Hedge Funds Fact Sheet

Redmayne Bentley

The image of hedge funds has been tarnished largely as a result of George Soros's Quantum Fund which helped force the Pound out of the European Exchange-rate Mechanism (ERM) in 1992. They are now seen as risky investments when, originally, they were designed to protect against risk. The sheer size of hedge funds allows them to wield great influence in global markets and the economy. Individual hedge funds can be in control of capital worth billions of pounds with a large number of trades on the London Stock Exchange believed to be conducted on their behalf.

DEFINITION

Defining a hedge fund is difficult due to the Complex Instruments that they can invest in and the strategies that they adopt (see below). There is no simple and all-encompassing definition. Ultimately, a hedge fund is a private and predominantly unregulated collection of money, whose managers actively invest in a wide range of investment products, with the ability to make substantial profits from falling as well as rising assets. The hallmark of a hedge fund is to make absolute returns - returns greater than zero. Common strategies that are followed include:

- **Directional -** returns generated from movements in share prices, both up and down.
- **Relative value** - returns from the relative under or over-valuation of similar securities.
- **Event driven** - extracting returns from market or stock specific events.

DIRECTIONAL	RELATIVE VALUE	EVENT DRIVEN
Long/short - buying stocks 'long' in anticipation that the price will rise, and simultaneously selling stocks 'short' in anticipation that they can be bought back cheaper, thus profiting from the difference.	**Convertible arbitrage** - exploiting pricing inefficiencies between convertible securities and the corresponding stocks.	**Distressed securities** - specialising in companies that trade at discounts to their value because of (potential) bankruptcy.
Emerging markets - specialising in emerging markets such as China and India.	**Fixed-income arbitrage** - exploiting pricing inefficiencies between fixed-income securities.	**Merger arbitrage** - exploiting pricing inefficiencies between merging companies.
Currency - capitalising on favourable currency movements.	**Asset and mortgage** - fixed income arbitrage strategy using asset-backed securities.	**Special situations** - specialising in restructuring companies or companies engaged in major corporate transactions.
Global macro - investing in securities based on the general macro-economic outlook, e.g. Gross Domestic Product and inflation.	**Commodities arbitrage** - exploiting price inefficiencies in the commodity markets, e.g. oil and gold.	

MECHANICS

As the name suggests, a hedging approach is often pursued to offset any potential losses, with the most publicised hedge being an equity "long/short" hedge. Even with a hedging policy, the nature of some of the investments attaches a component of high risk to the hedge funds. Derivative products and leverage are often used to make investments, which are both considered uncertain and risky. Hedge funds can either be open-ended (such as a unit trust), or closed-ended (like an investment trust). Open-ended funds do not have restrictions on the amount of shares that can be issued, and if demand is high enough, the fund will continue to issue shares no matter how many investors. A closed-ended fund operates in a similar way to a publicly quoted company, in that it issues a restricted number of shares, with the price determined by demand. These shares can be traded amongst investors on a recognised exchange.

Funds of hedge funds have developed, offering access to new investors. They provide benefits that are similar to hedge funds, but often with lower minimum investment levels. Funds of hedge funds can invest across a range of hedge funds offering increased diversification across strategies and thus, offering reduced risk.

Hedge funds are not regulated by the Financial Conduct Authority (FCA), however, the FCA does supervise hedge fund managers and has implemented new rules for hedge funds to disclose any large short positions that they are holding. Most hedge funds lack transparency with only a handful of people fully aware of the true operations.

INVESTING IN HEDGE FUNDS

To invest in a hedge fund, one has to be a high net worth and sophisticated investor who is aware of the risk implications. Potential investors should seek professional advice before considering investing in a hedge fund. Initial investments are rarely less than £100,000, although closed-ended funds do not have any minimums. Hedge fund mangers will charge a management and performance fee. Management fees typically range from 1% to 4%, with performance fees of 20% and above. Performance is measured by the absolute returns and not by a benchmark. Some managers will also charge a withdrawal fee, if the money has been withdrawn before a certain period of time has elapsed. This is to encourage long-term investment in the fund. Thus, gains can be easily eroded by the charges alone.

Investors will also need to consider the tax implications of hedge fund investing.

Under the current regulations and the rules of the Financial Conduct Authority (FCA), we are required to satisfy ourselves that you have the experience and knowledge to enable you to understand the risk involved when dealing in 'complex instruments' such as hedge funds. Therefore, before you can trade in these you must undertake an assessment to demonstrate your knowledge and understanding of complex instruments, and this will involve completing our ***Complex Instruments: Appropriateness Assessment Form***. For further information please contact your **usual Redmayne Bentley office**.

Investments and income arising from them can fall as well as rise in value and you may lose some or all of the amount you have invested. Tax treatment depends on the specific circumstances of each individual and may be subject to change in the future.

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