What are hedge funds?

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The use of hedge funds in personal financial portfolios has grown dramatically since the start of the 21st century. A hedge fund is basically a fancy name for an investment partnership. It's the marriage of a professional fund manager, who can often be known as the general partner, and the investors, sometimes known as the limited partners, who pool their money together into the fund.

The limited partners contribute funding for the assets and the general partner manages it according to the fund's strategy. A hedge fund's purpose is to maximize investor returns and eliminate risk. If this structure and objectives sound a lot like those of mutual funds, they are, but that is basically where the similarities end. Hedge funds they are generally considered to be more aggressive, risky and exclusive than mutual funds

The very name "hedge fund" derives from the use of trading techniques that hedge fund managers are permitted to perform. In keeping with the aim of these vehicles to make money, regardless of whether the stock market has climbed higher or declined, the managers can "hedge" themselves by going long (if they foresee a market rise) or shorting stocks (if they anticipate a drop). Even though hedging strategies are employed to reduce risk, most consider their practices to carry increased risks.

Aim of Hedge Funds

One common theme among nearly all mutual funds is their market direction neutrality; they expect to make money whether the market trends up or down. In this way, a hedge fund management team resembles traders more than classic investors. Some mutual funds employ these types of techniques more than others, and not all mutual funds engage in actual hedging.

Key Hedge Fund Characteristics

1. ***Only open to "accredited" or qualified investors.*** Investors in hedge funds have to meet certain net worth requirements – generally, a net worth exceeding $1 million (excluding their primary residence) or an annual income that has surpassed $200,000 for the past two years.

2. ***Wider investment latitude.*** A hedge fund's investment universe is only limited by its mandate. A hedge fund can basically invest in anything – land, real estate, derivatives, currencies and other alternative assets. Mutual funds, by contrast, usually have to stick to stocks or bonds.

3. ***Often employ leverage.*** Hedge funds will often use leverage or borrowed money to amplify their returns, which potentially exposes them to a much wider range of investment risks – as demonstrated during the Great Recession of 2007-2009. In the subprime meltdown, which kicked off the recession, hedge funds were especially hard-hit due to an increased exposure to collateralized debt obligations and high levels of leverage.

4. ***Fee structure.*** Instead of charging an expense ratio only, hedge funds charge both an expense ratio and a performance fee. The common fee structure is known as "Two and Twenty" (or "2 and 20"): a 2% asset management fee and then a 20% cut of any gains generated.

There are more specific characteristics that define a hedge fund, but basically because they are private investment vehicles that only allow wealthy individuals to invest, hedge funds can pretty much do what they want, as long as they disclose the strategy upfront to investors. This wide latitude may sound very risky, and at times it can be. Some of the most spectacular financial blow-ups have involved hedge funds. That said, this flexibility afforded to hedge funds has led to some of the most talented money managers producing some amazing long-term returns.

A Hedge Fund at Work

To better understand hedge funds and why they have become so popular with both investors and money managers, let's set one up and watch it work for one year. I will call my hedge fund "Value Opportunities Fund, LLC." My operating agreement – the legal document that says how my fund works – states that I will receive 25% of any profits over 5% per year, and that I can invest in anything anywhere in the world.

Ten investors sign up, each putting in $10 million, so my fund starts with $100 million. Each investor fills out his investment agreement – similar to an account application form – and sends his check directly to my broker or to a fund administrator, an accounting firm that provides all the book- and recordkeeping work for an investment fund. The administrator will record his or her investment on the books and then wire the funds to the broker. Value Opportunities Fund is now open, and I begin managing the money. Once I find attractive opportunities, I call my broker and tell him what to buy with the $100 million.

A year goes by and my fund is up 40%, so it is now worth $140 million. Now, according to the fund's operating agreement, the first 5% belongs to the investors. So the capital gain of $40 million would first be reduced by $2 million, or 5% of $40 million, and that goes to the investors. That 5% is known as a "hurdle" rate, because I have to first achieve that 5% "hurdle" return before earning any performance compensation. The remaining $38 million is split: 25% to me and 75% to my investors.

Based on my first-year performance and the terms of my fund, I have earned $9.5 million in compensation in a single year. The investors get the remaining $28.5 million along with the $2 million hurdle rate cut for a capital gain of $30.5 million. As you can see, the hedge fund business can be very lucrative. If I were managing $1 billion instead, my take would have been $95 million and my investors, $305 million. Of course, many hedge fund managers get vilified for earning such exorbitant sums of money. But that's because those doing the finger-pointing fail to mention that my investors made $305 million. When is the last time you heard an investor in a hedge fund complain that his fund manager was getting paid too much?

Two and Twenty

But what perhaps gets the most criticism is the other part of the manager compensation scheme: the "2 and 20," used by a large majority of hedge funds currently in operation.

As mentioned above, the 2 and 20 compensation structure means that the hedge fund's manager receives 2% of assets and 20% of profits each year. It's the 2% that gets the criticism, and it's not difficult to see why. Even if the hedge fund manager *loses* money, he still gets a 2% of AUM fee. A manager overseeing a $1 billion fund could pocket $20 million a year in compensation without lifting a finger. Worse yet is the fund manager who pockets $20 million while his fund loses money. He or she then has to explain to investors why their account values declined, while justifying getting paid $20 million. It's a tough sell and one that doesn't usually work. In the fictional example above, my particular fund charged no asset management fee and instead took a higher performance cut – 25% instead of 20%. This gives a hedge fund manager an opportunity to make more money – not at the expense of the fund's investors, but rather alongside them. Unfortunately, this no-asset-management-fee structure is rare in today's hedge fund world. The 2 and 20 structure still prevails, although many funds are starting to go to a 1 and 20 setup.

Types of Hedge Funds

Hedge funds can pursue a varying degree of strategies including macro, equity, relative value, distressed securities and activism. A macro hedge fund invests in stocks, bonds and currencies in hopes of profiting from changes in macroeconomic variables such as global interest rates and countries' economic policies. An equity hedge fund may be global or country-specific, investing in attractive stocks while hedging against downturns in equity markets by shorting overvalued stocks or stock indices. A relative-value hedge fund takes advantage of price or spread inefficiencies. Other hedge fund strategies include aggressive growth, income, emerging markets, value and short selling.

Another popular strategy is the "fund of funds" approach in which a hedge fund mixes and matches other hedge funds and other pooled investment vehicles. This blending of different strategies and asset classes aims to provide a more stable long-term investment return than those of any of the individual funds. Returns, risk and volatility can be controlled by the mix of underlying strategies and funds.

Notable hedge funds today include the Paulson Funds, a group of various hedge funds founded by John Paulson. Paulson became famous after his fund reaped billions from betting against mortgages back in 2008. Paulson has other specific hedge funds, including one that invests solely in gold, for example.

Pershing Square is a highly successful and high-profile activist hedge fund run by Bill Ackman. Ackman invests in companies that he feels are undervalued with the goal of taking a more active role in the company to unlock value. Activist strategies typically includes changing the board of directors, appointing new management or pushing for a sale of the company. Carl Icahn, a well-known activist, also heads up very successful activist hedge funds. In fact, one of his holding companies, Icahn Enterprises (IEP), is publicly traded and gives investors who can't or don't want to directly invest in a hedge fund an opportunity to bet on Icahn's skill at unlocking value.

Regulations for Hedge Funds

Another unique feature of hedge funds: They face little regulation from the Securities and Exchange Commission, especially compared to mutual funds, pension funds and other investment vehicles. That's because hedge funds mainly take money from those "qualified" or accredited investors, high-net-worth individuals who meet the net worth requirements listed above. Although some funds operate with non-accredited investors; U.S. securities laws dictate that at least a plurality of hedge fund participants are qualified. The SEC deems them sophisticated and affluent enough to understand and handle the potential risks that come from a hedge fund's wider investment mandate and strategies, and so does not subject the funds to the same regulatory oversight.

But make no mistake, hedge funds are regulated, and recently they have been coming under the microscope more and more. Hedge funds have gotten so big and powerful (by most estimates, thousands of hedge funds are operating today, collectively managing over $1 trillion) that the SEC is starting to pay closer attention. And breaches such as insider trading seem to be occurring much more frequently, an activity regulators come down hard on.

Five years ago, the hedge fund industry experienced one of the most significant regulatory changes to come along in years. In March 2012, the *Jumpstart Our Business Startups Act* (*JOBS Act)* was signed into law. The basic premise of the JOBS Act was to encourage funding of small businesses in the U.S by easing securities regulation. The *JOBS Act* also had a major impact on hedge funds: In September 2013, the ban on hedge fund advertising was lifted. In a 4-to-1 vote, the SEC approved a motion to allow hedge funds and other firms that create private offerings to advertise to whomever they want, though they still can only accept investments from accredited investors. While hedge funds may not look like venture capitalists, because of their wide investment latitude they are often key suppliers of capital to startups and small businesses. Giving hedge funds the opportunity to solicit would in effect help the growth of small businesses by increasing the pool of available investment capital.

Hedge fund advertising deals with offering the fund's investment products to accredited investors or financial intermediaries through print, television and the internet. A hedge fund that wants to solicit (advertise to) investors must file a “Form D” with the SEC at least 15 days before it starts advertising. Because hedge fund advertising was strictly prohibited prior to lifting this ban, the SEC is very interested in how advertising is being used by private issuers, so it has made changes to Form D filings. Funds that make public solicitations will also need to file an amended Form D within 30 days of the offering’s termination. Failure to follow these rules will likely result in a ban from creating additional securities for a year or more.

Not For Everyone

It should be obvious that hedge funds offer some worthwhile benefits over traditional investment funds. Some notable benefits of hedge funds include:

- Investment strategies that have the ability to generate positive returns in both rising and falling equity and bond markets
- Hedge funds in a balanced portfolio can reduce overall portfolio risk and volatility and increase returns
- A huge variety of hedge fund investment styles – many uncorrelated with each other – that provide investors the ability to precisely customize investment strategy
- Access to some of the world's most talented investment managers

Of course, hedge funds are not without risk as well:

- Concentrated investment strategy exposes hedge funds to potentially huge losses.
- Hedge funds tend to be much less liquid than mutual funds. They typically require investors to lock up money for a period of years.
- Use of leverage, or borrowed money, can turn what would have been a minor loss into a significant loss.

The Bottom Line

A hedge fund is an official partnership of investors who pool money together to be guided by professional management firms, not unlike a mutual fund. Despite this common purpose, hedge fund operations are distinctly different from mutual funds. Compared to mutual funds, hedge funds are less regulated; have more stringent minimum investment requirements; pursue more flexible and potentially risky strategies; and operate with far less disclosure.

The investing purpose of hedge funds is to maximize returns, but managing firms use different strategies to achieve this goal. While they do not have all of the same requirements as other investments, hedge funds still have a prospectus, called the "offering memorandum," which details the specific strategy of the fund, including leverage limits.

Many of the most talented portfolio managers aim to work for mutual funds because of their characteristic fee structures. Not only are management fees higher than those for mutual funds, but hedge funds include additional fees that mutual funds do not assess. Incentive fees based on profits earned can range from 10%-30%, although higher fees have been agreed upon. Hedge fund investors expect very large levels of returns from their managers and often require any losses incurred to be recouped before future profits count towards incentive fees.

In the United States, hedge funds operate under different regulatory guidelines than most other kinds of investment arrangements. The majority of hedge fund investors are "accredited," meaning they earn very high incomes and have existing net worths in excess of $1 million. Since hedge fund participants are considered "sophisticated," these investment vehicles do not receive regulatory oversight from the SEC, and therefore have much greater operational flexibility. For this reason, hedge funds have earned a dubious reputation as a speculative luxury for the rich.

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