The need to understand hedge funds better

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AS HEDGE funds return to favour and be- come more easily available, do investors know what they are getting into?

The question is especially relevant given that it was not too long ago that hedge funds were shunned following the spectacular US$3.6 billion (SG$3.6 billion) col- lapse of Long Term Capital Management in the late 1990s. Since then, other hedge funds like the Tiger Fund and more recently, Amaranth Advisors, have periodically made headlines for staggering losses.

Hedge funds hold a total of US$120 bil- lion of assets in Asia, an almost 10-fold in- crease since 2002, according to a survey by Institutional Investor’s Alpha magazine. The number of funds has quadrupled to more than 700 in the same period.

Singapore now hosts more than 100 hedge funds, up from fewer than 20 be- fore 2001. Assets under management ex- ceed US$1 billion, according to the Mon- etary Authority of Singapore.

Hedge funds are similar to unit trusts in that they pool the funds of various in- vestors and often invest in publicly-traded securities. However, investors in hedge funds usually include sophisticated high net worth individuals and they often give the hedge fund managers the mandate to pursue more aggressive absolute return in- vestment strategies. This means that they seek positive ab- solute returns, regardless of the perform- ance of an underlying market benchmark.

Professor Francis Koh, professor of fi- nance from the Singapore Management University (SMU), agrees that there is a need for more understanding and education in the area for hedge funds, not just for in- vestors but also the people who market the funds. The SMU recently opened a S$4 million Hedge Fund Centre on its premises, geared towards educating finance practitioners and the investing public about hedge funds, and to raise the profile of this sector regionally.

"Presently, investment professionals marketing hedge funds, including those rec- ommending hedge funds to retail investors, are "generalists" used to offering products, which often avoid investing strategies em- ployed by hedge funds," said Professor Fran- cis Koh, professor of finance at the SMU.

"There is a need to exercise more safeg- uards and an increased duty of care when hedge funds are marketed to retail in- vestors, as retail investors generally have less access to investment information. They may not fully appreciate the potential loss and the risks involved. Thus, there is a need for more disclosure of risks and return, and investment advice from the mar- keter/investment adviser," he said, adding that it was also necessary to better the skill sets of the professionals marketing hedge funds.

Mr Arun Abey, executive chairman of ipac financial planning, agrees. He believes that financial planners around the world are not sufficiently trained to sell hedge funds.

"Hedge funds are more expensive than regular unit trusts, as their sales and man- agement fees are usually higher. Hedge funds typically charge an annual fee equal to 1 per cent of assets managed and the managers receive a share – usually 20 per cent – of the investment gains.

"Mr Abey noted that hedge funds had evolved over the years, with more struc- tured and transparent processes and im- proved risk management systems.

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HOME TO MANY: Singapore now hosts more than 100 hedge funds.

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MAJOR HEDGE FUND MELTDOWNS

FAILURES are common in the hedge fund industry. Researchers by financial adviser ipac shows that as many as 15 per cent of hedge funds fail each year. Here are some of the high-profile collapses:

1997 Long-Term Capital Management
The most famous hedge fund collapse was that of Long Term Capital Manage- ment (LTCM), which began trading with US$1 billion, had developed an arbitrage strategy based on com- plex mathematical models that profited from temporary changes in market behav- iour. The scheme was quite successful, until it unravelled in 1998 because of an over-confident bet on falling Russian finan- cial markets. The result was a US$5 bil- lion (SG$5 billion) loss.

2000 Tiger Funds
Hedge fund manager Julian Robertson employed a long-short equity strategy, underpinned by a value investing philoso- phy. The fund bet against the dotcom boom in 2000, short-selling overvalued tech stocks. When tech stocks continued to soar, Tiger Management suffered massive losses and closed despite having US$2 bil- lion in financial backing from investors.

2005 Amaranth
Top derivatives traders at Swiss banking giant UBS set up this Singapore hedge fund in 2002, with a core strategy involving credit derivatives. The fund reportedly came unstuck following wrong-way bets on South Korean derivatives, which lost the fund almost 20 per cent of its US$7.4 billion. Panicked investors redeemed funds and the scheme closed its doors in June last year.

2006 Amaranth Advisors
US-based technology hedge fund Amaranth started the year with US$7.4 bil- lion, hit a high of US$8.2 billion, before los- ing 55 per cent on a wager on the prices of natural gas. Nored for an imaginary flower that never exists, Amaranth had bet that the difference between natural gas futures in the summer and winter would continue to get larger, but energy prices declined. The company remains afloat.

Ms Chiu Sin YL, director and head of retail at Schroder Investment Management believes that adopting a FoHF approach al- lows investors two key benefits:

"Firstly, it enables investors to cost-effi- cient access to manager selection, portfo- lio construction, risk management and funds monitoring."

Secondly, the FoHF approach allows in- vestors to gain from diversification through exposure to different strategies and fund managers.

"This is especially important as dif- ferent types of hedge funds perform dif- ferently during different economic periods. For example, a merger arbitrage strategy performs best during boom markets, while distressed securities perform well during recessions," Ms Chiu explained.