NAGDCA NOTES

Hedge Funds: A Primer

The modern day hedge fund was modeled after a fund created by Alfred Winslow Jones in 1949. The strategy was to sell short some stocks while buying others, making some of the market risk "hedged". Jones was the first to combine short selling, the use of leverage, and limited partnership structure to avoid regulation, and a 20% incentive fee as compensation for the managing partner.

Hedge funds are investment funds or "investment pools" that allow several people to invest in a wider range of funds than may be feasible for a single investor, they also charge performance fees, and are typically open to only a limited range of investors, such as accredited investors. In the United States, hedge funds are open to accredited investors only. To be considered an accredited investor, one must follow very strict guidelines which are found below. Because of this restriction they are usually exempt from any direct regulation by the SEC, NASD and other regulatory bodies. They are considered to carry high risk, but with a potential of a high rate of return.

"The federal securities laws define the term accredited investor in Rule 501 of Regulation D as:
http://www.sec.gov/answers/accred.htm

1. a bank, insurance company, registered investment company, business development company, or small business investment company;
2. an employee benefit plan, within the meaning of the Employee Retirement Income Security Act, if a bank, insurance company, or registered investment adviser makes the investment decisions, or if the plan has total assets in excess of $5 million;
3. a charitable organization, corporation, or partnership with assets exceeding $5 million;
4. a director, executive officer, or general partner of the company selling the securities;
5. a business in which all the equity owners are accredited investors;
6. a natural person who has individual net worth, or joint net worth with the person's spouse, that exceeds $1 million at the time of the purchase;
7. a natural person with income exceeding $200,000 in each of the two most recent years or joint income with a spouse exceeding $300,000 for those years and a reasonable expectation of the same income level in the current year; or
8. a trust with assets in excess of $5 million, not formed to acquire the securities offered, whose purchases a sophisticated person makes."

While most of today's hedge funds still trade both long and short stocks, some do not trade stocks at all, instead focusing on other financial instruments including commodity futures, options, foreign currency and emerging market debt. Assets under management of the hedge fund industry totaled $1.2 trillion at the end of the second quarter of 2006. This was up 19% from the previous year and nearly twice the total three years earlier. Total estimated assets for the industry grew by 24% in 2006 to a total of $1.9 trillion. Performance is said to have accounted for 33% of the total increase.

Because hedge funds typically use leverage/gearing or debt to invest, the positions they can take in the financial markets are larger than their assets under management. The number of hedge funds increased 10% during the past year to reach around 9,000. It is anticipated that the hedge fund assets will grow at an annualized rate of 15% between 2006 and 2008 while the actual number of hedge funds is likely to remain relatively flat.

Hedge funds have increasingly become involved in "shareholder activism" in the U.S., by taking large stakes in companies and mounting a takeover or insisting upon management improvements. Also, in the U.S., the political influence and campaign contributions of hedge funds has come under increasing scrutiny.

Hedge funds may also experience scrutiny due to their fee structure. Usually, hedge fund managers will receive both a management and a performance fee. As with other investment funds, the management fee is computed as a percentage of assets under management. These management fees can range from 1.5% to 2%. Other fees that administrators must pay close attention to are performance fees, high water marks, and hurdle rates.

Performance Fees, which give a share of positive returns to the manager, are one of the defining characteristics of hedge funds. The performance fee is computed as a percentage of the fund's profits, counting both paper 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. For managers who perform well, the performance fee is extremely lucrative. 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. Many managers argue that performance fees help 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 for giving managers an incentive to take risk, possibly excessive risk, as opposed to high long-term returns. In an attempt to control these problems, fees are usually limited by high water marks and sometimes by hurdle rates.

A "high water mark" is often used in hedge funds. This means that the manager does not receive incentive fees unless the value of the fund exceeds the highest net asset value it has previously achieved. 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 a performance fee every other year, enriching the manager but not the investors. However, this mechanism does not provide complete protection to investors; a manager that has lost money may simply decide to close the fund and start again with a clean slate – provided that he can persuade investors to trust him with their money. A high water mark is sometimes also referred to as a "Loss Carryforward Provision".

Some hedge funds also specify a "hurdle rate", which signifies that the fund will not charge a performance fee until its annualized performance exceeds a benchmark rate, such as "T-bills" or a "fixed percentage", over some period. 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 in a bank account. This may seem appealing to many, but this practice has diminished as demand for hedge funds has outstripped the supply of "hurdles".

Tips from the SEC when considering hedge funds (www.sec.gov/answers/hedge.htm):

Read a fund's prospectus or offering memorandum and related materials. Make sure you understand the level of risk involved in the fund's investment strategies and ensure that they are suitable to your entity's investing goals and policies, time horizons, and risk tolerance. As with any investment, the higher the potential returns, the higher the risk you must assume.

Understand how a fund's assets are valued. Funds of hedge funds and hedge funds may invest in highly illiquid securities that may be difficult to value. Moreover, many hedge funds give themselves significant discretion in valuing securities. You should understand a fund's valuation process and know the extent to which a fund's securities are valued by independent sources.

Ask questions about fees. Fees impact your return on investment. Hedge funds typically charge an asset management fee of 1-2% of assets, plus a "performance fee" of 20% of a hedge fund's profit. A performance fee could motivate a hedge fund manager to take greater risks in the hope of generating a larger return. Funds of hedge funds typically charge a fee for managing your assets, and some may also include a performance fee based on profits. These fees are charged in addition to any fees paid to the underlying hedge funds.

> Tip: If you invest in hedge funds through a fund of hedge funds, you will pay two layers of fees: the fees of the fund of hedge funds and the fees charged by the underlying hedge funds.

Understand any limitations on your right to redeem your shares. Hedge funds typically limit opportunities to redeem, or cash in, your shares (e.g., to four times a year), and often impose a "lock-up" period of one year or more, during which you cannot cash in your shares.

Research the backgrounds of hedge fund managers. Know with whom you are investing. Make sure hedge fund managers are qualified to manage your money, and find out whether they have a disciplinary history within the securities industry. You can get this information (and more) by reviewing the adviser's Form ADV. You can search for and view a firm's Form ADV using the SEC's Investment Adviser Public Disclosure (IAPD) website. You also can get copies of Form ADV for individual advisers and firms from the investment adviser, the SEC's Public Reference Room, or (for advisers with less than $25 million in assets under management) the state securities regulator where the adviser's principal place of business is located. If you don't find the investment adviser firm in the SEC's IAPD database, be sure to call your state securities regulator or search the NASD's BrokerCheck database for any information they may have.

Don't be afraid to ask questions. You are entrusting your money to someone else. You should know where your money is going, who is managing it, how it is being invested, how you can get it back, what protections are placed on your investment and what your rights are as an investor. In addition, you may wish to read NASD's investor alert, which describes some of the high costs and risks of investing in funds of hedge funds."

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