Glossary

absolute-return fund An absolute-return fund attempts to perform positively for investors regardless of general direction or market conditions by investing in a range of long and short positions with low correlation to the markets. An absolute-return fund measures the gain or loss of the portfolio as a percentage of capital invested.

ABX ABX, also known as the asset-backed securities index, is a credit derivative that has asset-backed securities underlying it.

accredited investor Rule 501 or Regulation D of the Securities Act of 1933 defines an accredited investor as any of the following:

- A bank, insurance company, registered investment company, business development company, or small business investment company.
- An employee benefit plan, within the meaning of the Employee Retirement Income Security Act, if a bank, insurance company, or registered investment advisor makes the investment decisions, or if the plan has total assets in excess of $5 million.
- A charitable organization, corporation, or partnership with assets exceeding $5 million.
- A director, executive officer, or general partner of the company selling the securities.
- A business in which all the equity owners are accredited investors.
- A natural person who has individual net worth, or joint net worth with the person's spouse, that exceeds $1 million at the time of purchase.
- A natural person with income exceeding $200,000 in each of the two most recent years or joint income with a spouse exceeding $300,000 for those years and a reasonable expectation of the same income level in the current year.
- A trust with assets in excess of $5 million, not formed to acquire the securities offered, whose purchases a sophisticated person makes.

administrator A service provider hired by an investment manager to calculate performance and net asset value for the fund, perform record-keeping functions, perform fund accounting, act as transfer agent, and maintain all books and records for the fund manager.

alpha The premium investment return of an investment over a benchmark index such as the S&P 500. Positive alpha indicates that the investment manager has earned a premium over the index and returns are driven by the manager, not the index. The stronger the investment results relative to the index, the stronger the management team and research process of the investor.

alternative assets Alternative assets include any nontraditional investments that would not be found in the standard investment portfolio. Alternative assets include hedge funds, private equity funds, real estate partnerships, forestry investments, and oil and gas partnerships.

arbitrage An investment strategy that attempts to exploit the price difference between the same or similar financial instruments, commodities, or currencies. An arbitrageur may buy a contract for crude oil in the New York market at a lower price and simultaneously sell it in the Chicago market at a higher price.

assets under management (AUM) Assets under management includes all investments that are managed by a fund manager to gauge the amount of fund balances.

average annual return (annualized rate of return) Cumulative compounded gains and losses divided by the number of years of a fund's existence.

average rate of return Sometimes referred to as ROR, the average return of investment over a fixed period of time. ROR is used to compare returns on investments over a period of time, and is usually expressed on an annualized basis.

back testing Back testing uses historical data to evaluate past performance results. Often referred to as a hypothetical portfolio, it simulates investment returns over a past period of time to determine the performance outcome if the strategy had been followed in the past.

basis points One basis point is 1/100th of a percentage point or 0.01 percent. Conversely, 100 basis points (bps) is 1 percent.

bear market A market that is characterized by a period of falling prices that may last from several months to several years.

beta The measure of volatility or risk of a security or portfolio in comparison with an index. Beta represents the percentage change in the price given a 1 percent change of the index. The higher the beta, the higher the risk. A beta of 1.0 indicates that the asset follows the index, whereas a beta less than 1.0 indicates that the asset has lower volatility.

black box A computer program in which a series of inputs are processed using preprogrammed logical procedures to return an output. This output is then used by traders to determine whether to buy, sell, or hold a security. A black box is an integral part of any quantitative strategy fund.

Bloomberg terminal A proprietary software and hardware system that enables its users to view and analyze market data movements and securities trades in real time.

bull market A market that is characterized by a period of rising prices that may last from several months to several years.

Calmar ratio Used to determine return on a downside risk-adjusted basis. It can be computed by dividing the compounded annual return by the maximum drawdown (*see* **Drawdown**).

cap and trade A system to provide economic incentives for firms to reduce emissions by allowing their reductions to be converted to and traded as credits in given emissions markets.

capital structure arbitrage Consists of investors profiting from a pricing inefficiency within the capital structure of a single firm. For example, an investor can go long convertible bonds and short the underlying common stock.

carbon emissions trading A cap and trade system particular to carbon dioxide emissions.

CDX CDX, also known as the credit default swap index, is a credit derivative that represents a basket of credit securities pertaining to various credit entities. The CDX index contains only companies from emerging markets and North America.

clearing The process of reconciling transactions between a fund manager and broker dealers and the prime broker after trades have been entered, executed, and settled involves the process of clearing.

collateralized bond obligation (CBO) A structured credit product backed by high yield bonds placed into separate tranches, with corresponding credit ratings—senior tranches, mezzanine tranches, and equity tranches. Losses flow upstream from the junior tranches into the senior tranches; therefore, the riskier lower tranches offer higher coupon rates (*see* **coupon rate**).

collateralized debt obligation (CDO) A structured credit product backed by fixed-income assets, including pools of bonds, loans, and other assets, placed into separate tranches, with corresponding credit ratings—senior tranches, mezzanine tranches, and equity tranches. Losses flow upstream from the junior tranches into the senior tranches; therefore, the riskier lower tranches offer higher coupon rates (*see* **coupon rate**).

collateralized loan obligation (CLO) Similar to a collateralized debt obligation with the difference being that in the case of the CLO, only loans are packaged into the security.

commodity trading advisor (CTA) A person or entity that provides expert advice to investors on investments in commodity futures, options, and foreign-exchange contracts is referred to as a CTA.

compounded average growth rate (CAGR) The year-after-year growth of an investment for a specified period of time.

coupon rate The term used to describe the interest rate on a bond when it is issued. The name originates from the fact that some bonds have actual coupons attached to them that can be removed and used for redemption of interest payments.

credit crunch An abrupt reduction of the availability of loans or a sharp increase in the cost of loans.

credit default swaps A credit derivative that involves two counterparties. Party A makes periodic payments to party B, and in exchange, party A has the promise that if a third party, party C, defaults, party A will receive the full payoff from party B. Therefore, party A is said to be the "buyer" of credit protection and party B is the "seller" of credit protection. Party C is referred to as the "reference entity." Credit default swaps are used to hedge credit risks when making loans.

custodian A bank, trust company, or other financial institution that holds the fund assets and provides other services, including receiving funds from investors, distributing redemption proceeds, providing safekeeping services, and reporting fund transfers.

delta The ratio that illustrates how the change in the price of an asset affects the price of an option. For example, if a call option has a delta of 0.5, an increase of $1 in the price of the asset will result in an increase of $0.50 in the price of an option. Conversely, for a put option, a delta of 0.5 followed by an increase in price of the asset of $1 would result in a decrease in the price of the option of $0.50.

derivative A financial instrument that is valued based on the underlying value of another security or benchmark index. Derivatives include options, credit default swaps, futures, interest rate swaps, and interest rate caps and floors.

diversification A portfolio strategy that is structured to add investment positions to lower portfolio volatility and reduce exposure to reduce the upside and downside volatility.

drawdown The amount of decline from the prior peak return level of the fund.

due diligence A process that describes the research of a manager and the strategy used by an investor that involves the performance results and operational procedures of an investment partnership and investment team. While the term originated by broker/dealers for business transactions, it refers to the overall detailed review of a hedge fund strategy and activity to ensure that the fund manager complies with the marketing documents and legal documents governing the fund and strategy.

emerging markets Emerging economies in countries that are developing and becoming mature. The term refers to developing economies including Russia, Mexico, Brazil (and Latin America in general), India, China, much of Southeast Asia, and Eastern Europe.

enterprise risk The risk associated with the creation and management of young businesses and their transition from start-ups to more mature companies.

equity market neutral An expression used to describe a strategy that is free from any market risk in the equity markets to which it could have exposure.

event-driven A type of strategy in which the manager invests in stocks of companies that are termed "special situations," such as in distressed, in the process of being acquired.

exposure The extent to which an investment has the potential to change based on changes in market conditions. In hedge funds, exposure is measured on a net basis. Net exposure takes into account the difference between the long positions versus the short positions. For example, if a fund is 150 percent long and 65 percent short, the net exposure would be 85 percent. Gross exposure takes into consideration the total exposure, such as 235 percent gross in the preceding example.

fair value The price at which a security would trade between parties.

financing risk The likelihood of a loss based on the duration of the repayment period.

forward contract An agreement in an over-the-counter derivative instrument that requires one party to sell and another party to buy a specific security or commodity at a preset price on an agreed-upon date in the future. The forward price of the contract is contrasted with the spot price, which is the price of the asset at the spot date.

fund of funds An investment fund that implements an investment strategy that invests in other hedge funds or other investment vehicles to provide portfolio diversification for a wide range of investors. Generally, a fund of funds does not own securities directly.

futures contract An agreement to buy or sell a specific amount of a commodity or security at a specific date in the future.

gamma Measures the rate of change of delta with respect to the price of the underlying asset.

general partner The general partner is one or more individuals or a firm that operates, develops, and runs a limited partnership and is responsible for the debts of the partnership.

haircut A percentage that is subtracted from the value of an asset used as collateral in order to reflect the perceived risk associated with holding the asset.

hedge fund A global term used to describe investment vehicles that are exempt from registering under the Securities Act of 1940.

high water mark A reference in the offering documents that provides for the manager to earn an incentive fee only after the fund's performance surpasses its highest net asset value from the prior period.

hurdle rate A minimum rate of return that the fund must achieve before the fund manager receives an incentive (performance) fee. The hurdle rate may be a fixed rate such as LIBOR or the one-year Treasury bill rate plus a fixed spread of basis points.

incentive fee (performance fee) A fee that a fund manager receives that depends on profits generated in the portfolio. The compensation fee is generally 20 percent of all profits over a fixed level.

inception date The specific period on which a fund begins trading.

internal rate of return (IRR) The annualized compounded rate of return that an investment could potentially earn, based on past performance.

leverage The amplification of results, either negative or positive, through the use of borrowed funds or debt creation.

limited liability company (LLC) A legal structure often used by investment partnerships in which the owners of the LLC receive limited personal liability for operating the business.

limited partnership A business organizational structure in which the general partner manages the business, assumes the legal obligations for limited partners, and receives the economic benefit of the business for the benefit of the limited partners, who receive the cash flow but have no corporate or legal obligations.

liquidity The ability of an investment to be sold or converted to cash without dramatically affecting its price in the market. Liquidity varies according to market conditions, size of the position, and the historic trading volume of the security.

lockup The term for which an investor must maintain an investment in the fund until the first period before redemption is permitted. Initial lockups generally are for one year but may range as long as five years for some specific-purpose hedge funds.

long position A position of an investor who buys a security (or derivative) and expects the value of the security to rise in price.

management fee The fee that investment partnership investors pay to the investment manager to offset the operating expenses of the underlying fund. The annual fee generally ranges from 1 percent to 2 percent of the investor's capital account balance in the fund and is usually collected on a quarterly basis.

margin call The order from a broker/dealer for an investor that is using margin in a securities account to provide additional monies or securities to bring the account up to the minimum maintenance level required by the lending firm. It also may be called a house call or maintenance call.

market neutral A strategy that seeks to reduce risk exposure to the market index. Also referred to as zero beta, the strategy seeks to achieve a return that is a spread to an index, such as Libor, by hedging long positions and will have no correlation to the underlying index. This term is often misused as the strategy should be long and short equal levels of market capitalization, sectors, and industry positions to be judged market neutral for an equity strategy.

mean reversion A method for investing in stocks whereby the mean price at which a stock is traded is calculated. The investors then either purchase additional stocks when they are priced below the mean price or sell stocks when they are priced above the mean price.

minimum investment The smallest amount that an investor is permitted to invest in a hedge fund as an initial investment. Minimum investment requirements generally range from $500,000 to $5 million.

net asset value (NAV) The market value of a fund's total assets.

net exposure The percentage of a portfolio's assets invested in long positions minus the percentage of a portfolios assets invested in short positions. For example, if a portfolio is 80 percent long and 40 percent short, net exposure will equal 40 percent (80 – 40).

offshore fund A private investment company open to a limited range of accredited investors that is set up outside of the United States, generally in an offshore financial center such as the Cayman Islands. It is available for investment to non-U.S. citizens or non-U.S. taxpayer entities such as foundations and endowments. These offshore domiciles offer significant tax benefits for eligible investors.

onshore fund A private investment partnership that is open to a limited range of accredited investors set up in the United States. Available for investment to U.S. citizens only.

operational risk The risk associated with a company's operations; it is not inherent in either financing risk (*see* **financing risk**) or systemic risk (*see* "Systemic risk"). It can be thought of as the risk associated with a business that is failing due to human incompetence.

option A contract that gives parties the right to buy or sell a specific asset or security at a specific strike price at a specific future date.

performance fee A fee paid to the investment manager that is based on the increase in net asset value of the underlying fund. Performance fees are generally 20 percent of the increase of NAV and are assessed annually.

PerTrac (PerTrac Financial Solutions, LLP) A commercially available service that provides an investment platform for portfolio analytics for hedge fund and traditional long-only investment.

poison pill A strategy used to increase the likelihood of negative results for an investor that attempts a takeover of a company.

portfolio risk The overall risk presented by the securities in which a portfolio's assets are invested.

prime broker A reference to the full range of investment services provided by an investment bank or commercial bank to hedge funds. It includes operational services, trading, reporting, securities lending, technology support, and financing.

private-equity fund A pooled fixed-life investment vehicle that makes equity or debt investments in companies, with a management fee and carried interest paid to the management company.

private placement memorandum (PPM) A document that sets forth the offering term for the fund and includes all business terms such as fees, restrictions, and a detailed description of the investment strategy.

pro forma (from the Latin, meaning *for the sake of form*) A method of describing projected figures for a current or future investment. It is important to remember that pro forma figures are estimates and do not satisfy generally accepted accounting practices (GAAP) rules.

quantitative analysis Security analysis that uses objective statistical information to determine when to buy and sell securities.

quantitative fund A hedge fund that employs solely quantitative analysis and models to decide how to allocate and trade its assets and securities respectively.

quantitative model A model that utilizes numerical information to determine whether a security is attractive (*see* **black box**).

redemption The sale of all of an investor's interests in a fund.

redemption fee A fee often imposed by a hedge fund manager if the redemption occurs before the end of the first redemption period.

redemption notice period The official notice period that an investor must provide to the hedge fund manager before withdrawing the investment from the fund.

Regulation D (Reg D) A Securities and Exchange Commission (SEC) regulation concerning private placement exemptions; it allows companies to raise capital through the sales of equity or the creation of debt, without the need to register any of these securities with the SEC.

repurchase agreements Also known as repos or RPs, repurchase agreements occur when a seller sells a security for cash by agreeing to repurchase it at a premium at a later date.

rho A measurement of the rate of change in the price of a derivative relative to a change in the risk-free interest rate.

risk arbitrage A practice whereby investors bet on potential mergers or acquisitions of companies by shorting the stock of the acquirer and going long the stock of the potential target, hoping that if the transaction takes place, the acquirer's stock will fall and the target company's stock will rise.

Section 3(c)(1) A provision in the Investment Company Act of 1940 that permits hedge funds to have less than 100 investors, provided all investors are qualified purchasers, and allows the exclusion of the funds from registration with the SEC.

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Sharpe ratio Developed by Nobel Laureate William Sharpe, the ratio measures the reward of a portfolio's excess return relative to the volatility of the portfolio. It represents the absolute return less the risk-free interest rate divided by the standard deviation of returns.

short selling The practice of borrowing a stock, selling it at a high market price, hoping that the market price will decrease and, thus, the stock can be repurchased at a lower price and returned to its original owner. The difference is then pocketed by the short seller. Nowadays, it is possible to short sell by using options that enable the exerciser to sell options at a strike price which, if higher than the market price, will enable the short seller to profit.

short-sell rule A regulation created by the Securities and Exchange Commission (SEC) that prohibited short sales from being placed on a downtick in the market price of the shares. In July 2007, this rule was changed, enabling short sales of securities on any price tick in the market.

standard deviation A measure of the dispersion of a group of numerical values from the mean and indicates the level of portfolio volatility. The higher the number, the higher the level of volatility. It is a basis of comparison of volatility of different investment strategies.

statistical arbitrage An opportunity for investors to profit from price mismatch between securities identified through the use of sophisticated mathematical modeling techniques. StatArb, as it is often abbreviated, involves very short holding periods and a large number of securities traded, as well as a powerful IT infrastructure.

style drift A term used to describe manager behavior that consists of a divergence from the manager's initial investment style.

survivorship bias The tendency of mutual fund companies to drop their worst performing mutual funds, resulting in a better track record and a distortion of the data used to describe past performance.

systemic risk The risk presented by the market itself; it impacts all securities encompassed in that particular market.

theta Measures the rate of decrease in the value of an option as time passes.

traditional investments Products whose performances are correlated with broad stock market or fixed-income markets.

treynor ratio Measures returns earned in excess of those that could have been earned on a riskless investment per unit of market risk. It is calculated by subtracting the average return of the portfolio and subtracting the risk-free rate and then dividing the answer by the beta of the portfolio.

vega A measure of how sensitive the price of an option is compared to a 1 percent change in implied volatility. It is the derivative of the option price with respect to the underlying asset.

VIX The ticker symbol for the Chicago Board Options Exchange Volatility Index, often used as a measure of the S&P 500 Index options.

Wilderhill Clean Energy Index An index used as a benchmark for investments in the alternative energy space.

GLOSSARY SOURCES

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Hedge Fund Alert Glossary: www.hfalert.com/NewPagesIndex.cfm?Article_ID=61250

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Venture Japan—Hedge Fund Glossary of Terms: www.venturejapan.com/index.htm