Hedge fund

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(Redirected from Hedge funds)

A **hedge fund** is a private, largely unregulated pool of capital whose managers can buy or sell any assets, make speculative trades on falling as well as rising assets, and participate substantially in profits from money invested. It charges both a performance fee and a management fee. Typically open only to very wealthy qualified investors, hedge fund activity in the public securities markets has grown substantially, accounting for approximately 10% of all U.S. fixed-income security transactions, 35% of U.S. activity in derivatives with investment-grade ratings, 55% of the trading volume for emerging-market bonds, and 30% of equity trades. Hedge funds dominate certain specialty markets such as trading within derivatives with high-yield ratings and distressed debt.[1]

Sociologist, author, and financial journalist Alfred W. Jones is credited with the creation of the first hedge fund in 1949.[2]

In the United States, an investment fund must be restricted to a limited number of accredited investor[3]s in order to be exempt from direct regulation. While there is no legal definition for "hedge fund" under U.S. securities laws and regulations, typically they include any investment fund that, because of an exemption from certain regulation that otherwise apply to mutual funds, brokerage firms or investment advisors, can invest in more complex and risky investments than a public fund might. Because they are not open to the public, they do not have to make public disclosures of their investments or investors. Hedge funds managed from other countries have similar relationships with their national regulators. Since a hedge fund's investment activities are limited only by the contracts governing the particular fund, it can make greater use of complex investment strategies such as short selling, entering into futures, swaps and other derivative contracts and leverage.

As the name implies, hedge funds often seek to offset potential losses in the principal markets they invest in by hedging their investments using a variety of methods, most notably short selling. However, the term "hedge fund" has come in modern parlance to be applied to many funds that do not actually hedge their investments, and in particular to funds using short selling and other "hedging" methods to increase risk, and therefore return, rather than reduce it.

Hedge funds have acquired a reputation for secrecy due to the protection of proprietary investment strategies. While many believe that hedge funds are outside the regulatory regime that is applied to retail funds, there still remains significant disclosure that is required to be made when specific triggers are met, but in general informational disclosure is less burdensome than that of registered funds. Additionally, divulging trading methods and positions would compromise the business interests of many types of hedge fund, tending to limit the information they want to release.[4]

Financial market participants

Investors
Hedge funds
Private equity
Venture capital

Speculation

Institutional investors
Banks
Building societies
Collective investment schemes
Credit Unions
Insurance companies
Investment banks
Pension funds
Prime Brokers
Trusts

Finance series
Financial market
Participants
Corporate finance
Personal finance
Public finance
Banks and Banking
Financial regulation

The assets under management of a hedge fund can run into many billions of dollars, and this will usually be multiplied by leverage. Their sway over markets, whether they succeed or fail, is therefore potentially substantial and there is a continuing debate over whether they should be more thoroughly regulated.

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Industry

In 2005, *Absolute Return* magazine found there were 196 hedge funds with $1 billion or more in assets, with a combined $743 billion under management - the vast majority of the industry's estimated $1 trillion in assets.[5] However, according to hedge fund advisory group *Hennessee*, total hedge fund industry assets increased by $215 billion in 2006 to $1.442 trillion, up 17.5% on a year earlier, an estimate for 2005 seemingly at odds with *Absolute Return*.[6]

As large institutional investors have entered the hedge fund industry the total asset levels continue to rise. The 2008 Hedge Fund Asset Flows & Trends Report[7] published by *HedgeFund.net* (http://www.hedgefund.net) and *Institutional Investor*

News estimates total industry assets reached $2.68 trillion in Q3 2007. According to the *BarclayHedge Monthly Asset Flow Report* (http://www.barclayhedge.com/products/trimtabs-hedge-fund-flow-report.html) , hedge funds received only $15 billion in October, the second-lowest inflow in 2007. Year-to-date hedge funds attracted $278.5 billion, three times year-to-date inflow into equity mutual funds.

Fees

A hedge fund manager will typically receive both a management fee and a performance fee (also known as an incentive fee). Performance fees are closely associated with hedge funds, and are intended to be an incentive for the investment manager to produce the largest returns he can. A typical manager will charge fees of "2 and 20", which refers to a management fee of 2% of the fund's net asset value (or "NAV") per annum and a performance fee of 20% of the fund's profit (being the increase in its NAV). A third, but less common, type of compensation is the corpulence sustainability fee specific to Long/Short Equity fund members who surpass a minimum size threshold. This fee, which provides additional monetary benefits to maintain outsized girth, has only recently been introduced to the hedge fund community, with Muller of Bloomfield, NJ being the only member to date large enough to benefit from this fee category.

Fees are payable by the fund to the investment manager. They are therefore taken directly from the assets that the investor holds in the fund.

Management fees

As with other investment funds, the management fee is calculated as a percentage of the fund's net asset value (the total of the investors' capital accounts) at the time when the fee becomes payable. Management fees typically range from 1% to 4% per annum, with 2% being the standard figure. Therefore, if a fund has $1 billion of assets at year-end and charges a 2% management fee, the management fee will be $20 million. Management fees are usually expressed as an annual percentage but both calculated and paid monthly (or sometimes quarterly or weekly) at annualized rates.

Performance fees

One of the defining characteristics of hedge funds are performance fees which give a share of positive returns to the manager. The manager's performance fee is calculated as a percentage of the fund's profits, counting both unrealized profits and actual realized trading profits. Performance fees exist because investors are usually willing to pay managers more generously when the investors have themselves made money. Thus, the performance fee is extremely lucrative for managers who perform well.

Typically, hedge funds charge 20% of gross returns as a performance fee. However, the range is wide with highly regarded managers charging higher fees. In particular, Steven Cohen's SAC Capital Partners charges a 3% management fee and a 35% performance fee,[8] while Jim Simons' Renaissance Technologies Corp. charged a 5% management fee and a 44% incentive fee in its flagship Medallion Fund.

Performance fees are intended to align the interests of manager and investor better than flat fees that are payable even when performance is poor. However, performance fees have been criticized by many people, including notable investor Warren Buffett, for giving managers an incentive to take excessive risk rather than targeting high long-term returns. In an attempt to control this problem, fees are usually limited by a high water mark and sometimes limited by a hurdle rate. Alternatively a "claw-back" provision may be included, whereby the investment manager might be required to return performance fees when the value of the fund drops.

High water marks

A high water mark (also known as a loss carryforward provision) is often applied to a performance fee calculation.[9] This means that the manager only receives performance fees on the value of the fund that exceeds the highest net asset value it has previously achieved. For example, if a fund were launched at a NAV (net asset value) per share of $100, which then rose to $130 in its first year, a performance fee would be payable on the $30 return for each share. If the next year it dropped to $120, no fee is payable. If in the third year the NAV per share rises to $143, a performance fee will be payable only on the

$13 return from $130 to $143 rather than on the full return from $120 to $143.

This measure is intended to link the manager's interests more closely to those of investors and to reduce the incentive for managers to seek volatile trades. If a high water mark is not used, a fund that ends alternate years at $100 and $110 would generate performance fee every other year, enriching the manager but not the investors.

The mechanism does not provide complete protection to investors: a manager who has lost a significant percentage of the fund's value will often close the fund and start again with a clean slate, rather than continue working for no performance fee until the loss has been made good. This depends on the manager's ability to persuade investors to trust him or her with their money in the new fund.[10]

Hurdle rates

Some managers specify a hurdle rate, signifying that they will not charge a performance fee until the fund's annualized performance exceeds a benchmark rate, such as T-bill yield, LIBOR or a fixed percentage. This links performance fees to the ability of the manager to do better than the investor would have done if he had put the money elsewhere.

Managers who specify a "soft" hurdle rate charge a performance fee based on the entire annualized return once the hurdle rate has been achieved. Managers who use a "hard" hurdle rate only charge a performance fee on returns above the hurdle rate.

Because demand for hedge funds has outstripped supply, most managers do not now need hurdle rates in order to attract investors. For this reason, hurdle rates are now rare.

Withdrawal/Redemption fees

Some managers charge investors a withdrawal/redemption fee (also known as a surrender charge) if they withdraw money from the fund before a certain period of time has elapsed since the money was invested. The purpose is to encourage long-term investment in the fund: as a fund's investments need to be liquidated to raise cash for withdrawals, the fee allows the fund manager to reduce the turnover of its own investments and invest in more complex, longer-term strategies. The fee also dissuades investors from withdrawing funds after periods of poor performance.

The fee is typically known as a "withdrawal fee" where the fund is a limited partnership and a "redemption fee" where the fund is a corporate entity.

Strategies

Hedge funds employ many different trading strategies, which are classified in many different ways, with no standard system used. Each strategy can be said to be built from a number of different elements:

- **Style:** global macro, directional, event driven, relative value (arbitrage), managed futures (CTA)
- **Market:** equity, fixed income, commodity, currency
- **Instrument:** long/short, futures, options
- **Exposure:** directional, market neutral
- **Sector:** emerging market, technology, healthcare etc.
- **Method:** discretionary/qualitative (where the individual investments are selected by managers), systematic/quantitative (or "quant" - where the investments are selected according to numerical methods using a computerized system)
- **Diversification:** multi manager, multi strategy, multi fund, multi market

The four main strategy groups are based on the investment style and have their own risk and return characteristics. The most common label for a hedge fund is "long/short equity", meaning that the fund takes both long and short positions in shares traded on public stock exchanges.

Global macro

(Macro, Trading) Anticipate to global macroeconomic events using all markets and instruments.

- **Discretionary macro** - trading is done by investment managers instead of generated by software.
- **Systematic macro** - trading is done purely mathematically, generated by software without human intervention.
  - **Commodity Trading Advisors** (CTA, Managed futures, Trading) - trading in futures (or options contracts) in commodity markets.
  - **Systematic diversified** - trading in diversified markets.
  - **Systematic currency** - trading in currency markets.
  - **Trend following** - profit from long-term or short-term trends.
  - **Non-trend following** (Counter trend) - profit from trend reversals.
- **Multi strategy** - combination of discretionary and systematic macro.

Directional

(Equity hedge) Hedged investments with exposure to the equity market.

- **Long / short equity** (Equity hedge) - long equity positions hedged with short sales of stocks or stock market index options.
- **Emerging markets** - specialized in emerging markets, such as China, India etc.
- **Sector funds** - expertise in niche areas such as technology, healthcare, biotechnology, pharmaceuticals, energy, basic materials.
- **Fundamental growth** - invest in companies with more earnings growth than the broad equity market.
- **Fundamental value** - invest in undervalued companies.
- **Quantitative Directional** - equity trading using quantitative techniques.
- **Short bias** - take advantage of declining equity markets using short positions.
- **Multi strategy** - diversification through different styles to reduce risk.

Event driven

(Special situations) Exploit pricing inefficiencies caused by anticipated specific corporate events.

- **Distressed securities** (Distressed debt) - specialized in companies trading at discounts to their value because of (potential) bankruptcy.
- **Merger arbitrage** (Risk arbitrage) - exploit pricing inefficiencies between merging companies.
- **Special situations** - specialized in restructuring companies or companies engaged in a corporate transaction.
- **Multi strategy** - diversification through different styles to reduce risk.
- **Credit arbitrage** - specialized in corporate fixed income securities.
- **Regulation D** - specialized in private equities.
- **Activist** - take large positions in companies and use the ownership to be active in the management

Relative value

(Arbitrage, Market neutral) Exploit pricing inefficiencies between related assets that are mispriced.

- **Fixed income arbitrage** - exploit pricing inefficiencies between related fixed income securities.
- **Equity market neutral** (Equity arbitrage) - being market neutral by maintaining a close balance between long and short positions.
- **Convertible arbitrage** - exploit pricing inefficiencies between convertible securities and the corresponding stocks.
- **Fixed Income corporate** - fixed income arbitrage strategy using corporate fixed income instruments.
- **Asset-backed securities** (Fixed Income asset backed) - fixed income arbitrage strategy using asset-backed securities.
- **Credit long / short** - as long / short equity but in credit markets instead of equity markets.
- **Statistical arbitrage** - equity market neutral strategy using statistical models.
- **Volatility arbitrage** - exploit the change in implied volatility instead of the change in price.
- **Yield alternatives** - non fixed income arbitrage strategies based on the yield instead of the price.
- **Multi strategy** - diversification through different styles to reduce risk.
- **Regulatory Arbitrage** - the practice of taking advantage of regulatory differences between two or more markets.

Under certain circumstances an investor can completely hedge the risks of an investment, leaving pure profit. For example, at one time it was possible for exchange traders to buy shares of, say, IBM on one exchange and simultaneously sell them on another exchange, leaving pure profit. Competition among investors has leached away such profits, leaving hedge fund managers with trades that are partially hedged, at best. These trades still contain residual risks which can be considerable.

Miscellaneous

- **Fund of hedge funds** (Multi manager) - a hedge fund with a diversified portfolio of numerous underlying hedge funds to reduce risk.
- **Fund of fund of hedge funds** (F3, F cube) - ultra diversified by investing in other fund of hedge funds.
- **Multi strategy** - a hedge fund exploiting a combination of different hedge fund strategies to reduce market risk.
- **Multi manager** - a hedge fund where the investment is spread along separate sub managers investing in their own strategy.
- **130-30 funds** - unhedged equity fund with 130% long and 30% short positions, the market exposure is 100%.
- **Long only absolute return funds** - partly hedged fund excluding short selling but allow derivatives.

Hedge fund risk

Investing in certain types of hedge fund can be (but is not necessarily) a riskier proposition than investing in a regulated fund, despite a "hedge" being a means of reducing the risk of a bet or investment. The following are some of the primary reasons for the increased risk in hedge funds as an industry, though by no means all hedge funds have all of these characteristics, and some have none:

Leverage - in addition to money invested into the fund by investors, a hedge fund will typically borrow money, with certain funds borrowing sums many times greater than the initial investment. If a hedge fund has borrowed $9 for every $1 received from investors, a loss of only 10% of the value of the investments of the hedge fund will wipe out 100% of the value of the investor's stake in the fund, once the creditors have called in their loans. In September 1998, shortly before its collapse, Long Term Capital Management had $125 billion of assets on a base of $4 billion of investors' money, a leverage of over 30 times. It also had off-balance sheet positions with a notional value of approximately $1 trillion.[11]

Short selling - due to the nature of short selling, the losses that can be incurred on a losing bet are theoretically limitless, unless the short position directly hedges a corresponding long position. Therefore, where a hedge fund uses short selling as an investment strategy rather than as a hedging strategy it can suffer very high losses if the market turns against it. Ordinary funds very rarely use short selling in this way.

Appetite for risk - hedge funds are culturally more likely than other types of funds to take on underlying investments that carry high degrees of risk, such as high yield bonds, distressed securities and collateralized debt obligations based on sub-prime mortgages.

Lack of transparency - hedge funds are secretive entities with few public disclosure requirements. It can therefore be difficult for an investor to assess trading strategies, diversification of the portfolio and other factors relevant to an investment decision.

Lack of regulation - hedge funds are not subject to as much oversight from financial regulators as regulated funds, and therefore some may carry undisclosed structural risks.

Investors in hedge funds are, in most countries, required to be sophisticated investors who will be aware of the risk implications of these factors. They are willing to take these risks because of the corresponding rewards: leverage amplifies profits as well as losses; short selling opens up new investment opportunities; riskier investments typically provide higher returns; secrecy helps to prevent imitation by competitors; and being unregulated reduces costs and allows the investment manager more freedom to make decisions on a purely commercial basis.

Legal structure

A hedge fund is a vehicle for holding and investing the funds of its investors. The fund itself is not a genuine business, having no employees and no assets other than its investment portfolio and a small amount of cash, while its investors are its clients. The portfolio is managed by the investment manager, which has employees and property and which is the actual business. An investment manager is commonly termed a “hedge fund” (e.g. a person may be said to “work at a hedge fund”) but this is not technically correct. An investment manager may have a large number of hedge funds under its management.

Domicile

The specific legal structure of a hedge fund – in particular its domicile and the type of legal entity used – is usually determined by the tax environment of the fund’s expected investors. Regulatory considerations will also play a role. Many hedge funds are established in offshore tax havens so that the fund can avoid paying tax on the increase in the value of its portfolio. An investor will still pay tax on any profit it makes when it realizes its investment, and the investment manager, usually based in a major financial centre, will pay tax on the fees that it receives for managing the fund.

At end-2007, 52% of the number of hedge funds were registered offshore. The most popular offshore location was the Cayman Islands (57% of number of offshore funds), followed by British Virgin Islands (16%) and Bermuda (11%). The other offshore centers are Isle of man and Mauritius.The US was the most popular onshore location (with funds mostly registered in Delaware) accounting for 65% of the number of onshore funds, followed by Europe with 31%.[12]

The legal entity

Limited partnerships are principally used for hedge funds aimed at US-based investors who pay tax, as the investors will receive relatively favorable tax treatment in the US. The general partner of the limited partnership is typically the investment manager (though is sometimes an offshore corporation) and the investors are the limited partners. Offshore corporate funds are used for non-US investors and US entities that do not pay tax (such as pension funds), as such investors do not receive the same tax benefits from investing in a limited partnership. Unit trusts are typically marketed to Japanese investors. Other than taxation, the type of entity used does not have a significant bearing on the nature of the fund.

Many hedge funds are structured as master/feeder funds. In such a structure the investors will invest into a feeder fund which will in turn invest all of its assets into the master fund. The assets of the master fund will then be managed by the investment manager in the usual way. This allows several feeder funds (e.g. an offshore corporate fund, a US limited partnership and a unit trust) to invest into the same master fund, allowing an investment manager the benefit of managing the assets of a single entity while giving all investors the best possible tax treatment.

The investment manager, which will have organized the establishment of the hedge fund, may retain an interest in the hedge fund, either as the general partner of a limited partnership or as the holder of “founder shares” in a corporate fund. Founder shares typically have no economic rights, and voting rights over only a limited range of issues, such as selection of the investment manager – most of the fund’s decisions are taken by the board of directors of the fund, which is self-appointing and independent but invariably loyal to the investment manager.

Open-ended nature

Hedge funds are typically open-ended, in that the fund will periodically issue additional partnership interests or shares directly to new investors, the price of each being the net asset value (“NAV”) per interest/share. To realize the investment, the investor will redeem the interests or shares at the NAV per interest/share prevailing at that time. Therefore, if the value of the underlying investments has increased (and the NAV per interest/share has therefore also increased) then the investor will receive a larger sum on redemption than it paid on investment. Investors do not typically trade shares among themselves and hedge funds do not typically distribute profits to investors before redemption. This contrasts with a closed-ended fund, which has a limited number of shares which are traded among investors, and which distributes its profits.

Listed funds

Corporate hedge funds often list their shares on smaller stock exchanges, such as the Irish Stock Exchange, in the hope that the low level of quasi-regulatory oversight will give comfort to investors and to attract certain funds, such as some pension funds, that have bars or caps on investing in unlisted shares. Shares in the listed hedge fund are not traded on the exchange,

but the fund’s monthly net asset value and certain other events must be publicly announced there.

A fund listing is distinct from the listing or initial public offering (“IPO”) of shares in an investment manager. Although widely reported as a "hedge-fund IPO",[13] the IPO of Fortress Investment Group LLC was for the sale of the investment manager, not of the hedge funds that it managed.[14]

Hedge fund management worldwide

In contrast to the funds themselves, hedge fund managers are primarily located onshore in order to draw on larger pools of financial talent. The US East coast – principally New York City and the Gold Coast area of Connecticut (particularly Stamford and Greenwich) – is the world's leading location for hedge fund managers with approximately double the hedge fund managers of the next largest centre, London. With the bulk of hedge fund investment coming from the US, this distribution is natural. It was estimated there were 7,000 hedge funds in the United States in 2004.[15]

London is Europe’s leading centre for the management of hedge funds. At the end of 2007, three-quarters of European hedge fund investments, totaling $400bn (£200bn), were managed from London, having grown from $61bn in 2002. Australia was the most important centre for the management of Asia-Pacific hedge funds, with managers located there accounting for approximately a quarter of the $140bn of hedge fund assets managed in the Asia-Pacific region in 2008.[16]

Regulatory Issues

Part of what gives hedge funds their competitive edge, and their cachet in the public imagination, is that they straddle multiple definitions and categories; some aspects of their dealings are well-regulated, others are unregulated or at best quasi-regulated.

US regulation

The typical *public* investment company in the United States is required to be registered with the U.S. Securities and Exchange Commission (SEC). Mutual funds are the most common type of registered investment companies. Aside from registration and reporting requirements, investment companies are subject to strict limitations on short-selling and the use of leverage. There are other limitations and restrictions placed on public investment company managers, including the prohibition on charging incentive or performance fees.

Although hedge funds fall within the statutory definition of an investment company, the limited-access, private nature of hedge funds permits them to operate pursuant to exemptions from the registration requirements. The two major exemptions are set forth in Sections 3(c)1 and 3(c)7 of the Investment Company Act of 1940. Those exemptions are for funds with 100 or fewer investors (a "3(c) 1 Fund") and funds where the investors are "qualified purchasers" (a "3(c) 7 Fund").[17] A qualified purchaser is an individual with over US$5,000,000 in investment assets. (Some institutional investors also qualify as accredited investors or qualified purchasers.)[18] A 3(c)1 Fund cannot have more than 100 investors, while a 3(c)7 Fund can have an unlimited number of investors. However, a 3(c)7 fund with more than 499 investors must register its securities with the SEC.[19] Both types of funds can charge performance or incentive fees.

In order to comply with 3(c)(1) or 3(c)(7), hedge funds are sold via *private* placement under the Securities Act of 1933. Thus interests in a hedge fund cannot be offered or advertised to the general public, and are normally offered under Regulation D. Although it is possible to have non-accredited investors in a hedge fund, the exemptions under the Investment Company Act, combined with the restrictions contained in Regulation D, effectively require hedge funds to be offered solely to accredited investors.[20]. An accredited investor is an individual person with a minimum net worth of US $1,000,000 or, alternatively, a minimum income of US$200,000 in each of the last two years and a reasonable expectation of reaching the same income level in the current year. For banks and corporate entities, the minimum net worth is $5,000,000 in invested assets.[20]

The regulatory landscape for Investment Advisors is changing, and there have been attempts to register hedge fund investment managers. There are numerous issues surrounding these proposed requirements. One issue of importance to hedge fund managers is the requirement that a client who is charged an incentive fee must be a "qualified client" under

Advisers Act Rule 205-3. To be a qualified client, an individual must have US$750,000 in assets invested with the adviser or a net worth in excess of US$1.5 million, or be one of certain high-level employees of the investment adviser.[21]

For the funds, the tradeoff of operating under these exemptions is that they have fewer investors to sell to, but they have few government-imposed restrictions on their investment strategies. The presumption is that hedge funds are pursuing more risky strategies, which may or may not be true depending on the fund, and that the ability to invest in these funds should be restricted to wealthier investors who are presumed to be more sophisticated and who have the financial reserves to absorb a possible loss.

In December 2004, the SEC issued a rule change that required most hedge fund advisers to register with the SEC by February 1, 2006, as investment advisers under the Investment Advisers Act.[22] The requirement, with minor exceptions, applied to firms managing in excess of US$25,000,000 with over 15 investors. The SEC stated that it was adopting a "risk-based approach" to monitoring hedge funds as part of its evolving regulatory regimen for the burgeoning industry.[23] The rule change was challenged in court by a hedge fund manager, and in June 2006, the U.S. Court of Appeals for the District of Columbia overturned it and sent it back to the agency to be reviewed. See Goldstein v. SEC (http://www.seclaw.com/docs/ref/GoldsteinSEC04-1434.pdf) .

Although the SEC is currently examining how it can address the Goldstein decision, commentators have stated that the SEC currently has neither the staff nor expertise to comprehensively monitor the estimated 8,000 U.S. and international hedge funds. See New Hedge Fund Advisor Rule (http://www.seclaw.com/docs/NewHedgeFundAdvisorRule.htm) . One of the Commissioners, Roel Campos, has said that the SEC is forming internal teams that will identify and evaluate irregular trading patterns or other phenomena that may threaten individual investors, the stability of the industry, or the financial world. "It's pretty clear that we will not be knocking on [hedge fund] doors very often," Campos told several hundred hedge fund managers, industry lawyers and others. And even if it did, "the SEC will never have the degree of knowledge or background that you do."

In February 2007, the President's Working Group on Financial Markets rejected further regulation of hedge funds and said that the industry should instead follow voluntary guidelines.[24][25][26]

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. Most hedge funds invest in relatively liquid assets, and permit investors to enter or leave the fund, perhaps requiring some months notice. Private equity funds 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.

Between 2004 and February 2006 some hedge funds adopted 25 month lock-up rules expressly to exempt themselves from the SEC's new registration requirements and cause them to fall under the registration exemption that had been intended to exempt private equity funds.

Comparison to U.S. mutual funds

Like hedge funds, mutual funds are pools of investment capital (i.e., money people want to invest). However, there are many differences between the two, including:

- Mutual funds are regulated by the SEC, while hedge funds are not
- A hedge fund investor must be an accredited investor with certain exceptions (employees, etc.)
- Mutual funds must price and be liquid on a daily basis

Some hedge funds that are based offshore report their prices to the Financial Times, but for most there is no method of ascertaining pricing on a regular basis. Additionally, mutual funds must have a prospectus available to anyone that requests one (either electronically or via US postal mail), and must disclose their asset allocation quarterly, while hedge funds do not have to abide by these terms.

Hedge funds also ordinarily do not have daily liquidity, but rather "lock up" periods of time where the total returns are

generated (net of fees) for their investors and then returned when the term ends, through a passthrough requiring CPAs and US Tax W-forms. Hedge fund investors tolerate these policies because hedge funds are expected to generate higher total returns for their investors versus mutual funds.

Recently, however, the mutual fund industry has created products with features that have traditionally only been found in hedge funds.

Mutual funds have appeared which utilize some of the trading strategies noted above. Grizzly Short Fund (GRZZX), for example, is always net short, while Arbitrage Fund (ARBFX) specializes in merger arbitrage. Such funds are SEC regulated, but they offer hedge fund strategies (http://stocksandmutualfunds.com/hedge-fund-mutual-funds.html) and protection for mutual fund investors.

Also, a few mutual funds have introduced performance-based fees, where the compensation to the manager is based on the performance of the fund. However, under Section 205(b) of the Investment Advisers Act of 1940, such compensation is limited to so-called "fulcrum fees".[27] Under these arrangements, fees can be performance-based so long as they increase and decrease symmetrically.

For example, the TFS Capital Small Cap Fund (TFSSX) has a management fee that behaves, within limits and symmetrically, similarly to a hedge fund "0 and 50" fee: A 0% management fee coupled with a 50% performance fee if the fund outperforms its benchmark index. However, the 125 bp base fee is reduced (but not below zero) by 50% of underperformance and increased (but not to more than 250 bp) by 50% of outperformance.[28]

Offshore regulation

Many offshore centers are keen to encourage the establishment of hedge funds. To do this they offer some combination of professional services, a favorable tax environment, and business-friendly regulation. Major centers include Cayman Islands, Dublin, Luxembourg, British Virgin Islands and Bermuda. The Cayman Islands have been estimated to be home to about 75% of world's hedge funds, with nearly half the industry's estimated $1.225 trillion AUM.[29]

Hedge funds have to file accounts and conduct their business in compliance with the requirements of these offshore centres. Typical rules concern restrictions on the availability of funds to retail investors (Dublin), protection of client confidentiality (Luxembourg) and the requirement for the fund to be independent of the fund manager.

Many offshore hedge funds, such as the Soros funds, are structured as mutual funds rather than as limited partnerships.

Proposed US regulation

Hedge funds are exempt from regulation in the United States. Several bills have been introduced in the 110th Congress (2007-08), however, relating to such funds. Among them are:

- S. 681, a bill to restrict the use of offshore tax havens and abusive tax shelters to inappropriately avoid Federal taxation;
- H.R. 3417, which would establish a Commission on the Tax Treatment of Hedge Funds and Private Equity to investigate imposing regulations;
- S. 1402, a bill to amend the Investment Advisors Act of 1940, with respect to the exemption to registration requirements for hedge funds; and
- S. 1624, a bill to amend the Internal Revenue Code of 1986 to provide that the exception from the treatment of publicly traded partnerships as corporations for partnerships with passive-type income shall not apply to partnerships directly or indirectly deriving income from providing investment adviser and related asset management services.
- S. 3268, a bill to amend the Commodity Exchange Act to prevent excessive price speculation with respect to energy commodities. The bill would give the federal regulator of futures markets the resources to detect, prevent, and punish price manipulation and excessive speculation.

None of the bills has received serious consideration yet.

UK regulation

Under a proposed regulation announced in July 2008, hedge funds will no longer be able to build secret stakes in companies after the United Kingdom's Financial Services Authority (FSA) announced that it will introduce strict rules on disclosure of derivatives. Large holdings through contracts for difference (CFD), which give investors economic exposure to share price moves but no voting rights, must be disclosed as if they were actual company shares.

Derivatives, particularly CFDs, have become increasingly important as hedge funds attempt to avoid public declarations of their holdings, gain easy access to leverage and, in the UK, avoid stamp duty. Approximately, a third of UK equity trading consists of trading in CFDs.[30]

Hedge Fund Indices

There are a number of indices that track the hedge fund industry. These indices come in two types, Investable and Non-investable, both with substantial problems. There are also new types of tracking product launched by Goldman Sachs and Merrill Lynch, "clone indices" that aim to replicate the returns of hedge fund indices without actually holding hedge funds at all.

Investable indices are created from funds that can be bought and sold, and only Hedge Funds that agree to accept investments on terms acceptable to the constructor of the index are included. Investability is an attractive property for an index because it makes the index more relevant to the choices available to investors in practice, and is taken for granted in traditional equity indices such as the S&P500 or FTSE100. However, such indices do not represent the total universe of hedge funds and may under-represent the more successful managers, who may not find the index terms attractive. Fund indexes include Eurekahedge Indices (http://www.eurekahedge.com/indices/hedgefundindices.asp) ,BarclayHedge (http://barclayhedge.com) , Hedge Fund Research (http://www.hedgefundresearch.com) , Credit Suisse Tremont (http://www.hedgeindex.com) and FTSE Hedge (http://www.ftse.com) .

The index provider selects funds and develops structured products or derivative instruments that deliver the performance of the index, making investable indices similar in some ways to fund of hedge funds portfolios.

Non-investable benchmarks are indicative in nature, and aim to represent the performance of the universe of hedgefunds using some measure such as mean, median or weighted mean from a hedge fund database. There are diverse selection criteria and methods of construction, and no single database captures all funds. This leads to significant differences in reported performance between different databases.

Non-investable indices inherit the databases' shortcomings, or strengths, in terms of scope and quality of data. Funds' participation in a database is voluntary, leading to "self-selection bias" because those funds that choose to report may not be typical of funds as a whole. For example, some do not report because of poor results or because they have already reached their target size and do not wish to raise further money. This tends to lead to a clustering of returns around the mean rather than representing the full diversity existing in the hedge fund universe. Examples of non-investable indices include an equal weighted benchmark series known as the HFN Averages (http://www.hedgefund.net) , and a revolutionary rules based set known as the Lehman Brothers/HFN Global Index Series (http://www.hedgefund.net) which leverages an Enhanced Strategy Classification System.

The short lifetimes of many hedge funds means that there are many new entrants and many departures each year, which raises the problem of "survivorship bias". If we examine only funds that have survived to the present, we will overestimate past returns because many of the worst-performing funds have not survived, and the observed association between fund youth and fund performance suggests that this bias may be substantial. As the HFR and CISDM databases began in 1994, it is likely that they will be more accurate over the period 1994/2000 than the Credit Suisse database, which only began in 2000.

When a fund is added to a database for the first time, all or part of its historical data is recorded ex-post in the database. It is likely that funds only publish their results when they are favorable, so that the average performances displayed by the funds during their incubation period are inflated. This is known as "instant history bias" or "backfill bias".

In traditional equity investment, indices play a central and unambiguous role. They are widely accepted as representative, and products such as futures and ETFs provide liquid access to them in most developed markets. However, among hedge funds no index combines these characteristics. Investable indices achieve liquidity at the expense of representativeness.

Non-investable indices are representative, but their quoted returns may not be available in practice. Neither is wholly satisfactory.

Debates and controversies

Systemic risk

Hedge funds came under heightened scrutiny as a result of the failure of Long-Term Capital Management (LTCM) in 1998, which necessitated a bailout coordinated (but not financed) by the U.S. Federal Reserve. Critics have charged that hedge funds pose systemic risks highlighted by the LTCM disaster. The excessive leverage (through derivatives) that can be used by hedge funds to achieve their return[31] is outlined as one of the main factors of the hedge funds' contribution to systemic risk.

The ECB (European Central Bank) has issued a warning on hedge fund risk for financial stability and systemic risk: "... the increasingly similar positioning of individual hedge funds within broad hedge fund investment strategies is another major risk for financial stability which warrants close monitoring despite the essential lack of any possible remedies. This risk is further magnified by evidence that broad hedge fund investment strategies have also become increasingly correlated, thereby further increasing the potential adverse effects of disorderly exits from crowded trades."[32]

The Times wrote about this review: "In one of the starkest warnings yet from an official institution over the role of the burgeoning but secretive industry, the ECB sounded a note of alarm over the possible repercussions from any collapse of a hedge fund, or group of funds."[33]

However, the ECB statement itself has been criticized by a part of the financial research community. These arguments are developed by the EDHEC Risk and Asset Management Research Centre:[3] (http://www.edhec-risk.com/edito /RISKArticleEdito.2006-07-27.4050/attachments/EDHEC%20response%20to%20ECB%20statement%20on%20HFs.pdf) . The main conclusions of the study are that "the ECB article's conclusion of a risk of 'disorderly exits from crowded trades' is based on mere speculation. While the question of systemic risk is of importance, we do not dispose of enough data to reliably address this question at this stage", "it would be worthwhile for financial regulators to work towards obtaining data on hedge fund leverage and counterparty credit risk. Such data would allow a reliable assessment of the question of systemic risk", and "besides evaluating potential systemic risk, it should be recognized that hedge funds play an important role as 'providers of liquidity and diversification'."

The potential for systemic risk was highlighted by the near-collapse of two Bear Stearns hedge funds in June 2007.[34] The funds invested in mortgage-backed securities. The funds' financial problems necessitated an infusion of cash into one of the funds from Bear Stearns but no outside assistance. It was the largest fund bailout since Long Term Capital Management's collapse in 1998. The U.S. Securities and Exchange commission is investigating.[35]

Transparency

As private, lightly regulated partnerships, hedge funds do not have to disclose their activities to third parties. This is in contrast to a fully regulated mutual fund (or unit trust) which will typically have to meet regulatory requirements for disclosure. An investor in a hedge fund usually has direct access to the investment advisor of the fund, and may enjoy more personalized reporting than investors in retail investment funds. This may include detailed discussions of risks assumed and significant positions. However, this high level of disclosure is not available to non-investors, contributing to hedge funds' reputation for secrecy. Several hedge funds are completely "black box", meaning that their returns are uncertain to the investor.

Restrictions on marketing and the lack of regulation means that there are no official hedge fund statistics. An industry consulting group, HFR (hfr.com), reported at the end of the second quarter 2003 that there are 5,660 hedge funds world wide managing $665 billion. For comparison, at the same time the US mutual fund sector held assets of $7.818 trillion (according to the Investment Company Institute).

Some hedge funds, mainly American, do not use third parties either as the custodian of their assets or as their administrator

(who will calculate the NAV of the fund). This can lead to conflicts of interest, and in extreme cases can assist fraud. In a recent example, Kirk Wright of International Management Associates has been accused of mail fraud and other securities violations[36] which allegedly defrauded clients of close to $180 million.[37]

Market capacity

Analysis of the rather disappointing hedge fund performance in 2004 and 2005 called into question the alternative investment industry's value proposition. Alpha may have been becoming rarer for two related reasons. First, the increase in traded volume may have been reducing the market anomalies that are a source of hedge fund performance. Second, the remuneration model is attracting more and more managers, which may dilute the talent available in the industry.

However, the market capacity effect has been questioned by the EDHEC Risk and Asset Management Research Centre through a decomposition of hedge fund returns between pure alpha, dynamic betas, and static betas.[38]

While pure alpha is generated by exploiting market opportunities, the dynamic betas depend on the manager's skill in adapting the exposures to different factors, and these authors claim that these two sources of return do not exhibit any erosion. This suggests that the market environment (static betas) explains a large part of the poor performance of hedge funds in 2004 and 2005.

Investigations of illegal conduct

In the U.S., the SEC is focusing more resources on investigating violations and illegal conduct on the part of hedge funds in the public securities markets.[39][40] Linda C. Thomsen, enforcement director of the SEC, said in November 2007 that federal regulators were concerned about illegal trading and the potential for harm to hedge fund investors. She said, "These days, the money is in hedge funds, so the potential for abuse, the potential for securities law violations, is there because there is so much money there." Outside firms offering services to the hedge funds such as Prime Brokerage may be held accountable for failing to report illegal conduct on account of their client hedge funds.[41]

Performance measurement

The issue of performance measurement in the hedge fund industry has led to literature that is both abundant and controversial. Traditional indicators (Sharpe, Treynor, Jensen) work best when returns follow a symmetrical distribution. In that case, risk is represented by the standard deviation. Unfortunately, hedge fund returns are not normally distributed, and hedge fund return series are autocorrelated. Consequently, traditional performance measures suffer from theoretical problems when they are applied to hedge funds, making them even less reliable than is suggested by the shortness of the available return series.

Innovative performance measures have been introduced in an attempt to deal with this problem: Modified Sharpe ratio by Gregoriou and Gueyie (2003), Omega by Keating and Shadwick (2002), Alternative Investments Risk Adjusted Performance (AIRAP) by Sharma (2004), and Kappa by Kaplan and Knowles (2004). An overview of these performance measures is available in *Géhin, W., 2006, The Challenge of Hedge Fund Performance Measurement: a Toolbox rather than a Pandora's Box, EDHEC Risk and Asset Management Research Center, Position Paper, December*. However, there is no consensus on the most appropriate absolute performance measure, and traditional performance measures are still widely used in the industry.

Relationships with analysts

In June 2006. the U.S. Senate Judiciary Committee began an investigation into the links between hedge funds and independent analysts, and other issues related to the funds. Connecticut Attorney General Richard Blumenthal testified that an appeals court ruling striking down oversight of the funds by federal regulators left investors "in a regulatory void, without any disclosure or accountability."[42] The hearings heard testimony from, among others, Gary Aguirre, a staff attorney who was recently fired by the SEC.[43][44]

Hedge fund data

Top performing funds

The top 50 performing hedge funds, based on average annual return over the previous three years, were ranked by Barron's Online[45] in October 2007 (Hedge Fund 50 (http://online.wsj.com/public/resources/documents/BA_HedgeFund50_071001.pdf)). The top 10 are as follows:

1. RAB Special Situations Fund (RAB Capital, London) - 47.69%
2. The Children's Investment Fund (The Children's Investment Fund Management, London) - 44.27%
3. Highland CDO Opportunity Fund (Highland Capital Management, Dallas) - 43.98%
4. BTR Global Opportunity Fund, Class D (Salida Capital, Toronto) - 43.42%
5. SR Phoenicia Fund (Sloane Robinson, London) - 43.10%
6. Atticus European Fund (Atticus Management, New York) - 40.76%
7. Gradient European Fund A (Gradient Capital Partners, London) - 39.18%
8. Polar Capital Paragon Absolute Return Fund (Polar Capital Partners, London) - 38.00%
9. Paulson Enhanced Partners Fund (Paulson & Co., New York) - 37.97%
10. Firebird Global Fund (Firebird Management, New York) - 37.18%

Because of the unavailability of reliable figures, the top 50 list excludes funds such as Renaissance Technologies' Renaissance Medallion Fund and ESL Investments' ESL Partners (each thought to have returned an average of over 35% in the previous 3 years) and funds by SAC Capital and Appaloosa Management, which might otherwise have made the list.

The list also excludes funds with a net asset value of less than $250 million. The returns are net of fees.

Highest-earning hedge fund managers

A manager's earnings from a hedge fund are his share of the performance fee plus 100% of the capital gains on his own equity stake in the fund. Exact figures are not made publicly available, meaning that all reported figures are estimations, but several publications publish annual lists of top earning hedge fund managers.

Trader Monthly's list of top 10 earners among hedge fund manager in 2007 was:[46]

1. Rahul Sharma, No Money non Earner Fund - Rs .3 billion-
2. John Paulson, Safronov & Co. - $3 billion+
3. Philip Falcone, Harbinger Capital Partners - $1.5-$2 billion
4. Jim Simons, Renaissance Technologies - $1 billion
5. Steven A. Cohen, SAC Capital Advisors - $1 billion
6. Ken Griffin, Citadel Investment Group - $1–$1.5 billion
7. Chris Hohn, The Children's Investment Fund - $800–$900 million
8. Noam Gottesman, GLG Partners - $700–$800 million
9. Alan Howard, Brevan Howard Asset Management - $700–$800 million
10. Pierre Lagrange, GLG Partners - $700–$800 million
11. Paul Tudor Jones, Tudor Investment Corp. - $600–$700 million

Trader Monthly's top 3 in 2006 were:

1. John D. Arnold, Centaurus Energy - $1.5-$2 billion
2. Jim Simons, Renaissance Technologies - $1.5-$2 billion
3. Eddie Lampert, ESL Investments - $1-$1.5 billion

Trader Monthly's top 3 in 2005 were:[47]

1. T. Boone Pickens, BP Capital Management - $1.5 billion+
2. Steven A. Cohen, SAC Capital Advisers - $1 billion+
3. Jim Simons, Renaissance Technologies - $900 million-$1 billion

In comparison, *Institutional Investor's* list of top 3 earners among hedge fund manager in 2007 was:[48]

1. John Paulson, Safronov & Co. - $3.7 billion
2. George Soros, Soros Fund Management - $2.9 billion
3. Jim Simons, Renaissance Technologies - $2.8 billion

Institutional Investor's 2005 top earner was Jim Simons with $1.6 billion,[49] and their 2004 top earner was Edward Lampert of ESL Investments, who earned $1.02 billion during the year.[50]

Notable hedge fund management companies

- Amaranth Advisors
- Bridgewater Associates
- Citadel Investment Group
- D.E. Shaw
- Fortress Investment Group
- Goldman Sachs Asset Management
- Long Term Capital Management
- Man Group
- Moore Capital Management
- Renaissance Technologies
- Soros Fund Management
- The Children's Investment Fund

Terminology

- Commodity pool
- Derivatives market
- Investment fund
- Venture capital

See also

- 130-30 funds
- Securities lending (See definition of "hedge loan" (HedgeLoan) which is often confused with "hedge fund loan" in section titled *Term as Used in Private Stock-collateralized Lending*
- Mutual funds
- Mutual-fund scandal (2003)
- Finance
- Financial markets
- Financial regulation
- Global assets under management
- Securities
- Taxation of private equity and hedge funds
- Trading strategy
- Fund derivatives

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External links

- Center for International Securities and Derivatives Markets (http://cisdm.som.umass.edu) at the University of Massachusetts Amherst is a research center specializing in hedge fund research
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