A Primer on Hedge Funds

Not a day goes by when the phrase "hedge fund" doesn't appear in the headline of some newspaper or Web site. In fact, hedge funds are so popular now that former Federal Reserve Chairman Alan Greenspan recently described them as "extraordinarily important… the pollinating bees of Wall Street."

At present there are an estimated 8,800 of those "pollinating bees" in the U.S., controlling some $1.2 trillion. And according to Greenspan, hedge funds, private equity and similar investments will dominate the investment landscape in the 21st century in the United States.

For many people, however, there is little known about, and much fear associated with, hedge funds, which according to the FINRA are basically private investment pools for wealthy, financially sophisticated investors. Who should use them, when should they use them and why are just some of the questions in search of answers.

What are hedge funds? David A. Vaughan, a partner with Dechert LLP, in written comments to the SEC in 2003 said a "hedge fund" is an expression believed to have been first applied in 1949 to a fund managed by Alfred Winslow Jones. Mr. Jones' private investment fund combined both long and short equity positions to "hedge" the portfolio's exposure to movements in the market.

Hedge funds today are not necessarily defined by a particular strategy and often do not "hedge" in the economic sense. According to the FINRA Web site, for instance, there is no exact definition of the term "hedge fund" in federal or state securities laws. Traditionally, they have been organized as partnerships, with the general partner (or managing member) managing the fund's portfolio, making investment decisions, and normally having a significant personal investment in the fund, the FINRA wrote.

According to the FINRA, hedge fund managers typically seek absolute positive investment performance. This means that hedge funds target a specific range of performance, and attempt to produce targeted returns irrespective of the underlying trends of the stock market. This stands in contrast to investments like mutual funds, where success or failure is often measured in terms of relative performance comparisons to a stock index, like the Dow Jones Industrial Average.

To get positive investment performance, FINRA suggests that hedge fund managers use sophisticated investment strategies and techniques that may include, among other techniques: short selling; arbitrage; hedging; leverage; investing in distressed or bankrupt companies; investing in derivatives, such as options and futures contracts; investing in volatile international markets; and investing in privately issued securities. Most funds are dedicated to a single strategic approach, while other funds, known as multi-strategy funds, combine two or more strategies in an attempt to reduce risk through diversification of investment methods.

Hedge funds generally charge two types of fees: one based on the assets, the other based on the fund's performance. Performance fees of 20 percent of profits are common, along with a fixed annual asset-based fee typically 2 percent, but sometimes as low as 1 percent or as high

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as 4 percent. A fund charging 2 percent of assets and 20 percent of profits would be said to charge “two and twenty.”

Hedge funds are usually only open to limited numbers of wealthy, financially sophisticated investors or what are called accredited investors or qualified purchasers. An accredited investor is, according to the SEC, a natural person who has individual net worth, or joint net worth with the person’s spouse, that exceeds $1 million at the time of the purchase or a natural person with income exceeding $200,000 in each of the two most recent years or joint income with a spouse exceeding $300,000 for those years and a reasonable expectation of the same income level in the current year. In most cases, the minimum initial investment for a hedge fund is $1 million or more. The reason for such high minimums is that such pools are limited in the number of investors they are allowed to have.

Hedge funds, however, are not for everyone, even the super wealthy or super sophisticated. According to the FINRA, hedge funds are private investments, prohibited from advertising or otherwise publicly offering their securities and are therefore not required to register with the SEC as investment advisers. As a result, FINRA notes that unregistered private hedge funds do not provide many of the investor protections that apply to registered investment products, such as mutual funds. Hedge funds generally are not subject to numerous mutual fund rules, such as regulations: requiring that fund shares be redeemable; protecting against conflicts of interests; requiring disclosure of information about a fund's management, holdings, fees and expenses, and performance; and limiting the use of leverage. Advocates of the hedge fund structure note that freedom from these regulatory restrictions is precisely necessary in order for the fund to pursue its strategies and that this is an important advantage of the hedge fund manager when competing in the arena.

As for measuring performance, there continues to be great debate with some financial planners suggesting that it’s difficult to conduct a benchmark or peer-to-peer comparison and others noting that there are many databases that now track hedge fund performance.

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