Alternative Investments – Hedge Funds

A hedge fund is a partnership where experienced, qualified and institutional investors pool funds to deploy these in a variety of sophisticated investment techniques.

In contrast to other types of funds open to the public, hedge funds´ ownership structures are restricted. Further, they are less strictly regulated, can use leverage, take short positions and hold long/short positions in derivatives. And, whereas private equity funds generally invest in illiquid assets and only return capital after a number of years, hedge funds tend to invest in relatively liquid assets and are usually open-ended: Therefore, they allow investors to invest and withdraw capital periodically based on the fund's net asset value.

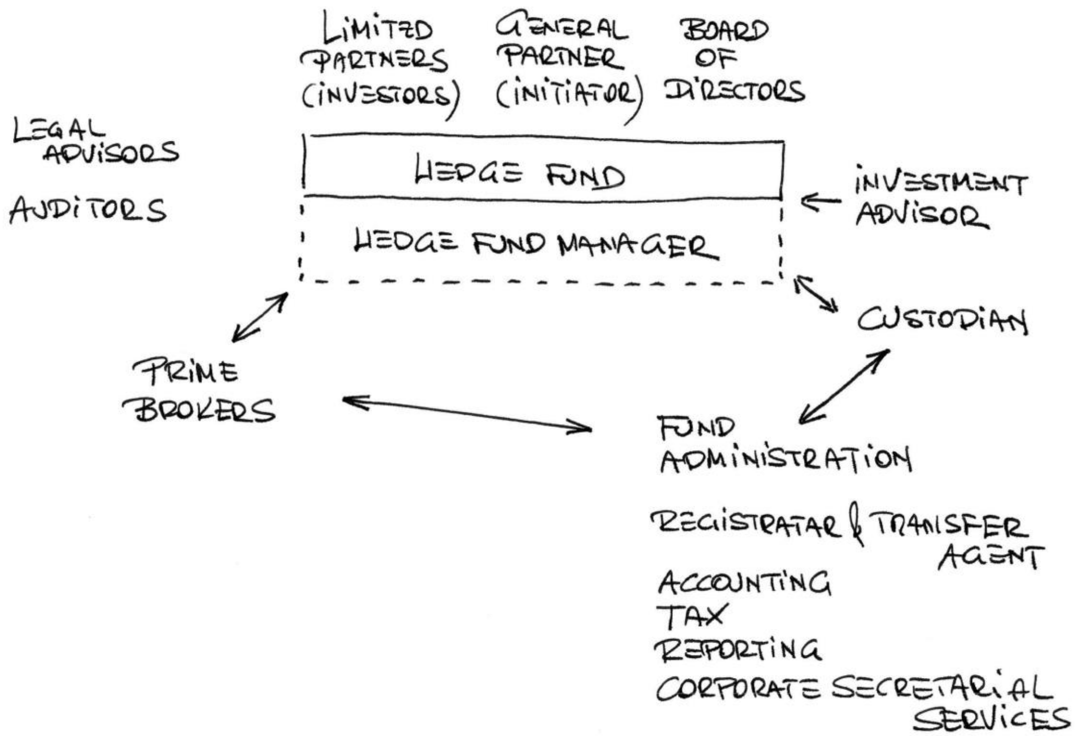
There are no formal definitions of what can constitute a hedge fund. However, despite risk, volatility and return profiles differ widely, following major categories can be identified:

- Event-driven strategies take advantage of inefficient price changes in the course of (anticipated) corporate restructurings, mergers and takeovers, asset sales, spin-offs, bankruptcies, and others.
- Relative value (arbitrage) strategies exploit price discrepancies between related securities which is expected to be resolved over time, such as:
    - Fixed income arbitrage: Pricing inefficiencies between related fixed income securities.
    - Equity market neutral: Differences in stock prices by going long and short in stocks within the same sector, industry, market capitalization, country, which also creates a hedge against broader market factors.
    - Convertible arbitrage: Pricing inefficiencies between convertible securities and corresponding stocks.
- Macro strategies seek gains from global economic events and trends such as interest rate changes, currency changes, political changes, by acquiring holdings with positive or negative exposure to such macro events.
- Equity hedge strategies seek to benefit from long and/or short positions in equities and derivatives.

Having been around since the 1920s, originally hedge funds were set up to smoothen a specific (market) portfolio´s performance as well as reduce its volatility. Today, it is common for hedge fund investment strategies aiming for a positive return on investment regardless of whether markets are rising or falling (absolute return). Although hedge funds are often considered risky investments, amid applying sophisticated hedging techniques their strategies´ expected returns can be substantially less volatile than those of stock market-focused retail funds.

2/20 is a typical hedge fund fee structure, composed of 2 per cent management fee for the pool of assets under management, and 20 per cent of returns if a specified hurdle rate is met. (Hard hurdle: Fees paid only on returns in excess of the benchmark. Soft hurdle: Fees paid on the entire return as long as the hurdle is reached/exceeded).

Hedge funds do not only have highly complex legal, tax and domicile structures. Same applies for services provided to them: Next to a fund´s manager, auditor or administrator, it is the fund´s prime broker who assumes a particularly unique role. The function of prime brokerage, usually divisions of large investment banks, bundles a package of services to hedge funds: Latter need the ability to borrow securities (for going short) and cash to be able to invest on a netted basis and achieve an absolute return. In addition, the prime broker provides a centralized securities clearing facility for the hedge fund. That allows the fund´s collateral requirements to be netted across all deals handled by the prime broker. – The prime broker, on the other hand, benefits by earning fees (spreads) on financing a hedge fund's margined long and short cash and security positions, and by charging, in some cases, fees for clearing and related services.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GENERAL PARTNER (INITIATOR)
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LEGAL ADVISORS
AUDITORS
HEDGE FUND
HEDGE FUND MANAGER
INVESTMENT ADVISOR
CUSTODIAN
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