

Investing in Hedge Funds

24 March 2012

By **Richard Cox**, Global Editor of Global Investor Spotlight



The term "Hedge Fund" is widely used in the media but many new investors are mostly unclear about what the term means and about the services that fund managers provide. Specifically, these are funds that manage a portfolio of assets using a variety of investment strategies (such as long, short, leveraged or derivative positions) to capitalize on price trends in both foreign and domestic markets.

The goal of any successful hedge fund is to generate returns for investors that beat those seen in the country's benchmark stock index. Unlike mutual funds, hedge funds are limited by fewer regulations because they are seen as being offered to a smaller, more sophisticated group of investors who possess a significant amount of knowledge with respect to the ways financial markets operate. For this audience, hedge funds are generally viewed as superior to mutual funds because the larger number of investment strategies implemented by hedge fund managers will tend to generate greater returns relative to other types of asset management.



Different from Simple Hedging

One common point of confusion for newer investors is the relationship with the word "hedging," which is an action taken to reduce risk by taking off-setting positions. The effect of this, however, is that any potential gains are also eliminated. The first hedge funds did engage in these

practices, looking to hedge against potential losses seen during bear markets. Short positions were often taken to balance the risk in long positions, providing an alternative for investors as this something that is generally not done in mutual funds. Nowadays, hedge fund managers implement a wider variety of investment strategies to maximize



◀ returns and sometimes this entails taking on more risk than what is seen when hedging.

Evaluating Different Funds

Media portrayal of hedge funds is sometimes negative, but a well-researched effort into the different fund options that are available can yield positive results and add diversification to your existing portfolio. So, what are some of the factors that should be considered before money is actually invested? First, we must look at some of the basic strategies and fund types so that a proper evaluation can be made and deficient funds can be avoided. One of the most common mistakes occurs when new investors

In order for a hedge fund to accept your business, there first must be an indication that you have sufficient investment capital.

“follow the herd” and chase gains that have already been made by a successful fund. Unfortunately, there are problems with this approach, as it is not clear whether similar results can be achieved in the future and there is often little understanding of how the previous gains were actually obtained.

Although it's impossible to become an expert fund analyst overnight, anyone considering a new investment in this type of fund should have some basic knowledge of their strategies and methods, the ways these funds are structured, and how these funds can be added to a diversified portfolio.

Fund Requirements

In order for a hedge fund to accept your business, there first must be an indication that you have sufficient investment capital. Managers meet this requirement by asking new clients to submit an in-depth questionnaire. These forms will ask for specific details of your total asset holdings (including bank savings, stocks, futures contracts, real estate, and commodities holdings). Once this information is assessed, the new client will either be classified as an accredited investor (those with a net worth above \$1 million), or as a qualified purchaser (those with assets totaling \$5 million, not including a primary residence or business property).

One key point, however, is that hedge fund managers are not required to actually check these assets and without this documentation, it is up to the client to provide accurate information so that an excessive amount of money is not put at risk. In some cases, financial references are required but most would agree that there are few very companies that will actually do an exhaustive check of your tax returns for verification. By law, hedge fund managers are made to ask these questions in order to be in compliance with the US Securities and Exchange Commission (SEC), which is the government agency responsible for protecting private investors. Since hedge funds do actually put money at risk (even if it's

For new investors with no experience researching hedge funds, it is always wise to seek counsel as a confirmation of the company's reputation and performance

always be remembered that even though the SEC exists to protect investor rights, the agency is not able to watch your money at all times. Because of this, a reliable auditor should always be used so that an accurate annual review can be undertaken from an objective source. Another factor to watch is whether or not an established, well-known and reputable law firm signs off on all of the funds legal documents.

A Wide Variety of Options

Given that there are literally thousands of hedge funds available on the open market, new investors should not be overly concerned about choosing a corrupt company, even though newspapers often focus on the horror stories of unwitting investors losing excessive amounts of money. The fact is, these stories are relatively rare and can be avoided if your choice is well-researched and verified by objective sources. A bigger factor for many investors is the initial capital outlay, as the minimum investment is generally somewhere between \$500,000-\$1 million.

Entering into Exclusive Funds

Some of the most well-known hedge funds will even have minimum capital outlays that are much higher, and this is one characteristic that could limit the range of options for some investors. There are legal provisions, however, which allow fund managers to accept

investments from 35 people who are not characterized as "accredited." This does allow some investors who do not meet some of the original requirements to get into an exclusive fund but usually the investor needs to know one of the managers in order for this to occur. It is relatively rare for unaccredited investors to hear about exclusive funds in other ways because the SEC restricts the advertising allowed by hedge fund managers.

Meeting the requirements to become an accredited investor can make it much easier to enter into a hedge fund. To reach this end, the combined net worth of you and your spouse must be at least \$1 million, which includes the value of your primary residence. The individual income requirement is \$200,000, while the joint income requirement is \$300,000. Some suggest that these requirements should be higher, so that a higher level of market awareness can be seen in the investor group, but at this stage there is no suggestion that these requirements will change. The exception to this rule is seen in funds with more than 99 shareholders. In this case, only investors classified as qualified purchasers will be allowed to invest their capital in the fund. ■

At the time of publication, the author holds no position, long or short, in and of the funds mentioned.

◀ a conservative, calculated risk) these legal requirements are put in place to ensure that smaller investors do not lose more than they can afford.

Choosing an Advisor

For new investors with no experience researching hedge funds, it is always wise to seek counsel as a confirmation of the company's reputation and performance. Even though it is atypical, there are many stories of firms that have claimed huge returns only to find out later that the income was misstated. Because of this, new investors should seek outside advice from independent brokerages to ensure that the prospective fund is following the law and stating its earnings in an accurate and transparent fashion.

One clue that a hedge fund is above board can be seen when fund assets are held by a third party brokerage. This practice makes it more difficult for fund managers to hide assets or illegally withdraw money from the fund. It should