

- Hedge funds are how the other half invests.

If you've got a few hundred thousand just sitting around not doing anything, read this.

By Tom Bakos

A HEDGE FUND

is a private investment vehicle usually structured as a limited partnership. In effect, the limited partners pool their funds, which are invested and managed by a general partner. The general partner almost always has substantial assets of his own invested in the fund, too. Therefore, the interests of the general partner who manages the fund are aligned with those of the limited partners who are investing in the fund.

Since hedge funds are structured as *private investments*, they're exempt from some Securities and Exchange Commission (SEC) regulatory requirements. As a result, fund managers have broad discretion over the types of assets and investment styles they use. Investments are made primarily in publicly traded securities or financial derivatives. Hedge funds don't necessarily control investment risk by hedging, but hedging is always a tool available to a hedge fund manager.

The primary compensation for the general partner/fund manager is an incentive fee, typically equal to 20 percent of the net profit of the partnership. In addition, most hedge funds provide a management fee equal to at least 1 percent of the assets under management. In many cases, a hurdle rate of return must be exceeded by some multiple and any prior losses must be repaid before the general partner is eligible to receive any incentive income. Hedge fund managers are paid quarterly, sometimes annually. In addition, of course, the general partner participates in income generated by the fund through his investment as a limited partner.

Hedge funds usually take in new money only once per quarter. With new cash coming in only at expected times, the fund can make more effective investment decisions aimed at maximizing return. In order to build stability into their asset base, hedge fund managers usually require limited partners to lock in their investment for an initial period of at least a year. After this, redemptions may be made only periodically (as often as

quarterly) and with significant advance notice. Therefore, hedge funds represent a rather illiquid investment. Quarterly (sometimes monthly) performance reports are prepared.

Hedging

Hedging is an investment strategy designed to minimize or eliminate investment risk caused by possible future adverse changes in market values. Such a strategy involves use of the futures markets and usually has a cost associated with it. In other words, while properly hedging an investment portfolio will reduce potential future losses, it will also limit potential future gains. The investment tools that can be used today as hedges consist of: selling short; call and put options; futures contracts; and other unique derivative instruments.

A hedge can be as simple as selling a futures contract to lock in the future price of a commodity that, in effect, eliminates the risk of any future price fluctuation. However, since the future price is locked in, the seller can't participate in any price rise above the negotiated selling price.

Alfred Winslow Jones developed the first hedge fund in 1949. Jones used short sales and leverage in a conservative investing program designed to shift the burden of investment performance from market timing to stock picking. He was successful at this and remained in relative obscurity for 17 years, until 1966 when details of his model were revealed in a *Fortune* magazine article written by Carol J. Loomis: "*The Jones Nobody Keeps Up With.*" The hedge fund industry took off from there.

Living on the Hedge



While hedging was part of Jones' model, it's not consistently used in all funds referred to as hedge funds today. Fund managers do, in general, try to control risk while at the same time maximizing performance. An overriding goal of all hedge funds is to make money whether the market goes up or down.

Hedge Funds as a Private Investment

By restricting its purchasers to sophisticated investors, as defined in securities law and regulation, and by not advertising as part of a general public offering, a hedge fund is characterized as a private investment. As such, it's exempt from registration as a security under the Securities Act of 1933 (the 1933 Act) and as an *investment company* under the Investment Company Act of 1940 (the 1940 Act). In addition, the investment advisor is exempt from registration under the Investment Ad-

visors Act of 1940 if he is not providing advice to a registered investment company.

In general, investing money through a limited partnership/hedge fund is considered investing in a *security*. However, *registration* as a security under the 1933 Act is avoided if no public offering is made and only accredited investors are allowed to invest.

An *accredited investor* is defined in Regulation D of the 1933 Act as a natural person whose individual or joint (with spouse) net worth exceeds \$1,000,000 or has had an individual income of \$200,000 (or joint income with spouse of \$300,000) in each of the last two years and can reasonably expect this level of income in the current year.

An accredited investor can also be any director, executive officer, or general partner of the issuer of the securities being

offered. The definition is broad enough to also include banks, private business development companies, 501(c)3 organizations, and trusts that meet specified requirements.

A limited partnership/hedge fund is an *investment company* under the 1940 act. However, hedge funds are not required to be registered as investment companies under the 1940 act if they restrict their sales as specified in either section 3(c)(1) or 3(c)(7) of the 1940 Act and don't involve themselves in a public offering of their securities.

Section 3(c)(1) exempts from registration as an investment company any issuer: "whose outstanding securities are beneficially owned by not more than 100 persons, and is not making and does not presently propose to make a public offering of its securities."

Under section 3(c)(7), added by the National Securities Markets Improvement Act of 1996, there is no limit on the number of investors, but: "each investor must be a *qualified purchaser* (as defined in 2(a)51 of the 1940 Act), and no public offering of the securities may be made or contemplated."

A qualified purchaser is intended to be a sophisticated investor who doesn't require the specific protections provided by the registration process normally required of investment companies. A *qualified purchaser* is defined by the 1940 act as: "a natural person or family-owned company owning at least

\$5,000,000 of investments (as defined by the SEC); any trust (not specifically formed to acquire the securities offered) the trustee and each settler of which are qualified purchasers; or any person, acting for his own account or for the accounts of other qualified purchasers, who in the aggregate owns and invests at least \$25,000,000 in investments."

By limiting the number of its investors to under 100, a hedge fund can avoid registration as an investment company under the 1940 act per section 3(c)(1), and need only abide by the less financially restrictive *accredited investor* definition contained under the 1933 act. And, under the 1933 act, Regulation D, Rule 506, up to 35 purchasers are not required to meet the specific financial requirements of an accredited investor. They need only satisfy the requirement that they have, or are believed to have, sufficient knowledge and experience in financial and business matters to make them capable of evaluating the merits and risks of the prospective investment.

If the number of investors in the hedge fund is greater than 100, then **each** must meet the more financially restrictive definition of qualified purchaser found in 1940 act 3(c)(7) in order for the hedge fund to be exempt from registration as an investment company.

Hedge funds are also subject to state securities and investment advisor laws. The Employee Retirement Income Security Act of 1974 (ERISA) will also be a factor if 25 percent or more of fund assets are pension or benefit funds from plans subject to ERISA. Typically, hedge funds limit ERISA funds to less than 25 percent. Clearly, IRS laws and regulations must also be considered.

Consequences of Being a Private Investment

Unlike mutual funds, which are highly regulated registered investment companies, hedge funds are private investments and have little regulation of the types of assets they can invest in. They may use derivative instruments, leveraging, short selling, real estate, or commodities at the discretion of the general partner.

By going short, using leverage, and taking very concentrated positions in equities, hedge funds can significantly improve overall performance. Theoretically, the availability of hedging instruments allows the hedge fund manager to manage the additional risk that goes along with the higher returns.

Hedge funds today have many different investment styles and strategies. Fund managers typically tend to stick to one of these tightly focused strategies. Industry groups have attempted to categorize these strategies into investment style groups. Some of the names used to describe these styles are: convertible arbitrage; distressed securities; emerging markets; growth; global macro; market neutral; market timing; opportunistic; sector; short selling; special situations.

A hedge fund that invests in other hedge funds is known as a *fund of funds*. An advantage to investors is that they can benefit from due diligence exercised by the fund of funds manager in evaluating the hedge fund investments to be made. This could



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yield superior performance compared to what the investor might have been able to achieve by making his own choices.

In addition, the diversity of fund managers and investment styles can control risk. A disadvantage is that the investor incurs another layer of fees—those of the fund of funds together with those passed through from the hedge funds invested in.

Hedge Fund Size and Performance

As of 1998, there were more than 5,800 hedge funds worldwide, with more than \$300 billion in assets under management. A typical fund (mode average or most frequent) would have \$10 million in assets with minimum investment required of \$250,000. A middle-sized (or median average) hedge fund would have \$22 million under management with a \$250,000 minimum investment requirement. The mean average fund would be about \$87 million in assets and require over \$600,000 as a minimum investment. The fund manager incentive fee would tend to be smaller than 20 percent of net income for larger funds.

Size matters in a hedge fund. Often participation in a hedge fund is purposely limited in order to keep the overall size of the fund down and more manageable with respect to the particular investment opportunity being addressed. This allows a fund to be invested for maximum return without exceeding available investment opportunities or the capacity of its fund manager.

Over the past 12 years (1988 - 1999) hedge funds have outperformed equity mutual funds on average 20.1 percent to 15 percent. Some hedge funds have had exceptional performance.

Hedge Funds vs. Mutual Funds

■ *Mutual funds are registered investment companies*, highly regulated by the SEC, with disclosure requirements and restrictions on the types of investments they can make. Hedge funds are unrestricted in the types of investments they can make, although hedge fund managers tend to stay within the investment strategies they understand. Therefore, hedge funds tend to be specialized, using hedge strategies unavailable to mutual

funds. Hedge funds have little or no disclosure requirements.

■ *Mutual funds are public offerings* (hedge funds are not) and usually very little of the investment company's own money is in the fund.

■ *Mutual fund investors share equally in the gains and losses in the fund* proportional to their investments. In a hedge fund, the general partner is paid a portion (~ 20 percent) of the fund return as an incentive fee (in addition to a percentage of the funds under management, as in a mutual fund) before the limited partners share in proportion to their investment.

■ *Mutual fund performance is measured against a relative standard* such as the S&P 500 Index or against other mutual funds in their sector. Hedge funds have an absolute measure of performance and are expected to make money in all market conditions. Therefore the future performance of mutual funds depends on the direction of the equity market. The future performance of hedge funds, however, isn't generally related to the direction of the equity market, as hedge fund strategies are aimed at making money in all market conditions. ●

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