

The Hedge Fund sector: History and present context

What is a hedge fund?

The term hedge fund was originally used to describe a type of private investment fund that charges investors a performance fee, uses leverage to magnify returns and short selling to limit market risk. This description still fits many hedge funds but by no means all.

There is no legal or regulatory definition of a hedge fund in the UK and the range of funds covered by the term is very wide. Not all use leverage. Not all engage in short selling. And a few are now even quoted and open to retail investors.

As a result hedge funds are easier to recognise than to define. However, they tend to share certain characteristics and are generally susceptible to the elephant test: although hard to describe, you know a hedge fund when you see it.

It is important to distinguish between the hedge funds and hedge fund managers, the asset managers that manage the fund. It is the hedge fund manager that are the subject of this report and the best practice standards apply to them.

In contrast to traditional, long-only asset managers, hedge funds manager tend to have a number of extra tools in their toolkit, which they use to increase returns and manage investment risk. They include

- Going short of stock to generate returns and/or hedge market exposure. Going short involves borrowing stock and then selling it in order to profit from the value of the security falling.
- Using leverage to magnify returns. Leverage in this context means buying securities using borrowed money.
- Employing derivatives to generate returns and/or reduce risk. Derivatives can be a very efficient way of increasing exposure and therefore potential profit/loss or of hedging exposure thereby reducing risk.
- Trading much more actively than traditional managers

But none of these characteristics define hedge funds because, while some hedge funds will share some or all or many of these characteristics, other do not. For instance, as mentioned above not all funds use leverage or derivatives. Equally, most equity hedge funds are not hedged in the traditional sense (some would argue these are not true hedge funds) and have a net long exposure to the market.

Perhaps the one feature that is common to virtually all hedge funds is the fee structure. Typically hedge funds will charge investors a management fee of 1.5-2.0% and a performance fee of 20%. This means managers are heavily incentivised to generate good performance for investors.

The focus of the HFWG report

The focus of the HFWG report is on the hedge fund managers – the asset managers who manage the funds. The majority of HFWG members are based in the UK, the centre of the European industry, although many of the funds they manage may be

registered offshore. In this respect, hedge funds are no different from many traditional asset managers which often manage offshore registered or domiciled funds.

Funds of hedge funds

This report is not about best practice standards at funds of hedge funds. Unlike a hedge fund manager, a fund of hedge funds does not invest in underlying shares or securities but invests clients' money in a collection of individually managed hedge funds in the same way as other investors do. The skill of fund of hedge funds lies in picking successful managers and, for this, funds of hedge funds will typically charge a 1% management fee and 5-10% performance fee.

History of hedge funds

The father of the modern hedge fund industry was a financial journalist called Alfred Winslow Jones. Jones was born in Australia in 1901 but brought up from the age of four in the US. He graduated from Harvard University and worked at one stage as a US diplomat in Berlin in 1930s. He later joined Fortune, the US business magazine, where he became interested in investment and established an investment partnership.

He structured the fund as a limited partnership with fewer than 99 investors to avoid the regulatory requirements of the US Investment Company Act of 1940 and for the general partner or fund manager to take 20% of profits as compensation. His investment approach involved using leverage to increase exposure and magnify returns while at the same time using short selling of stocks to remove market risk. His aim was to hedge out market risk by taking as many short positions as long positions so that his fund was "market neutral". In other words, returns would depend not on whether the stock market went up or down but purely on whether he picked the right stocks.

When Fortune published an article about Jones in 1966, dozens of others began to follow his approach.

In its early years, the hedge fund industry remained relatively small and attracted little publicity. But the number of hedge funds, and the total assets under management began to increase significantly during the 1990s and the rate of growth has accelerated enormously in the last few years.

There were a number of reasons for this growth. First, the attractiveness of the hedge fund remuneration structure was a big incentive to talented traders and investors to leave investment banks and large asset managers to set up on their own. Second, the intellectual freedom afforded by running your own hedge fund and not being bound by the institutionalised, benchmark-driven approach of many traditional asset managers lured many talented investors to the hedge fund world. Third, advances in technology made it much easier for talented individuals in the financial industry to set up their own investment boutiques, outsourcing back office functions to large suppliers.

Today the hedge fund industry has some of the most talented people in the financial industry among its ranks. The activity of some hedge funds is very similar to that of

the proprietary trading desks of the big investment banks while others fall more into the category of long-term investors.

Where the industry has got to now

There are various different sources of data about the size of the hedge fund industry which are not entirely consistent. However, according to International Financial Services (IFSL), there is an estimated \$1.5 TN of hedge fund assets under management globally (12/2006) compared with \$1 TN at the end of 2004 and only \$130 BN in 1996.¹ Over the same period, the number of hedge funds has grown from 130 (1996) to 9000 (2006).

The majority of hedge fund assets are managed out of the US, which accounts for an estimated 65% of global hedge fund assets, down from 82% in 2002. Europe accounts for 24% of hedge fund assets, with four-fifths of European hedge fund investments managed out of the UK.¹

The early investors in hedge funds were high net worth individuals and their family offices, often family or friends of the fund manager, in keeping with the private investment partnership approach. US endowments such as the universities of Yale and Harvard were among the first institutional investors to start investing in hedge funds, but now a broad array of institutional investors, including many big pension funds, have investments in hedge funds.

This has contributed to the institutionalisation of the hedge fund industry as institutional investors tend to favour bigger funds with well-developed compliance and risk management functions. The result has been the concentration of a significant proportion of hedge fund assets among a small number of big managers.

The majority of hedge funds are private open-ended investment vehicles, although an interesting recent development has been the emergence of closed end quoted funds that are aimed at a wider market including retail investors.

The range of investment styles

Hedge funds are often described as an asset class but this is misleading. Some hedge funds do share certain return characteristics but they invest in a broad range of different asset classes ranging from equity to debt, real assets and even property.

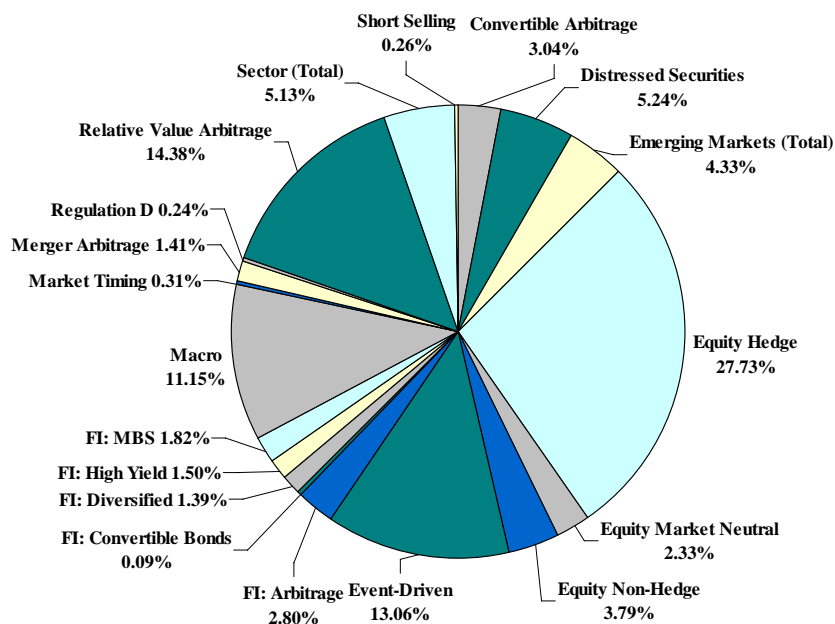
Equity hedge funds are the largest single category and most of these are long/short equity funds. They may be investing in domestic or international stocks. Sometimes these funds can be market neutral. However, it is rare that they have no exposure to the equity market, following the model pioneered by Alfred Jones. In practice such funds are generally net long but limit their market exposure by selling some stocks short. As a result their returns are not fully correlated to the equity market. Often this type of hedge fund will outperform in a bear market and underperform in a bull market.

¹

Other hedge funds embrace a range of different strategies aimed at generating absolute returns. They include credit or fixed income hedge funds, convertible arbitrage, merger or event arbitrage, multi-strategy arbitrage and distressed securities. Another significant group of hedge funds falls into the macro category, these funds focus on macroeconomic conditions, taking leveraged bets on the direction of currencies, interest rates, commodities and stock markets.

The following chart provides a breakdown of the different types of hedge funds by investment strategy.

Breakdown of assets under management by strategy



*FI = Fixed Income

Private equity and hedge funds

Hedge funds are often compared with private equity but the two industries are very different. Private equity funds generally make a limited number of large, illiquid investments in unquoted companies. Often they take controlling stakes in companies and investors in private equity funds may be locked in for up to 10 years.

By contrast hedge funds are generally investing in more liquid, tradeable securities and investors can usually withdraw their money with monthly or quarterly notice periods.

However, there has been some convergence between the two industries. On rare occasions hedge funds have bought companies outright and some hedge funds invest in unconventional, illiquid assets ranging from venture capital to film production.

The regulatory regime for hedge funds

Hedge funds are often referred to by the media as an unregulated industry. This is not the case in the UK where any hedge fund manager engaged in investment management activity must be authorised and therefore regulated by the Financial Services Authority (FSA). This requires being considered by the regulator as fit and proper to conduct investment business and involves an obligation to comply with FSA Principles, rules and guidance. All hedge fund managers operating in the UK are covered by this regulatory regime whether they are managing money for UK investors or for investors based overseas.

In other words, all hedge fund managers in the UK are regulated. Even though the funds themselves are often based offshore in foreign jurisdictions such as the Cayman Islands or British Virgin Islands and are not regulated by the FSA, a UK-based manager is still under an obligation to comply with FSA principles in respect of any offshore fund which it manages.

The situation in the US is different in that many hedge fund managers employ the “private adviser exemption” from registration with the Securities and Exchange Commission which is available provided the hedge fund manager (i) has fewer than 15 clients during the preceding 12 months²; (ii) does not hold itself out generally to the public as an investment adviser; and (iii) is not an adviser to any registered investment company.

Conclusion

The term “hedge fund” is used to cover a huge range of investment vehicles, which invest in a large variety of strategies. The defining feature has been the manner in which this investment is carried out. To date the wording has seemed appropriate. However, in future the generic term will become less important and more emphasis will be given to the strategy or range of assets that the manager specialises in. Whatever happens in the future, the way hedge funds are structured and they go about their business give them enough in common to justify this report’s best practice recommendations.

² Note: A legal entity that receives investment advice based on its investment objectives can be counted as one client for the purpose of determining whether the adviser qualifies for the private adviser exemption. Thus, a hedge fund manager can count a hedge fund as one client regardless of the number of investors that hold a beneficial interest in it. The Securities and Exchange Commission attempted to change the method of counting towards the 15 client threshold by the adoption of a rule (Rule 203(b)(3)-2) in December 2004 that would have made managers look through the fund and count every investor as a client. The effect of this rule would have been that most managers would have been unable to rely on the private adviser exemption. The rule was vacated and remanded by the US Court of Appeal in June 2006