Hedge funds 101

These funds can be lucrative. But with potential high returns comes higher risk. RUCHIKA TULSHYAN provides guidelines

THE concept of hedge funds is not new in investment, yet novice investors know very little about them. Perhaps this is with good reason, as even the most experienced of investors are often wary about hedge fund investments. Welcome to the big bad world of high returns but even higher risk that is hedge funds!

A hedge fund is generally a private investment fund which is sometimes characterised by unconventional strategies – strategies other than long investments in bonds, equities and money markets. Organised primarily as limited partnerships, the functionality relies on “hedging” the market risk. In layman’s terms, this could mean selling short some stocks while buying others, and thus being able to reduce the risk of solely adopting a single investment position.

The hedge fund manager is the general partner or manager of the fund and shares a limited partnership with the investor. The fund manager makes all investment decisions, which are based on a previously agreed strategy. In return for managing the investor’s funds, the hedge fund manager receives not only a management fee but also a performance/incentive fee. The former is a calculated percentage of the assets under management while the latter is a calculated percentage of the profits obtained by the fund.

The bulk of hedge fund assets are managed by “long/short” equity strategies while others rely on buying shares of a company in the process of a merger or acquisition. With any complex strategy employed by hedge fund partnerships, the potential risk of losses is very high. A special type of investment fund known as a “fund of funds” does not trade in assets directly and instead invests only in other types of investment funds such as hedge funds.

In general, young or novice investors should not invest in hedge funds since the risks in hedge fund strategies are very high,” comments Mohyn Tso, assistant professor of finance at the Singapore Management University (SMU).

“Moreover, it is difficult for young investors to partake in your average hedge fund given that one needs to invest a minimum of around S$100,000. The primary benefit of hedge funds is that their returns do not closely track those of other asset classes. For sophisticated investors who, unlike young investors, already hold other assets in their portfolios, that parlays into added diversification. That said, young investors who are still keen on hedge funds may want to start by investing in a fund of funds (which is essentially a managed pool of hedge funds), where the risks and minimum investment requirements are lower.”

The real appeal for thrill-seeking investors is the high returns in hedge funds. According to recently released data from Hedge Fund Research Inc., assets under management of the hedge fund industry totalled US$1.225 trillion at the end of the second quarter of 2006. In Asia-Pacific alone, hedge funds’ assets in 2005 soared to US$15 billion, as reported by International Financial Services, London.

To make it easier for young investors, Salman Haider, Citibank Singapore’s head of investments, has a checklist for investing in hedge fund assets:

- **Examine your investment portfolio**
  Before buying a hedge fund, an investor should examine its portfolio, consider his current assets’ combined risk potential, and decide if it is realistic to make changes that could significantly enhance the potential return without an excessive increase in the potential risk. The value of adding hedge funds tends to be its potential to reduce the overall risk of a portfolio, as they are usually not directly correlated to the “traditional” asset classes such as equities and bonds.

- **Understand the risks involved**
  Do not be mistaken that hedging against risks means little or no risk is involved in the investment or that one’s position would be well covered once hedged.

- **Do your homework**
  Investors who wish to consider a hedge fund should do their homework and examine its strategy very closely. This is where a financial advisor can play a valuable part. Some hedge funds may require investors to lock up their investments for a period and may not open transactions on a daily basis.

- **Find an experienced fund manager**
  Additionally, if investors do not have the aptitude, knowledge or time, they should find appropriate advisors who can assist them. An experienced fund manager can help investors maximise their returns from hedge fund investments.

- **Do your research**
  Investors should read the prospectus carefully, understand how the hedge fund’s assets are valued, ask questions about the fees, understand the limitations on the rights to redeem, and research the background of the hedge fund managers.

While the hedge fund industry is certainly very attractive for investors looking for high returns, it is also one that can damage your portfolio significantly more than other methods of investment. Those who want to “hedge their bets” should do so with great caution and understanding of the industry.