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Hedge Funds

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Executive Summary

- Hedge funds aim to offer absolute returns in both up and down markets. They generally have little correlation with other traditional asset classes and hence offer diversification benefits when included in an investment portfolio.

- A common type of hedge fund is the fund of hedge funds (FOHF). The FOHF invests in 20 or more single strategy hedge funds to provide the benefits of diversification.

- Hedge funds operate largely in an unregulated environment and their lack of transparency and regulatory governance could pose a serious risk for the investors.

- In Singapore, under the restricted recognised scheme, only persons qualified as “sophisticated investors” as defined by the MAS are allowed to invest in hedge funds. Alternatively, if the fund is registered for retail sales, then all persons are eligible to invest, subject to the minimum investment amount of S$20,000.

- Investors are advised to do their research and due diligence before investing in a hedge fund. To minimize risk exposed to any one of the hedge fund managers, fund of hedge funds (FOHF) is a preferred mode of investment.

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(1) What are Hedge Funds?

Hedge fund as an alternative investment class has expanded rapidly especially in the last 3 years. Data from Alternative Fund Services Review indicated that at the beginning of 2001, hedge funds managed only US$500 billion, but there are now 11,000 hedge funds, managing US$1.16 trillion in assets.

Unlike a typical unit trust where the fund manager can only long (buy) a stock, hedge funds have significantly more leeway in their management strategies. There are many types of hedge funds with different strategies. Some of the strategies adopted by the hedge fund managers include equity hedge, equity long short, managed futures, arbitrage, event driven, global macro, and relative value. The four more common strategies are discussed below.

(a) Equity Hedge
This strategy aims to profit from identifying securities that are undervalued or overvalued relative to each other within a sector. A decision will normally be made using a statistical model to buy the undervalued stock and short sell the overvalued stock, on the assumption that the prices will eventually converge. This strategy is expected to have relatively low correlation and beta to the market.

(b) Equity Long Short
The manager will attempt to identify stocks that they consider undervalued or overvalued on an outright basis and enter into a long or short position before the market reacts to the apparent mispricing. The investment decision lies with the manager and the performance of this strategy depends on the manager's market timing skills. This strategy will show a higher correlation and beta to the market than the equity hedge strategy.

(c) Managed Futures
A managed futures strategy implies that instruments such as futures, options, forwards, swaps and various other derivative instruments are used. The manager typically invests in both the long and short side of various markets, including the stock index, fixed income, foreign exchange and commodities markets. Some managers use a systematic approach, while others may prefer to use technical analysis, contrarian or mean reversion approaches.

(d) Arbitrage
The manager that uses the arbitrage strategy looks to exploit the pricing differences of similar securities between different markets. By buying the asset that is underpriced in one market and selling it in the overvalued market, the manager can lock in the difference as its profit. Arbitrage strategies can be employed in the stock, fixed income or derivatives markets. Since it is not dependent of the direction of the market, it has low volatility in all market conditions.

(2) Fund of Hedge Funds (FOHF)

For individuals, FOHF is the preferred mode of investment into hedge funds. FOHF pools investors' monies into 20 or 25 individual strategy hedge funds, which gives it the benefit of diversification and reduces the inherent risks found within each strategy. Man Investments is currently the world's largest manager of FOHF. According to Forbes, Man attracted 10% of all new monies that flowed into hedge funds last year. It now has over 250 structured products and at least US$38 billion under management.

In Singapore, hedge funds are mostly marketed in 2 ways. The first is the restricted recognised scheme where a FOHF, which is usually domiciled offshore, is sold to investors who fulfil the "sophisticated investor" requirements. Under MAS rules, a sophisticated investor is someone who invests a minimum of S$200,000 in a restricted scheme, or who has a personal net asset of at least S$2 million, or who has a minimum net income of S$300,000 per year.

The second form is one that is registered with the MAS for retail investors and it will require an investor to invest a minimum of S$20,000. However, the minimum sum can be waived if the fund provides a capital guarantee.

(3) Some common features of Hedge Funds and FOHF

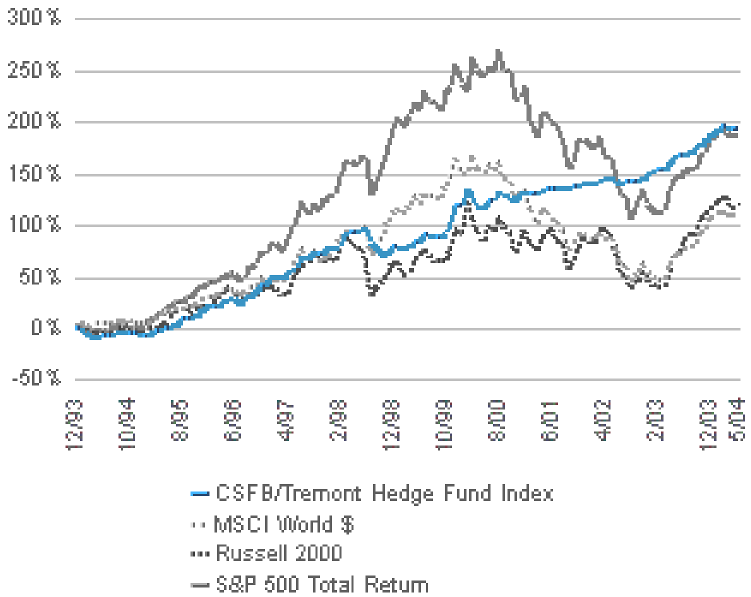
Hedge funds are not benchmarked to any particular index and offer **absolute returns** on the investments. As a result, hedge funds tend to have low correlation with traditional asset classes like equity or bonds and thus provide diversification benefits. As an example, Man Investment's Man IP-220 achieved an annualised return of 19% since inception in December 1996 till March 2004, with volatility of 18.5% as compared to the S&P 500's annualised return of 6.94% and volatility of 17.60% over the same period.

As shown below, the correlation of the hedge funds, as represented by the CSFB/Tremont Hedge Fund Index, with major world indices are fairly low.

Correlations	CSFB/Tremont Hedge Fund Index	Risk Free	MSCI World $
Dow	0.40	0.07	0.89
MSCI World $	0.47	0.00	1.00
MSCI EAFE $	0.41	-0.07	0.94
S&P 500 Total Return	0.47	0.08	0.94
NASDAQ	0.53	0.01	0.78

Source: www.hedgeindex.com Correlation from January, 1994.

Below is a chart showing the performance of the CSFB/Tremont Hedge Fund Index versus the MSCI World, Russell 2000 and the S&P 500 Total Return since December 1993.



Source: www.hedgeindex.com

The returns over the past 5 years are shown below.

Net Performance	CSFB/Tremont Hedge Fund Index	MSCI World $
1 Month	-0.23%	0.98%
3 Months	-0.53%	-1.65%
6 Months	4.58%	8.06%
1 Year	10.62%	24.17%
2 Years	19.40%	12.47%
3 Years	25.49%	-1.29%
5 years	59.34%	-3.99%

Source: www.hedgeindex.com

The CSFB/Tremont Hedge Fund Index comprised 425 funds as of May 1, 2004. It includes both open and closed funds located in the US and offshore, but does not include FOHF. In order to qualify for inclusion in the index, a fund must have a minimum of US$10 million under management, a 12-month track record, and audited financial statements. One particular shortcoming of the hedge fund index is that it is survivor-biased, as hedge funds that subsequently fold up due to non-performance will then be excluded from the index.

It is very common for hedge funds to charge **performance fees** in addition to management fees. The performance fees feature ensures that the interest of the managers is aligned with those of the investors and it provides great incentives for outperformance. Importantly, these hedge funds should also have a **high watermark** feature that ensures performance fees are paid only when the funds are able to perform consistently over time and when the funds have recouped any losses incurred in the previous periods.

Some funds provide a form of **capital guarantee** for the investor if the fund is held till maturity. The period can range from 5 to 13 years. Guaranteed funds are close ended and the guarantee is provided by the zero coupon bonds which the fund purchases at the initiation of the fund. In addition, a bank may also provide a secondary guarantee for the initial investment amount. However, investors might not receive the guaranteed amount should they redeem prior to maturity, but will instead receive the prevailing market value which could be less than the guaranteed amount.

Some of these guaranteed funds may offer a **profit lock-in** feature. The fund will lock in the profits every time when its returns hit a predetermined level. It then will allocate a certain portion of its realised profits to zero coupon bonds to preserve the value of the fund. This way, investors are assured of receiving their capital plus the lock-in profits at maturity.

Leveraging is a common feature of hedge funds to increase the trading capital of the fund. By using derivative instruments like futures, which has inherent leverage, the fund can trade up to many times its net asset value and thus can generate a higher return than if it had only used traditional securities such as stocks. Managers can also leverage by borrowing from banks, although this will entail some borrowing costs.

(4) Risks

In the US, Hedge funds are **exempted from the set of rules** that governs the mutual funds (unit trusts), equities and most other investments. Hedge funds are also not required to keep audited books. Many hedge fund managers tend to disclose very little information on the basis of their investment decisions, claiming proprietary and privacy for fear of losing their edge over their competitors. However, this lack of transparency and regulatory governance has made hedge funds risky for investors.

Performance fees with a high watermark may sometimes be the reason why some hedge fund managers decide to **terminate the funds**. This usually occurs when the fund suffers losses in early years and when the fund manager feels it is unlikely that the high watermark could be reached in the near future. As the manager can no longer look forward to the performance fees, the existing fund is often closed and whatever capital is left in the fund is then returned to the investors.

There are claims that hedge fund managers tend to "**cherry pick**" and report only the winners, but not the losers when publishing performance. The reliability of such data showing hedge funds' outperformance against the other asset classes was raised in a recent working paper, "A Reality Check on Hedge Funds Returns", published by Free University Amsterdam. It noted that of the 3,600 funds tracked, the average net return was only 6.4% annually for the 6 years through 2002 which was actually lower than the 6.9% annual return noted for the S&P 500 index and the 7.5% return for the Lehman Brothers' intermediate bond index for the same period.

(5) Recent history of some failed Hedge Funds

Back in 1998, **Long Term Capital Management** (LTCM) was a hedge fund that was run by top financial experts (such as Myron Scholes and Robert Merton, who won a Nobel Prize for their option pricing theories, the Black-Scholes-Merton Model) who excelled in risk management. However, LTCM collapsed in late 1998 and in the process, caused a crisis in the financial markets.

It initially started with LTCM losing heavily in Russian bonds when Russia defaulted on its debts in August 1998 and devalued the Russian rouble. As panic set in, investors began to sell off other securities that were issued by other high risk countries. Swap spreads rose dramatically as a result of the crisis, and LTCM lost US$1.6 billion as it had been short on swap spreads. Option prices also rose and LTCM incurred another US$1.3 billion worth of losses. At the beginning of August 1998, LTCM had US$3.6 billion in equity capital but within five weeks, LTCM had to be rescued from insolvency.

A hedge fund's association with respectable Wall Street houses also do not guarantee superior results. Dozens of investors sued Bank of America in February 2004 for allegedly allowing hedge fund **Lancer Management** to print falsified returns bearing the bank's name. Bank of America had allegedly allowed the fund manager fill in the values of the fund's securities when it should have calculated the market values independently. Even big banks are not spared the risks. Morgan Stanley lost a total of US$25 million for investors by investing in funds from Lancer Management and **Beacon Hill's Safe Harbor Fund**.

More recently, in mid 2004, it was discovered that the securities owned by the Hong Kong hedge fund, **Global Diversified Trading** (GDT) have been subjected to market manipulation. The investors in the fund are only expected to receive 3% of their investments back.

The latest scandal involving hedge funds is another Hong Kong hedge fund, namely the **CSA Absolute Return Fund**, managed by Charles Schmitt of Charles Schmitt & Associates (CSA). On June 15, 2004, the Hong Kong Securities and Futures Commission (SFC) suspended all trading of the fund and froze all assets under management. So far, only US$145 million of the fund's reported net asset of US$197 million have been accounted for. Although investigations on the alleged fraud are still on going as at time of writing, it has been announced that whatever the outcome, the fund will be liquidated and all available assets will be returned to investors.

(6) Conclusion

Generally, hedge funds' performances were positive in 2003. However, they did not match the stellar performances of the global stock markets. Hedge funds tend to outperform stocks in a declining or range-trading market but may underperform in a rising market.

Hedge funds often involve taking positions in currency, bond, stock and commodity markets. While they may provide attractive returns when the managers get them right, the aggressive taking of positions may however increase volatility and the potential for large losses. The unregulated nature of hedge funds has also provided loopholes for dishonest managers to exploit and take advantage of investors.

Hedge funds offer absolute returns irrespective of market conditions and provide diversification benefits by having little correlation with traditional asset classes. Nevertheless, before investing in hedge funds, investors should do proper research and due diligence on the hedge fund managers and understand the funds' methodologies and their risk return characteristics. Investors should also select the manager who has performed consistently over time rather than simply choosing the best performer for the last few months.

It is important for investors to speak to their financial advisors to determine how much of their investment portfolio should be invested in hedge funds. A typical weighting would be not more than 10% of the total portfolio.