Lecture 11- Hedge Fund Overview

Characteristics:

- Almost complete flexibility in relation to investment, both long and short positions
- Ability to borrow money (and further increase leverage) to enhance returns
- Minimal regulation
- Some liquidity- since investors ability to get their money back is restricted through lock up agreements and quarterly disbursement limitations thereafter
- Investors include only wealthy individuals and institutions e.g. university endowments, pension funds and qualified institutional buyers
- Fees reward managers for performance
- Neither SEC or ASIC have a definition for a hedge fund and its rules

Comparing Hedge Funds and Mutual/Superannuation Funds:

- Hedge funds and mutual/super fund- pools of investment capital- only similarity
- Mutual funds must price assets daily & offer daily liquidity. Hedge funds quarterly reporting, and liquidity only has certain limitation mentioned above
- In US and Aus, hedge funds limited to accredited investors, mutual funds not
- Mutual funds heavily regulated, hedge fund regulation is limited
- Mutual funds usually receive management fees substantially lower than hedge, and generally don't receive performance fees like hedge
- Mutual typically doesn't use leverage, whereas it is the foundation of hedge funds
- Hedge funds broader array of strategies (long & short, & other exposures)

Fees:

- Both management and performance fee typically for hedge funds
  - Hedge fund management fees usually 2% of Net asset value
  - Performance fees approx.. 20% of increase in funds NAV
- Significantly higher than most other money managers except private equity funds

Return Objectives:

- Hedge funds target absolute returns- IR's that are always positive and don't depend on performance of broad markets and the economy, unlike mutual funds
- Lack of correlation an attractive characteristic for investors attempting either lower risk in investment portfolio while keeping returns unchanged or increase returns without increasing risk
  - However, some correlation to the market after heavy losses after GFC
- Attempt to achieve double digit returns most years

Leverage:

- Frequently borrow to increase size of investment portfolio and increase returns
- E.g. hedge fund received $100mil from investors, fund might leverage by combining investor funds with $300mil, using $400mil as collateral against $300mil loan- this is called a margin loan
- Another form of leverage is repo agreements- hedge fund agrees to sell security to another for predetermined price, then buy security back at a higher price in future
- Also, selling securities short and using proceeds to purchase other securities and through derivative contracts that enable hedge funds to create exposure to an asset without using as much capital as required by buying asset directly

Impact of leverage:

- When hedge funds borrow money, both losses and gains are magnified
- E.g. hedge fund using $100mil investor money and $300 borrowed = $400mil, 25% fall in value would result in loss of entire investor capital ($100 mil), whereas increase of 25% would see 100% return on their investment (excluding fees)
- During 2008 GFC, leverage available to funds dropped significantly

Fund of Funds:

- Investment fund that invests in a portfolio of other investments
- Attempts to provide a broad exposure to the hedge fund industry & risk diversity
- Typically charge management fee of 1-1.5% and performance fees of 10-20%
    - If a fund of funds invests in a dozen hedge funds that charge '2 and 30 avg', total fees become about 3.25% and 35% respectively
    - For some investors, these fees outweigh benefits of investing in hedge funds
- However, those who have insufficient capital for hedge funds or are not qualified investors can invest in funds of funds as the only vehicle to these funds
- Many fund of funds have more than 10 different hedge funds, provide more diversification than some achieve directly
- Some high net worth investors channel money through funds of funds because they value the due diligence process- funds of funds weed out poor funds managers

Growth

- Hedge funds grew at remarkable rate since 1990, from 530 to 7,200 in 2011, primarily due to:
    - Diversification
    - Absolute returns
    - Increased institutional investing

- Favourble market environment
- Human capital growth- high compensation
- Financial innovation
- Electronic trading platforms