Hedge Funds

Hedge funds are not for the faint-hearted.
Or are they?
Hedge funds are not regulated.
Or are they?
Hedge funds are more volatile than more traditional investments.
Or are they?
Hedge funds are not accessible for small investors.
Or are they?
Hedge fund performances are not measurable.
Or are they?

Background

By investment standards hedge funds are relative newcomers on the block. The first hedge fund is accredited to Alfred Winslow Jones who decided in 1949 that he had a better system of managing money than traditional fund managers. His novel approach, discovered while researching an article for his employers at Fortune Magazine, was to hedge potential risk in his long stock positions by selling other stocks to offset the impact on his portfolio of any wider market reversal.

However, like many successful investors before him and since, he kept his new techniques to himself. It was not until 1966 that investors woke up to the delightful simplicity of what the by now extremely wealthy Mr. Jones had been doing. Once the news article pointed out that in the past year Jones' funds had outperformed the best performing mutual fund by 44% and that over the previous five years had a return 85% better than its nearest traditional rival, it wasn't long before others were rushing to copy him.

Within two years over 200 new "hedge funds" were launched including ones by several individuals set to become legends of the industry, including George Soros, Warren Buffet and Michael Steinhardt.

However, many of these new hedge fund managers quickly drifted away from Jones' original principles when they found that allocating a portion of their assets to short sales weighed heavily on performance returns during the boom markets of the late 1960s. This lack of insurance began to be exposed as markets turned in 1969/70 and eventually saw many simply close their doors as the bear market turned into a rout in 1973. This shakeout served to discourage many new entrants to this sector, even as markets began to improve towards the end of the 1970s and by the mid 1980s research indicated that less than 70 funds were operating with any conviction.

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But the early 1990s brought its rewards for the survivors, most spectacularly George Soros' Quantum Fund and its forays into the currency market – particularly its aggressive short stance on sterling that eventually accelerated sterling's exit from the European Exchange Rate Mechanism in 1992.

The ability of hedge funds to diversify into new markets and the advent of new trading tools, combined with the favorable press the hedge funds were starting to attract, saw a re-birth of the industry. By the end of that decade there were an estimated 4,000 hedge funds in operation.

The onset of another bear market shortly into the new Millennium once again produced turmoil in the industry. But the experience of past mistakes, combined with much more widely diversified investment strategies – both in terms of markets and more sophisticated instruments/techniques – limited the fallout.

Today there are an estimated 7,000 hedge funds. Clearly that is too many for the individual to research and to identify opportunities or risks – even if they had money to invest in these funds. In recent years, fund of funds have been developed as a means of encouraging smaller investors to invest in the hedge fund market.

Hedge Funds – A New Asset Class

The specialist nature of hedge funds, in terms of their relative freedom from regulation, their exclusive investor profile and the diverse nature of their investments are the main factors that set them aside from mutual funds. The other defining difference is leveraged investment, with hedge funds openly borrowing (sometimes as much as 10 times the pledged investment capital) in order to be able to dominate some of the investment opportunities they identify.

A key factor differentiating hedge funds from their publicly traded mutual counterparts is the remuneration of the fund's partners or managers. Typically they will keep 20% of the profits, as well as a management fee that is often 1% or more annually of the assets under management. Huge potential rewards, but it also ensures a commitment to maximise returns for the other investors.

Many classify hedge funds as "alternative" investments, in that a typical portfolio looks for alternatives to traditional long-only positions in stocks and bonds. However, while popular perceptions of hedge funds present them as "high risk – high return" initiatives, but only a small percentage fit this profile. Many are more conservative entities looking to simply better equity market returns. Given the scope available to fund managers a wide range of strategies are used. Some of the more popular include:

- Equity Hedge
- Commodity Trading Association (CTA) / Managed Futures
- Global Macro
- Merger Arbitrage
- Distressed Securities
- Convertible Arbitrage
- Equity Arbitrage
- Fixed Income Relative Value.

Of course, many will be multiples of these and one individual investment could be defined under several of the listed headings. One way for an investor to access a cross section of hedge fund management strategies is to follow the fund of funds route, effectively specialist hedge funds that invest in other individual specialist funds. More difficult to follow is the way some hedge fund managers drift away from their original stated investment mandate, potentially exposing investors to risk they would prefer to avoid or duplicating investments held elsewhere. In a mutual fund these developments would be quickly identified through the much more transparent nature of the industry imposed by strict regulatory control. A fund of funds manager will be better positioned to keep closer scrutiny on these possible developments.

Types of Hedge Funds

Equity Hedge
These hedge funds consist of a core holding of long equities hedged at all times with tactical short sales of stocks and/or stock index options. In addition to equities, some hedge funds may have limited assets invested in other types of securities.

Commodity Trading Association (CTA) / Managed Futures
Managed futures funds take long and short positions in liquid financial futures such as currencies, interest rates, stock market indices and commodities.

Global Macro
Macro funds make leveraged investments on anticipated price movements of stock markets, fixed interest securities, interest rates, foreign exchange and physical commodities and derivatives on such instruments. Macro managers employ a "top-down" global approach to forecast shifts in world economies, political fortunes or global supply and demand for resources, both physical and financial. They may invest in any markets using any instruments to participate in expected market movements.

Merger Arbitrage
Merger Arbitrage involves investments in event-driven situations such as leveraged buy-outs, mergers and hostile takeovers. Normally, the stock of an acquisition target appreciates while the acquiring company's stock decreases in value. These strategies generate returns by purchasing stock of the company being acquired and in some instances, selling short the stock of the acquiring company.

Distressed & Opportunities
Distressed Securities strategies invest in, and may sell short, the securities of companies where the security's price has been, or is expected to be, affected by a distressed situation. This may involve reorganisations, bankruptcies, distressed sales and other corporate restructurings. Depending on the manager's style, investments may be made in bank debt, corporate debt, trade claims, common stock, preferred stock and warrants.

Opportunities involve investing in opportunities created by significant transactional events, such as spin-offs, mergers and acquisitions, bankruptcy reorganisations, recapitalisations and share buybacks. Instruments include long and short common and preferred stocks, as well as debt securities and options.

Convertible Arbitrage
Convertible Arbitrage involves purchasing a portfolio of convertible securities and hedging a portion of the equity risk by selling short the underlying common stock. Managers may also seek to hedge interest rate exposure under some circumstances.

Equity Arbitrage
The Equity Arbitrage strategy is a market neutral strategy that seeks to profit by exploiting pricing inefficiencies between related equity securities, neutralising exposure to directional market risk by combining long and short positions in broadly equal amounts.

Fixed Income Relative Value
Fixed Income Relative Value is a market neutral hedging strategy that seeks to profit by exploiting pricing inefficiencies between related fixed income securities while neutralizing exposure to interest rate risk. Managers attempt to exploit relative mispricing between related sets of fixed income securities. The generic types of fixed income hedging trades include: yield-curve arbitrage, corporate versus Treasury yield spreads, municipal bond versus Treasury yield spreads and cash versus futures.

Performance and Returns
'Spectacular' is a word used regularly when discussing hedge funds' performance, both on the upside and the reverse. Certainly the long-term performance of the entire hedge fund universe stands up to scrutiny when compared with Equity Mutual Funds or for equity benchmarks.

But it is also well known that there have been some high profile failures, often with far-reaching consequences as in Long Term Capital Management's demise in 1998. According to some estimates around a fifth of all hedge funds failed in 2002. However, this does not seem to have deterred those who specialise in the industry with the total number of funds continuing to grow. It should also be remembered that spectacular failure is not something unique to hedge funds in the financial services universe, as all investment styles have been subject to their share of unwanted scrutiny in recent years. The fall out as a result of the sup prime market within The US, is something which may yet be revealed as a catalyst for a world wide banking crash. Recent action by The Fed, would seem to indicate that there remain grave concerns as to the impact which may be felt across global markets.

Total funds under management in hedge funds are now estimated to exceed $1.0 trillion worldwide (though by comparison not much more than 10% of those in mutual funds) in some 7,000 funds. However, Hedge Funds continue to grow in terms of assets under management. For example, new legislation became law in Germany from the start of 2004 and this has created a surge of money into Hedge Funds from Germany, many other countries are following suit changing their legislation in recognition the roll which Hedge Funds play in creating a In broad terms a very conservative fund of funds will target returns of 8-12% and will contain many "market neutral" hedge funds that exhibit a very low correlation to the underlying markets. In other words the investment intention is to remove market volatility.

A moderately conservative fund of funds will target 12-17% returns over a pre-determined multi-year strategy. These will combine a selection of "market neutral" funds with a smattering of other higher risk strategies.

A more aggressive fund of funds will still only aim for returns of 15-20% as it will still be aiming to have a lower-than-market statistical risk. However, it will contain a higher weighting of funds that are more closely correlated with the markets. Something to take into consideration when examining hedge fund performance is whether returns are net of fees, or calculated prior to fees. Many funds report performance numbers before fees are extracted, which can distort numbers greatly in the funds' favor. This is key, as a positive month can instead turn negative when fees are factored in – and we have already emphasised the much higher level fees awarded.

The next factor when judging hedge fund performance is how returns are classified, with some of the basic breakdowns used in the industry being: pro forma, managed account, estimated, confirmed, and audited. Hedge fund performance that is pro-forma basically means the numbers have one or more assumptions or hypothetical conditions built into the data. So if in a fund of funds there are ten funds that are planned to be invested in, and the data is compiled for the last year from those funds, the numbers would be classified as pro-forma. These are not actual returns, just hypothetical ones generated through a test.

This is just one example of where the lack of transparency in the hedge fund sector places a much greater onus on the individual investor than he would have to be aware of if purely investing in traditional markets.

For this reason, many consider the fund of funds route as the most accessible. Due diligence, allocation of percentages, monitoring of existing investments and searching for new opportunities becomes a full time job and a difficult one. Most investors are not able to perform all these tasks which is why they need the services of an advisor.

Glossary

Alpha
Measures the value a fund manager produces, by comparing performance to that of a risk-free investment (Treasury bills). For example, if a fund had an alpha of 1.0 during a given month, it would have produced a return during that month that was one percentage point higher than the benchmark Treasury. Alpha can also be used as a measure of residual risk, relative to the market in which a
fund participates.

Beta
Gauges the risk of a fund by measuring the volatility of its past returns in relation to the returns of a benchmark. A fund with a beta of 0.7 has experienced gains and losses that are 70% of the benchmark's changes. A beta of 1.3 means the total return is likely to move up or down 30% more than the index. A fund with a 1.0 beta is expected to move in tandem with the index.

Closed Fund
A hedge fund or open-end mutual fund that has at least temporarily stopped accepting capital from investors,
usually due to rapid asset growth. Not to be confused with a closed end fund

Drawdown
The percentage loss that a fund incurs from its peak net asset value to its lowest value. The maximum drawdown over a significant period is sometimes employed as a means of measuring the risk of a vehicle. Usually expressed as a percentage decline in net asset value.

Fund of Funds
An investment vehicle consisting of shares in hedge funds and private equity funds. Some of these multi-manager vehicles limit holdings to specific managers or investment strategies, while others are more diversified. Investors in funds of funds are willing to pay two sets of fees, one to the fund of funds manager and another set of (usually

High Water Mark
A provision to ensure a fund manager only collects incentive fees on the highest net asset value previously
attained at the end of any prior fiscal year - or gains on actual profits for each investor. For example, if the value of an investor's contribution falls to $750,000 from $1 million in the first year and then rises to $1.25 million in year two, the manager would only receive incentive fees from that investor on the $250,000 that represented actual profits in year two. The minimum return necessary for a fund manager to start

Hurdle Rate
The minimum return necessary for a fund manager to start collecting incentive fees. The hurdle is usually tied to a benchmark rate such as Libor or the one-year Treasury bill rate plus a spread. If the manager sets a hurdle rate equal to 5% and the fund returns 15%, incentive fees would only apply to the 10% above the hurdle rate. Drawdown Fund of funds, Incentive General partner, High-water mark, Hurdle rate, Incentive Performance Fee. The charge - typically 20% - that a fund manager assesses on gains earned during a given 12 month period. For example if a fund posts a return 40% above its hurdle rate, the incentive fee would be 8% (20% of 40%) – provided that the high-water mark does not come into play.

Leverage
The borrowed money that an investor employs to increase buying power and increase its exposure to an investment. Users of leverage seek to increase their overall invested amounts in hopes that the returns on their positions will exceed their borrowing costs. The extent of a fund's leverage is stated either as a debt-to-equity ratio or as a percentage of the fund's total assets that are funded by debt. Leverage can also come in the form of short sales, which involve borrowed securities.

Management Fee
The charge that a fund manager assesses to cover operating expenses. Investors are typically charged separately for costs incurred for outsourced services. The fee ranges from an annual 0.5-2.0% of an investor's entire holdings usually collected quarterly.

Prime Broker
A large bank or securities firm that provides various administrative, back-office and financing services to hedge funds and other professional investors. Prime brokers can provide a wide variety of services, including trade reconciliation (clearing and settlement), custody services, risk management, margin financing, securities lending for the purpose of carrying out short sales, record keeping, and investor reporting. A prime brokerage relationship doesn't preclude hedge funds from carrying out trades with other brokers, or even employing others as prime brokers. To compete for business, some prime brokers act as incubators providing office space and services to help new fund managers get off the ground.

Sharpe Ratio
A measure of how well a fund is rewarded for the risk it incurs. The higher the ratio, the better the return per unit of risk taken. It is calculated by subtracting the risk-free rate from the fund's annualised average return and dividing the result by the fund's annualised standard deviation. A Sharpe ratio of 1:1 indicates that the rate of return is proportional to the risk assumed in seeking that reward. Developed Prof. William Sharpe of Stanford University

Sortino Ration
Also called the "upside potential ratio." Similar to the Sharpe ratio, it was developed by the Pension Research
Institute to determine the amount of "good" volatility that a fund's investment portfolio possesses – that is, it seeks to define the amount by which the investment pool's value may increase, based on expected pricing fluctuations.

Volatility
The likelihood that an instrument's value will change over a given period of time usually measured as beta.