FAQ – Module 21

1) SOME OF THESE HEDGE FUND STRATEGIES SEEM PRETTY RISKY. WHY ARE THEY CALLED HEDGE FUNDS IF THEY PRESENT SO MUCH RISK?

I think the following from the early part of Chapter 21 will help solve your dilemma:

"Despite the popular name, some funds do not hedge their positions at all. Therefore, it is best to think of a hedge fund as a type of fund structure rather than a particular fund strategy."

2) WHAT IS A "HOME RUN" IN THE CONTEXT OF THE MARKETS?

A home run in baseball is considered to be a big hit. The expression can be applied to many types of activities, including the markets. When a person strikes out (another baseball analogy), it means the person has lost money or made no money on a trade. A home run is the opposite - the person made a lot of money from a trade.

3) WHAT ARE PRO-FORMA RETURNS?

Pro forma means that the results presented are based, in part, on assumptions rather than actual fact. That means the results presented are, at best, hypothetical. The term is most often associated with financial statements where the data provided is done in advance of the actual fact, meaning the information presented is based on hypothetical information.

4) HOW DO YOU DEFINE A SOPHISTICATED INVESTOR?

As the text mentions, an investor must be classified as an accredited investor or sophisticated investor to buy hedge funds.

The provincial securities commission defines who qualifies as an accredited investor or sophisticated investor. To find the definition of accredited investor or sophisticated investor, you need to check with the securities commission for the province in which you reside. However, most definitions are based purely on the wealth of the investor (for example, the investor combined with spouse must have financial assets exceeding a specified dollar amount), and the investor's net income (for example, the investor combined with their spouse must have at a net income exceeding a specified dollar amount in each of the last two years).

5) I THOUGHT THAT A CLOSED-END FUND COULDN'T REDEEM UNITS FROM INVESTORS?

The text states the following: "Closed-end funds are pooled investment funds that issue a limited or fixed number of shares. The number of shares or units in closed-end funds remains fixed, except in rare cases of an additional share offering, share dividend, or share buy-back."

"Funds that have the flexibility to buy back their outstanding shares periodically are known as interval funds or closed-end discretionary funds. They are more popular in the United States. In Canada, closed-end funds may also be structured with buyback or termination provisions."

So closed end funds indeed have the capability of redeeming shares from investors based on certain conditions. What separates closed end funds from open-end funds is that open-end funds continuously redeem units (i.e., every business day of the year, with little or no exception).

6) CAN YOU PLEASE EXPLAIN THE HIGH WATER MARK AND HURDLE RATE AND PROVIDE AN EXAMPLE?

The hurdle rate is an additional limitation on when a manager can collect an incentive fee. For example, if you insist that the manager can collect incentive fees only after 5% of new profits, you are describing both a high water mark and hurdle rate. In other words, if the manager does not turn any new profits, there are no incentive fees paid at all. If the manager does turn a profit, incentive fees would be paid only if a particular performance has been achieved.

So if the high water mark isn't reached, no point in discussing incentive fees. If the high water mark is reached, the manager must exceed a particular % gain before receiving any incentive fees.

The hurdle rate acts as a means of targeting a particular gain per year for which a manager must strive. Think about the following scenario that excludes a hurdle rate:

Suppose the manager has $500 million under management and will receive performance fee of 15% on new profits. In the first year, the fund increases in value to $501 million.

That leads to an incentive fee of $150,000. Pretty good for a year's work, even though the fund increased in value by only 0.20%. So the next year, the fund increases in value to $502 million and the manager receives an incentive fee of $150,000 again, even though the fund increased in value by only 0.199%. Not much motivation to make the assets grow when even just a small gain can provide a large incentive fee.

But see what happens now if there is a hurdle rate of 5% before the manager can collect incentive fees. If the fund started at $500 million, the fund would have to increase to $526 million in order for the manager to collect the same $150,000 incentive fee in the first year. The hurdle rate is a great way to target a return on the fund.

7) WHAT IS A BENCHMARK?

A benchmark is used for performance comparisons. For example, the return generated by a portfolio manager who invests in large-cap Canadian equity stocks may be compared to the S&P/TSX composite index. The index is the benchmark against which the portfolio is compared.

8) WHAT IS LOW CORRELATION?

Low correlation would be a value close to zero, meaning there is no specific relationship between the hedge fund and the market to which the fund is compared - i.e., the returns produced by the hedge fund are independent from the performance of market to which the fund is compared. A number close to negative one would be a high negative correlation and would mean that as the market moves in one direction, the hedge fund moves in the opposite direction without fail.

9) IN A MERGER ARBITRAGE, WHY WOULD ONE COMPANY'S STOCK RISE WHILE THE OTHER FALLS?

Typically in an acquisition, the company to be acquired experiences an increase in stock price (makes sense since an acquisition price is generally higher than the current market price of the stock, so the price creeps higher).

At the same time, many view the acquiring company as being at a disadvantage for increasing in size, possibly diluting shareholder equity, and taking on more debt, etc. This can be a negative for the company and they may experience some downward price pressure.

10) IN A LONG/SHORT EQUITY STRATEGY, HOW CAN THE INVESTOR MAKE MONEY IN BOTH MARKET DIRECTIONS?

If expected to make a profit under all market conditions, the hedged component would presumably profit in a rising market if the longs increase more in value than the shorts fall in value. In a falling market the hedged component would presumably profit if the shorts increased in value more than the longs fell in value. This kind of circumstance depends on the ability of the manger to select the right stocks.

One would definitely not make a directional bet unless there was a definite belief in market direction.

11) IN THE LONG/SHORT EQUITY EXAMPLE IN THE TEXT, WHY WOULD THE PORTFOLIO DECLINE BY ONLY 8% IF THE MARKET FELL BY 20%?

Please look at the example again in the text. Notice that the manager invests $600 long in General Motors and $600 short in Ford Motor Company. The manager makes a further directional bet in the amount of $400 on General Motors. Based on this, the Net Exposure is:

($1,000 - $600) / $1,000 = 40%

When the market falls by 20%, the drop in the price of Ford theoretically leads to a short sale profit that eliminates the loss on $600 of the stock invested in General Motors. That leaves another $400 (or 40% based on the formula) exposed in the market.

If the market falls by 20%, the $400 is reduced to $320 (an $80 loss). Based on the formula in the text, this $80 loss represents an 8% decline.

Or, as the text states, if the market declines by 20%, the overall fund's exposure to this decline would only be 40% of the market decline, or 8%.

What if the market went up in price? Since the $600 long stock is cancelled out by the $600 short stock, the only exposure to the market rise is the remaining $400 in General Motors. If the market rises by 20%, the $400 increases to $480. Based on the formula in the text, this $80 gain represents an 8% increase.

12) DON'T SIMULTANEOUS LONG AND SHORT POSITIONS IN A STOCK RESULT IN THE INVESTOR NOT OWNING ANYTHING AT ALL?

Taking a long and short position simultaneously means you are creating a long position at the same time that you are creating a short position. The long and short stocks, however, are different companies. To take a long and a short position in the exact same stock cancels each other out. No matter what the market does, you wouldn't make any money at all.

13) WHAT DOES NET EXPOSURE REFER TO?

Net exposure refers to how much you are participating in a market and in what way.

For example, if you have nothing but long stocks in your portfolio, your net exposure is 100% long. In other words, you are fully exposed to market influences - as the market rises or falls, in theory, you will participate 100% in that market move.

If you have nothing but short stocks in your portfolio, your net exposure is 100% short. In other words, your are fully exposed to market influences - as the market rises or falls, in theory, you will participate 100% in that market move.

If you have 50% of your portfolio value in long stocks and 50% of your portfolio in short stocks, you have no net exposure, because the two positions cancel each other out.

Whether the market goes up or down, in theory, your portfolio should remain unchanged.

There is a formula for net exposure that you can examine in Chapter 21 of your text.

14) WHAT ARE "FUND OF FUNDS"?

"Fund of funds" is the generic term for a fund that invests in other funds, rather than in individual securities. There are plenty of mutual funds out there that are structured as a fund of funds, where the mutual fund invests exclusively in other mutual funds. One might also find a hedge fund that invests exclusively in other hedge funds, rather than implementing strategies with individual securities.