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**Hedge Funds**

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## Introduction

In recent years, hedge funds have grown dramatically in popularity, both with individual and institutional investors. This growth in popularity can be attributed to many different factors, including the growth of wealth among individuals in the last ten years, investor's ever-expanding desire for new investment alternatives and the need to further diversify their portfolio beyond traditional investment approaches. As such, it is vital that you as a financial advisor are empowered with a sound understanding of how hedge funds operate and the potential advantages they can provide. This course will equip you with a clear understanding of hedge funds and an enhanced ability to engage clients in a discussion and analysis about the potential efficacy of investing in hedge funds. Specifically, this course will address the following objectives.

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| Objective  At the conclusion of this module, you should be able to:   * What is a hedge fund? * The history of hedge fund investing * The benefits of investing in hedge funds * Key issues investors should consider before investing in hedge funds * The legal structure of hedge funds and accredited investor requirements * Common investment strategies employed by hedge funds |

## What is a Hedge Fund?

The first real question to answer is, "What is a Hedge Fund?" In many respects, hedge funds are very similar in nature and structure to mutual funds or Common Trust Funds in that they are all pooled investment vehicles managed under a specific investment mandate. The major difference in a hedge fund is its legal structure. Hedge funds are private investment partnerships and, as such, are not subject to regulation by the SEC. Because hedge funds are not subject to oversight by the SEC, they are able to employ more diverse investment strategies than traditional investment vehicles.

One of the easiest ways to help clients understand hedge funds is to compare them to traditional pooled investment vehicles (such as Mutual Funds, Common Trust Funds, etc.) The chart below gives a detailed comparison of hedge funds and traditional pooled investment vehicles. Keep in mind that these are general comparisons and will not always hold true. For example, some traditional investments do use short interest.

**Comparison of Investment Vehicles**

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|  | **Hedge Funds** | **Traditional Investments** |
| **Return Objective** | Absolute Returns | Benchmark Relative Returns |
| **Correlation to Market Indices** | Low Correlation | High Correlation |
| **Use of Leverage** | Uses Leverage | Prohibited from Using Leverage |
| **A Use of Short Interest** | Able to Short Securities | Long Only/Unhedged |
| **Degree of Regulation/Oversight** | Limited Regulatory Restrictions | High Degree of Regulation |
| **Transparency** | Limited Disclosure | Total Transparency |
| **Liquidity** | Limited Liquidity | Total Liquidity |
| **Fees** | Asset Based and Incentive Fees | Asset Based Fees |
| **Ability for Manager to Invest in the Fund** | Allowed | Not Allowed |

## Don't Confuse "Hedge" Funds with "Hedging"

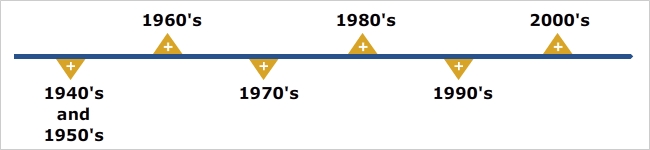
The confusion that many have in understanding hedge funds is often the result of the dual use of the term "hedge" in reference to the legal structure of the entity versus the strategy of "hedging". Hedging as an investment strategy implies the use of leverage in some form to either expose or protect a portfolio from market or security movements. Most typically, hedging refers to a long position in a portfolio with a component in a short position to protect the assets from downside risk. However, just as the terms "Mutual Fund" or "Common Trust Fund" do not accurately describe the strategies applied in all of these vehicles, the term "hedging" does not necessarily reflect the strategy employed in all hedge funds. In fact, there are some hedge funds that do not use any hedging strategies at all. Simply put, Hedge Funds are little different from Mutual Funds in that they are pooled investment vehicles. The primary differences are:

* Hedge Funds are Private Placement offerings organized as Limited Partnerships or Limited Liability Companies
* Hedge Funds can only be offered to a limited number of "Accredited Investors" and/or "Qualified Purchasers"
* Hedge Funds are not regulated by the SEC
* Hedge Funds are granted more investment management flexibility

One of the most significant challenges in positioning hedge funds with clients is educating them on what a hedge fund is. Often, individuals will confuse "hedge funds" with "hedging."

## The History of Hedge Fund Investing

Hedge funds have become increasingly popular over the past 10 years, experiencing tremendous growth in both the number of investors participating in hedge funds and the number of hedge funds offered in the marketplace. In fact, it is estimated that nearly $1 Trillion are currently invested in hedge funds. However, while their popularity has boomed in recent years, hedge funds have been in existence for a long period of time. **Click each date to learn more.**



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| **1940's and 1950's**  The first hedge fund in the United States was formed in 1949 by Alfred Jones, who started an equity fund organized as a limited partnership. |

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| **1960's**  Hedge funds became increasingly popular as managers sought a vehicle that would enable them to use leverage in the portfolio to take advantage of the bull market. |

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| **1970's**  Many of the leveraged funds from the 1960's were decimated by the bear market of the early 1970's. |

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| **1980's**  Through the 1980's, only a few new hedge funds were formed, raising money from wealthy investors primarily through word-of-mouth marketing. However, the extraordinary performance of Julian Robertson and George Soros drew tremendous attention during this period. |

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| **1990's**  Hedge funds regained their popularity, luring many top managers away from equity trading desks and mutual funds companies. This increased both the number of funds offered and the tenacity with which they were sold. |

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| **2000's and beyond**  Today, hedge funds have become an increasingly well-known and popular investment vehicle for both wealthy investors and institutions. In fact, it is estimated that institutions account for nearly 30% of the assets invested in hedge funds today. |

## General Features and Advantages of Hedge Funds

Now that we have given a general overview of what hedge funds are, let's examine a few of the advantages hedge funds can offer investors. Click each advantage to learn more.

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| Shorting Securities |
| Previous to the National Market Securities Improvement Act of 1996, mutual funds were prohibited from selling securities short. While this Act repealed that restriction, very few mutual funds employ this strategy. On the other hand, hedge funds tend to use it more frequently. "Shorting" is the act of selling something you do not own, which creates a "short" position in the fund portfolio. It is accomplished by borrowing a security to deliver against the sale, with the expectation that the security will drop in value, allowing the fund to buy it back in the open market at a lower price and cover the debt with the "cheaper" security. Shorting allows the fund to generate positive returns, even in a bear market; but it also introduces an element of risk because prices could increase, requiring short positions to be covered at higher prices. It should also be noted that shorting rules, i.e., selling short only on an uptick, must be followed by hedge funds just as with any other investors.  Another common use for a short position in a hedge fund is to offset the "systematic risk" (i.e. general market exposure risk) of a corresponding long position. Systematic risk is risk related to the portfolios general exposure to the market itself. In simplistic terms, having a portfolio that is 50% long, with a corresponding 50% short position, the portfolio has a market neutral stance and is not as susceptible to the direction of the market itself. However, the portfolio still has the potential to generate positive returns because of the movement of its individual holdings. This can allow the manager to lower the general risk profile of the fund while maintaining the ability to generate returns. |
| The Ability to Use Leverage |
| Leverage occurs when a manager establishes total positions in the fund that exceed the total value of the funds assets. The primary way of establishing this excess exposure is through the purchase of futures, options or commodities. All of these instruments are derivatives, meaning that their value is based on another underlying security or asset such as a bond, stock, or index. Because these instruments allow a manager to establish an exposure to the underlying security without having to directly buy the security itself, the manager is able to establish full exposure to the asset or security with a smaller upfront dollar commitment. If prices move as anticipated, this strategy may produce incrementally higher rates of return than in a portfolio owning the underlying asset itself, just as purchasing securities on margin can leverage an individual's portfolio. Likewise, it introduces increased risk because of the leverage that is being employed. |
| Greater Concentration |
| In many hedge funds, the manager has expertise in a specific niche of the market. Because of the limited size of hedge funds, in comparison to mutual funds, the manager may achieve greater concentration in that particular niche. Allowing the manager to narrow his/her focus, seems to provide even greater knowledge and understanding of that particular segment of the market. But consider that greater concentration can also concentrate the risks. |
| Greater Flexibility |
| Hedge Funds generally afford the portfolio manager greater flexibility than Mutual Funds in managing the portfolio. Specifically, Hedge Funds can use leverage and sell short, and are not subject to the diversification restrictions imposed on Mutual Funds. In addition to being subject to less burdensome regulatory requirements, Hedge Funds are typically smaller than Mutual Funds, enabling the mangers to react more quickly to changes in the market. But take heed and realize that if improperly utilized, shorting, leveraging, and less regulation can increase risk to the investor. |
| Performance-Based Fees |
| Unlike regulated funds, hedge fund managers can have their fees tied to the performance of the fund. This has lured a number of the most successful managers in the country to the hedge fund management industry. For successful managers, this provides substantial earnings potential in excess of that which is available from traditional fund management; therefore, some contend that hedge funds tend to attract the best and brightest managers. Others note that this can create incentive for the manager to take on higher risk. |
| Adaptability to Changing Markets |
| The ability for managers to utilize a full complement of investment techniques and securities allows them the ability to be much more nimble and creative in their pursuit of investment returns. The use of leverage, shorting and other derivative instruments are not always available to managers in traditional investment vehicles, which can limit their return potential, especially in a bear market.  Do note that as we will discuss later in this course, there are many types of hedge fund strategies. The ability of a manager to generate investment returns is dependent upon their strategy and their skill in adapting to various market environments. There is never a guarantee of positive returns in any strategy, inclusive of hedge. |

## Key Benefits of Investing in Hedge Funds

As outlined previously, hedge funds allow managers greater latitude and flexibility in the strategies they can employ in managing the funds. However, discussing these features can often lead to the client becoming confused and/or turned off by what they may perceive to be a highly risky approach. It is important, therefore, that you focus first on communicating the key benefits hedge funds may offer. **Click each key benefit to learn more.**

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| Potential for Higher Returns |
| Because hedge funds are granted the ability to utilize a wider range of investment strategies, including the use of leverage, they have the **potential** to generate higher returns than traditional investment approaches. This **potential** for higher returns has been a strong lure for many investors. Prompted by stories from others detailing dramatic returns from hedge funds, many investors have sought those same rewards. However, just because this flexibility provides the **potential** for increased returns does not mean that all hedge fund investments will be effective. It is important that investors be very careful in conducting due diligence when selecting a hedge fund. In this analysis, it is important to also understand that hedge funds are not held to the same level of disclosure requirements as traditional investments, so this due diligence can be more difficult in many instances. |
| Increased Diversification Potential |
| The more quantifiable reason, and the more prudent basis for making an allocation to a hedge fund, is the potential for increased diversification. A study by Duke University found that over half of all mutual funds had a correlation to the market of greater than 75%, while, in contrast, over half of all hedge funds have a correlation to the market of less than 25%. This study is clear evidence that by investing a portion of a portfolio in hedge funds, investors are able to achieve higher levels of diversification in their overall portfolio. |

The following pages provide more detailed information on these two key benefits offered by hedge funds.

## Hedge Funds: Greater Flexibility Can Translate into Greater Return Potential

As defined previously, one of the reasons for investing in hedge funds is the increased return potential that they offer relative to traditional pooled investment vehicles. The chart below clearly illustrates that equity hedge funds have historically outperformed the S&P 500 by a wide margin, this during a period when a vast majority of equity funds underperformed relative to this benchmark.

Although historical returns can be important indicators as to the effectiveness of a particular investment strategy, past performance alone is not enough to substantiate making a commitment to a hedge fund. It is vital that investors understand the approach the manager uses to generate the returns in the portfolio. While there are countless investment approaches being employed in managing hedge funds today, it is important that you be able to give potential investors a clear understanding of how the greater investment flexibility afforded to hedge funds can translate into greater return potential. It is also important that individual investors take note that hedge funds often seek realized gains to maximize pre-tax rates of return without consideration of the taxable nature of the returns.

To help you in explaining this benefit to clients, consider the following examples.

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| **Explaining Flexibility to Clients: Example 1**  In the late 1990's, traditional equity managers, with restrictions on their ability to use leverage, could only seek to pick the best stocks to participate in the bull market, while hedge fund managers often used leverage in their portfolios to generate higher rates of return. Likewise, when market conditions deteriorated, hedge funds could employ a wider range of strategies than traditional investment vehicles to protect, and even grow, capital. While traditional managers could only increase their cash position to preserve capital, hedge fund managers had the flexibility to use the market decline as an opportunity, establishing short positions to further protect capital and potentially produce positive returns in the portfolio.  Note that while any hedge fund manager had the flexibility to use shorting and other investment strategies during a bear market, this does not mean they actually did so or were always effective when they did. Just as with any investment strategy, the returns are directly related to the strategy being used in the hedge fund itself, as well as the skill of the manager in implementing the strategy. There is never a guarantee of a fund delivering positive returns or protecting capital in any market environment. |

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| **Explaining Flexibility to Clients: Example 2**  Although all hedge funds are afforded the same degree of investment flexibility, it is important to keep in mind that all hedge fund managers are not equal. No different from the fact that all mutual funds do not produce the same return profiles, hedge funds managers returns also vary dramatically. They have the flexibility to produce returns through various strategies not available to traditional portfolio managers, but they still have to accurately predict when to employ each strategy to add value.  Increased Return Potential Bar Chart   |  | | --- | | **Fat tails**  Fat tails are a product of kurtosis, a pattern of return distributions characterized by outlying returns that are infrequent in occurrence but extreme in magnitude. A fund susceptible to kurtosis can appear deceivingly attractive based on traditional risk management analysis (i.e., the fund may exhibit high returns with low standard deviation, despite being prone to a singular massive negative return). Fat tail risk is especially relevant to hedge fund return patterns, as the very characteristics that have allowed the asset class to outperform traditional investments over time – the ability to short, to use leverage, to take positions in illiquid securities – have correspondingly made managers more vulnerable to spectacular losses experienced over very short periods. |   Source: Van Hedge International |

## Hedge Funds: Low Correlation, Greater Diversification

Another key benefit hedge funds can offer is the potential to achieve greater portfolio diversification. Institutional and individual investors alike are seeking ways to further diversify their portfolios and optimize performance. Hedge funds typically have extremely low correlations (the lower the correlation coefficient, the more diversification potential) relative to traditional approaches and standard benchmarks, making them a highly effective strategy for those seeking to enhance portfolio diversification.

To further illustrate the potential diversification benefits offered by hedge funds, consider the following. Because hedge funds, as evidenced by the index returns, provide a higher average annualized return with lower standard deviation (i.e. volatility), they are a very effective way to increase overall portfolio return and dampen overall volatility. The result of adding hedge fund positions or allocations to a client's overall asset mix can be a more efficient portfolio structure.

The bottom line is simple - participants can potentially reduce the risk profile of their overall portfolio by investing a portion of their assets in a well-diversified hedge fund.

## Important Note About Hedge Fund Investments

The previous pages have discussed the numerous benefits of investing in hedge funds. While it has been indicated previously, it is important to note that hedge funds provide the POTENTIAL for these benefits, yet not every hedge fund will deliver these benefits in all circumstances. This is no different than with any other investment strategy or investment manager. Every investment in a hedge fund should be scrutinized to ensure that the fund meets the unique needs of each client. In addition, as is the case with any other investment, the fund should be continuously monitored to assess the ongoing effectiveness and validity of the investment.

## Review Exercise

Before proceeding, it is important to make sure that there is a clear understanding of the basic structures of a hedge fund and the reasons that an investor may want to investigate the use of them in their portfolio. **Select the best response for each question.**

1. **Which of the following choices would be primary reasons for making an investment in a hedge fund? (Click all that apply)**

* Liquidity of the assets

**Incorrect**. Please review the general features and benefits of a hedge fund and try again.

* **The ability to reduce overall portfolio volatility in a diversified asset allocation plan**

**Correct**. Investors considering a hedge fund have the potential for increased returns from unique investment strategies employed, potential for increased diversification, and the potential for positive returns even in a bear market because of the ability to use futures and options.

* **The potential for increased returns in the overall portfolio**

**Correct**. Investors considering a hedge fund have the potential for increased returns from unique investment strategies employed, potential for increased diversification, and the potential for positive returns even in a bear market because of the ability to use futures and options.

* **The potential for positive returns in a bear market**

**Correct**. Investors considering a hedge fund have the potential for increased returns from unique investment strategies employed, potential for increased diversification, and the potential for positive returns even in a bear market because of the ability to use futures and options.

* Ability for the individual investor to participate in investment strategies typically open only to institutional clientele

**Incorrect**. Please review the general features and primary benefits of a hedge fund and try again.

1. **Which of the following are true of a hedge fund in distinguishing it from a typical mutual fund? (Click all that apply)**

* **The ability for the manager to use futures**

**Correct**. Hedge funds differ from mutual funds in that the manager can leverage the portfolio through futures contracts, and sell securities short. Also, because the SEC does not regulate them, they can trade very aggressively and also have the ability to take incentive based fees.

* Tighter restrictions from the SEC regarding the monitoring of these potentially risky investment vehicles

**Incorrect**. Please review the general features and benefits of a hedge fund and try again.

* **The ability for the manager to sell securities short**

**Correct**. Hedge funds differ from mutual funds in that the manager can leverage the portfolio through futures contracts, and sell securities short. Also, because the SEC does not regulate them, they can trade very aggressively and also have the ability to take incentive based fees.

* **The ability for the manager to trade more aggressively**

**Correct**. Hedge funds differ from mutual funds in that the manager can leverage the portfolio through futures contracts, and sell securities short. Also, because the SEC does not regulate them, they can trade very aggressively and also have the ability to take incentive based fees.

* A fee structure restricted to a set percentage of the assets under management

**Incorrect**. Please review the general features and benefits of a hedge fund and try again.

## The Legal Structure of Hedge Funds

One of the more important issues related to hedge funds is understanding the legal structure of these investment vehicles. As we have stated earlier, a hedge fund is a private investment partnership. The impetus for establishing a hedge fund in part relates to the ability to avoid the regulation, reporting requirements and oversight of the SEC. The primary purpose in this effort is to achieve the freedom to employ more aggressive investment tactics, such as hedging and using leverage to either enhance performance or mitigate downside volatility. To effectively garner this investment freedom, domestic hedge funds are formed as limited partnerships.

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| **The Limited Partnership**  In a limited partnership, the investors are limited partners and the investment manager(s) are general partners. In this legal structure, the Limited Partners have liability limited to the amount of money that they invest in the partnership. However, the General Partners, who most often have a portion of their personal assets invested in the partnership, will have unlimited liability. This unlimited liability stems mainly from the use of leverage, where losses can exceed the amount of money invested. |

## Important Offering Restrictions

It is important to understand that these private placement investments cannot be advertised or discussed with the general public. Any communication regarding these investments, including general discussions or solicitations, can be made only to investors that meet certain requirements that denote them as either an "Accredited Investor" or a "Qualified Purchaser." What constitutes an Accredited Investor and a Qualified Purchaser is addressed on the following page. Failure to comply with these restrictions jeopardizes the private nature of the offering and thereby causing the fund to lose its "hedge fund" status.

## Investor Requirements

Up until 1996, hedge funds structured as limited partnerships, in order to remain outside the auspices and control of the SEC and the Investment Company Act of 1940, were restricted to 100 total partners, generally one (1) General Partner and ninety-nine (99) Limited Partners (investors). Obviously, this maximum limit on the number of investors in a hedge fund was restrictive. Therefore, in 1996, Congress passed the National Market Securities Improvement Act of 1996 that effectively expanded the maximum number of participants in a private investment partnership to provide for no more than 99 "Accredited investors" and no more than 499 "Qualified Purchasers."

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| **Overview** | The following is a detailed description of the qualification standards that each investor in a hedge fund (or any other private investment offering) must meet. **Click on each term to view more information.** |
| **Accredited Investor** | An Accredited Investor is defined in Rule 501 of Regulation D under the Act of 1933. Generally speaking, an accredited investor is defined as an individual who:   * Is a natural person whose net worth, or net worth joint with their spouse, is over $1 million dollars; OR * Had an annual income of $200,000 or more for the past two years (or $300,000 jointly with a spouse) and has a reasonable expectation of reaching that level in the current year.   There are far more numerous definitions for Accredited Investors that are formed as an "entity". In general, institutions or other "entities" must have at least $5,000,000 in investable assets and must not be formed for the purpose of investing in the fund.For a list of such entities, **click here.**   |  | | --- | | **Accredited Investor**   * An IRA or other self-directed investment plan established for the benefit of one or more individuals, where the investment decisions are made by accredited investors. * An employee benefit plan, other than a participant directed plan, maintained by a state, its agencies or any other instrumentality for the benefit of its employees with assets in excess of $5,000,000. * A trust with assets in excess of $5,000,000, formed for specific purposes other than the acquisition of the partnership securities and whose investment decision was made by a "sophisticated person," as defined in the Act of 1933. * A bank. * A Savings and Loan, as defined in the Act of 1933, acting in either its fiduciary or individual capacity. * A broker/dealer registered under the Securities Exchange Act of 1934. * An insurance company, as defined in the Act of 1933. * An investment company registered under the 1940 Act. * A small business development company licensed by the U.S. Small Business Administration. * An employee benefit plan, other than a participant directed plan, within the ERISA Act of 1974, if the plan fiduciary makes the investment decision OR the plan has in excess of $5,000,000 in assets. * Any entity in which each of the equity owners are "accredited investors," as described heretofore. |   The intent is that any investor who meet the qualifications set forth have a degree of sophistication and understanding that allows them to evaluate the inherent risks in the investment strategy and thereby do not need the oversight of the SEC or other government agency to safeguard them in their investment efforts. |
| **Qualified Purchaser** | In general, a "Qualified Purchaser" is a "natural person" with at least $5,000,000 in investable assets. Investment assets include any asset held for its investment value and purpose. This does not include holdings such as residential or business related real estate, or controlling interests in privately held businesses. For an institution, the definition of a "Qualified Purchaser" relates, in general, to investment assets exceeding $25 million. **For a more detailed description of the requirements for a "Qualified Purchaser", either an individual or an entity, click here.**   |  | | --- | | **Qualified Purchaser**  **If the investor is an individual, that individual must be:**   * A natural person with a investments of over $5 million, OR * A natural person who is a "knowledgeable employee" of the issuer, as defined in the Investment Company Act of 1940.   **If the investor is an entity (an institution), it must be:**   * A corporation, partnership or other entity acting in its own account or the accounts of others and in total has at least $25,000,000 in investment assets, and is not formed for the sole purposes of acquiring shares in the partnership. * A family company or trust that owns at least $5,000,000 of investments and is not formed solely for the purposes of acquiring shares in the partnership. * A non-family trust where each contributor to the trust is a "qualified investor" and the trust is not formed solely for the purposes of acquiring shares in the partnership. * A "Qualified Institutional Buyer," as defined in Rule 144(a)(1)(ii), with at least $25,000,000 in securities and are not an affiliated person of the dealer. * Any company where each owner is a “qualified purchaser.” | |

One additional restriction on hedge funds relates to the amount of ERISA assets that can be invested in a fund. No more than 25% of the assets in the fund can be contributed by ERISA plans.

## Subscribing to a Hedge Fund - The Legalities

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| **Overview** | When an investor subscribes to a hedge fund, there are three important documents that will be reviewed by the potential investor, with some requiring signatures indicating the legal acceptance of a binding contract with the partnership. **Click on each document type to view more information.** |
| **Offering Memorandum** | The Offering Memorandum, also called the Private Placement Memorandum, Disclosure Document or Prospectus, provides a general summary of the hedge fund and partnership agreement. This document includes information on the fees, the investment strategy to be employed, redemption features of the fund, information on the investment manager and key staff, and other information important for the investor to understand before making an investment in the partnership. In essence, it is the first legal disclosure the investor will receive regarding the fund itself and is very similar in nature to the prospectus of a common mutual fund. |
| **Subscription Agreement** | The Subscription Agreement is an application to the partnership for acceptance into the fund. Remember that a hedge fund is a private placement offering. As such, investors are screened and invited based on certain restrictions. The Subscription Agreement requires the investor to provide specific information regarding their suitability for inclusion into the partnership. |
| **Partnership Agreement** | Also commonly referred to as the Limited Partnership Agreement, this document is a contract between the investor (limited partner) and the partnership. The purpose of this document is to clearly specify the rights and obligations of both the limited and general partners and the structure of the operation for the partnership. Every investor is required to sign the Partnership Agreement, thereby agreeing to abide by the rules and obligations set forth.  Each and every year, the partnership will prepare a K-1 partnership form for tax purposes. Every investor in the partnership will receive this form, indicating the tax consequences of the investment activities related to the funds activities over the previous year. |

## Communicating Hedge Fund Fees

Just as it is important to help potential investors understand and evaluate the benefits of investing in a hedge fund, it is important that they also understand the fees charged by the fund. Although similar in some respects to traditional investment approaches in that hedge funds typically charge an annual management fee on the assets invested in the fund, hedge funds typically charge a performance-based fee as well. This results in hedge fund fees that can be significantly higher than with other traditional investments. Following is an overview of the fee structures typically employed in hedge funds.

Management & Administrative fees

These fees are charged separately to investors to cover the investment management of the assets and general expenses of the fund and its operations. Generally, the investment management fee will range from 1-2% of the assets under management, with the administrative fee running much smaller.

Performance fees

The performance fee can be the most substantial fee that is charged to the investor. This fee is in addition to any other fees that are charged on either a monthly or an annual basis, and relate to the general partners sharing in the overall returns of the fund. Generally, performance-based fees are charged as 20% of the total returns of the fund. While this may seem simple, there are three primary methods used to calculate the performance-based fee. **Click each type of variation to learn more.**

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| 20% of all positive returns |
| Some managers allocate 20% of the total return of the fund to the general partners. In this case, if the fund has a 10% return for the year, a return of 2% will be allocated to the general partner. |
| "Hurdle Rate" Performance Fee |
| In this case, there is a "bogey" that the manager must beat in order to earn the performance fee. Generally, the manager defines an index or other appropriate benchmark against which the funds returns are compared. The manager earns 20% of any incremental gains above the benchmark. |
| "High Water Mark" |
| The third variation of performance-based fees in hedge funds is based on a high-water mark for the fund's assets. As the market value increases during each fee period (typically a year), it sets a new "water mark". If the value at the end of a fee period has declined from the previous period, then no performance based-fee is due for that period or any subsequent period until the value rises back up above that "water mark" at the end of a fee period. This fee structure is designed to protect the limited partners in the fund from excessive fees. All losses from one fee period carryover to subsequent years, the losses must be recouped before the general partner receives performance incentive fees. Without this feature, a fund could lose half its value in one period, and charge a performance fee for regaining that loss in the following period. |

Clearly the fees associated with investing in a hedge fund will normally be higher than the fees charged by traditional investment vehicles. Because the fees can be higher, you should be prepared to simply describe the methods used to calculate performance-based fees and discuss the potential value that hedge funds may add to an overall portfolio, thus offsetting the higher costs. Following are some of the reasons investors should consider when evaluating the fees charged by a hedge fund. First, many hedge funds are able to charge higher fees because of the expertise of the managers and the ability to generate higher total returns than traditional investment alternatives.

Additionally, hedge funds are typically limited in the total amount of assets they can manage effectively. Because many funds cap the size of the fund, they need to charge higher fees to generate the level of revenues required to maintain their operations and provide competitive compensation to the manager in order to retain them.

## Domestic and Offshore Hedge Funds

Understanding the basic structure of a hedge fund as a limited partnership is only the first level of knowledge necessary. The domicile of the hedge fund has a specific impact on the profile and objectives, and especially the tax consequences for a hedge fund investor.

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| **Overview** | Relative to locale, hedge funds can be divided into two types: Domestic Hedge Funds and Offshore Hedge Funds.  **Click on each type of fund to view more information.** |
| **Domestic Hedge Funds** | Domestic hedge funds, structured in the United States, are the most commonly used by individual investors. They are taxed just like mutual funds or separately managed accounts, with all tax burdens flowing through to the limited partners investing in the fund. Gains are taxed at the qualifying rate, either short-term or long-term, and losses in the fund can offset gains. Dividends are taxed as income. |
| **Offshore Hedge Funds** | Offshore hedge funds are domiciled in tax havens such as Bermuda, Cayman Islands, British Virgin Islands, Ireland or other tax havens throughout the world. While these offshore funds typically utilize a corporate structure in their formation, there is no entity level tax imposed on the clientele because of the situs of the fund. |

Offshore funds are primarily for non-U.S. investors, but they also have specific advantages for tax-exempt U. S. entities. U. S. tax-exempt entities (e.g., 501(c) Corporations) investing in a typical domestic hedge fund structure would be subject to taxation on all gains deemed to be unrelated business taxable income (UBTI). While it requires a specific legal opinion from the tax-exempt entity's counsel, UBTI may include income or gains that were the result of the use of leverage in the fund or through any acquisition indebtedness that may be part of a specific hedge fund's strategy. Because such leverage might be the primary way that a hedge fund generates return, the offshore status of the partnership may help eliminate the tax implications related to UBTI. The only downside to the offshore status for these investors would be the lack of U.S. government oversight and recourse under U.S. laws.

## Organizational Structure

The following graphics provide more detail on the various parties involved in the structure of hedge funds, as well as the flow of funds and services between the interested parties. **Click each box in the structures to learn more about the role each entity plays.**

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| **Domestic Hedge Fund Structure** | **Offshore Hedge Fund Structure** |

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| **Investment Manager**  Provides investment management services to the fund in return for an annual management fee. Typically, the investment manager is also a shareholder as well as the general partner of the limited partnership. |

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| **Domestic Fund (Limited Partnership or LLC).**  Domestic hedge funds, structured in the United States, are the most commonly used by individual investors. They are taxed just like mutual funds or separately managed accounts, with all tax burdens flowing through to the limited partners investing in the fund. Gains are taxed at the qualifying rate, either short-term or long-term, and losses in the fund can offset gains. Dividends are taxed as income. |

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| **Offshore Hedge Funds**  Offshore hedge funds are domiciled in tax havens such as Bermuda, Cayman Islands, British Virgin Islands, Ireland or other tax havens throughout the world. While these offshore funds typically utilize a corporate structure in their formation, there is no entity level tax imposed on the clientele because of the situs of the fund. |

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| **Limited Partnership Assets**  The partnership assets represent the pooling of all the assets by partners (i.e., investors) in the fund. These assets are managed by the hedge fund manager within the structure of the limited partnership or LLC entity. |

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| **Shareholders**  The shareholders generally are comprised of the limited partners in the fund. Just as in a mutual fund, their assets are pooled with the other investors and they receive a pro-rata share of the partnership interests based on their investment. |

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| **Attorney**  The attorney provides legal counsel and generally performs the compliance functions for the fund. |

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| **Accountant**  The fund accountant will provide the basic fund accounting services including partnership accounting and the audits of the funds returns. |

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| **Administrator**  The Administrator provides a variety of functions including audits, maintaining rewards, and fulfilling requirements under anti-money laundering rules such as the Patriot Act. In many situations, these duties may be outsourced to outside administrators, while in larger funds, these operational duties are typically performed in-house. |

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| **Prime Broker**  Typically, the master custodian and record keeper for the fund, the prime broker, acts as a central clearing system for the trades in the fund. The prime broker provides the liquidity for the short positions and margin transactions in the fund. |

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| **Brokers/Transaction Brokers**  While the prime broker is the main brokerage relationship for the fund, the managers will trade through other broker/dealers as well to obtain research, perform specialized trades or provide access to specialized investments or underwritings. |

## Review Exercise

**Choose the best response to each of the following scenarios.**

1. **A hedge fund structure offering shelter for entities subject to UBTI is a/an:**

* **Offshore Fund**

**Correct**.

* Domestic Fund

**Incorrect**.

1. **The legal document and contract signed by an investor as a limited partner in the fund, detailing the rules and practices of the limited partnership, the:**

* Subscription Agreement

**Incorrect.**

* **Partnership Agreement**

**Correct.**

1. **A personal investor with annual income over $200,000 for the last three years is a/an:**

* Qualified Purchaser

**Incorrect.**

* **Accredited Investor**

**Correct.**

1. **An institutional Investor with $25 million in investable assets is a/an:**

* **Qualified Purchaser**

**Correct.**

* Accredited Investor

**Incorrect**.

1. **The performance-based fee structure whereby the general partner receives incentive compensation based on outperforming a benchmark is called a:**

* High Water Mark Performance Fee Structure

**Incorrect.**

* **Hurdle Rate Performance Fee Structure**

**Correct.**

1. **A personal investor with investment assets totaling over $5 million is a/an:**

* Accredited Investor

**Incorrect.**

* **Qualified Purchaser**

**Correct.**

## Understanding Basic Hedge Fund Strategies

Just as there are myriad different approaches applied to managing traditional investments (i.e. Small Cap Value Equity, Emerging Markets, Diversified Fixed Income, etc.), there are many different investment strategies used in managing hedge funds. This list provides a brief overview of the most common investment approaches used in managing hedge funds. **Review the following considerations.**

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| **Consideration** | **Description** |
| **Convertible Arbitrage** | Constructing long portfolios of convertible bonds and hedging these positions by selling short the underlying stock of each bond. |
| **Distressed Securities** | Investing in securities of companies that are experiencing financial or operational difficulties. |
| **Emerging Markets** | Investing long in securities of companies in countries with developing or "emerging" financial markets. |
| **Equity Hedge** | Combining core long holdings of equities with short sales of stock or stock index options. Portfolios can be anywhere from net long to net short depending on market conditions. |
| **Equity Market Neutral** | Approximately equal dollar amounts of offsetting long and short equity positions. Portfolios are insulated from a systematic turn of events that affects valuations of the stock market as a whole. |
| **Event Driven** | Investing in the outcomes of the significant events that occur during corporate life cycles, such as bankruptcies, financial restructurings, mergers, acquisitions, and the spin-off of a division or subsidiary. |
| **Fixed Income Arbitrage** | Offsetting long and short position in related fixed-income securities and their derivatives whose values are mathematically or historically interrelated but in which the arbitrageurs believe that the relationship is temporarily dislocated or will soon change. |
| **Macro** | Identifying extreme price value disparities and persistent trends in stock market, interest rate, foreign exchange rates, and physical commodities and making leveraged bets on the price movements that they anticipate in these markets. |
| **Merger Arbitrage** | Investing in companies that are being acquired or are involved in a merger. Typically, the common stock of a company being acquired or merged is bought and the stock of the company acquiring is sold short. |
| **Sector** | Investing in a group of companies or segment of the economy with a common product or market. |
| **Short Selling** | Seeking profits from a decline in the value of stocks. |

## Considerations in Selecting a Hedge Fund

When comparing hedge funds, it is important to keep in mind the after-tax returns of the fund and the liquidity of the fund. **Click each consideration to learn more.**

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| After Tax Return |
| When evaluating the performance of hedge funds, it is important to consider the after tax returns. While the absolute returns may be spectacular, oftentimes the excessive realization of short-term gains can significantly degrade performance, as they are taxed at rates up to 35%. Any investor in a hedge fund should clearly understand that these vehicles are not necessarily tax efficient, and investors should maintain sufficient liquidity in other holdings to cover the potential tax liabilities that can be incurred. |
| Liquidity |
| Another consideration is the liquidity of the fund. Many hedge funds have limited withdrawal windows, sometimes as limited as once a year. This may be an important issue for individuals and a very important consideration for tax-exempt entities, particularly when investing in offshore funds. If there is the potential need for access to the invested assets, the investor may be best served to find a partnership with monthly withdrawal opportunity. |
| Transparency |
| Investors should keep in mind that hedge funds are private placement offerings and as such are not subject to normal disclosure rules regarding their investment practices. While it is probably in their best interests to keep clients informed, the fund managers and General Partner have no duty to do so. Investors should do considerable due diligence before selecting any fund. |

## A Fund of Funds Structure: An Attractive Alternative

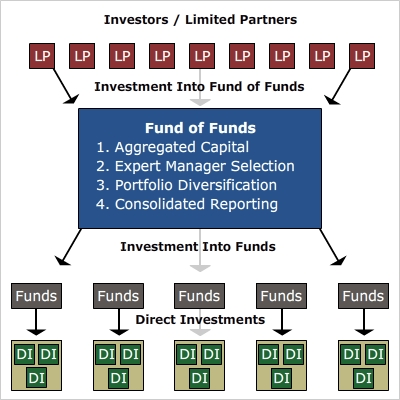
Each of these individual approaches to managing a hedge fund has merit. However, just as with traditional investments, approaches tend to move in and out of favor. To achieve diversification across multiple management approaches would typically require an individual to have a large pool of assets and the time and expertise required to select and oversee hedge fund managers in each discipline. Clearly this is a strategy that very few can employ.

The solution for investors seeking a hedge fund that is broadly diversified across multiple strategies is a fund of funds. Fund of Funds are simply pooled investment vehicles that invest in several different funds. Under this structure, investors (limited partners) invest in a hedge fund of funds which is managed by the Fund's General Partner.

The Fund Manager then invests the assets in hedge funds to build a diversified portfolio invested in multiple hedge fund strategies. To put it in very simple terms, the Manager of a Fund of Funds simply selects hedge fund managers for the portfolio in a manner very similar to how a mutual fund portfolio manager selects individual securities for their mutual funds

The diagram below gives a graphic illustration of how a Fund of Funds is structured.

**Fund of Funds Structure**

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## Benefits of a Fund of Funds Structure

For many investors, a Fund of Funds structure provides significant benefits that outweigh the existence of an additional layer of fees (and potentially carried interest). If you, as an advisor, have determined that a Fund of Funds structure is most appropriate for an individual, it is important that you be well versed in communicating these benefits.

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| **Overview** | The following is an overview of some of the benefits of this structure and ideas as to how to communicate these benefits effectively to a client. **Click on each type to view more information.** |
| **Ongoing Oversight** | No different from any other asset class, selecting attractive hedge funds requires experience and insight coupled with a disciplined process of research and analysis. Likewise, the hedge funds must be proactively monitored to ensure they are managed effectively on an ongoing basis. This is a process few individuals have the time or experience to implement. A Fund of Funds structure is managed by the General Partner responsible for providing ongoing oversight of the individual hedge funds that are held in the Fund. |
| **Increased Diversification** | Because a Fund of Funds invests in multiple hedge fund strategies, the Fund can achieve broader diversification across multiple approaches. Achieving this level of diversification by participating directly in a similar number of qualified hedge funds would require significant assets. |
| **Access to a Broader Selection of Hedge Funds** | Many hedge funds require high minimum initial investments (some as high as $10 million). Because assets are pooled, a Fund of Funds structure can provide individuals a means of participating in these funds without having to commit to the normal minimum initial investment. Likewise, many of the top funds may be closed to new individual investors. A Fund of Funds can provide access to these premium funds. |

## Summary

Hedge Funds can be a highly effective investment alternative for qualified participants seeking new strategies to increase the return potential and diversification in their portfolio. However, many investors do not fully understand what hedge funds are and how they can be used to achieve these goals. By mastering the topics covered in this course you will be equipped with the ability to discuss the merits of investing in hedge funds..

The following is a quick review of the key concepts covered in this course:

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| **Section** | **Key Points** |
| The legalities of Hedge Funds | * General Structure * General Partner and Limited Partners * Investor Requirements * Fee Structures and Arrangements |
| Purpose of Hedge Funds | * Diversification, Increased Return Potential |
| Tax Implications of Hedge Fund structures | * Domestic versus offshore hedge funds * UBTI and the Implications for Institutional Investors * Pre-Tax vs. After-Tax Returns * K-1 Tax Reporting |
| Domestic & Off Shore Fund Structures | * Flow of Funds * Parties in the Fund Structures (Prime Broker, Broker, Manager, General Partner, Limited Partner) |
| Benefits of Hedge Funds | * Why Investors Should Consider These Vehicles * Common Investment Strategies Employed by Hedge Funds * Key Considerations Before Investing in A Hedge Fund |

## Conclusion

This concludes the material for this subject. At this time you may return to any sections in which you feel the need for further study.