

Hedge Funds

What is a Hedge Fund?

'Hedge fund' is a generic term covering a very wide range of funds that adopt non-traditional investment methods and the Hedge Fund Association recognises at least 14 distinct investment strategies adopted by its members. Funds vary considerably in terms of the risk involved, level of borrowing (i.e. gearing) and the investments purchased, and many use derivatives in their investment approach. Though the funds do not necessarily hedge their investments against adverse market moves, the term is used to distinguish them from regulated retail investment funds such as mutual funds and pension funds.

Hedge funds' activities are limited only by the terms of the contracts governing the particular fund. They can follow complex investment strategies, being long or short assets and entering into futures, swaps and other derivative contracts. The funds, often organised as limited partnerships in the United States, typically invest on behalf of institutions and high-net-worth individuals. Hedge funds are typically domiciled in an offshore jurisdiction, such as Bermuda, Cayman Islands, British Virgin Islands, where regulation of investment funds permits wider powers of investment. As private, lightly regulated partnerships, hedge funds do not have to disclose their activities to third parties.

How does a Hedge Fund work?

A common objective is to generate returns that are not closely correlated to those of the broader financial markets. But for all their variety, there are some common features:

Absolute Return

Hedge funds do not generally adopt a 'long only' strategy, i.e. holding a portfolio of equities and/or bonds. The funds aim for an absolute return with limited volatility, rather than performance relative to a benchmark to produce positive returns in both bull and bear markets. The approaches used are explained below.

Limited Correlation

The various investment methods of hedge funds mean that they often have limited or even negative correlation to the markets in which they operate. As a consequence, even when markets are falling, hedge funds can and do achieve positive returns but the opposite is true too.

Hedge Fund Investment Strategies

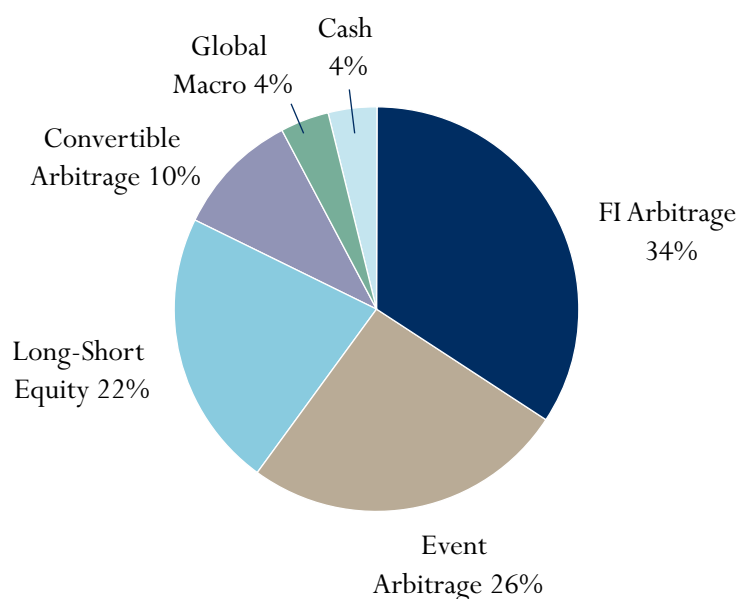
Whilst there are no universally agreed definitions, there are four broad categories of hedge fund strategy:

Long/Short funds: These funds invest in equity and/or bond instruments, combining long investments – in other words buying the asset – with short sales (i.e. selling a stock in anticipation of it falling and being able to buy back at a lower price, thus making a profit) of individual securities and derivatives to reduce market exposure. Long/short funds can operate with a bias towards either the long or short side, or balance the two in a ‘market neutral’ approach.

Relative Value funds: These are often referred to as ‘quant’ (short for quantitative analysis) funds which adopt ‘market neutral’ strategies because there is no market-related element in their returns. Instead the managers rely on arbitrage to produce returns i.e. by identifying and exploiting pricing anomalies between similar investments or combinations of investments. Although these strategies have limited volatility they can still suffer when market liquidity dries up as recently witnessed in financial markets during the sub-prime liquidity panic, which caused many funds to collapse.

Event Driven funds: Here hedge funds use price movements arising from anticipated corporate events to achieve their returns. The approach tends to be uncorrelated with investment markets but usually performs best in strong market conditions when there is generally greater corporate activity. As with relative value funds, event driven funds generally fall in the low volatility range of hedge funds.

Trading Strategy funds: This type of fund probably most closely matches the public perception of a hedge fund. In reality they now represent a relatively small part of the sector. They trade in currencies, bonds, equities and/or commodities. In each asset class they may use the same long/short approach as equity hedge funds.



Points to Consider

Consider Fees – Usually the hedge fund manager will receive both a management fee and a performance fee. As with other investment funds, the management fee is computed as a percentage of assets under management. Annual management fees might typically be 1.5% to 2.0%. Typically, hedge funds charge 20% of gross returns as a performance fee, but again the range is wide, with highly regarded managers demanding higher fees.

Comparison to Private Equity Funds – Hedge funds are similar to private equity funds in many respects. Both are lightly regulated, private pools of capital that invest in securities and compensate their managers with a share of the fund's profits. Hedge funds can invest in very illiquid assets, hence making it difficult for investors to enter or leave the fund easily. Private equity funds also invest primarily in very illiquid assets such as early-stage companies and so investors are 'locked in' for the entire term of the fund. Hedge funds often invest in private equity companies' acquisition funds.

How Do You Invest?

Minimum subscription to this type of investment is usually high – (\$100,000) – although investing in a 'fund of funds' can be made for smaller considerations. Investors need to be certain that they understand the risks involved with this type of investment which can be high. One feature of many hedge funds is that they are not as liquid as other collectives – exit points are pre-determined, e.g. the last day of each quarter, and investors need to apply to withdraw funds in advance and will have no idea as to the likely value.