# What are Hedge Funds?

Hedge funds are an alternative type of investment that uses pooled funds from accredited investors to implement numerous strategies with the hope of earning attractive returns. Although similar to mutual funds, Hedge Funds have some significant differences. Hedge Funds often do better than other investments during market declines, which adds to their attractiveness yet can take on considerable risk.

Hedge funds may be managed conservatively or aggressively. Some managers look for good quality investments, while other managers invest in anything that might result in a good return. Management styles vary from fund to fund and can change over time.

Hedge Funds may also use derivatives. Derivatives receive or "derive" much of their value from another financial instrument, which is the underlying security. This can include various options contracts, futures contracts, and credit default swaps. Many of these derivatives can provide solid and consistent returns, while others are risky and speculative. Derivatives only exist for a certain length of time and can decrease in value or waste away, even if the underlying asset's price moves in the desired direction.

Hedge Funds often use leverage or borrowed money to invest in larger position sizes with the hope of experiencing higher returns. Borrowing money is a double-edged sword. Gains can be more significant, but the risk is also greater.

Futures contracts have very high leverage. They allow future prices to be "locked-in" now or are used to hedge against adverse future price movements. Types of futures contracts include stocks, bonds, indexes, currencies, gold, oil, and cotton. It is common for a futures contract to be held by only putting up 3-12% of the value of the contract. This can be great when prices move in the right direction. However, this can be detrimental if prices move in the wrong direction.

Hedge Funds may be active in both domestic and international markets. Some seek investments within the US, while others will span the globe looking for suitable investments. Some Hedge Funds may practice both. Foreign investments can provide good returns but also have risks due to unfavorable currency exchange rates, geopolitical events, and rules and regulations imposed by various governments.

Hedge funds are generally only accessible to “accredited” investors since they have fewer SEC regulations than mutual funds. The financial requirements can be substantial for getting into a Hedge Fund. This may be beyond what most individual investors are capable of doing. Those with high incomes and/or net worth are the typical Hedge Fund investors. This is different than mutual funds, in which low minimum requirements allow for easier access and availability.

Hedge Funds often perform better during volatile times and bear markets. Whether this is perceived or justified, investors often flock to Hedge Funds when market conditions become “complicated.”

**Hedge Funds Goals**

Hedge Funds are designed to take advantage of specific market opportunities. For example, some Hedge Funds may focus on going long while others may concentrate on going short. Some Hedge Funds concentrate on both.

Hedge funds may use a variety of investment strategies and are often classified according to an investment method. The method can be established by the Hedge Fund Manager in which Investors are buying a “name.” Some Hedge Fund Managers have become well-known, if not famous. Many investors will enter a Hedge Fund merely because of the name or reputation of the manager.

There is substantial risk diversity and investing methods with Hedge Funds. Rarely are two Hedge Funds alike. Each feels it has the edge over

the others as they try to outperform each other. Some Hedge Funds are conservative, while others are very aggressive. Risk versus reward is critical to consider. Investors want to experience good returns. However, greater returns usually involve taking on more risk.

**Who Can Invest?**

Legally, Hedge Funds are most often set up as private investment limited partnerships that are open to a limited number of investors. They require a significant initial minimum investment. People of certain “financial standing” invest in Hedge Funds. This can include famous celebrities and politicians. These investors often have influence in political and regulatory spheres, which benefits the freedom and flexibility of Hedge Funds. Such freedom can also force actions by these influential investors if they get burned. The limited partnership allows for fund managers to be protected. Investors can’t go after a manager personally if they do something wrong or lose money. Hedge Funds may also limit the number of investors, which means others desiring to enter must get in line. An initial investment can range from $100,000-$2 million.

Investments in Hedge Funds are usually illiquid as they often require investors to keep their money “tied up” in the fund for a specific period of time. This gives the Hedge Fund the time and the freedom to perform by ensuring sufficient funds are available to invest. This can also hide the actions of Hedge Funds, causing there to be a delay in receiving information if something goes wrong. Hedge Funds can prevent funds from being accessed while it is invested. From a business angle, this makes sense. They want to avoid a “run” on the Hedge Fund in which many investors are trying to withdraw funds simultaneously. Typically, Hedge Funds will limit withdrawal periods to specific intervals, such as quarterly or bi-annually.

**Characteristics of Hedge Funds**

The Securities and Exchange Commission (SEC) states that Hedge Funds are only open to "qualified "or accredited investors. Requirements include:

- An annual income over $200,000 for the past two years or,
- A net worth of over $1 million (not including an investors' primary residence).

These investors are deemed suitable to handle the potential risks. The reasoning is if things go wrong, they won't get completely wiped out. However, investors may accel in their specific professions (doctors, lawyers, entertainers, etc.), but that does not necessarily make them savvy in the financial markets. Unlike a profession or occupation in which those who are successful often enjoy much control and influence, the financial markets are out of their control.

A Hedge Fund's investment method is only limited by its mandate or an explanation of what the Hedge Fund will do. This may include the type of investments, risks assumed, and the primary investment philosophy of the Hedge Fund. A Hedge Fund can invest in anything (land, real estate, stocks, derivatives, and currencies).

Mutual funds, by contrast, have to follow the prospectus, which is typically only in long positions. There are exceptions. The prospectus is the mutual fund "laws," whereas Hedge Funds will often have greater freedom and flexibility. Of course, Hedge Funds often leave themselves "an out" to avoid taking personal responsibility while shifting the blame and financial burdens to investors.

Also, Hedge Funds often use leverage, or borrowed money, to try to achieve better returns. Individual investors often do this as well. For example, if a Hedge Fund has $1 million to invest, a margin account will allow for the buying power of $2 million. Any borrowed money must be

paid back in full. This can be great if things go right but very bad if things go wrong.

Hedge Funds have a Fee structure. Unlike mutual funds, instead of usually only charging an expense ratio for no-load mutual funds, Hedge Funds often charge both an expense ratio and a performance fee. Typically, this can be a 2% asset management fee and a 20% cut of any gains. Investors may be okay with this if they make money, while this can bother others.

Hedge Funds can pretty much do anything as long as it is disclosed to investors. However, since Hedge Funds often promote a “secret edge” that makes them unique and better than other Hedge Funds, there can be a significant time lag before investors are informed of what has happened. By the time an investor may realize what has transpired, it may be too late.

Some massive failures and scandals have involved Hedge Funds. This includes SAC Capital, The Galleon Group, Long-Term Capital Management, Pequot Capital, Amaranth Advisors, Tiger Funds, Aman Capital, Marin Capital, Bailey Coates Cromwell Fund, and the biggest and most famous is the Madoff Investment Scandal. Currently, Archegos Capital Management has made the news due to being over-leveraged.

Hedge Funds, in general, don’t last very long and are susceptible to failure. About 33% percent of Hedge Funds fail each year, and a Hedge Funds' average life is about five years. Despite the statistics, funds flowing into Hedge Funds currently continues to increase.

Some Hedge Funds have produced fantastic consistent returns. A list of successful Hedge Funds includes Bridgewater Associates, Renaissance Technologies, Man Group, AQR Capital Management, Two Sigma Investments, Millennium Management, Elliott Management, and BlackRock. BlackRock is the world’s largest money manager and has become significant in the Biden Administration by occupying many cabinet and leadership roles.

The 2008 financial meltdown hurt many Hedge Funds.  Hedge Fund failures were a primary reason behind the collapse. Also, influential banks and Wall Street institutions such as Bear Sterns and Lehman Brothers collapsed during the crisis.

Investors seek good returns and often use Hedge Funds to try to achieve them. Hedge Fund investors must do their homework, realizing the more something seems like a “sure thing,” the more likely it is to end badly. Investors often base decisions on what someone else says rather than by making their own decisions. Independent conclusions should be made based on the best research available.

**Why is it called a Hedge Fund?**

The name “Hedge Fund” is primarily traditional and does not accurately describe what most Hedge Funds do. “Hedging" is the practice of attempting to reduce risk. If an investment is owned yet risks losing value, an opposing position of some sort may be set up to offset losses.

In life, there is insurance that covers such things as health, car, homes, etc. As necessary as insurance is, premiums bite into a household budget. The same is true with investments. Insurance is available, but it often comes at the price of sacrificing returns. When a Hedge Fund manager, or any investor, does not perceive or plan for immediate risks, the available types of insurance may not be implemented.

Additionally, the financial crisis also showed that investments that should have behaved in a certain way after being tested with different scenarios ultimately behaved differently than expected. This caused a ripple effect through the investment community, banks, and eventually to average Americans. The crisis became worldwide and impacted millions of businesses and people.

Hedge Fund investment strategies and methods are often proprietary and closely guarded. This is often why many investors like Hedge Funds. They want to cash in on returns while allowing someone else to do the work.

**Hedge Fund Risks**

Some investment strategies expose Hedge Funds to potentially massive losses. The risks may not be apparent when an investment is initiated but may become risky when exposed to real-life circumstances. When combined with borrowing money and changes in the market climate, what worked on paper and was tested may not work when exposed to actual market events and conditions.

Investing methods that were successful during specific periods may no longer be effective. The financial markets can change. Some truths are always the same, while new and innovative approaches may replace older and more traditional methods. New companies, technologies, and opportunities can often replace what was once effective in the past.

**Hedge Fund Manager Pay Structure**

Hedge Fund managers typically require a fee of 2% of the assets under management (AUM) and 20% of the profits each year as compensation. Even if the Hedge Fund loses money, the manager can still receive 2% of the assets. Some investors may not have a problem with this, while others don't like this at all. For example, if a manager oversees $1 billion in assets, the manager could "earn" $20 million a year in compensation without doing anything.

Some Hedge Funds have implemented fee limitations, known as high-water marks, to help make Hedge Funds more appealing to investors. This can prevent Hedge Fund managers from getting paid on the same returns twice, which is similar to double-taxation. There may also be fee caps to help prevent managers from taking on excess risk.

As with many CEOs and company officials, compensation is often earned based on performance. If a company does well, the management is rewarded. If the company does not do well, the management is not rewarded. The same type of structure is often used with Hedge Funds but usually has a twist. This may be fine when it has been a good year, and everybody is happy. However, paying fees on top of enduring losses and tax liabilities can seem unfair during difficult times.

**The Future of Hedge Funds**

Hedge Fund controversies have included:

- Insider trading: There are two types of insider trading:
    1. Legal: company officers who buy and sell shares must report what they have done. Many investors use this information to make decisions. The reasoning is that company insiders know what is really going on. If they are buying, an investor may decide to buy as well, and vice versa. However, there are lags in reporting times, and a big opportunity may have been missed by the time an investor learns this information.
    2. Illegal: If a company insider shares non-public information with anybody, this is unlawful insider trading. The plot of the first “Wall Street” movie centered around this act. Also, it was how Martha Stewart got into trouble for lying during a federal investigation. If she had acknowledged her actions, it might have gone relatively unnoticed. However, since she lied during the investigation, that is what sent her to prison.
- Tax avoidance: Some Hedge Funds are established in countries outside of the US to avoid regulations and avoid paying some or all taxes.
- Management overpayment: As discussed earlier, some Hedge Fund managers receive very high compensation, which some investors may deem unfair.

- A lack of regulation. One enticement of Hedge Funds is avoiding rules and regulations. Hedge Funds can have a tremendous amount of capital. Sometimes this can be used to support or attack political candidates and incumbents. The desire is to have “Hedge Fund friendly” politicians. Hedge Funds can have friends on both sides of the aisle, meaning Republicans and Democrats. In such cases, Hedge Funds may remain generally neutral politically, as long as the politicians support Hedge Fund interests.

Hedge Fund activities have led the SEC and US Congress to consider changes. This includes:

- New regulations for Hedge Funds. There is a disconnect between Wall Street and Washington, DC. Typically, Wall Street views the actions in Washington, DC, as little more than entertaining or irritating theater. However, when Hedge Fund interests are concerned, the game can change. Also, many Hedge Fund investors are politicians who ultimately have their own best interests in mind (there are always exceptions). If a rule or regulation is passed or changed that can impact a politician directly, it is more likely to benefit the politician.
- Hedge Fund advertising rule changes have allowed Hedge Funds to solicit potential investors directly. The rules used to be more stringent, but changes have allowed Hedge Funds to advertise more aggressively.

Some changes have been slow because Hedge Funds can have lots of money, power, and influence.

**Smart Money**

There are two classifications of investors:

1. <u>The Smart Money</u>: There are groups of investors who have tremendous influence over the financial markets. This is called

the Smart Money. Institutional investors, market mavens, central banks, some funds, and other financial professionals are considered to be the Smart Money.

2. The Dumb Money: Everybody else.

Hedge Funds can have billions of dollars under management. When it is decided to buy or sell in the markets, Hedge Funds leave a trail of their actions. On the surface, these transactions may appear to be the Smart Money. In actuality, it is a large amount of the Dumb Money. Just because a Hedge Fund may have lots of money does not necessarily mean they are the Smart Money.

**Conclusion**

Hedge Funds play a significant role in the financial markets in the US and globally. This can be positive by increasing volume and liquidity or harmful by implementing illegal, immoral, or unethical practices. Most individual investors will not invest in Hedge Funds due to disqualifying as an accredited investor. However, understanding Hedge Funds and paying attention to them is good practice. It can also be interesting. The hard part is figuring out the actions by the Smart Money versus a large amount of the Dumb Money.