



Hedge funds are here to stay

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Hedge funds can play a very positive role in investment portfolio performance argues Rory Quinlan of HSBC.

Hedge funds have come in for quite a bit of bad publicity of late. They have been wrongly associated in the public consciousness with the root causes of the financial market turmoil of recent years. This is mainly due to a lack of understanding of what has become a standard core holding for investors across the world. Indeed, despite the global downturn, total hedge fund assets under management globally still stand at around US\$1.5 trillion.

The difficulty in understanding hedge fund strategies and how they can perform in different market conditions can, unfortunately, deter investors from entering what can be a very efficient way of managing money.

The first point to clear up about hedge funds is that they don't offer supernormal returns nor do they entail unlimited risk. They are simply another way of investing rather than an asset class in themselves. In fact, they take their name from the use of 'hedging' to minimise risk.

The important thing to remember, however, is that hedge funds do not aim to outperform equities over short periods of time. In years where the stock market is performing strongly, hedge funds will typically catch a good proportion of the upside, but not all of it. On the other hand, the benefits of holding hedge funds are more apparent in the years where equities are experiencing market downturns and where they have helped to preserve capital. This is among the many reasons why hedge funds should be part of well-balanced investment portfolios at present.

The ability of hedge funds to invest in both directions, as opposed to traditional fund managers' long only strategies, means that they can generate positive returns even when markets are falling. They can also exploit short-term market inefficiencies in areas such as currencies and bonds again giving the potential to generate positive returns regardless of market conditions. This means that they can be used to protect capital in a downturn and are a more efficient way of investing and managing volatility than long only funds which are tied directly to market performance.

Among the key attractions of hedge fund investment is the incentive regime. Funds typically charge a fairly standard basic fee of 1% or 2% and quite a high commission of up to 20% of gains made. This aligns the incentives with the interests of the client as the remuneration of the manager is directly linked to the fund's performance. Another very strong attraction is the fact that hedge fund managers typically invest their own money along with that of their clients. These managers are not mere bystanders watching as their clients' investments grow or shrink – they are directly involved and committed parties.

Flexibility and agility are also hallmarks of well-managed hedge funds. They can use leverage, derivatives and short positions in order to enhance returns or offset potential losses in the short term while still looking to longer term positions if necessary. They tend not to be caught off guard by sudden market changes.

But there are risks and some drawbacks to take into account before deciding on how much to commit to hedge funds. The first and most obvious factor to be taken into account is that



they operate in a less regulated environment. Most funds are classified as “unregulated” and this puts a high premium on investment advice and a thorough due diligence process is required to mitigate concerns arising from this status. Not all Hedge Funds are the same, just as not all equity fund managers are the same. This is why you need an expert who understands the intricacies of the market and its vehicles to ensure you have a full understanding of what you are investing in and what level of risk you are taking.

They tend to be less transparent than a standard mutual fund and tend not to publish details of their positions and price; performance reports are only issued monthly at best. This makes monitoring and performance tracking more difficult. However, trusted investors with whom the fund manager has built a strong relationship will be given access to this information on an as-needed basis thus enabling thorough monitoring of the investment.

The other major concern for many retail investors is the lack of liquidity associated with them. In many cases hedge funds will only allow subscriptions and redemptions on a monthly or quarterly basis. Furthermore, some hedge funds can have long lock-up periods, where an investor is not permitted to redeem from the fund unless for example a period of six months, a year or even two years has passed – with any redemption during the lock-up period incurring a hefty penalty.

That said, the benefits of hedge fund investment can outweigh these drawbacks and risks – and indeed the industry particularly if the investor is in a position to carry out the necessary due diligence and gain access to the fund strategy and performance information on a regular basis. It is also absolutely vital to choose the right manager; this can't be done simply on the basis of personal impressions; robust qualitative and quantitative research is required

It is worth noting that a new breed of Hedge Fund based investment vehicles will come on line through 2010 as many established Fund of Hedge Fund providers launch collective investment vehicles that will invest in a basket of Ucits (Undertakings for Collective Investments in Transferable Securities) compliant Hedge Funds. These funds, dubbed as “Newcits” come about as a direct result of investors demands for greater protection, liquidity and regulation.

Ironically, the recent market turmoil has arguably made hedge fund investment safer than ever as the level of investor scrutiny under which the funds are being set up has been greatly heightened.

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