

Hedge Fund

Hedge funds are one of the fastest growing asset classes, with an estimated \$600 billion under management globally. Significant falls in international equity markets have been investors become increasingly interested in these products.

A feature of this asset class is the diversity of investment strategies pursued, rather than their uniformity. The name “hedge fund” can be misleading. To hedge means to protect against losses. Yet many hedge funds do not pursue strategies to protect against losses.

Generally, they seek positive returns regardless of whether markets are rising or falling by pursuing different investment strategies using various financial instruments. They aim for returns that do not closely track the returns of traditional asset classes such as Australian and international equities, property, fixed interest and cash.

How do they differ from traditional managed funds?

Hedge funds aim to derive positive returns despite the direction of markets, while the returns of traditional managed funds usually track the return of a particular index. To achieve these positive returns, hedge funds will generally use derivatives such as options, futures, swaps and warrants, and they may also “sell short”. Selling short entails borrowing a financial instrument and selling it, and then hopefully buying it back at a lower price – to make a profit.

Traditional managed funds are typically restricted in their use of derivatives and are usually not allowed to sell short. Hedge funds may also use leverage, meaning they can borrow to invest, generally not an option for traditional funds.

Traditional managed funds are required to disclose their investment strategies but hedge funds tend to be less regulated as it is expected that investors are more sophisticated and wealthy. Hedge funds compensate their managers and key investment personnel with performance-related incentive fees and fixed-management fees. Managers and key investment personnel of traditional managed funds are usually compensated by the size of funds under management. Managers of hedge funds also have a significant personal stake in the fund.

The difference in compensation and ownership structure will invariably mean that the managers of hedge funds are driven more by pure investment performance, compared with managers of traditional managed funds.

How have they performed?

Hedge funds available to Australian investors have only been operating for a few years and it is difficult to make a judgement based on their performance history.

The performance of single -strategy hedge funds as a group has been highly variable but they have not generally satisfied their investment objectives over the past three years. However, most of them have produced positive returns above cash.

“Fund of hedge funds” have also generally failed to satisfy their investment objectives over the past three years but have posted positive returns above cash. This was over a period characterised by significant declines in international equity markets.

It is important to remember that past performance is not guarantee of future performance, and the selection of a hedge fund or fund of hedge fund should not be based solely on past performance.

What are the risks?

Given the diversity of investment strategies pursued by hedge fund managers, the risks can be high and complex compared with traditional managed funds.

Some of the added risks are associated with the use of leverage.

This investment strategy can help to amplify positive returns but can also amplify negative returns – potentially making the returns from hedge funds highly variable. The reliance on the skills of the manager, rather than a step-by-step investment process, can seriously disrupt the continued success of the hedge fund.

What is a fund of hedge funds?

A fund of hedge funds is a vehicle that invests in other hedge funds. It will typically invest in between 20 and 50 underlying hedge funds. This can reduce many of the risks associated with single-strategy hedge funds.

The trade off is that investors receive lower returns compared with single-strategy hedge funds.

There are about 6000 hedge funds around the world pursuing different strategies.

What are the benefits of including hedge funds in a portfolio?

Hedge funds will usually aim to achieve positive returns regardless of the direction of markets. Therefore, they can be useful in a portfolio that consists of traditional asset classes such as Australian and international equities, property, fixed interest and cash.

When the returns of these asset classes are falling – and the hedge fund returns can achieve their aim of positive returns – they can help to smooth out the returns of the portfolio as a whole.

However, the ability of hedge funds to derive positive returns regardless of market movements is still uncertain. The returns of individual hedge funds can vary significantly and therefore professional input into the selection process is important to find those that are likely to achieve their investment objectives. In recent years, the returns of the poorer hedge funds and fund of hedge funds have sometimes more closely resembled the returns of traditional asset classes, reducing their effectiveness within a portfolio.

How do I invest in a hedge fund?

There are few single -strategy hedge funds available to ordinary investors. Most are wholesale funds and require minimum investments of \$500,000. There are vehicles such as mastertrusts and wrap accounts that allow ordinary investors to pool their money, enabling them to invest in wholesale hedge funds.

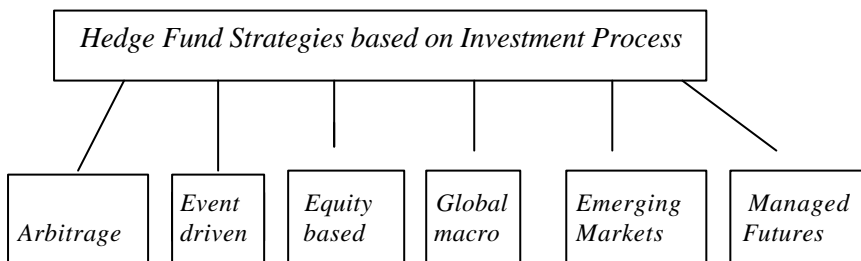
There are fund of hedge funds available to small investors with a minimum investment of \$1000. There also a wider variety of wholesale fund of hedge funds available to investors that can be accessed through mastertrusts and wrap accounts.

Acknowledgement: The Melbourne Age 10/02/03.

Characteristics of a hedge fund

- ? *No uniformity*
- ? *Use a range of financial instruments*
- ? *Performance largely derived by manager*
- ? *Don't always hedge against risk*
- ? *Risk is hard to quantify*
- ? *Difficult to benchmark*

Hedge funds can have a range of Investment strategies



Source: AIMA and ASSIRT Hedge Fund Booklet

US hedge funds have high failure rates

<i>Year</i>	<i>Hedge funds going out of business</i>
<i>1994</i>	<i>1.5%</i>
<i>1995</i>	<i>14.6%</i>
<i>1996</i>	<i>19.6%</i>
<i>1997</i>	<i>33.0%</i>
<i>1998</i>	<i>42.3%</i>

Source: Hedge Funds: cutting through the hype, C. Belaerts. Adapted from van Eyk Research