AN INTRODUCTION TO HEDGE FUNDS

Whilst as a business we prefer plain vanilla index tracking investments, we are aware of the use of derivative products within the investment environment and, indeed, we realise that some clients are prepared to take higher levels of risk in return for potentially higher returns.

The purpose of this note is to try and explain the benefits and risks of these products so that you can get a basic knowledge of the concepts before considering the minutia of any specific offering.

1. WHAT IS A HEDGE FUND? 1
1.1 The Use Of Options 2
1.2 The Use Of Gearing 2
1.3 The Manager Believes They Can Outperform 2
1.4 The Fund Can Benefit From Rises Or Falls In The Underlying Investments 2
1.5 Hedge Funds Are Not Protected By The FSCS 3
1.6 The Investment Is Opaque 3
1.7 Regulatory Control Can Be Insufficient 3
1.8 You Cannot Cancel The Plan 3
1.9 Your Investment May be Unrealisable 3
2. OUR RECOMMENDED HEDGE FUNDS 3
2.1 Managers 4
2.2 Liquidity 4
2.3 The DB Hedge Fund Index .... **Error! Bookmark not defined.**
3. SUMMARY 4

1. WHAT IS A HEDGE FUND?

The name hedge funds is derived from the original reason for creating options which was “to hedge one’s bets” with regard to the future value of various commodities (wheat, barley, pork, beef etc).

Whilst derivatives and options are still used as a precaution within larger investment portfolios (for instance, many investment funds hedge foreign currencies back to Sterling to reduce currency risk) within this explanation the use of hedge funds is usually to achieve high returns in exchange for greater risks.

Hedge funds usually have some, or all, of the following characteristics:

1.1 The Use Of Options

Undertaking multiple series of trades in physical products is incredibly expensive. Because of this hedge funds tend to deal in promises which do not require the holding of the physical product. There may well be security behind the promise and there may well be some link to the commodity asset or product within the overall arrangement, but fundamentally most of the trade is handled using promissory notes.

1.2 The Use Of Gearing

Most hedge funds operate leaving the majority of the investment in cash whilst using a small proportion in a highly geared way. For instance, a hedge fund manager may take an option on the FTSE 100 to fall in value (shorting the index) and he may purchase the option at a rate of 200% of any falls. In the event that his prediction is correct he gets 200% of the fall in the index, but conversely if he is incorrect he has to pay over 200% of the rise. As you would expect, other than a deposit no money passes hands until the option closes.

1.3 The Manager Believes They Can Outperform

There would be no point in having a very expensive hedge fund if the manager did not believe they could recoup their excessive charges and still provide you with a return which reflects the risk you are taking. Whether the fund is using mathematical algorithms to try and match/beat market trends or the fund manager believes they have some power to pick the right stock or sectors which will outperform, the offer has to be of significant returns.

1.4 The Fund Can Benefit From Rises Or Falls In The Underlying Investments

Hedge funds fall into two main categories, “long” which means they are betting on investments rising and “short” which means the manager is betting on funds falling. For instance, if you see a fund stating it is “long only” the manager will only look at assets with a view to them increasing in value.

By way of example, the Man AHL fund looks at trends and tries to make a profit from assets if the trend is an increase or decrease in value. The Man Euro hedge fund is a long only investment.

1.5 Hedge Funds Are Not Protected By The FSCS

As you would expect, a high risk investment does not have any safety nets!

1.6 The Investment Is Opaque

Depending on the hedge fund manager, the investor may know a little about how the fund invests or nothing at all. Some hedge fund managers are incredibly secretive whilst others use mathematical algorithms to try and beat the market. To all intents and purposes, however, for the average investor this is “smoke and mirrors” so has to be taken completely on trust.

1.7 Regulatory Control Can Be Insufficient

Although within the UK hopefully the regulators will prevent managers running off with your cash, this has certainly been an issue within the USA. If you wish to invest in hedge funds choose only the largest managers to reduce this risk to a minimum.

1.8 You Cannot Cancel The Plan

As you would expect from any high risk investment, you rarely get cancellation rights.

1.9 Your Investment May be Unrealisable

Depending upon what your manager has invested in, you may not be able to withdraw your funds without significant notice. Many hedge funds only trade once every month and some trade only once every few months.

2. OUR RECOMMENDED HEDGE FUNDS

This heading is in fact a misnomer. As an advisory firm our preference is for clients to choose a wide range of passive investment funds which will provide close to market returns with the minimum of risk.

It would, however, be naive of us to ignore investment alternatives which appeal if you are a very high risk taker. We therefore adopt an attitude that it is better for us to be involved in helping you choose hedge fund type investments in an effort to try and reduce the chances of you losing your shirt!

2.1 Managers

Opt for managers from the larger firms, such as Man, F&C, Aberdeen, Jupiter to name but a few. Many of these funds are registered in Luxembourg or the Cayman Islands where, in our view, the regulatory protections are minimal. We feel it is important that the provider is of a significant size to hopefully reduce the propensity for them to exit with your money!

2.2 Liquidity

Again, we prefer funds which are UCITS or ETFs so that we know they are traded frequently (ideally daily). We accept this precludes many hedge funds who do not have the liquidity available to meet daily redemptions.

3. SUMMARY

We wish to make it clear that these notes should not be considered by anyone as a recommendation to purchase any form of hedge fund. If you look at the fund fact sheets or key investor documentation invariably on a risk scale of 1 to 7 they will be a 7. If you are still minded to have a flutter please get in touch.