Hedge Fund or Mutual Fund?

Find out on page 2

Hedge Fund Fees Explained

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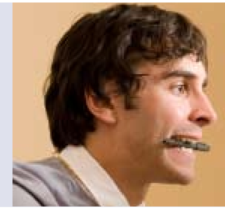

Hedge Fund "Due Diligence"

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HEDGE FUND CHEAT SHEET™

Brought to you by the Hedge Fund Marketing Alliance

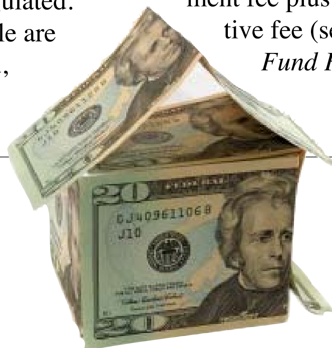
What's Inside –

- **Avoid the high cost of** due diligence by investing in a hedge fund of funds. An actively managed portfolio of hedge funds is a solid alternative. **Page 2**
- **Transparency of hedge funds** has always been an issue and the pressure for more information is on. Move beyond the "black box." **Page 3**
- **Investment strategies are varied**. There are many different hedge fund strategies available to hedge fund managers. We explain common hedge fund strategies. **Page 4**
- **Regardless of your investment objectives**, the quality of the hedge fund database you use can make a big difference in the success you achieve. **Page 5**
- **Understanding hedge fund terms** is no easy task for the beginner. Here we define some of the most comment phrases used in the hedge fund industry. **Page 6**

What is a Hedge Fund?

Sophisticated investors can benefit

The term "hedge fund" is applied to a variety of investment styles, but there are some common characteristics. Hedge funds are not regulated by the SEC the same way publicly held funds are regulated. Their clientele are sophisticated, wealthy investors or institutions. Strategies can involve most asset classes, and shorting as well as leverage are common. Manager compensation usually includes a fixed management fee plus an incentive fee (see *Hedge Fund Fees*).



Why Invest in a Hedge Fund?

Hedge funds can make sense in an overall portfolio context, for a number of reasons. Here are a few:

Diversification – hedge funds add a level of diversification to an investment portfolio, since their returns are often not correlated with those of other asset classes.

Downside Protection – since hedge funds can hold both long and short positions, they usually are less volatile than typical long-only portfolios, and some funds can provide a layer of protection in a declining market.

Absolute Return Focus – hedge funds concentrate on making positive returns in all kinds of markets–achieving an absolute return.

Active Management Focus – hedge fund managers are applying strategies they believe will add alpha. They are using their skill at interpreting information to actively exploit an inefficiency in the market.

Who Invests in a Hedge Fund?

"**Sophisticated investors**" do - those who do not need the protection provided by the regulations that apply to mutual funds. These are entities, or wealthy individuals that must pass either an "**accredited investor**" test or a "**qualified purchaser**" test. An accredited investor is an individual whose net worth exceeds $1 million, or whose income in the last 2 calendar years exceeds $200,000/yr, and who expects more of the same. It can also be an entity with assets exceeding $5 million. A qualified purchaser is someone with over $5 million who invests in total assets, or one of a number of entities. Many hedge funds rely on sections 3 (c) (1) or 3 (c) (7) of the Investment Company Act of 1940 to avoid registration and regulation as investment companies. That is why a hedge fund partnership may often be referred to as

a "3 c 1" or a "3 c 7" fund.

Hedge funds are prohibited from advertising their funds to the public. However, some hedge funds choose to register with the SEC. This enables them to have a lower minimum investment, and an unlimited number of investors (3c1/3c7 funds have limits).

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The Difference Between a Hedge Fund and a Mutual Fund

Hedge funds and mutual funds are both "pooled" vehicles, but there are more differences than similarities. For instance, a mutual fund is registered with the SEC, and can be sold to an unlimited number of investors. Most hedge funds are not registered and can only be sold to carefully defined sophisticated investors. Usually a hedge fund will have a maximum of either 100 or 500 investors. Mutual funds may advertise freely; hedge funds may not. Other differences include:

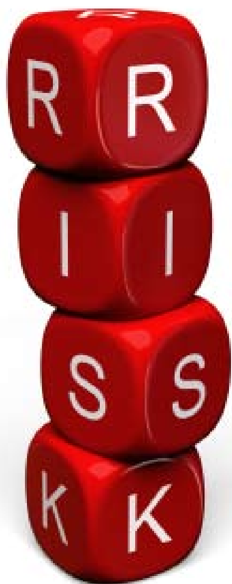
Flexibility – the hedge fund manager has fewer constraints to deal with; he can sell short, use derivatives, and use leverage. He can also make significant changes to the strategy if he thinks it is appropriate. The mutual fund manager cannot be as flexible. If he changes his strategy, he will be accused of "style drift".

Paperwork – a mutual fund is offered via a prospectus; a hedge fund is offered via the private placement memorandum.

Liquidity – the mutual fund often offers daily liquidity (you can withdraw at any time); the hedge fund usually has some sort of "lockup" provision. You can only get your money periodically.

Absolute vs. Relative – the hedge fund aims for absolute return (it wants to produce positive returns regardless of what the market is doing); the mutual fund is usually managed relative to an index benchmark and is judged on its variance from that benchmark.

Self-Investment – the hedge fund manager is expected to put some of his own capital at risk in the strategy. If he does not, it can be interpreted as a bad sign. The mutual fund does not face this same expectation.



Legalities

Legally, hedge funds are usually set up as **Limited Liability Corporations** (LLCs), or as **Offshore Corporations**. Hedge funds are usually labeled as "**onshore**" (domestic U.S.) or "**offshore**". The onshore fund is for U.S. investors, who must face tax consequences. To avoid these consequences, non-U.S. investors often opt for the offshore fund, which is domiciled outside the U.S. (e.g., Bermuda, Cayman Islands, etc.). A manager will often run the same strategy in both an onshore and an offshore fund, so both U.S. and non-U.S. citizens may take advantage of it.

A hedge fund should fully disclose its operations, people and methods in its **Private Placement Memorandum** (PPM), or **Offering Document**. The PPM explains the fund strategy, risks, fees, restrictions, etc. It is not the official legal document; that is called the **Partnership Agreement** (or the Articles of Incorporation if it is an offshore fund). The **Subscription Agreement** requires signatures of the investor and the fund's general partner, and usually includes a questionnaire to determine whether the investor and the fund are suited for each other.

Role of the Prime Broker

Hedge fund managers often trade with a number of brokers. The fund's prime broker (if they have designated one) provides a consolidation service—this means the executing brokers are instructed to settle all trades with the prime broker. Since this results in all the trade information being in one place, reporting becomes much easier. The prime broker's role has evolved with the growth of the hedge fund industry, and it provides a number of other useful services, including custody of the securities, loaning of

Continued next page

The Hedge "Fund of Funds"

The hedge **fund of funds** (FOF) has become an appealing avenue into hedge funds for many investors. Simply put, it is an actively managed portfolio of hedge funds. The investor hires a third party to perform all aspects of hedge fund due diligence. Investors do this for a number of reasons. First, the **due diligence process is complex and expensive**. You need knowledge, experience and access to hedge fund databases. It also involves a bit of career risk—if you choose the wrong funds, you might lose your job.

Another reason is to get **diversification**. An FOF usually invests in a number of strategies, the returns of which are often historically non-correlated (a benefit). Further, an investor can **get access to the top hedge funds**. Some FOF managers have very good relationships with fund managers, and can invest in them while others find themselves locked out. **Smaller minimum investments** are an additional appealing aspect. However, due to some fraud cases and "blow-ups," some investors have begun to doubt the due diligence capabilities of FOFs. They may create their own portfolio of funds, or may be more comfortable with a registered, "hedge-like" mutual fund.

The above **benefits come at a cost**. A hedge fund of funds will charge a management fee (and sometimes an incentive fee) to perform this service, over and above the fees charged by the underlying hedge fund managers. Also, since it is difficult to understand all of the FOF's underlying strategies, the investment is usually a matter of trust. The relatively **short track record** of many FOFs makes developing trust somewhat difficult.

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securities for short sales, providing margin financing, and providing back office technology and reporting. As competition among prime brokers heats up, the role of technology is growing. The prime broker can actually help a hedge fund manager to gather assets by making introductions to potential investors. This is known as capital introduction.

Hedge Fund "Transparency"

Transparency of a hedge fund has always been an issue, but as larger institutions move toward investing in hedge strategies, it takes on more importance. Most institutions do not want to invest in a "**black box**"—they want to know what is in the fund and what the fund's risk characteristics are. This desire to know what is in the fund is in direct conflict with the fund manager's desire to keep that information private. If a manager runs a proprietary methodology that adds value, why should the portfolio holdings be known to anyone? If they were, someone might figure out the strategy and eat up some of the alpha.

Some progress is being made on this front. To raise assets, some funds have agreed to the institution's transparency demands. Others are opting for a partial solution, but never showing the detailed holdings of a portfolio. Some prime brokers can provide summary data on a portfolio (overall risk characteristics, etc.). To many investors, this is satisfactory. A number of firms that specialize in risk analytics are working to develop standardized summary hedge fund risk measures to satisfy most hedge fund investors.

Hedge Fund Fees

Hedge fund fees are often higher than those of mutual funds and they frequently involve both a management fee and a performance fee. A commonly-quoted hedge fund fee is "**two and twenty**"—an annual two percent of assets fee plus 20 percent of the gains over some base return or "hurdle rate."

The **management fee** was a basic part of the early hedge fund compensation schemes. These fees are generally determined annually (but don't often change) as a percentage of the net value of the fund, ranging from one percent to four percent, and are typically paid to the fund manager in quarterly installments. Smaller funds may determine this percentage by seeking to cover the operating costs of management of the fund, while larger funds may offer higher management fee percentages in order to attract and retain greater fund management expertise.

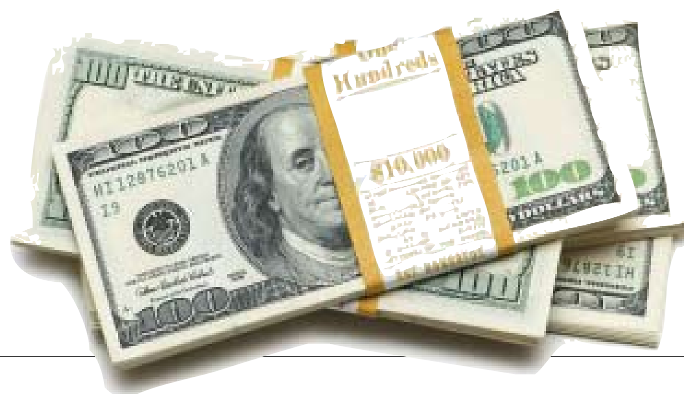
In addition to management fees, hedge fund managers are typically paid a **performance fee**, calculated as a percentage of the profits gained by the fund under their management. The performance fee is generally around twenty percent of the increase in value over a specified period of time, although some larger management firms have charged as much as forty percent of the profits. Because fund managers are rewarded with performance incentive fees based on net value gains, but are not penalized on losses, some limiting measures are employed by hedge funds as a means of competing for investors, such as high water marks and hurdle rates.

High water marks refer to performance fee policies that specify that the fund manager will only be paid a percentage of the profits if the net value of the fund exceeds the previous highest value achieved by the fund. A fund must actually make up losses before it can charge an incentive. In other words, if a $1,000,000 investment loses 50% in the first year (leaving $500,000), then earns 100% the following year, it cannot charge an incentive fee the second year because the investment is only back to where it began. Some investors feel the high-water mark can lead to the manager taking on more risk, if he is in a position where he has to play catch-up. Others would not invest without it.

Hurdle rates, also referred to as minimum acceptable rates of return, are also used as a determining factor for hedge fund performance fees, by measuring fund performance against an external benchmark. Where hurdle rates are applied, performance fee percentages are not paid to the fund manager unless the rate of return on the fund meets or exceeds that benchmark rate. The rates used for comparison may be a pre-determined percentage, or some other financial industry measure such as the rate of return on US treasury bills, or other rates of return in the financial industry. Guaranteeing that performance fees will not be levied helps to reassure investors that they will be compensated somewhat if the return fails to exceed that of other investment options.

In addition to management fees and incentive or performance fees, some hedge funds also charge withdrawal fees when money is removed by an investor from a hedge fund account. These fees usually are applied to a certain time period, such as withdrawals within a set number of years of the initial investment, or to withdrawals above a certain amount, usually defined as a given percentage of the investment. Withdrawal fees are meant to discourage casual withdrawals from the fund assets, in order to allow fund managers to employ longer-term strategies. Other funds address this problem with **lock-up periods**, which refer to a minimum amount of time that must pass after the initial investment before the investor may withdraw money from the fund.

"Times have changed and managers are setting fee structures lower than the traditional structure in order to earn back the attention of institutional investors."



INVESTMENT STRATEGIES

Hedge Fund Investment Strategies

There are many different hedge fund investment strategies. Here are some of the most common:

Convertible Arbitrage – the fund manager typically holds a convertible bond long, and sells short the underlying common stock. Returns come from bond coupon payments and the short rebate. There is a cash outflow as well, to cover dividend payments on the short positions.

Dedicated Short Bias – the goal is to earn returns by maintaining net short exposure (more dollars short than long) in securities. The number of dedicated short sellers varies based on market condition. It is common to see a "short bias," and still hold some securities long—a hedged position.

Distressed Securities – an event-driven strategy, focusing on companies in financial trouble. Positions in debt or in equity can be both long and short. The event might be a bankruptcy, a distressed sale or some other form of corporate event for exploitation.

Emerging Markets – involves equity or debt investing in emerging markets around the world. Each market is unique and has its own rules. For example, some countries lack derivative markets or simply prohibit short selling. Hedging is more difficult (or impossible) in markets like these, so most investing here is long-only.

Equity Market Neutral – the equity market neutral manager takes both long and short positions in stocks while minimizing exposure to the systematic risk of the market (i.e., a beta of zero is desired). The long and short sides are equal in dollar amount ("dollar neutral"). Returns are generated by the spread between the longs and the shorts + the short rebate + the difference between dividends earned on long positions and dividends paid on short positions. Quantitative models are often employed to automate these strategies.

Event-Driven – focuses on opportunities in corporate events like a merger, acquisition, bankruptcy, reorganization, or simply some bad news about a company. An example would be those who sold Enron short at the right time.

Fixed Income Arbitrage – seeks to profit from price discrepancies in related fixed income instruments. A manager might buy long a bond he thinks is undervalued and sell short a similar bond he thinks is overvalued. One goal is to neutralize interest rate risk.

Fund of Funds – involves active management of a portfolio of hedge funds. For more information on hedge funds of funds see page 2.

Global Macro –Leveraged directional bets are made using many of the world's financial instruments (stocks, bonds, commodities, currencies, derivatives, etc.). Some bets can be huge and this strategy allows great flexibility.

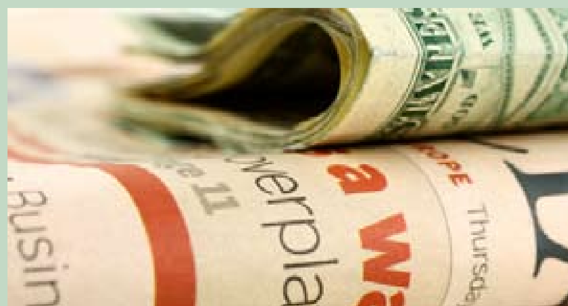
Long/Short Equity – picks both long and short stock candidates, but does not attempt to be market-neutral. The manager may switch from net long to net short, but most long/short equity strategies have a long bias. Investors see this strategy as a way to generate returns in a rising market while reducing volatility.

Managed Futures Strategy – invests in financial and commodities futures markets. Directional bets are made with long and/or short positions. The managers are called Commodity Trading Advisors (CTAs).

Statistical Arbitrage – known as "stat arb," this strategy uses quantitative models to predict price discrepancies in securities. Market neutrality is often used. The models often employ some mean reversion assumptions.

Hedge Fund Indices

Market indices have long been accepted in the conventional investment world, but continue to develop in the hedge fund world. Hedge fund strategies are so diverse that the development of a generally-accepted hedge fund index is difficult. New funds are constantly being launched and others are closing or shutting down. Some funds use leverage, and some use shorting strategies. A moving target is hard to hit accurately, but a number of organizations are trying.



The CSFB/Tremont Hedge Fund Index (based on the TASS hedge fund database) is frequently cited in the media. The index is broken down into a number of sub-categories (event-driven, etc.) for comparisons. Various criteria are applied to the database to select funds for inclusion. Other indices competing for investors' attention include the MSCI Hedge Fund Indices, and indices from Hedge Fund Research, Hennessee Group and Dow Jones. Each has its own method for index construction, and may have different sub-categories. As organizations collect more data, rest assured that we will see more indices and some of these will be "investable". There are also new indices with a geographic focus, such as Asia or Europe.

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RESEARCH

The importance of Hedge Fund "Due Diligence"

Due diligence is the term assigned to investigating a hedge fund (or any investment) in detail. It delves into more than just historic returns and their volatilities. Investors want to understand the fund **Strategy** and its risks, the **Fund** itself, and the fund **Manager**, and do so with **quantitative** and **qualitative research**. Quantitative Due Diligence concentrates mainly on the strategy itself, while Qualitative Due Diligence concerns itself with characteristics of the Fund and of the Manager.

Quantitative Due Diligence digs into the numbers generated and implied by the hedging strategy, and why. It also wants to know how the strategy works (is it model-driven?), whether it makes intuitive sense, and if it is repeatable. Is there good information in the strategy, or is the manager just a lucky or skilled trader without a discipline? Speaking of trading, there should be a well-defined trading process. Some of the measures used in Quantitative Due Diligence are listed here, but these do not fully address the risk assessment that is necessary. A strategy has risk exposures that are not obvious. The way a hedge fund is run will result in certain risks such as market risk, currency risk, sector risk, interest rate risk, country risk and factor risk (style, size, etc.). It is not easy to get a handle on these and other risks, so an entire cottage industry has sprung up that offers risk analytics for hedge funds. A number of analytic software/data providers are devising ways to examine hedge fund risks without asking for too much transparency (see section on transparency).

Qualitative Due Diligence focuses more on the Fund itself, and on the Manager of the fund. The Fund characteristics that are reviewed are somewhat "legalistic," and involve the terms of participating in the fund or partnership. Diligent investors want to know things like the minimum investment, the fee structure, the "lockup" period and liquidity rules, whether leverage is employed (does the manager borrow money to invest?), what the latest audited fund financials look like, transparency issues and even information on the Fund's current investors.

Perhaps the most expensive and time-consuming part of due diligence involves investigating the fund Manager. Ultimately, you want to be reasonably sure that the Manager will run the portfolio the way he has proposed, and that the infrastructure and resources are in place to do so. This leads to a significant question and answer session, such as:

- Where did the fund principals come from, and what are their backgrounds?
- Has the manager invested some of his own money in the fund?
    - Who is the prime broker?
    - Who is the custodian of the assets?
    - Who is the compliance person, and what is his background?
    - What data sources and analytic software is used to run the product?
    - Who is the fund administrator?
    - Can the Manager adequately explain the strategy and its risks taken? Do you feel that the Manager is being evasive when answering questions?
    - How are the key people compensated? Is there significant incentive for them to stay with the firm?
    - Have many people recently left the firm? Why?
- Do the key people in the investment process have other duties at the firm?

In the end, investors are investing in people, not just a strategy. Lots of detailed questions may be asked, but due diligence is not fail safe. By being diligent, however, one can increase the odds of making money and of avoiding fund "blowups." Due diligence will not guarantee that one selects the best manager, but it may help avoiding some of the worst.

Hedge Fund Databases

The hedge fund due diligence process often begins by screening a **hedge fund database**. A growing number of organizations collect data on hedge funds. The idea is similar to a collection of mutual fund data, but there are a few unique characteristics. The first characteristic is **incomplete coverage**. Many hedge funds are not registered with the SEC, so they do not have to report data to anyone. Those that seek additional assets most likely will do so, especially if returns have been good. Those with mediocre returns or that have reached capacity may choose not to report. This may bias the average return. **Survivorship bias** can be another trait of the hedge fund database. A number of hedge funds fail each year, and some databases may remove the history of these "dead" funds. This can bias the overall returns upward if we assume the dead funds had poor returns. Another issue involves **selection**; databases don't necessarily apply the same selection criteria when choosing funds for inclusion. These databases have not been collecting data as long as the mutual fund databases have, so some funds have not been around long enough for one to tell whether returns are attributed to **luck or skill**.

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DEFINITIONS

Common Hedge Fund Terms

Absolute Return – the goal is to have a positive return, regardless of market direction. An absolute return strategy is not managed relative to a market index.

Arbitrage – any strategy that invests long in an asset, and short in a related asset, hoping the prices will converge.

Attribution – the process of "attributing" returns to their sources. For example, did the returns to a portfolio (over and above some benchmark) come from stock selection, industry/sector over- or under-weighting or factor weighting. Software programs are helpful in reporting an attribution.

Hurdle Rate – the return where the manager begins to earn incentive fees. If the hurdle rate is 5% and the fund earns 15% for the year, then incentive fees are applied to the 10% difference.

Leverage – one uses leverage if he borrows money to increase his position in a security. If one uses leverage and makes good investment decisions, leverage can magnify the gain. However, it can also magnify a loss.

Opportunistic – a general term that describes an aggressive strategy with a goal of making money (as opposed to holding on to the money one already has).

Pairs Trading – usually refers to a long/short strategy where one stock is bought long, and a similar stock is sold short, often within the same industry. Buying the stock of Home Depot and shorting Lowe's in an equal amount would be an example.

Portfolio Simulation – involves testing an investment strategy by "simulating" it with a database and analytic software. Often referred to as "backtesting" a strategy. The simulated returns of the strategy are compared to those of a benchmark over a specific time frame to see if it can beat that benchmark.

Short Rebate – if you borrow stock and then sell it short, you have cash in your account. The short rebate is the interest earned on that cash.

Transportable Alpha – the alpha of one active strategy can be combined with another asset class. For example, an equity market-neutral strategy's value-added can be "transported" to a fixed income asset class by simply buying a fixed income futures contract. The total return comes from both sources.

Quantitative Hedge Fund Definitions

Alpha – the return to a portfolio over and above that of an appropriate benchmark portfolio (the manager's "value added").

Beta – a measure of systematic (i.e., non-diversifiable) risk. The goal is to quantify how much systematic risk is being taken by the fund manager vis-à-vis different risk factors, so that one can estimate the alpha or value-added on a risk-adjusted basis.

Correlation – a measure of how strategy returns move with one another, in a range of –1 to +1. A correlation of –1 implies that the strategies move in opposite directions. In constructing a portfolio of hedge funds, one usually wants to combine a number of non-correlated strategies (with decent expected returns) to be well diversified.

Drawdown – the percentage loss from a fund's highest value to its lowest, over a particular time frame. A fund's "maximum drawdown" is often looked at as a measure of potential risk.

R-Squared - a measure of how closely a portfolio's performance varies with the performance of a benchmark, and thus a measure of what portion of its performance can be explained by the performance of the overall market or index. Hedge fund investors want to know how much performance can be explained by market exposure versus manager skill.

Sharpe Ratio – a measure of risk-adjusted return, computed by dividing a fund's return over the risk-free rate by the standard deviation of returns. The idea is to understand how much risk was undertaken to generate the alpha.

Value at Risk - a technique which uses the statistical analysis of historical market trends and volatilities to estimate the likelihood that a specific portfolio's losses will exceed a certain amount.

Absolute vs. Relative – the hedge fund aims for absolute return (it wants to produce positive returns regardless of what the market is doing); the mutual fund is usually managed relative to an index benchmark and is judged on its variance from that benchmark.

Self-Investment – the hedge fund manager is expected to put some of his own capital at risk in the strategy. If he does not, it can be interpreted as a bad sign. The mutual fund does not face this same expectation.

Hedge Fund
JOBS DIGEST

If you are seriously interested in pursuing a career in hedge funds, we invite you to visit JobSearchDigest.com to see the types of positions available and to begin your search.

Since 2002, Job Search Digest has helped finance and investment professionals to be much more effective in their job search. Every day their team researches all the online job sources (including the specialty niche sites) and captures every Hedge Fund, Private Equity, Venture Capital and Investment Banking job — giving you a competitive advantage in your job search.

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