological innovations, whether of a financial nature or not, can become readily phantastic as they run the risk of "temporarily exceeding our ability to use those technologies wisely" (Lo, 2008).

Regulators are human themselves, and thus in theory equally prone to becoming caught up in basic assumption group thinking and a paranoid-schizoid state of mind (as the SEC's

inability to detect the Madoff fraud clearly illustrates). They need explicitly to recognise the key role unconscious fantasy plays in all financial activity so they can be more effective in taking appropriate action to prevent investors from being caught up in such a potentially dangerous way with the consequences we see on a regular basis.

Nevertheless, like more traditional mutual funds and other investment vehicles, most hedge funds and funds of hedge funds are properly constituted with appropriate risk controls and exercise proper due diligence. Much of the research evidence suggests that such alternative investment vehicles can potentially play a useful role in diversified investment portfolios. However, excitement, wishful thinking, and idealisation are all part of the potential transformation of hedge funds or any other investment vehicle into phantastic objects. Accompanied by a lack of appropriate oversight by regulators, this inevitably leads investors, however sophisticated, towards splitting off, projecting, and repressing the associated risk and anxiety with undesirable consequences for all parties involved.

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