

Investing in Hedge Funds

Information for the Retail Investor

Belgian CFA Society
Swiss CFA Society
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CFA Singapore



Hedge funds have become an important part of the world's financial market activity. Once they were an exotic investment vehicle solely for the wealthy and certain professional investors within the financial services industry. Now they manage \$1.6 trillion in assets worldwide and increasing numbers of mainstream investors, including some from the retail sector and institutions such as pension funds, are investing in them.

In many parts of the world, including Europe and the Asia Pacific region, retail investors with relatively little to invest may make use of hedge funds. Such funds have gained widespread publicity and with the potential for higher rates of return on investments, hedge funds may seem an increasingly attractive investment option for individuals less familiar with the complexities of financial risk and reward.

The CFA Institute Centre for Financial Market Integrity, along with the Belgian CFA Society, Swiss CFA Society, Hong Kong Society of Financial Analysts, and CFA Singapore, offer this brochure as an educational tool for those considering a hedge fund investment. The hedge fund sector is a highly diverse and often complex area of investment, with varying degrees of leverage and risk. Investors should take considerable care in investigating and determining whether an investment in these products is appropriate for their circumstances. This brochure is not intended to cover all aspects of investing in hedge funds. Rather, it provides a "primer" on many of the investment considerations and risk factors associated with this investment option. For more detailed information, investors are encouraged to contact various hedge fund associations and local regulatory authorities to review industry practices in their geographic area.

► What Are Hedge Funds?

Hedge funds are pooled investment vehicles that can invest in a wide variety of products including derivatives, foreign exchange, and publicly traded securities. In this they are similar to mutual funds, unit trusts, European UCITS, and other funded retail financial instruments. But much of the similarity ends there.

Most hedge funds are privately organised and, although managed by investment professionals, are not widely available to the public. They are extremely diverse in structure, employing a great variety of investment strategies. They can concentrate their investments in different types of assets in different markets around the globe, and can do so in a way that potentially heightens volatility and risk but may also bring higher returns. In some cases, hedge fund investments are not readily marketable, are non-public, and can be difficult to value.

There are also funds of hedge funds (FOFs) in which a professional manager will identify and select individual hedge funds to package into a single FOF instrument. Under this FOF structure, an individual investor will invest in the single instrument and thereby gain access to a diversified portfolio of hedge fund managers. The investor's returns will depend on the success or failure of all the funds in the package. This FOF structure offers two potential benefits: It leaves due diligence and the selection of individual funds to an experienced professional, and it can help defray risk by diversifying across a range of individual hedge fund strategies and managers.

The fee structure of both individual hedge funds and FOFs represents a considerable cost to the investor. There is no statutory or regulatory limitation on fees, and hedge fund managers usually charge both a management fee and an additional incentive fee based on the fund's performance. In the case of an FOF, a further fee is imposed over and above those charged by the underlying funds in the portfolio.

One caveat for investors to note is that the term “hedge fund” may be something of a misnomer. While some funds may employ strategies that are “hedged” in the traditional sense to mitigate or reduce risk, others may not hedge exposures or otherwise employ hedging techniques. It is not always readily apparent how volatile a given hedge fund strategy may be.

► **How Are Hedge Funds Different?**

Hedge funds are just one of a considerable range of alternative investment offerings available to investors in most developed markets. It is not the intent of this brochure to describe all such financial products and their characteristics. Instead, following are highlights of several of the characteristics that distinguish hedge funds from other investment opportunities.

For example:

- Hedge funds generally seek absolute returns regardless of market conditions, while mutual funds or unit trusts generally seek returns comparable to market indices or benchmarks;
- Hedge funds may engage in more aggressive strategies than mutual funds; these may include the practice known as short selling, use of extensive leverage, use of multiple currencies, and employing hedging and price-monitoring techniques that involve sophisticated derivative products such as options, futures, and swaps;
- Hedge funds use widely diverse strategies and commonly invest in lesser-known assets and markets including global fixed income, convertible securities, currencies, exchange-traded futures, over-the-counter derivatives, and commodity options;

- Hedge fund regulation varies widely around the world with little consistency in the level and focus of formal regulatory oversight; in several key jurisdictions, including the United States, many hedge funds and their managers are generally unregulated.

Investors should note a number of additional factors that distinguish hedge funds from other investment vehicles. The risk of investing in any one hedge fund varies, but generally hedge funds generate substantial returns by employing higher-risk strategies. In making informed investment decisions, investors should ask themselves whether the returns are sufficiently high and consistent to warrant the level of risk and volatility that such strategies entail.

It is likewise important to understand that, in many cases, the assets in which a hedge fund manager invests may be difficult to value accurately. In particular, the valuation of non-public, non-marketable securities can be a challenging task that should require transparent disclosure to investors.

The fees charged by hedge funds are an important consideration. These vehicles typically have a two-tier structure that includes both a management fee and an incentive fee based on a percentage of the fund's net gains. Investors should be aware of these two components and understand potential conflicts. For example, a portion of the fees depends on how asset valuations are determined and in the case of the annual incentive fee, the hedge fund manager may tend to take more risk in generating short-term gains.

In the world of professional investors, these hedge fund attributes may be attractive as a useful addition to an overall portfolio strategy. On the other hand, such attributes can lead to unexpected and excessive risks for retail investors who are often less diversified and less skilled than the professional investor in fully assimilating such factors. It is thus

important that the retail investor clearly understand the investment strategy, valuation process, fee structure, and other factors as outlined below in becoming an informed consumer of these hedge fund products.

► **What Retail Investors Should Know about the Hedge Fund and Its Manager**

There are key questions to which the potential retail investor in a hedge fund or FOF should get satisfactory responses before pressing ahead with a financial commitment. We set out below some of the main issues; the list is not exhaustive and there may be other questions that an investor will want to ask. The promptness, thoroughness, and accuracy of the hedge fund manager's responses should feature prominently in the retail investor's decision to proceed.

- 1. What is the background of the fund managers?** Potential investors should conduct detailed due diligence at the outset to learn about the credentials and experience of the fund's founders and principals. Of critical importance is gaining an understanding of the past performance of the manager in the particular strategy being offered. While such a past "track record" does not represent future performance, it does help the investor assess a manager's skill and ability to deliver returns. This is especially important in light of the increasing number of hedge fund managers around the globe who have not actually managed their own hedge fund or portfolio in the past.
- 2. What is the level of risk involved in the fund's investment strategy?** The wide range of investment strategies that hedge funds may implement brings an equally wide range of risks. Understanding the aggressive or conservative nature of a fund's strategy is critical to determining whether it meets the investor's goals and tolerance for risk.

- 3. What are the firm's compliance procedures?** It is important for a potential investor to determine if the fund manager follows a comprehensive set of compliance procedures, risk management procedures, professional standards, and a code of conduct in relation to dealing with clients. The compliance process should include a clear statement about how the firm manages its risk profile, responsibility for compliance procedures, and controls over conflicts of interest.
- 4. What are the minimum financial thresholds for investing in the fund?** Although hedge funds are available as an investment alternative to retail investors in many jurisdictions, there are often conditions that must be met. In the U.S., such funds may be restricted to "accredited investors" and "qualified purchasers," with minimum thresholds of income before an investment is permitted. In Europe there are differences between countries, but even in the European Union (EU) there is no comprehensive regulation governing who may invest in a hedge fund. In Asia, offshore registered hedge funds are available to accredited investors as in other markets. In Singapore and Hong Kong, onshore registered hedge funds are available to retail investors.

Depending on the jurisdiction, there may be specific quantitative or qualitative limitations for hedge fund investments by individuals, including any minimum subscription levels and/or rules for "qualifying" investors. In these circumstances, it is very important for the retail investor to check with the local regulatory authority to determine what limitations are in place and whether the investor conforms.

- 5. What is the fee structure and how are the managers compensated?** Typically, hedge funds charge a management fee of one to two percent of the amount invested plus a performance-based fee of 20 percent of all capital gains per year. FOFs are subject to an additional level as noted above. The investor must be certain to understand the full potential costs, when fees are paid, and how those fees are calculated and verified.

6. How is the value of the fund determined?

Understanding the valuation process is important as fund managers often have broad discretion over how they value the non-marketable assets in the fund. The manager must clearly disclose the valuation process, including timely notice of any changes or deviations in such process. There are several preferred valuation and performance reporting models in the market, such as the Global Investment Performance Standards (GIPS®), but no regulatory prescription for what the range of useable models can be. The retail investor is uniquely exposed to the hedge fund manager's actions and decisions in the valuation area. Accuracy in valuation and verification of process are key to the ultimate determination of the fund's performance and the amount of fees paid.

7. What are the limitations on an investor's right to redeem shares?

Many other pooled investment vehicles for retail investors, such as mutual funds, unit trusts, or the European UCITS, may be bought and sold with relative ease. The shareholder's stake often can be redeemed on demand. In the case of hedge funds, however, there are typically significant limitations on the ability to sell shares in the fund, and there even may be a "lock-out period" of several months or more after the initial investment, during which investors may not redeem their shares.

► **Suitability**

As with any investment, individuals need to consider whether hedge funds are a suitable part of their long-term investment strategy. If so, it is critical to take the time to find a manager they respect and trust, and to evaluate with that manager how a hedge fund investment would fit with the investor's financial situation, investment objectives, and risk tolerance. One way of ensuring confidence in a hedge fund manager is to determine whether the

manager is authorised by a statutory authority to provide asset management services—and is subject to that authority’s business conduct rules. Another key determination an investor may make is whether the manager complies with a relevant code of conduct issued by his or her industry association or professional body.

► Other Guidance

Where else can investors go for guidance? Various global regulators and trade organizations are primary sources for obtaining additional information on both the industry and the specific regulations applicable to hedge funds in each jurisdiction. Various industry or investor guides are available. Some outline responsibilities for conducting hedge fund operations and contain tips for any investor conducting a due diligence review of a particular fund or manager. For example, the CFA Institute Centre has published an Asset Manager Code of Professional Conduct (the “Code”) that provides a set of globally applicable ethical and professional standards for firms managing assets as separate accounts or pooled funds, including hedge funds and mutual funds. The Code was created specifically from the investor’s viewpoint, and offers an effective “checklist” of ethical conduct that investors should expect from their asset managers, thus generating a higher level of confidence in asset managers who adopt and enforce the Code in their work. Visit www.cfacentre.org to read a copy of the Code online. In addition, the Alternative Investment Management Association regularly offers guidance statements on many issues related to hedge fund management; visit their website at www.aima.org. Another resource is the Managed Funds Association publication, “Sound Practices for Hedge Fund Managers,” available at www.managedfunds.org.

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