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Handbook of Hedge Funds

François-Serge Lhabitant



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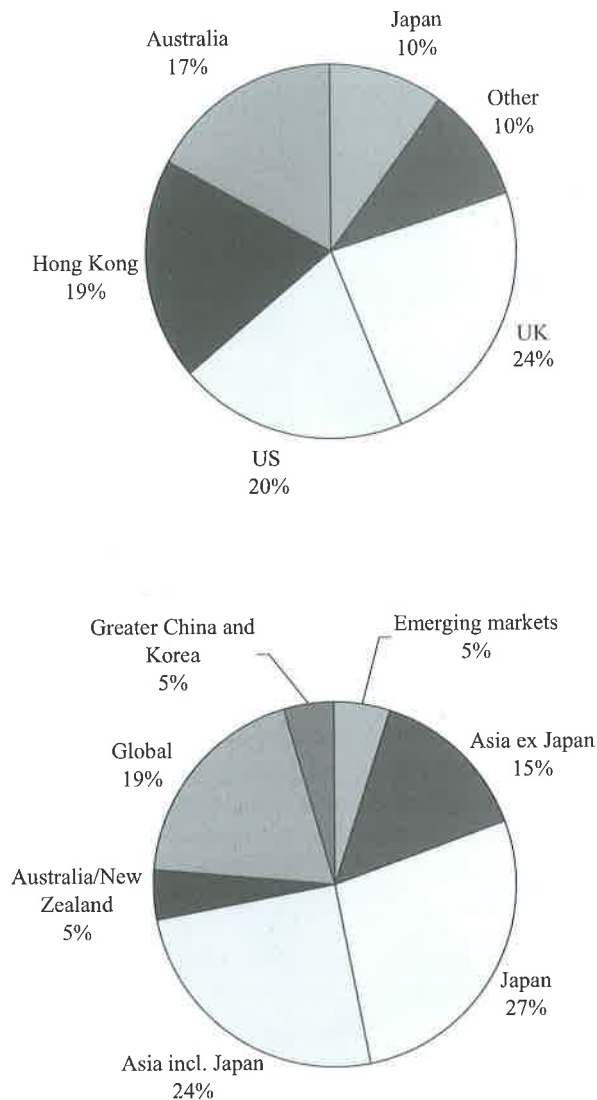


Figure 2.12 The Asian hedge fund industry in terms of fund domiciles (top) and investments (bottom). These statistics are based on the EurekaHedge database

Not surprisingly, an increasing number of US hedge funds have also set up European and Asian offices or concluded alliances, acquisitions, or distribution agreements.

2.8 THE KEY CHARACTERISTICS OF MODERN HEDGE FUNDS

The most surprising fact is that, despite sustained media and regulatory attention, the term "hedge fund" still has no precise legal definition. Even worse, several contradictory definitions exist (see Box 2.3) based on legal structures, investment strategies, superior returns, risk

Box 2.3 What is a hedge fund?

Here is a series of definitions of the term "hedge fund":

- "A risky investment pool, generally open only to well-heeled investors, that seeks very high returns by taking very great risks." (Money Central Investor)
- "A hedge fund is a private investment portfolio, usually structured as a limited partnership, open to accredited investors, charging an incentive-based fee, and managed by a general partner with every financial tool imaginable at his disposal." (Sierra Capital Planning Inc.)
- "An aggressively managed portfolio taking positions on speculative opportunities." (Investopedia.com)
- "A multitude of skill-based investment strategies with a broad range of risk and return objectives. A common element is the use of investment and risk management skills to seek positive returns regardless of market direction." (Goldman Sachs & Co.)
- "A loosely regulated private pooled investment vehicle that can invest in both cash and derivative markets on a leveraged basis for the benefit of its investors." (Thomas Schneeweis, University of Massachusetts)

taking or hedging, etc. Clearly, disagreement over a standard definition of hedge funds reflects the exponential growth in the number of products in existence. The industry has expanded to include indiscriminately pooled investment funds with strategies departing from long positions in bonds, equities or money markets, or a mix of these. This has led to the misleading situation in which the term 'hedge fund' no longer implies a systematic hedging attitude.

Fortunately, most new hedge funds still share a series of common characteristics that distinguish them easily from more conventional investment funds. Let us now review some of them, bearing in mind that these are just positive indicators of hedge fund activities rather than absolute signals.

Hedge funds are actively managed

There are only two ways to make money in a market. The first way is to take on a systematic risk (called "beta") for which the market rewards you with a risk premium. For instance, asset classes like equities have a higher expected return than cash over time for the simple reason that they are a riskier investment than cash. The same is true for long-duration bonds versus cash, corporate bonds versus treasuries, mortgages versus treasuries, emerging market debt versus developed market debt, etc. The second way is to take on specific risks and expect to be excessively rewarded by some "alpha". However, producing alpha requires some skills, because the alpha of the market is by definition a zero-sum game.

The performance of real hedge funds should normally result from active management decisions combined with the skills of their advisers (the "alpha") rather than from passively holding some asset class and enjoying the free ride of a risk premium (the "beta"). Indeed, there is no need to use hedge funds to gain some passive exposure to an asset class – the investor can do it alone at a much cheaper price. By contrast, hedge funds have a competitive advantage in the active management world – they collect information faster, they benefit from cheaper access

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to markets, they can afford to hire the best analysts and they enjoy superior trade execution and portfolio structuring.

Hedge fund advisers should therefore seek to add value through active management and skill-based strategies, and reject traditional investment paradigms, such as the efficient market hypothesis⁹ or modern portfolio theory.¹⁰ Rather, hedge fund managers believe that markets do not price all assets correctly. They therefore adopt specific strategies to exploit these inefficiencies.

Hedge funds are securitized trading floors

From a functional perspective, hedge funds are also very similar to the trading floors of investment banks. Indeed, several of the hedge fund strategies find their roots in investment banking activities, and the fund managers themselves often have a trading or investment banker background. The emergence of new technologies simply gave talented individuals and investment banking gurus (genuine or fake) the opportunity to start doing for their own account what they had been doing for several years within large institutions.

In addition, following the Asian crisis of 1997, several investment banks became a lot more nervous about proprietary trading – that is, taking risky positions on their own books. Consequently, they farmed out a lot of their proprietary trading activities to hedge funds, and numerous proprietary traders started creating their own hedge fund. Therefore, shrinkage in proprietary trading activities coincided neatly with a welter of hedge fund launches.

Hedge funds have flexible investment policies

To enhance the possibility of outstanding returns, hedge fund managers are usually given broad discretion over the investment styles, asset classes and investment techniques they can use. In particular, they can combine both long and short positions, concentrate rather than diversify investments (sometimes with some risk, see Box 2.4), borrow and leverage their portfolios, invest in illiquid assets, trade derivatives and hold unlisted securities. In the case of adverse markets, a hedge fund manager can try to move into cash, hedge against market declines, or implement short sell in an attempt to earn profits. He can also switch strategies or markets if there are better opportunities. This is in sharp contrast to mutual funds, which tend to have narrowly defined charters, a practice driven by industry and regulatory conventions.

A flexible investment policy is clearly a double-edged sword: it subjects the fund to greater “manager risk” but also allows the manager to adapt to market conditions so that he can pursue profits or control risk. It is, however, important to understand that a hedge fund does not necessarily employ all the permitted tools or pursue simultaneously all the available trading strategies. It merely has them at its disposal, if needed. By contrast, in a bear market, a narrowly focused manager would be compelled to stick to his mandates while his asset class or sector is sinking.

Hedge funds use unusual legal structures

Hedge funds come in a variety of legal forms. However, to avoid the numerous regulations that apply to financial intermediaries and/or to minimize their tax bills (Box 2.5), hedge funds

⁹ The efficient market hypothesis states that at any given time, security prices fully reflect all publicly available information.

¹⁰ Modern portfolio theory believes in perfect markets and results in the systematic passive indexing of portfolios.

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Box 2.4 eNote.com and the dangers of overconcentrated positions

The dangers of overconcentrated positions, illiquid stocks and price manipulation are perfectly illustrated by the eNote case.

eNote.com Inc. was a small Vermont-based firm that developed a television-based internet mail appliance for consumers and businesses that do not need or want to use personal computers. In May 2001, the Securities and Exchange Commission sued Burton G. Friedlander for misrepresenting the performance of his hedge fund, Friedlander International Inc. According to the SEC, Friedlander's hedge fund bought 5 million eNote preferred shares and 2 million warrants for eNote common stock in April 1999. It rapidly became eNote's biggest shareholder and kept increasing its position. In December 2000, it owned warrants for 11.7 million eNote shares, and eNote represented 40% of its portfolio.

Friedlander then started inflating the net asset value of his fund by buying large volumes of eNote shares at prices over their market value. Meanwhile, he continued to solicit new shareholders for his hedge fund, while simultaneously redeeming his personal shares at artificially inflated prices (Figure 2.13).

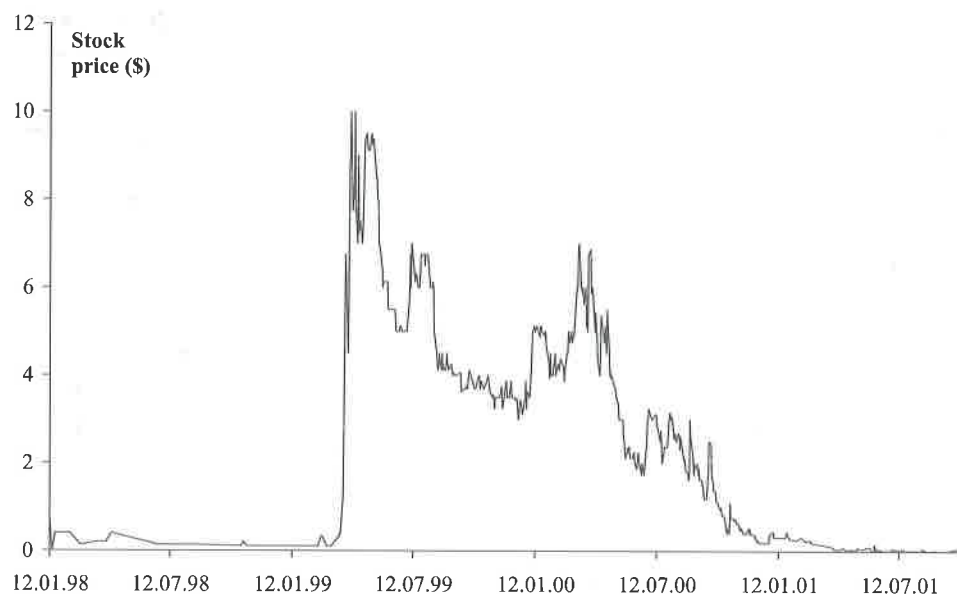


Figure 2.13 Movement of eNote share price, 1998–2001

This process continued for almost one year, until the SEC discovered the case and sued Friedlander.

use legal structures that are unusual in the asset management world. These are often limited partnerships or limited liability companies when targeting US investors, and offshore investment companies established in tax-favourable jurisdictions when operating outside the United States (Figure 2.14).

Box 2.5 Offshore funds, but Uncle Sam's courts

Offshore funds are usually intentionally designed and structured to avoid US taxes and laws. This is necessary to attract offshore investors, and in some instances, even certain tax-exempt US persons. Nonetheless, if something goes awry with the fund, investors and securities regulators seem to be increasingly inclined to bring claims in US courts against the fund and its service providers (most of the time the administrator and auditors). This has the obvious advantage of being able to claim huge damage awards against defendants who have deep pockets.

Defendants often argue that US courts lack subject-matter jurisdiction, because they carry out their functions entirely offshore and they have no US investors, and that forcing litigation on them in the US has the sole aim of saddling them with a heavy burden. But US courts often reject the *forum non conveniens* argument and are increasingly willing to extend their jurisdiction to securities law claims against offshore hedge fund managers and service providers. For instance, the simple fact that an offshore fund traded US securities or that some meetings took place in the US are now considered sufficient for a US court to exercise jurisdiction. The recent extension to offshore funds of the obligation to register as an investment adviser in the US is another example of this trend towards extra-territoriality.

Hedge funds offer limited liquidity

A hallmark of traditional investment funds is the opportunity for daily subscription and redemption. Investors perceive this daily liquidity as an advantage, because they can enter or exit

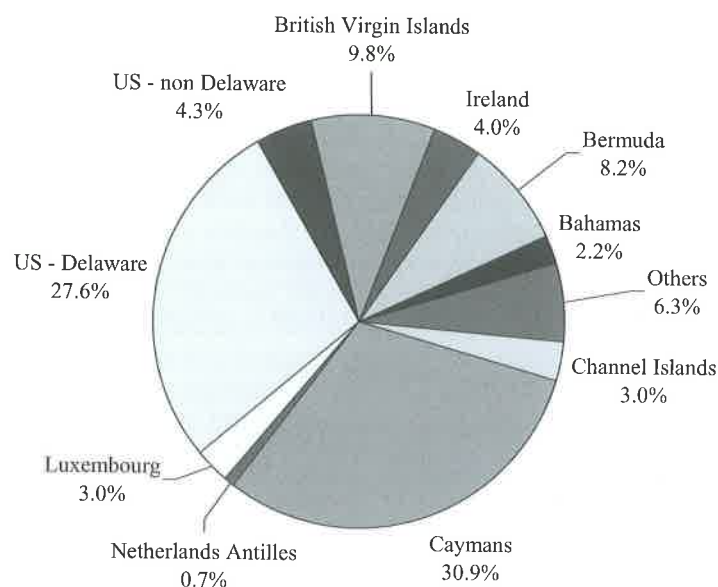


Figure 2.14 Estimated distribution of hedge fund domiciles (country of registration). These statistics are based on the Hedge Fund Research database

a fund whenever they wish. However, they often forget that a high liquidity normally comes at a cost:

- The fund needs to maintain a small cash pool as a liquidity buffer. Whether between the fund and the investor, or purely within the fund, most operations will actually impact this cash pool. For example, an investor purchasing shares in the fund will pay for them using cash that will go into the pool. An investor redeeming his shares in the fund will receive cash from the pool. And selling an asset in the fund will also generate cash for the pool, while purchasing an asset will require cash from the pool. Since the return on cash is usually lower than the expected return on other investments, the existence of the cash pool tends to lower the overall performance of the fund.
- The fund's shareholders are penalized with respect to newcomers or early withdrawers. When subscribing, new shareholders begin to participate in the fund's existing assets as soon as they receive their shares while, in reality, their cash contribution is still not yet invested. Moreover, their cash contribution will result in transaction costs (when the fund invests) to be shared between all shareholders. Similarly, when redeeming their shares, old shareholders are paid on the basis of the market value of the fund's assets, while in reality some of these assets will be sold to ensure the repayment, generating transaction costs to be shared by the remaining shareholders.
- Managers lose focus. Fund managers must also face the hassle of anticipating and dealing with daily subscriptions and redemptions from investors trying to time the markets themselves. They progressively become cash-flow managers rather than asset managers, and focus on shorter-term horizons.
- Some investment opportunities are not compatible with daily liquidity, simply because they are illiquid and hard to sell.

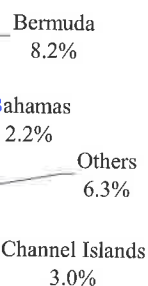
Hedge funds and their managers face the challenge of reconciling their objective of achieving above-average market returns relative to risk with their investors' desire for liquidity through periodic exit routes. The solution chosen by most hedge funds is simply to limit the subscription and redemption possibilities and to insist upon a minimum investment period.

- The **terms of subscription** specify at which dates investors can enter a hedge fund. Subscribing to a closed-end fund is only possible during its initial issuing period, while open-end funds offer new subscription windows on a regular basis (typically quarterly or monthly). Other than during these windows, subscription to an open-end fund is not possible.
- An initial **lock-up period** is mandatory. It is the minimum time an investor is required to keep his money invested in a hedge fund before being allowed to redeem his shares according to the terms of redemption. The usual lock-up period is one year, but longer periods are not uncommon, particularly in reputed funds. For instance, relying on its aura, the famous hedge fund, Long Term Capital Management, required a three-year lock-up from its investors, before it collapsed in 1998.
- The **terms of redemption** specify on what dates and under which conditions investors can redeem their shares. The current market standard seems to be at the end of each quarter, but longer redemption periods are not unusual, particularly in funds investing in rather illiquid markets or securities. However, many funds also have provisions to extend the terms of redemption if necessary, and some charge decreasing penalty fees to dissuade early redemption, or limit the number of shares that can be redeemed on any given redemption date (*gate*) see Box 2.6. Moreover, investors are often required to give **advance notice** of their wish to redeem (typically 30 to 90 days before actual redemption).

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Box 2.6 Gate provisions

Hedge fund managers are increasingly using gate provisions, i.e. limits on the maximum percentage of the fund's overall capital that can be withdrawn on a scheduled redemption date. Common limits are 20% in the case of annual redemptions or 10% in the case of more frequent redemptions.

A gate provision allows the manager to increase exposure to less liquid assets or trades without having the risk of facing a sudden liquidity crisis if a redemption date approaches and several investors want to redeem their shares. The exercise of a gate provision is usually left to the discretion of the board of directors of the fund. In extreme cases, a manager may also suspend the redemption rights (which investors hate) or decide to pay the redemptions in kind (which is not much appreciated either).

Although somewhat cramping from an investor's point of view, these restrictions should have a positive impact on a hedge fund's performance. They benefit all the partners by controlling cash-flow transactions, allowing managers to focus on investing rather than on redeeming assets of investors trying to time the markets themselves. With these guidelines, managers can also focus on relatively long-term horizons, hold illiquid positions (emerging markets, distressed or unlisted securities, etc.) and reduce cash holdings. We should also remember that these terms are much more favourable than the terms of private equity funds where investor liquidity is far more restricted, generally to the point of being tied to the disposal of the underlying investment or another liquidity event such as a public listing.

Of course, the existence of periodic exit routes for investors requires the hedge fund to periodically (concurrently with the timing of the exit route) strike a net asset value of its portfolio of investments to allow the investors to redeem (or purchase in the case of an entrance) units at the relevant net asset value at the relevant time.

Hedge funds charge performance fees and target absolute returns

While traditional fund managers charge solely a management fee, hedge fund managers impose both a management fee and an incentive fee. **Management fees** (Box 2.7) are usually expressed as a percentage of assets under management and are charged annually or quarterly. They range from 1 to 3% per year, and are essentially intended to meet operating expenses. **Incentive fees** aim at encouraging managers to achieve maximum returns. They typically range from 15 to 25% of the annual realized performance and enable hedge funds to attract the high-end talent necessary to run them.

To avoid agency problems and excessive risk taking, many funds include a **hurdle rate** and/or a **high-water mark** clause in their offering memorandum. The hurdle rate indicates the minimum economic performance that the fund adviser must achieve in order to be allowed to charge an incentive fee. The high-water mark states that any previous losses must be recouped by new profits before the incentive fee is to be paid. Generally, the high-water mark varies for each investor and is based on the maximum value of the investor's interest in the partnership since his initial investment in the fund. This protects investors from paying an incentive fee while they are just recovering from previous losses.

Box 2.7 RAM Capital changes its fees

Ritchie Capital Management is a global alternative asset management firm. It is considered to have some of the most innovative terms in the hedge fund business – although most investors might disagree with them. Its multi-strategy fund, RAM Capital, had approximately \$300 million invested in the Ritchie Energy Fund in 2005, and the rest of its capital in global macro, arbitrage, long–short equity and “experimental” strategies. RAM Capital used a series of internal and external managers, and their expenses were simply passed through to investors in the fund, resulting in a management fee of 7.9% in 2003 and more than 6% in 2004 – on top of the 20% performance fee.

On 29 August 2005, RAM Capital asked its investors to approve a set of changes to its terms. Rather than maintaining the pass-through structure, RAM Capital proposed charging a 1% management fee on equity contributions, plus 2% of all assets in the fund’s portfolio, including those bought with leverage. Investors had the choice of (i) accepting the new conditions and being subject to the new terms effective 1 September 2005; (ii) voting for the changes, opting out of the fund and paying an early-redemption fee; or (iii) voting against the changes. However, if the new terms were accepted, investors who voted against the changes would automatically be transferred to a dedicated share class whose first redemption date would be . . . 31 August 2008.

In addition to the fee terms, RAM Capital also sought approval to change its liquidity terms (quarterly with 45 days notice, or three-year by with 90 days notice), introduce a gate (10% of the fund size per quarter, with a maximum use for six consecutive quarters), allow the creation of illiquid side-pockets for private equity and reinsurance investments, change its Cayman Islands legal counsel, and change its name to Ritchie Multi-Strategy Global. Note that the auditor of the fund would remain the same – it had been changed the year before.

Several hedge funds also include a *proportional adjustment clause* in their offering memorandum. This clause states that if the fund manager loses money and some investors consequently withdraw their assets, the fund manager is allowed to reduce proportionally the amount of loss he has to recover by the percentage of the assets that were removed. As an illustration, a fund manager who lost \$20 out of \$100 would have to recover the same \$20 before charging performance fees. But if investors withdraw \$40 out of the remaining \$80 (that is, 50% of the remaining assets), the loss carried forward would be reduced to \$10 (that is, 50% of the loss).

Some funds have even gone one step further by introducing a *clawback clause* and a *loss recovery account*. The clawback clause stipulates that a portion of the incentive fee will be retained every year in a clawback account, usually until the account reaches a certain percentage of the assets. If future performance turns out to be negative, the clawback account is then debited to the client’s credit at the incentive fee rate. As an illustration, this allows a client paying a 20% incentive fee to recover 20% of his losses in a losing year by recovering portions of former incentive fees. If the negative relative performance exceeds the clawback account, then a loss recovery account will be established. Future incentive fees will be credited to this account, and no incentive fee will be earned by the manager until the loss recovery account has been reduced to zero.

Box 2.8 Jeff Vinik and Julian Robertson

Two interesting examples of the potential side-effects of performance fees are provided by the legendary hedge fund managers, Jeffrey Vinik and Julian Robertson. After four years running Vinik Asset Management, Jeffrey Vinik announced in October 2000 that he was quitting the industry to spend more time with his family. In those four years, the assets of his fund had soared from \$800 million to \$4.2 billion, for a gross return of 645.8%. This red-hot track record on Wall Street had allowed Jeffrey Vinik, Mike Gordon and Mark Hostetter, the three partners in the fund, to collect about \$1.7 billion of performance fees.

More recently, Julian Robertson, one of the most successful stock pickers on Wall Street for more than two decades, announced that he was closing his Tiger Management LLC hedge fund group. In 18 months, the assets under management had dwindled by \$16 billion to \$6 billion. The firm did not generate enough cash to pay its employees, essentially because it was unable to collect fees. Given the -4% performance in 1998, -19% in 1999 and -13% at the beginning of 2000, Robertson would have needed to earn 48% before he could again charge his clients fees!

All these mechanisms explain why hedge fund managers pursue an *absolute return target*, meaning that their goal is to be profitable regardless of the stock or bond market environment – their payroll depends directly on performance (Box 2.8). This differs significantly from traditional investment vehicles, which do compare their performance relative to standard market benchmarks and mostly care about the amount of assets they manage. However, it should be noted that incentive fees and high-water marks might also have adverse gambling effects on managers' behaviour. For instance, a manager who has achieved a good performance at the beginning of a given year may be tempted to lock in and secure his incentive fee by avoiding any risk taking until the fee is paid. Conversely, a manager with a high-water mark who has recorded a relatively poor performance has nothing to lose and may take on much more risk in an attempt to recover,¹¹ or possibly close his fund to start a new one. Fortunately, reputation costs should mitigate these effects.¹²

Note that several hedge fund managers in the US are using *deferred incentive compensation* for their offshore funds. Simply stated, prior to the start of the fiscal year, they elect to defer for up to 10 years payment of all or any portion of the management fee or performance fee earned with respect to that subsequent fiscal year. The deferred fees remain in the hedge fund's account and will appreciate or depreciate on the basis of the fund's subsequent performance. Technically, the deferred fees will be reflected on the hedge fund's books as a liability and will reduce the fund's net asset value. Any appreciation will be expensed as additional fees and any depreciation will be treated as a reduction of fees. Upon expiry of the deferral period, dissolution of the fund, or termination of the investment adviser agreement by the fund, all deferred performance (and management) fees are payable. On the termination of the investment adviser agreement, fees elected to be deferred will remain in the hedge fund until the end of the

¹¹ See, for instance, Brown *et al.* (1999).

¹² See, for instance, Fung and Hsieh (1997).

deferral period or the dissolution of the fund, whichever is the earlier. This permits a deferred taxation, if the managers do not have the ability to accelerate the payment.¹³

Hedge fund managers are partners, not employees

A hedge fund manager generally shares both upside and downside risks with investors because he has a significant personal stake in his fund. Combined with the incentive fee, his stake is supposed to closely align his interests with those of his investors, and encourage managers to seek substantial total returns while prudently controlling risks.

However, contrary to common belief, the personal wealth commitment is not necessarily a good indicator of motivation and can even produce undesirable side-effects. At the beginning of his career, for example, the fund manager has little to lose. He may be tempted to increase risk, knowing that in case of disaster, he can go back to being a traditional asset manager and recover quickly. At the other extreme, a successful fund manager at the end of his career will have so large a commitment in the fund that he will refrain from taking risks, even though these are well remunerated.

Hedge funds have limited transparency

Transparency is a controversial issue in the hedge fund community. First, let us recall that "transparency" is derived from the Latin words *trans* and *parere*, which translate into "to show oneself". In the world of fund managers, this can be understood as the ability to see what is behind the net asset value.

A feature of hedge funds has traditionally been their lack of transparency, which can easily be explained by two factors. First, the particular legal structure and the offshore registration of hedge funds preclude them from publicly disclosing performance information, detailed asset allocations or earnings. This could be considered by regulators as a public marketing activity, which is prohibited. Second, revealing specific positions about individual holdings or strategies could be precarious, both for the fund and for its investors. For instance, a fund beginning to accumulate shares with a view to achieving a strategic position in a company would not want to announce publicly what it is doing until it has finished accumulating the position. Nor would a fund short in an illiquid market disclose its holdings, fearing a short squeeze. As an illustration, Lowenstein noted that when Long Term Capital Management's problems became known to its Wall Street competitors, the latter began to take trading positions to exploit the difficulties faced by the struggling hedge fund. In that particular case, disclosure of specific positions clearly had a very damaging impact.

Therefore, hedge funds consider transparency as a double-edged sword. They prefer to remain rather discrete and sometimes opaque, at least when compared to mutual funds and when talking to non-investors. This has helped to perpetuate the mystery and uneasiness surrounding the hedge fund industry. However, the situation is gradually changing. Investors

¹³ Note that in 2005, the new Section 409A of the Internal Revenue Code came into application. Although it does not repeal the basic principles underlying the typical hedge fund fees deferral programme, it now requires certain deferred amounts to be included in current income and therefore subject to current tax. It also imposes a penalty equal to 20% of the compensation required to be included in gross income, unless certain technical requirements are satisfied. This has significantly curtailed the existing benefits for US-based fund managers. UK-based managers were also able to create similar tax characteristics through the use of Employee Benefit Trusts, but their use has now been severely restricted.

constantly request more information, and a minimum level of transparency for effective due diligence is now usually provided. Fund managers are also less reluctant to disclose aggregate data and risk data rather than detailed position data.

Hedge fund strategies are not scalable

Unlike the case of traditional investment management, size is not a factor of success in the hedge fund industry. The reason is that hedge fund strategies crucially depend on manager skills and available investment opportunities – two factors that are not scalable. Therefore, hedge funds have a limited ability to absorb large sums of money, and a manager may prefer to close his fund to new subscriptions once it has reached a target size. This allows managers to maintain a higher performance, and therefore to obtain higher performance fees. And if they really see opportunities, they still have the possibility of increasing their leverage. The recent demise of Julian Robertson's Tiger Fund, the liquidation of Jeff Vinik's fund, and the capitulation of George Soros' Quantum Fund are anecdotal evidence that smaller is usually better in single strategy funds. However, as we shall see, size may be an advantage in multi-strategy funds which actively deploy capital as market opportunities arise.

Hedge funds target specific investors

While mutual funds typically target retail investors, high net worth individuals (HNWIs) were historically the primary investors in hedge funds, as they sought to generate reasonable returns while protecting their capital.¹⁴ This is due to several factors, among which are:

- The legal limits on the number of partners if the fund is structured as a limited partnership. A small number of partners implies a large minimum capital investment per investor, frequently above \$1 million, to ensure that the fund has a sufficient amount of capital to enable it to operate properly.
- The relative complexity of hedge fund strategies and the lack of understanding of such strategies among smaller investors, on average.
- Other regulatory reasons requiring that only "sophisticated" investors may gain access to hedge funds.

In March 2004, Merrill Lynch and Cap Gemini Ernst & Young reported that, as at December 2003, 73% of HNWIs in the US held hedge fund investments. And according to US-based consultant Hennessee, they control approximately 44% of hedge fund assets. However, the landscape is gradually changing, with institutional investors increasing their allocations to hedge funds, as they seek alternative investments with low correlations to traditional portfolios of cash, bonds and stocks (Figure 2.15).

Affluent private individuals are also becoming increasingly interested in hedge funds, particularly because of the introduction of lower minimum fund requirements by funds of hedge funds and the creation of structured products such as capital guaranteed notes. This "affluent"

¹⁴ The term "HNWIs" usually encompasses individuals with more than \$1 million in net worth, as well as family offices and trust departments of private banks. Ready to commit for the long run, willing to bear high risks in exchange for high return prospects and having a sufficient level of net worth to invest sizeable amounts directly in a fund as partners, HNWIs are ideal targets for hedge funds. Their numbers have soared in recent years owing to the sudden creation of new wealth in successful initial public offerings, creation and sale of businesses, mergers and acquisitions, and the expansion of stock option plans as incentive compensation.

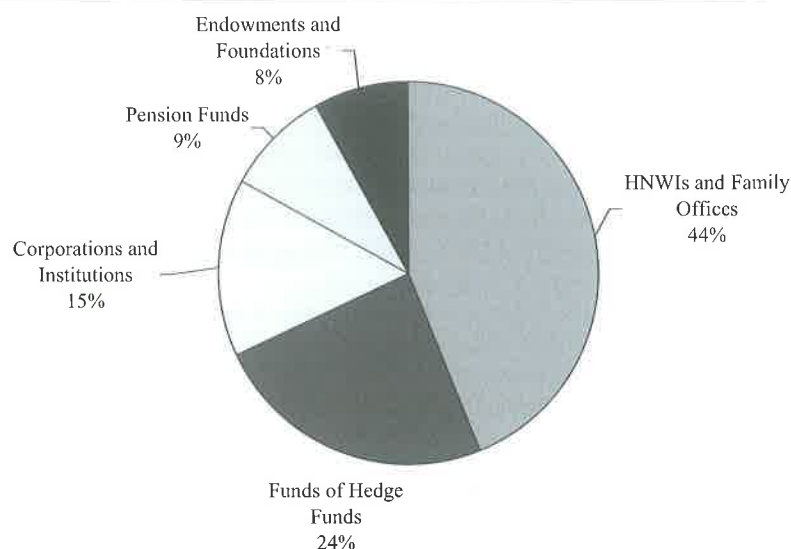


Figure 2.15 Estimated sources of capital for US hedge funds at the end of 2005

group typically comprises individuals with net worth ranging between \$500 000 and \$1 million (Table 2.2).

2.9 THE FUTURE

Today, the major source of future growth for hedge funds clearly seems to be institutional investors, i.e. pension and benefit plans, endowments and foundations, insurance companies and corporations. Entangled in their bureaucratic investment decision-making processes and restricted by their strict fiduciary responsibilities and the “prudent man” rule, institutional investors have long been under-represented in the hedge fund market. Initially, only the most adventurous institutions allocated small amounts of capital to hedge funds, with the goal of

Table 2.2 Categories of private investors in hedge fund

Category	Investable assets	Major distribution channels
Ultra-high net worth individuals	More than \$25 million	Private banks, trust companies, family offices, financial advisers
High net worth individuals	\$1 million to \$50 million	Private banks, trust companies, brokerage firms, attorneys, financial advisers
Affluent investors	\$500 000 to \$1 million	Commercial banks, mutual fund companies, brokerage firms, attorneys, insurers, financial advisers, funds of funds
Retail investors	Less than \$500 000	Funds of funds

diversifying their sources of returns and reducing portfolio risk. But the wake-up call came in 2000 with the decision of the California Public Employees Retirement System (Calpers) to commit \$11 billion in alternative investments, including \$1 billion of direct investments in hedge funds. This was a major stamp of approval, which convinced several pension funds, endowments and foundations to dip their toes into the hedge fund waters. This constituted a radical departure from their traditional approach, which had been heavily centred on bonds and light on anything remotely associated with risk. However, hedge funds and their absolute return approach also brought in a compelling new money management paradigm, which fiduciaries felt compelled to embrace.

The search for quality hedge fund capacity is not easy. It took Calpers almost four years to fully allocate its initial \$1 billion hedge fund commitment. Interestingly, rather than being secretive, Calpers widely publicized both its investment process and the list of specifications for the type of hedge fund it was looking for. This established a pattern that several other institutional investors emulated, therefore accelerating institutional participation in the hedge fund arena. US institutions are clearly well ahead in this process but European institutions are also increasingly attracted to hedge funds. However, several issues are still open, such as (i) the lack of transparency, (ii) the lack of regulation and risk control and (iii) the high level of fees. The answers to these and the increasing use of consultants for alternative investment manager selection will undoubtedly determine the shape of the hedge fund industry in the years ahead.