Investing in Hedge Funds

Investing in hedge funds is not for everyone. This is not simply a matter of financial advice, but a legal requirement, as spelled out in the Securities Act of 1933. This Act requires that hedge funds may only accept accredited investors, or those with at least $1 million in net worth or $200,000 annual income.

If this hurdle is met, the investor and financial advisor must then determine the **suitability** for an inclusion within the portfolio, ensure that it meets the investor's objectives and constraints, and conduct sufficient due diligence on the fund manager. Hedge funds, on average, have not added positive returns to investors over time.

Styles

Hedge funds have been described as using skill-based investment strategies. Primarily, returns are supposed to be driven from a firm's competitive advantages in getting investment information or analysis. There are many different investment strategies that are employed by hedge funds. The following strategies are just some of the more popular techniques that hedge funds use hoping to provide superior returns:

Global macro: Funds anticipate macroeconomic international events to drive allocation.

Equity market neutral (long/short): A strategy that attempts to have reduced or no net exposure to market swings, thereby focusing primarily upon individual stock selection to drive returns.

Short only: Investing primarily in stocks believed to decrease in value.

Distressed securities: These funds generate returns by identifying companies in financial trouble that they believe will turn around.

Event-driven: Investment selection is driven by return associated with a particular event, such as a merger or bankruptcy.

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Fund of funds: A hedge fund with investments in underlying hedge funds of various styles.

Role in Investment Markets

Despite the fact that hedge funds were viewed negatively following the 2008 financial crisis, many believe that they play an important role in the functioning of financial markets. Due to their various strategies, they may help reduce asset mispricing. These

REINKING
FINANCIAL CONSULTING

Ricardo Reinking, CFA

Reinking Financial Consulting
(952) 949-2166
www.ReinkingFinancialConsulting.com

funds may also add liquidity to the financial system and provide a source of risk transfer and diversification. Importantly, their capacity for leverage (borrowing money), the complexity in assessing the risks they present and importance in many markets have made them increasingly risky to financial markets. For this reason, tighter regulations have been discussed to ensure that hedge funds do not continue to pose a significant risk to global economies.

Selection of Hedge Fund Managers

Determining if a hedge fund is an appropriate investment

Determining whether or not investing in a hedge fund is appropriate must include an analysis based on your particular circumstances, goals and needs. There are particular characteristics of hedge funds that may impact suitability such as time horizon and liquidity constraints. Liquidity (or cash flow) constraints are of particular importance due to lock-up periods that most hedge funds have. These lock-up periods may allow investment withdrawals only quarterly or even annually. The performance of these investments can be volatile and anyone considering providing this level of capital must be comfortable with that variability. Tax considerations are always important in making any investment decision. Many hedge funds are structured as partnerships and have unique tax issues, something that should be discussed with a tax advisor.

Due diligence

The selection of individual hedge fund managers is just as important as hedge fund style selection. Due to the considerable size of investment required, a significant amount of due diligence must be undertaken before making the investment decision. Some important factors to consider in the manager selection process include: market opportunity, investment process, organization, people, terms and structure, and document review. Market opportunity is a study of the likelihood that a particular fund style will be successful given current market conditions. The investment process refers to identifying ways that the manager can add value above and beyond market returns. Organization and people includes a review of how the fund operates, who operates it, what experience they have, and their performance history. Terms and structure is an analysis of the fees charged and ensuring that manager and investor interests are aligned. Finally, a thorough review of the legal documents must be conducted to ensure that what is represented in marketing materials and presentations is what the fund will do.

Role in Portfolios

Investments in hedge funds could potentially add another level of diversification within the portfolio, thus adding return and reducing risk. For a particular portfolio, the benefit derived from adding a hedge fund in

Correlation between Hedge Fund Strategies and the S&P 500
(1990-2004, Source: CISDM 2005)

Stock Index or Hedge Fund Strategy	*S&P 500*	*HFCI*	*Global Macro*	*Equity Market Neutral*	*Short Only*	*Distressed Securities*	*Event-Driven*
S&P 500	1.00	0.59	0.26	0.09	-0.78	0.42	0.59
HFCI (Hedge Fund Composite Index)	0.59	1.00	0.72	0.32	-0.64	0.66	0.76
Global Macro	0.26	0.72	1.00	0.34	-0.18	0.29	0.33
Equity Market Neutral	0.09	0.32	0.34	1.00	0.00	0.14	0.13
Short Only	-0.78	-0.64	-0.18	0.00	1.00	-0.54	-0.66
Distressed Securities	0.42	0.66	0.29	0.14	-0.54	1.00	0.87
Event-Driven	0.59	0.76	0.33	0.13	-0.66	0.87	1.00

different styles could be noticeable, but improbable.

Two investments that are perfectly correlated have a correlation coefficient of 1, with no correlation this measure is 0, and perfect negative correlation is -1. Adding an investment to a portfolio that is perfectly correlated with other investments adds no diversification benefits, but low or negative correlation can be very beneficial in diversification efforts. The accompanying table shows how the returns of different hedge fund styles correlate with each other and with stocks, as measured by the S&P 500. It reveals that adding investments in hedge funds, no matter the style, are not highly correlated with stocks and therefore will increase the diversification within the portfolio. The other important factor to point out is the stark contrast in correlations across different fund strategies. This is why style selection is critical in portfolio planning.

Fees

Fees for investing in hedge funds **can be substantial and can significantly reduce net returns**. The usual fee structure is a 2 percent flat fee of total investment plus 20 percent of investment gains. However, many funds have a high water mark. Fees are only charged on investment gains when the investments have a greater value than this mark, thus eliminating the potential to pay gains on the same growth multiple times. Funds of funds are investment vehicles that can be used to gain access to multiple hedge funds. However, there are **additional fees charged by these funds**, on top of the fees charged by the funds that they invest in. Thus**, hedge fund fees can greatly reduce or even eliminate investment gains.**

Risks

Like any other investment, investing in hedge funds comes with associated risks. These funds are intended to lower overall risk to the portfolio while potentially increasing return prospects, but add the following individual risk characteristics:

Lack of transparency and regulation: Because of the investor requirements for hedge funds, there is little regulation that requires these funds to disclose their practices or individual positions in stocks. In effect, hedge funds become a "black box" and you don't know where your money is invested.

Lack of Liquidity: Most funds have lock-up periods, which can make it impossible to withdraw funds without proper notice. The available time frames for withdrawals can be quarterly or even annually.

Leverage: Some funds have historically borrowed significantly more than the money they started with in an effort to magnify positive returns. **The downside to this is that losses are also magnified**. To put this into perspective, some funds may borrow $4 for every $1 invested, for a total of $5. This means that if 20 percent is lost on the total, that all of the original $1 investment is lost.

Key Points to Remember

The suitability of the hedge fund style and of the individual manager selected, as it relates to portfolio objectives and constraints, is a critical part in the decision to invest in hedge funds.

Performance of hedge funds should be assessed with **tax implications** and **fees** in mind.

Due to minimal regulation of their practices, hedge funds require significant due diligence.

Based on historical data, we conclude that hedge funds are unlikely to have a positive impact on return within the portfolio.

RFCs Bottom Line

Our prospects and clients sometimes ask us why ***Reinking Financial Consulting*** never recommends investments in hedge funds. ***Simon Lack, CFA***, and author of "***The Hedge Fund Miracle" - The Illusion of Big Money and Why It's Too Good to Be True*** , provides strong arguments in support of our position within the first two minutes of this linked speech with a powerful quote:

"***If all the money that's ever been invested in Hedge Funds had been put in Treasury Bills instead, the results would have been twice as good***."

Furthermore, investments in Treasury Bills have produced only minimal returns relative to those generated by well-diversified portfolios over periods longer than five years.

Most importantly, at ***RFC*** we only recommend investments that offer complete **transparency**.

Ricardo Reinking, CFA

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