

# UNDERSTANDING HEDGE FUND INVESTMENTS



MACQUARIE

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# Introduction

Welcome to Macquarie's Understanding Hedge Fund Investments Handbook. This handbook has been written to help you gain a better understanding of hedge funds, and to help determine whether a hedge fund investment may suit you.

Over the last few years the demand for hedge funds from Australian investors has grown dramatically, as has the variety of hedge fund products available to Australian investors.

Whether you have invested in hedge funds before, or are looking to make your first investment, we hope you find this handbook a valuable tool in your ongoing investor education.

Cathy Kovacs  
Division Director  
Macquarie Portfolio Management Limited

# What are Hedge Funds

*Hedge Funds are also known as absolute return funds – they aim to generate positive returns regardless of the performance of the overall market.*

The term hedge fund is used quite broadly to describe managed funds that use a wider range of investment strategies or financial instruments than a traditional fund manager to generate returns. The aim of the hedge fund manager is to produce positive returns in both rising and falling markets.

A traditional fund manager aims to make a return 'relative' to an industry index or benchmark, such as the S&P/ASX 200 (the broad index used to measure the performance of the Australian share market). This means that the fund's return may be negative if the benchmark generates a negative return.

The hedge fund manager aims to deliver a total or 'absolute' return irrespective of the condition of the market. This quality inherent in hedge funds has led to the term 'absolute return fund' being synonymous with the term 'hedge fund'.

The term 'hedge' generally describes the strategy of protecting one investment by taking a position in another investment that is expected to act in a different, or even opposing, way. Hedge fund managers often make a core investment and then enter several other trades to remove specific risks that are not part of their core investment idea. Removing overall market risk is a common aim of this technique.

The hedge fund manager may invest in the same assets that the traditional manager uses, such as shares and bonds, but may also invest or trade in currencies and commodities. The hedge fund manager also has a broader range of investment strategies to draw on, including the use of short selling and derivatives, to generate absolute returns in a variety of market conditions. This means that hedge funds often differ in characteristics, such as volatility and return, from more traditional investments.

# The Australian Hedge Fund Industry

Hedge funds are not new in Australia, or to Australian investors. However the industry has experienced significant growth in the last few years, as demand from Australians for absolute return style investments has accelerated.

From government superannuation funds, to self managed superannuation funds, and individual investors, there is a general trend toward increasing the allocation to hedge fund investments.

Whereas once hedge funds were dominated by investments from very wealthy individuals, today hedge fund exposure can be found in many investors' direct portfolios, or in the superannuation funds they own.

At the end of March 2005, the estimated total size of the funds invested by Australians in Australian hedge funds was \$28 billion across 160 funds<sup>1</sup>. While this represented less than 2% of the total funds under management in Australia<sup>2</sup>, some government superannuation funds are investing up to 14% in hedge funds<sup>3</sup>.

Access for retail investors into hedge funds has also been made easier as more hedge fund managers open retail funds with lower minimum investments and administration platforms used by retail investors offer access to wholesale hedge funds.

<sup>1</sup> LCA Publications. [www.lcapublications.com](http://www.lcapublications.com)

<sup>2</sup> Reserve Bank of Australia, statistical tables - [www.rba.gov.au](http://www.rba.gov.au)

<sup>3</sup> [www.pss.gov.au](http://www.pss.gov.au)

# Hedge Fund Myths Dispelled

*There is risk inherent in any investment, but the belief that hedge funds are more risky than other investments may be misplaced.*

Here we discuss some hedge fund myths.

## **Myth One: Hedge funds are extremely risky**

There is risk inherent in any investment, but the belief that hedge funds are, by definition, more risky than other investments is misplaced.

Firstly, there should be a clear distinction between performance risk and operational risk.

Regarding performance risk, many hedge funds aim to control risk, not leave it unchecked. By protecting or hedging their portfolios against broad market risks hedge funds can present a lower risk profile than traditional funds.

Operational risk (that is, how well a hedge fund operates) is a matter to be assessed in relation to each individual fund. Investing with a reputable investment manager may mitigate this risk.

Investors may draw comfort from the fact that the Australian regulatory environment scrutinises hedge funds in the same way as traditional funds. Like any investment, though, you need to be informed before you make an investment decision and should seek professional advice if you think this could assist your decision.

### **Myth Two: Hedge funds will add risk to my portfolio**

The irony is that while hedge funds have been seen as risky, used wisely they can actually reduce risk in your total investment portfolio. Hedge funds often have a low correlation to traditional asset classes. For example, an equity-market neutral fund may provide a degree of protection during periods of hostile equity markets.

Of course, having too much exposure in any investment is risky. If you spread your investments wisely, hedge funds can form part of your diversification strategy, helping to strengthen your portfolio.

You should be also aware of the effects of “leverage” – see below.

### **Myth Three: Hedge funds generate massive returns**

Some hedge funds do aim to generate larger returns, but these funds also take on larger risk and can be quite volatile. There is a huge variety of hedge fund investments available, and many of them do not target extremely high returns – rather, they aim to generate less volatile and more consistent returns than traditional funds.

### **Myth Four: All hedge funds use vast amounts of leverage**

“Leverage” measures the level of financial risk a fund assumes relative to its capital. Leverage, or gearing, can be achieved by the fund borrowing money to invest, for example. Not all hedge funds use leverage, although many do. Funds that use leverage do so to enhance their returns. Some funds use leverage to enhance returns from low-risk trades, while other funds use leverage to increase exposure to directional trades. Leverage is a two-edged sword and funds that use leverage can be more risky than un-leveraged funds. Historically there have been instances of funds using excessive leverage unwisely and suffering large losses as a result. A hedge fund manager's risk management and leverage use policy is of key importance in assessing the manager for potential inclusion in a portfolio.

The important lessons here are to make sure you invest with a reputable manager who has the requisite experience to manage your money. You should ensure you invest only in those hedge funds that suit your investment profile and can add diversification and risk-reward benefits to your total investment portfolio.

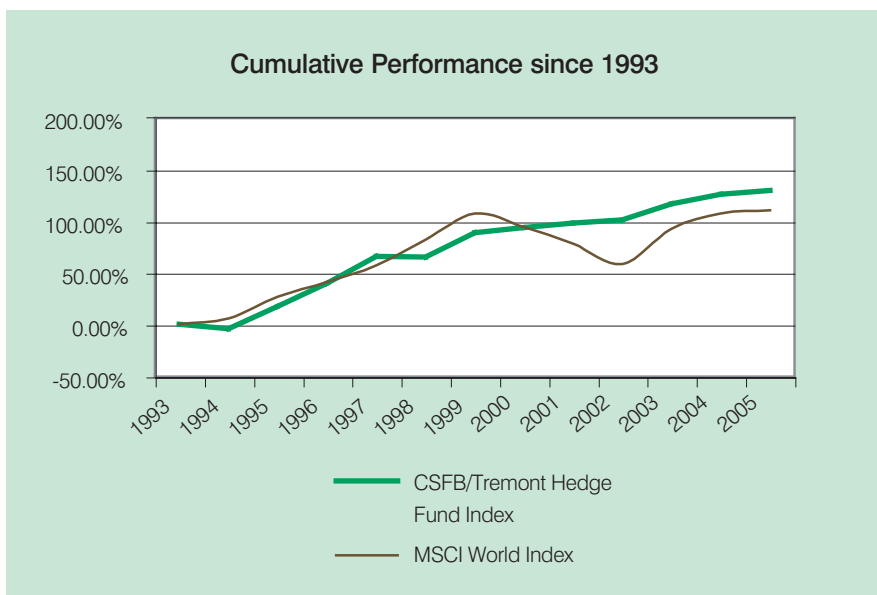
# Performance of Hedge Funds

## The Global Experience

To get a better picture of the benefit of hedge funds in a variety of market conditions, one should take into consideration both investment returns and the volatility of these returns.

The chart below shows the consistent positive performance of the CSFB/Tremont Hedge Fund Index (a global hedge fund index) compared to the MSCI World Index (an index of the world's sharemarkets).

What you can see is that over the most recent twelve years, hedge funds, as represented by the CSFB/Tremont Index, have provided a more consistent return than shares, as represented by the MSCI World Index.



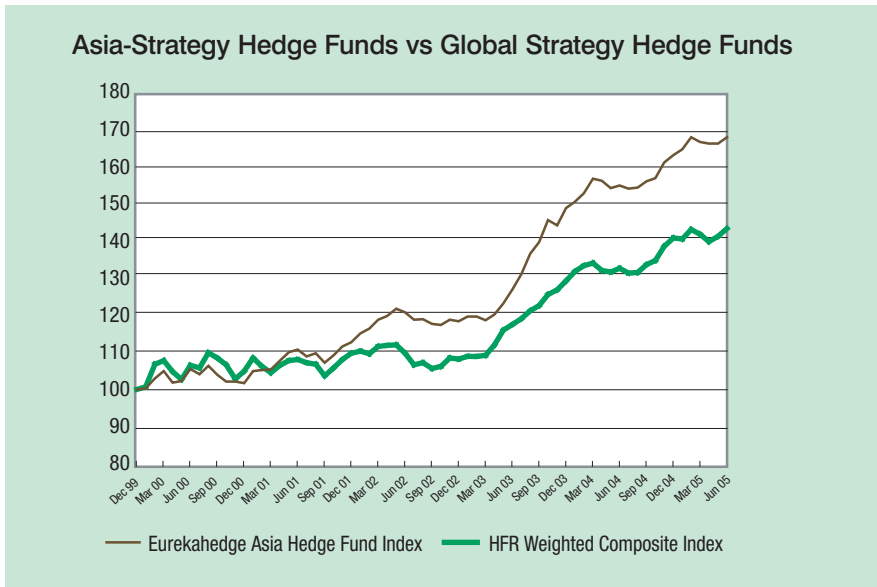
Source: Hedgeindex.com (August 2005).

The CSFB/Tremont Hedge Fund Index is the industry's first asset-weighted hedge fund index. The index universe is defined as funds with a minimum one-year track record, and minimum of US\$50m AUM, and current audited financial statements. It does not however cover all hedge funds that fall within this category globally.

The MSCI World Index is a free float-adjusted market capitalisation index which represents the performance of 23 developed market country equity indices.

## The Asia-Pacific Experience

Looking closer to home, we see that hedge funds in the Asia-Pacific region have capitalised on the volatility and relative inefficiencies that typify their target markets to enhance returns further, compared to global hedge funds.

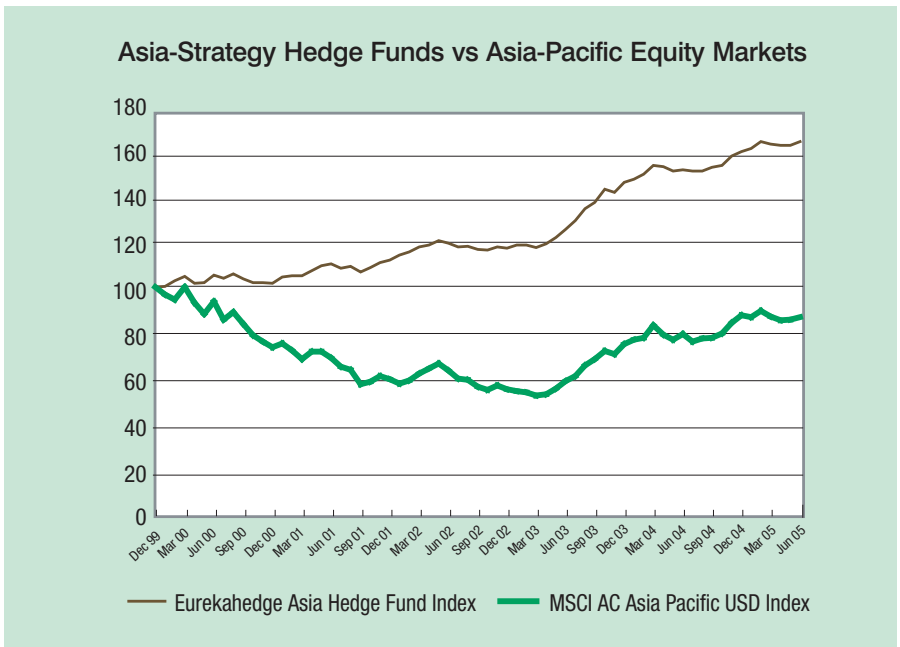


Source: Hedge Fund Research, Inc.,<sup>©</sup> HFR, Inc. August 2005. [hfr.test.hrf.com](http://hfr.test.hrf.com)

The HFR Fund Weighted Composite Index is a fund weighted index of over 1600 hedge funds encompassing a diverse range of strategies and markets.

The Eurekahedge Asia Hedge Fund Index represents the average monthly return on a non-weighted portfolio of substantially all Hedge Funds (whether or not still in existence) with a regional mandate limited to investments within the Asia-Pacific region.

Alternatively, we can evaluate the performance of the Asian hedge funds against the Asia Pacific equity markets and conclude that hedge fund managers are capitalising on the ability to make money in a variety of market conditions that traditional investment strategies don't provide.



The Eurekahedge Asia Hedge Fund Index represents the average monthly return on a non-weighted portfolio of substantially all Hedge Funds (whether or not still in existence) with a regional mandate focusing on investments within the Asia-Pacific region.

The MSCI Asia Pacific USD Index is a market capitalisation weighted index which represents the performance of 14 equity markets within the Asian Pacific region (including Australia and NZ).

## The Australian Experience

The following table shows recent documented performance of Australian hedge funds (to June 2004). Over this time, Australian hedge funds have shown relatively strong performance.

Performance of Australian Hedge Funds and Asset-class Benchmarks (%)				
	12 months to 30 June 2002	12 months to 30 June 2003	12 months to 30 June 2004	3 year Annualised
Australian hedge funds- All	9.2	11.2	12.2	10.8
- Single manager funds	12.6	15.0	16.5	14.6
- Funds of hedge funds	5.6	7.8	7.9	6.7
S&P/ASX200 Accumulation Index	-4.7	-1.7	21.6	4.4

Past performance is not a reliable indicator of future performance.

Hedge fund returns are net of fees.

Source: Reserve Bank of Australia, Financial Stability Review, September 2004.

The weaker performance of the Fund of hedge fund managers compared to the single managers may be explained by the fact that many of them make a large proportion of their investments in offshore managers, which have not performed as strongly as the Australian managers, and the slightly higher fee load they charge for selecting and monitoring the portfolio of underlying managers.

# Types of Hedge Fund Investments

There is a huge variety of hedge fund strategies and an even wider array of investments providing access to hedge funds.

For Australian investors, there are four main ways to access hedge funds:

1. Single strategy funds
2. Multi-strategy funds
3. Funds of hedge funds
4. Structured hedge fund products

## **Single Strategy Funds**

Single strategy funds invest directly in financial markets using one main investment strategy. The fund manager has usually developed its skills over many years and has established an 'edge' it believes to be sustainable through a variety of market conditions.

An example of a single strategy fund is an Australian equity long/short fund.

Single strategy funds usually have high minimum investments and capacity constraints, which limit the size to which the fund can grow.

## **Multi-Strategy Funds**

Multi-strategy funds are similar to single strategy funds in that they invest directly in financial markets. However, the multi-strategy manager uses more than one strategy to generate returns and can usually allocate the fund's capital dynamically in response to the perceived opportunity set for each strategy.

The benefit of a multi-strategy fund is that it provides greater diversity to the investor and may offer a reduced risk profile than the single strategy fund. The manager may add new strategies over time, thus helping to prevent capacity constraints.

## **Funds of Hedge Funds**

For many investors, Funds of hedge funds (FOFs") will be their first investment in hedge funds. FOFs do not invest in financial markets directly. Rather they invest in a portfolio of individual single strategy or multi-strategy funds.

The benefit of a FOF investment is that the FOF manager uses its expertise to establish and manage a diverse and robust portfolio, and to perform initial and ongoing due diligence on each invested manager. FOF managers will usually take a dynamic approach to portfolio management, and switch between strategies and funds as opportunities arise, thereby attempting to ensure a dynamic and efficient use of capital.

By pooling investor monies, FOFs are able to access funds that most individuals may not be able to access directly.

For the benefits FOFs provide, investors usually face an increased level of fees compared to a single strategy fund investment.

## **Structured Hedge Fund Products**

Structured hedge fund products provide access to either single strategy, multi-strategy or fund of hedge fund investments, with additional benefits.

Structured Hedge Fund products are usually closed end offerings. This means they are open to investors for a short time only, and once closed, run for a set period, which may be as little as 5 years or as much as 12 years.

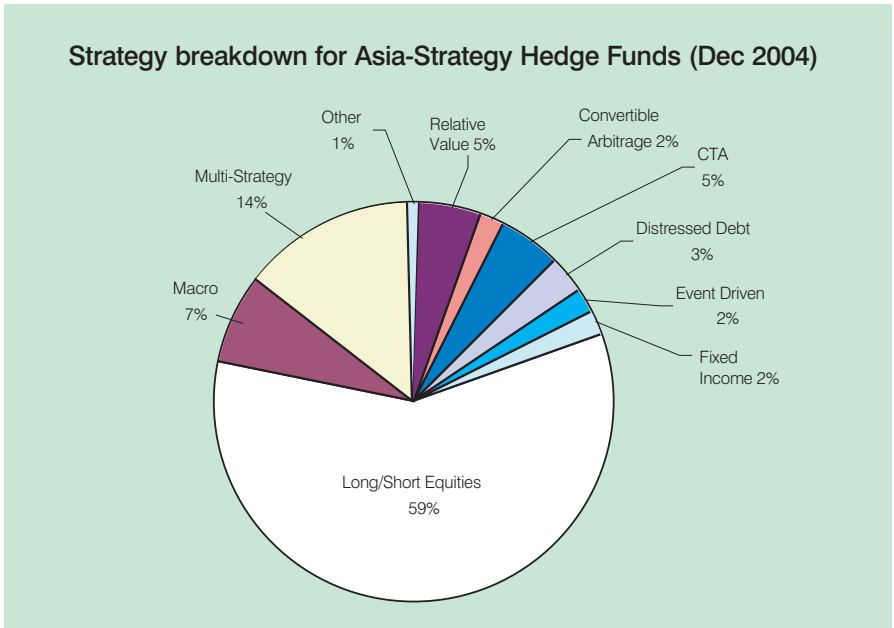
Additional benefits that structured hedge fund products may offer are:

- capital protection or capital 'guarantee';
- currency hedging;
- regular distributions; and
- optional leverage.

These benefits often mean that structured hedge fund products provide a degree of comfort required by some first-time investors.

# Hedge Fund Strategies

In the Asia-Pacific region alone there is now a significant breadth of investment strategies being employed by hedge fund managers, as indicated in the following pie chart.



Source: Eurekahedge (March 2005).

In this section we examine a few of the more common single strategies employed by hedge fund managers including:

- Long/Short Equities
- Equity Market Neutral
- Arbitrage
- Event Driven
- Global Macro
- Managed Futures (CTA)

**Long/Short Equities:** This strategy combines long positions in equities that are expected to increase in value, with short (sold) positions in equities that are expected to decrease in value. Investments can be made as individual ideas, sector trades or pairs trades, where one stock is bought and another sold short with the view that the former will outperform the latter. Managers usually have great flexibility in being able to hedge core positions with other shares, equity indices, options, warrants or hybrid securities. To short a stock, a fund borrows the relevant shares then sells them into the market, depositing the proceeds to generate cash returns. Short positions can act as a partial hedge against market risk but unlike traditional long only managers, often long/short managers short sell intending to generate a profit. Managers can shift their overall net exposure (which usually varies in a range from slightly net short to significantly net long) to match their view of the market.

**Equity Market Neutral:** Market Neutral managers aim to generate excess returns, known as alpha, regardless of the direction of the equity market. This is achieved by almost totally eliminating broad market risk, known as beta, from the portfolio. A portfolio of long and short equities positions is constructed such that the portfolio is almost neutrally positioned across risk dimensions which may include dollar value, market beta, sector exposure, market capitalisation and growth/value characteristics. The long and short portfolio is often selected using a model based on the manager's quantitative research. By attempting to remove all of these sundry risks, the manager is aiming to capitalise on stock-specific moves that the model predicts will occur, based on factors such as market momentum and analyst revisions.

**Arbitrage:** There are many types of arbitrage strategies offered by hedge funds, but generally arbitrage managers aim to profit from apparent mispricing between instruments based on the same underlying value-driver, traded in different markets or via different securities. Arbitrageurs can use shares, debt instruments, options, futures and other derivatives. Common arbitrages include trading mispricing in ordinary shares versus preference shares; debt futures versus interest rate swaps; and debt versus equity trades.

**Event Driven:** This strategy relies on investing in corporate events, such as mergers, acquisitions, capital re-structures and corporate finance raisings to generate profits. In the case of an on-market takeover, the event driven manager might, for example, aim to profit from the difference between the current price of a target security, and the manager's calculated fair value of the security under the terms of the proposed takeover. This calculation will take into consideration the probability of the deal being completed, or of a counter-bid emerging. If the takeover offer includes an offer of shares in the acquirer, there may be an opportunity to arbitrage the difference between the target shares and the acquirer's shares with the expectation that the share prices will converge.

**Global Macro:** Global macro is a highly flexible strategy usually involving active trading and managing of positions across global markets based on the manager's understanding of economic factors that drive inter-related markets. The macro manager may trade interest rates, commodities, currencies and equities with the expectation that prices of these instruments will change as economic factors come into play.

Investment styles vary greatly, depending on the expertise of the global macro manager, decisions are made using either the manager's judgement - called 'discretionary trading', or using systematic models which the manager has built based on historical pricing or fundamental information. Time frames for global macro trades can range from minutes to months.

**Managed Futures (sometimes called Commodity Trading Advisers, or CTAs):** CTAs can utilise directional, spread-based and option-based strategies applied to global futures markets. Futures contracts are available to access movements in commodities, currencies, equity indices and fixed income markets.

Managers who used managed futures either use their own discretion to interpret fundamental or technical analysis and take positions accordingly, or use systematic models to generate trading signals. Like the global macro manager, positions tend to be held for the short to medium term.

# Are Hedge Funds for You?

Considering there is a wide variety of hedge fund strategies and an even wider array of investments providing access to hedge funds, there could be a hedge fund to match your investment requirements.

The 'right' investment for you will depend on a range of factors which may include;

- Other investments in your portfolio;
- Appetite for risk;
- Requirements for income or growth;
- Requirement to access your funds at short notice;
- Time horizon for investments to perform;
- Available capital to invest now, and in the future.

Evaluating the investment opportunity with these considerations in mind should help you to decide which, if any, hedge fund investment suits your particular circumstances.

# Where Do Hedge Funds Fit in Your Portfolio?

*The complexities in determining appropriate allocations have meant that most hedge fund investments are allocated to the 'alternative asset' part of an investor's portfolio.*

Hedge funds are not an easily identifiable asset class, like equities, or cash.

Determining where hedge funds fit in your portfolio will probably be a very individual decision, which may depend on the underlying asset classes that the invested hedge fund managers invest in to generate returns, the strategy used and the risk/return profile of the funds.

For example, a single strategy or multi-strategy fund that only invests in Australian equities, could sit in the Australian equities part of your portfolio, and could act as a diversifier to traditional Australian equity investments. However this may not be the case if the fund doesn't display the typical characteristics of that particular market, for example if the fund has little or no correlation to equities, and has risk more akin to a bond style investment.

The complexities in determining appropriate allocations have meant that most hedge fund investments are allocated to the 'alternative asset' part of an investor's portfolio. This may be the logical approach if the hedge fund investments cover a range of asset classes, and they have very little correlation to any particular asset class.

As alternative asset investments, hedge funds can act as diversifiers, and hence risk reducers, to an investor's total portfolio.

# How Much Should You Allocate to Hedge Funds?

There are no widely accepted rules to determine a percentage amount to allocate to hedge funds. As previously discussed it will depend on the composition of your existing portfolio and your individual circumstances.

## Questions to consider include:

1. Which asset class am I allocating to?
2. Which asset class am I allocating from?
3. What other investments do I have in that asset class?
4. Is the investment adding or reducing portfolio risk?
5. How diversified is the investment?

If you have first decided that hedge funds are part of the alternative asset allocation, then you should also take into consideration what percentage of your alternative asset allocation hedge funds will occupy.

If you are considering a fund of hedge funds then conceivably you may be able to access your desired hedge fund exposure through a single investment. If you are considering single strategy managers, you may decide that several different investments are warranted to access the desired strategy mix.

If you are allocating to a single manager displaying high risk and high return characteristics, you may wish to start with a relatively small allocation. If the proposed investment is being chosen to enhance the risk-adjusted returns of your overall portfolio, then you may be able to justify a higher allocation.

For Australian retail investors, average suggested hedge fund style investment portfolio allocations range from 10% to 20% of total investments.

You should consult a financial adviser or other investment professional when deciding what allocation (if any) to alternative investments is suitable to you.

# Practical Issues to Consider

Before you make a final investment decision, you should read any disclosure document or other advice you receive carefully. Some common significant issues to consider are:

## ■ Fees

Hedge Fund managers require very specialised skills and offer exposure to non-traditional investment strategies. As such the hedge fund industry has established a different fee structure than the traditional funds management industry.

Hedge Fund managers tend to charge an annual base management fee, usually around 1%pa to 2%pa. They also frequently charge a performance fee. Performance fee calculations vary. Commonly managers charge around 15%-20% of the fund's performance above a certain target (known as a "hurdle") or with no hurdle. As the name suggests, the manager is only entitled to the performance fee when the fund outperforms. Managers usually implement a 'high-water mark' for calculating the performance fee. The existence of a robust high-water mark policy ensures that the manager is not able to charge performance fees on profits that are simply making good previous losses.

## ■ Liquidity

Hedge funds often have limited liquidity provisions. Given the complexity of the strategies used by the manager, trading costs, liquidity of sometimes complex trading instruments, and a desire to minimise administrative burdens, hedge funds usually offer monthly liquidity at best, with notice periods normally at or exceeding 30 days. At the extreme, funds may have lock-up provisions which prevent investors redeeming their funds within a certain time, sometimes years, after an initial investment is made.

Fund of fund managers have liquidity terms determined by the liquidity of the underlying single strategy managers in which they invest. The more liquid fund of hedge funds would provide monthly liquidity.

## ■ Capacity

A phenomenon well known to hedge fund managers is capacity constraints. This refers to the limited amount of money the manager can invest in their particular strategy without having a negative impact on performance.

To try to ensure that performance is maintained the manager will often put a limit on the amount of money it will accept into its fund. Once the fund reaches this limit, or gets close, the fund manager will refuse to accept new investors. Closing a fund to new clients is called “soft closing”, while refusing all additional investments is known as “hard closing”. The challenge for investors is to find managers with a proven track record, who are still open for new investment. It is often the case with good quality single strategy managers that demand exceeds supply.

## ■ Accessibility

Similar to the capacity constraint issue, excessive demand for some hedge fund strategies has allowed hedge fund managers to remain exclusive and to limit the investments they will accept. This usually results in high minimum investment requirements, sometimes as high as US\$1,000,000. These high minimums take most funds out of the realm of the majority of investors.

Demand has also enabled some managers to restrict access to certain types of investors, such as wholesale or sophisticated investors.

Funds of hedge funds can provide a solution to both capacity and accessibility issues for retail investors. By pooling the money from their investors they are able to meet the minimum investments required by single strategy managers. If their capital raising efforts are ongoing FOF managers may also be able to negotiate ongoing capacity with managers once they are soft-closed.

# Getting Started

This handbook had been written to provide you with some hedge fund basics. Armed with a greater understanding of the types of hedge funds and their role and position in your total portfolio, you should be better equipped to make investment decisions.

## **Direct Investors**

As discussed in the 'Practical Issues to Consider' section, direct retail investors may be excluded from some single strategy managers' offerings. Generally speaking, FOFs and structured hedge fund investments will be the first entry point for direct investors.

## **Indirect Investors**

Many fund managers make their funds accessible to retail investors via IDPS or wrap platforms. These platforms pool the investments from the individuals, allowing them to meet the minimums required by some managers. This may be a way for retail investors to gain access to funds that have very high minimum investments or would otherwise be closed to them.

## **Contacting a Financial Adviser**

If you use a financial adviser, or would like a total financial plan that incorporates the use of hedge funds, please contact a financial adviser to discuss an appropriate hedge fund investment strategy to meet your investment needs.

## **Fund Manager Information**

Some managers do cater for retail investors and provide a website or toll-free number to help further investor education.

And remember to read any disclosure document or other advice you receive carefully before making any investment decision.

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