Hedge Funds Explained

Expert knowledge means success

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Introduction

In the 1950's, the first hedge fund partnership was introduced using short selling and leverage together with a performance fee. The first Hedge Fund is thought to have been established in the US by one-time journalist and lecturer, Alfred Winslow Jones. Today, the increasing popularity of Hedge Funds, particularly since the early 1990's, has attracted a wide range of investors around the world. Participation has come from accredited individual investors and family offices, fund-of-funds, institutions and pension plans.

Initially, "Hedge Funds" described collective investment vehicles, often organised as private partnerships, that specialised in combining two investment techniques, short sales (borrowing a security and selling it in the hope of being able to repurchase it more cheaply before repaying the lender) and leverage (buying securities with borrowed money) in a way that reduced risk. By shorting a basket of stocks to protect against a general drop in equity prices, and then borrowing money to buy particular shares they deemed undervalued, these funds "hedged" their positions so as to prosper whichever way the market moved - hence the name. Modern hedge funds are a far more eclectic group. They share only one important characteristic: compensation strategies. Typically, hedge fund managers are paid a modest management fee, but receive a hefty percentage of any profits the fund makes.

The hedge fund industry has experienced enormous growth in the last decade, growing by some estimates from as few as 300 funds in 1990 to several thousand today. They have become highly visible and are thought to command up to $500 billion or more before leverage. The initial aim of the funds was to protect against market risk and earn greater return in times of sluggish stock-market performance. The notion had a simple elegance: If rich investors could cash in during booms by betting on winners, couldn't they profit during busts by betting against losers? The first funds were fairly simple, usually holding 50% of their assets in long-term investments that were expected to rise over time, and 50% in short positions in stocks or bonds that were considered overvalued. (In a basic short position a fund sells borrowed shares at one price with plans to repurchase them at a lower price after the stock falls.) If the market rose, they still had an upside in the winners; if it fell, they profited from short sales.

Until quite recently, hedge funds rarely made the headlines, usually only when there was a fall out or a fraud. Now both the mainstream media and specialist investment publications frequently carry articles about hedge funds.

Hedge Funds – What Are They?

"Hedge Fund" has no formal definition in securities law and the private investment vehicles that make up this "industry" are extremely diverse. Broadly defined, a Hedge Fund is an investment structure used by a professional money manager or group of managers that permits the management of a private, unregistered investment pool of capital and/or securities. A Hedge Fund is a pool of capital for leveraging an investment portfolio that uses a private partnership as its structural format. This structural format is made up of a General Partner (investment manager), and Limited Partners (investors).

A Hedge Fund is a very specialized, open-end investment company or private investment fund that permits the manager to use a variety of investment techniques normally prohibited in other types of funds. These techniques include borrowing money, selling short, and utilizing options, to name a few.

In short, hedge funds are private investment funds (similar to mutual funds), which offer investors the possibility of extraordinary gains with above-average risk. When providing these "gains," the Hedge Fund structure allows the fund manager to charge an incentive-based, performance fee which is based upon a percentage of profits that the fund returns to investors.

A Private Pool of Capital

A "hedge fund" refers broadly to any private pool of capital whose investment manager is compensated primarily on the fund's performance. Hedge funds seek superior returns relative to risk by utilizing a broad spectrum of investment styles, hedging strategies and financial instruments. The manager generally has a significant commitment of personal net worth invested in the fund.

Source: Hennessee Group LLC

Put Simply

Put simply, hedge funds are high risk offshore collective investment vehicles that aim to make money no matter what the market conditions.

The fund is managed aggressively with techniques such as selling 'short' and using complex financial tools including derivatives and arbitrage to bet on market movements.

The name of the game is absolute returns rather than simply beating the relative benchmark. For instance, if a unit trust is down 2% for the year, but the market it invests in has fallen 10%, the fund would probably be considered well managed. A hedge fund manager will aim to deliver at least a 10% return in the same conditions.

Hedge funds do not have to play by the same rules as conventional funds listed in London or New York. The UK and US refuse to recognise hedge funds. Therefore they are listed offshore and are unregulated.

This lack of regulation means nobody knows exactly how many of these funds exist. There are thought to be around 8,000 worldwide. But the number open to small investors is a tiny fraction of that.

The reliance on exemptions from securities registration limits the number of participants who must also satisfy accredited investor or institutional investor definitions.

Hedge Funds are considered alternative investments since they employ an investment strategy that differs from conventional (long position) money management. Hedge Funds come in many shapes and sizes but most have a number of characteristics in common:

- Hedge funds target positive returns, irrespective of the direction of underlying markets.
- Their common denominator is the opportunity to protect investment from any downside as well as the ability to generate absolute returns in all kinds of market conditions.
- A typical hedge fund might have a target net return of 15% per annum. A return profile of this nature clearly looks much more attractive in times when markets are weak or the outlook is uncertain.

When you think about hedge funds you will probably think of high rollers such as George Soros (Quantum Fund) and Julian Robertson (Tiger Funds) or the huge collapse of Long-Term Capital Management in 1998. Ordinary investors have been unable to get their hands on these high-risk, potentially high-return funds since most require a minimum investment of at least £100,000. But this situation is now changing. In 2001, several new funds were launched with much lower entry requirements. These are called "funds of hedge funds" and offer investors exposure to a diverse range of funds with the aim of reducing the risk involved. Some can also be held inside an individual savings account (ISA) wrapper.

Although they may be gaining in popularity, they should still be considered a big gamble. Remember the golden rule of investing: never put money into something you do not understand. Even if you think you understand Hedge Funds, you should still handle them with kid gloves.

Different Situations

Where traditional funds make money by investing in shares that will hopefully rise, Hedge Funds tend to have the edge – particularly in a bear market – as they use all the investment tricks available:

- The most common Hedge Fund is a 'long/short' fund. Going long is the conventional technique of buying a share hoping its price will rise. Going short means that the fund manager sells a share expecting it to fall, later buying it back for a lower price, booking a profit.
- Hedge Funds can also take big bets on swings in currencies or interest rates and invest heavily in emerging markets. Other funds look for wrinkles in the markets, where the price of a share, bond or derivative is behaving unusually (known as arbitrage). For example, the price of two different assets may historically move in a certain way, but for some reason the usual relationship has broken down. An arbitrage fund will move in, betting that it can profit when the normal link is restored.
- Some hedge funds specialise in exploiting takeover or merger situations - they invest on anticipated mergers, bankruptcy or corporate reorganisations by taking, for example, a long position in a company being taken over and a short position in the predator.
- Tactical or 'global macro' trading is perhaps the most volatile of all. It involves speculation on the future direction of markets.
- Funds of hedge funds - as the name suggests, invest in a spread of hedge funds, often employing a long/short investment strategy. They are at the lower end of the risk scale.

How Big is the Market?

The estimated size of the global hedge fund industry is US$1.9 trillion[1] and the money continues to flow in at a rate of several billion £s every year.

Who invests?

Because of the high risk, investors in hedge funds have traditionally been drawn from the ranks of institutional investors who have well diversified portfolios and can afford to take on the extra risk. But it is now possible to invest as little as £5,000 in hedge funds through an Individual Savings Account (ISA). Officially, the rules prohibit funds based on derivatives such as futures and options. But a loophole has been found: investing in existing funds through an offshore company.

The new breed of hedge fund works like a "funds of funds". To diversify risk and allow in investors with small amounts of money, a manager will set up a fund and then buy stakes in a number of hedge funds. All have a fixed life span and will be wound up within a set period.

What's Happening?

You can follow developments in the Hedge Fund industry by visiting:

Hedgeworld
www.hedgeworld.com

HedgeCo.Net
www.hedgeco.net

Hedge Fund Association
www.thehfa.org

Hedge Fund Centre
www.hedgefundcenter.com

Hedge Fund Managers

Hedge funds benefit by heavily weighting hedge fund managers' remuneration towards performance incentives, thus attracting the best brains in the investment business. But more traditional, experienced City analysts have expressed concern that many hedge fund managers do not have the right experience to deal with billions of dollars and the high risks involved.

Fees

Typically, hedge fund managers charge a 1% to 1.5% annual charge – similar to unit trusts. But they also take a 'performance fee' of anything from 7% to 25% of the return above a benchmark such as the bank base rate.
It means that a £100m hedge fund manager usually earns higher fees than that picked up by a £1bn unit trust manager. Of course, in common with traditional fund managers, they do not offer refunds of fees if the fund performs badly.

Why are they Risky?

It is a combination of things and the fact that hedge funds are highly geared - they borrow against their underlying assets. If a unit trust manager is sitting on a £100 million fund, this is all he can invest. But a hedge fund manager can borrow against this sum and may invest three or four times this amount in the market. If he makes the right call, he makes bigger returns. But debts and losses can be huge and can develop very quickly.

The Financial Services Authority rules forbid investment managers from mailing small investors with hedge fund products. All hedge funds currently in existence are unregulated, unauthorised funds which have no compensation scheme to back them up. They can only be sold to investors with whom companies already have an existing relationship. In March 2001, the FSA issued a warning to consumers advising them to wary of the new type of individual savings account that invite small investors to put money into hedge funds.

Hedge Fund Strategies[2]

It is important to understand the differences between the various hedge fund strategies because all hedge funds are not the same - investment returns, volatility, and risk vary enormously among the different hedge fund strategies. Some strategies which are not correlated to equity markets are able to deliver consistent returns with extremely low risk of loss, while others may be as or more volatile than mutual funds.

Key Characteristics

Many, but not all, hedge fund strategies tend to hedge against downturns in the markets being traded. Hedge funds are flexible in their investment options (can use short selling, leverage, derivatives such as puts, calls, options, futures, etc.). Hedge funds benefit by heavily weighting hedge fund managers' remuneration towards performance incentives, thus attracting the best brains in the investment business.

Hedge Fund Facts

- Estimated to be a $400-$500 billion industry and growing at about 20% per year, with approximately 7,000 active hedge funds.
- Includes a variety of investment strategies, some of which use leverage and derivatives while others are more conservative and employ little or no leverage. Many hedge fund strategies seek to reduce market risk specifically by shorting equities or derivatives.
- Most hedge funds are highly specialized, relying on the specific expertise of the manager or management team.
- Performance of many hedge fund strategies, particularly relative value strategies, is not dependent on the direction of the bond or equity markets -- unlike conventional equity or mutual funds (unit trusts), which are generally 100% exposed to market risk.
- Many hedge fund strategies, particularly arbitrage strategies, are limited as to how much capital they can successfully employ before returns diminish. As a result, many successful hedge fund managers limit the amount of capital they will accept.
- Hedge fund managers are generally highly professional, disciplined and diligent.
- Their returns over a sustained period of time have outperformed standard equity and bond indexes with less

volatility and less risk of loss than equities.

- Beyond the averages, there are some truly outstanding performers.
- Investing in hedge funds tends to be favoured by more sophisticated investors, including many Swiss and other private banks, who have lived through, and understand the consequences of, major stock market corrections. Many endowments and pension funds allocate assets to hedge funds.

Strategies

- Aggressive Growth: Invests in equities expected to experience acceleration in growth of earnings per share. Generally high P/E ratios, low or no dividends; often smaller and micro cap stocks which are expected to experience rapid growth. Includes sector specialist funds such as technology, banking, or biotechnology. Hedges by shorting equities where earnings disappointment is expected or by shorting stock indexes. Tends to be "long-biased."
  Expected Volatility: High
- Distressed Securities: Buys equity, debt, or trade claims at deep discounts of companies in or facing bankruptcy or reorganization. Profits from the market's lack of understanding of the true value of the deeply discounted securities and because the majority of institutional investors cannot own below investment grade securities. (This selling pressure creates the deep discount.) Results generally not dependent on the direction of the markets.
  Expected Volatility: Low - Moderate
- Emerging Markets: Invests in equity or debt of emerging (less mature) markets which tend to have higher inflation and volatile growth. Short selling is not permitted in many emerging markets, and, therefore, effective hedging is often not available, although Brady debt can be partially hedged via U.S. Treasury futures and currency markets.
  Expected Volatility: Very High
- Fund of Funds: Mixes and matches hedge funds and other pooled investment vehicles. This blending of different strategies and asset classes aims to provide a more stable long-term investment return than any of the individual funds. Returns, risk, and volatility can be controlled by the mix of underlying strategies and funds. Capital preservation is generally an important consideration. Volatility depends on the mix and ratio of strategies employed.
  Expected Volatility: Low - Moderate
- Income: Invests with primary focus on yield or current income rather than solely on capital gains. May utilize leverage to buy bonds and sometimes fixed income derivatives in order to profit from principal appreciation and interest income.
  Expected Volatility: Low
- Macro: Aims to profit from changes in global economies, typically brought about by shifts in government policy which impact interest rates, in turn affecting currency, stock, and bond markets. Participates in all major markets - equities, bonds, currencies and commodities - though not always at the same time. Uses leverage and derivatives to accentuate the impact of market moves. Utilizes hedging, but leveraged directional bets tend to make the largest impact on performance.
  Expected Volatility: Very High
- Market Neutral - Arbitrage: Attempts to hedge out most market risk by taking offsetting positions, often in different securities of the same issuer. For example, can be long convertible bonds and short the underlying issuers equity. May also use futures to hedge out interest rate risk. Focuses on obtaining returns with low or no correlation to both the equity and bond markets. These relative value strategies include fixed income arbitrage, mortgage backed securities, capital structure arbitrage, and closed-end fund arbitrage.
  Expected Volatility: Low
- Market Neutral - Securities Hedging: Invests equally in long and short equity portfolios generally in the same sectors of the market. Market risk is greatly reduced, but effective stock analysis and stock picking is essential to obtaining meaningful results. Leverage may be used to enhance returns. Usually low or no correlation to the market. Sometimes uses market index futures to hedge out systematic (market) risk. Relative benchmark index usually T-bills.
  Expected Volatility: Low
- Market Timing: Allocates assets among different asset classes depending on the manager's view of the economic or market outlook. Portfolio emphasis may swing widely between asset classes. Unpredictability of market movements and the difficulty of timing entry and exit from markets adds to the volatility of this strategy.
  Expected Volatility: High

- Opportunistic: Investment theme changes from strategy to strategy as opportunities arise to profit from events such as IPOs, sudden price changes often caused by an interim earnings disappointment, hostile bids, and other event-driven opportunities. May utilize several of these investing styles at a given time and is not restricted to any particular investment approach or asset class.
  Expected Volatility: Variable
- Multi Strategy: Investment approach is diversified by employing various strategies simultaneously to realize short- and long-term gains. Other strategies may include systems trading such as trend following and various diversified technical strategies. This style of investing allows the manager to overweight or underweight different strategies to best capitalize on current investment opportunities.
  Expected Volatility: Variable
- Short Selling: Sells securities short in anticipation of being able to rebuy them at a future date at a lower price due to the manager's assessment of the overvaluation of the securities, or the market, or in anticipation of earnings disappointments often due to accounting irregularities, new competition, change of management, etc. Often used as a hedge to offset long-only portfolios and by those who feel the market is approaching a bearish cycle. High risk.
  Expected Volatility: Very High
- Special Situations: Invests in event-driven situations such as mergers, hostile takeovers, reorganizations, or leveraged buy outs. May involve simultaneous purchase of stock in companies being acquired, and the sale of stock in its acquirer, hoping to profit from the spread between the current market price and the ultimate purchase price of the company. May also utilize derivatives to leverage returns and to hedge out interest rate and/or market risk. Results generally not dependent on direction of market.
  Expected Volatility: Moderate
- Value: Invests in securities perceived to be selling at deep discounts to their intrinsic or potential worth. Such securities may be out of favour or underfollowed by analysts. Long-term holding, patience, and strong discipline are often required until the ultimate value is recognized by the market.
  Expected Volatility: Low - Moderate

Who Offers Hedge Funds?

Firms with Hedge Fund products include or have included:

- Abbey National Asset Managers
- Coutts & Co
- Credit Suisse First Boston
- Deutsche Bank
- Global Asset Management (GAM)
- Henderson
- HSBC Republic
- Lazards
- Martin Currie
- Matrix Securities
- Morley Fund Management
- NDF Administration
- Norwich Union
- Scottish Value Management

Relevant Reading

- *Getting Started in Hedge Funds,* by Daniel Strachman, published by John Wiley & Sons Inc; ISBN: 0471316962.
- *All About Hedge Funds,* by Robert A. Jaeger, published by McGraw-Hill Education; ISBN: 0071393935.
- *The Hedge Fund Edge: Maximum Profit/Minimum Risk Global Trend Trading Strategies,* by Mark Boucher, published by John Wiley & Sons; ISBN: 0471185388.
- *Hedge Funds - Myths and Limits,* by F.-S. Lhabitant, published by John Wiley and Sons Ltd; ISBN: 0470844779.
- *Hedge Funds: Investment and Portfolio Strategies for the Institutional Investor,* by Jess Lederman (Editor), Robert A. Klein (Editor), published by Irwin Professional Publishing; ISBN: 155738861X.
- *Hedge Funds* - An Introduction to Skill Based Investment Strategies, ISBN: 0954259106.
- *Hedge Funds in Emerging Markets*, by Gordon de Brouwer, published by Cambridge University Press; ISBN: 0521802334.
- *Hedge Funds for Dummies,* by Ann C. Logue MBA, published by John Wiley & Sons, October 2008, ISBN 10: 0470049278.

Popular Misconception

The popular misconception is that all hedge funds are volatile - that they all use global macro strategies and place large directional bets on stocks, currencies, bonds, commodities, and gold, while using lots of leverage. In reality, less than 5% of hedge funds are global macro funds. Most hedge funds use derivatives only for hedging or don't use derivatives at all, and many use no leverage.

Hedge Funds and Short Selling

Short-Selling (in which traders bet on share prices falling) has come under fire. The technique involves investors borrowing an asset, such as shares, currencies or oil contracts, from another investor and then selling that asset in the relevant market hoping the price will fall. Although anyone can "short a position" in a company's shares, typically hedge funds have been the main players.

In September 2008, the Financial Services Authority (FSA) banned short-selling on certain shares until January 2009. The FSA's clampdown applies only to 29 leading financial stocks, and not to shares in all listed firms. Following chaos in the financial sector, the UK Government and FSA introduced rules that require fund managers to provide daily updates on positions they held before 19 September 2008. The ban also prevents them taking on new short positions in a list of 34 protected financial stocks. The FSA has been joined by other regulators around the world.

Further Information

The Hedge Fund Association[3] is an international not-for-profit association of hedge fund managers, service providers, and investors formed to unite the hedge fund industry and add to the increasing awareness of the advantages and opportunities in hedge funds.

This guide is for general interest - it is always essential to take advice on specific issues.

We believe that the facts are correct as at the date of publication, but there may be certain errors and omissions for which we cannot be responsible.

Important Notice

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References and Acknowledgements:

[1] Source: http://en.wikipedia.org/wiki/Hedge_fund

[2] This section is contributed by Dion Friedland, Chairman, Magnum Funds: http://www.magnumfund.com

[3] Visit: http://www.thehfa.org