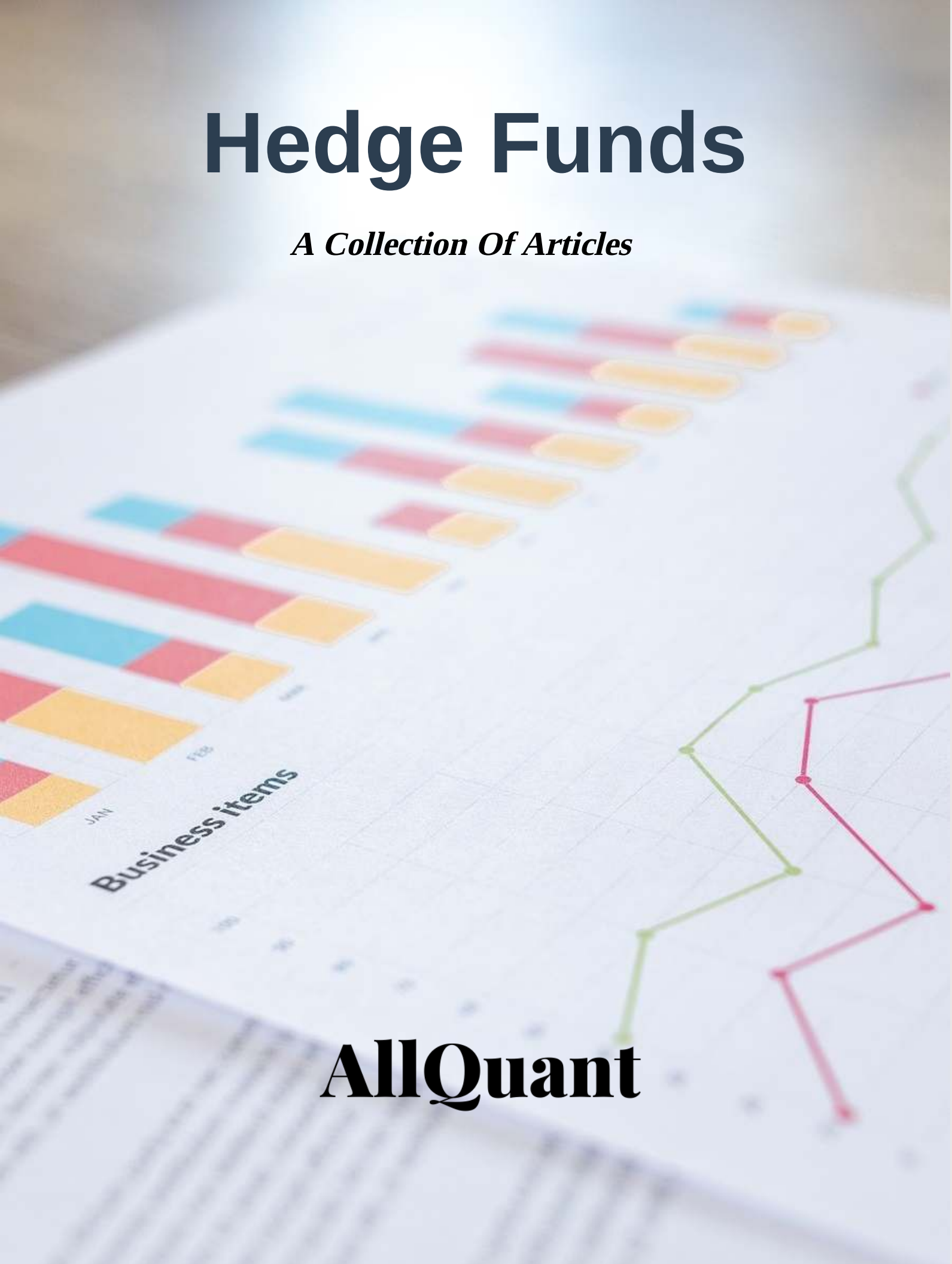
Hedge Funds

A Collection Of Articles



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Written By

Eng Guan Lim (E.G.)

16 Questions To Test What You Know About Hedge Funds

Ask anyone on the streets if they know what "hedge funds" are, and you will most likely be greeted with a blank look. And if not, thanks to bad press, a range of answers with often negative connotations. For example:

1. The name says it all. Well, they hedge.
2. It is a type of very risky investment. These guys are responsible for all, if not most, of the market crashes.
3. I have seen them on news. They charge ridiculously exorbitant fees but yet deliver mediocre results.

And the list goes on.

It might be instinctive, but as a professional in the industry, I see it as my duty to educate and correct any misconceptions that anyone might have about the work we do. Though I must admit that there are some facets of truth in these replies.

As an example, many hedge funds do hedge, but some don't. It is a matter of what strategy they use. Depending on what type of risks you are looking at, hedge funds may not be any riskier than your typical passive index funds or buy-and-hold stock portfolio. In fact, some risks, such as market risks, can actually be lower. As for fees, I would not deny that it is higher than most traditional investments. There are many debates on this both for and against. But ultimately, investors determine what they are willing to pay depending on the value they perceived. What perhaps might be a surprise to some though, is that despite performance trailing the markets in recent years, hedge funds actually still outperform over the longer term (starting from the 90s).

I will leave these for now, each of which can be a lengthy topic by itself. For now, let's answer some basic questions.

16 Questions To Test What You Know About Hedge Funds

1. Who founded the first hedge fund?

Many people does not know the answer to this question, even for those who work in this industry. Most just never bother to ask themselves this question and I am one of those when I first started my job. It is not a requirement to know and neither is it something that ever pops up in the course of my work while talking to colleagues or clients. At least, not that I remember. People tend to talk more about the greats of their time – Paul Tudor Jones, George Soros, Ray Dalio, Kenneth Griffin, Steve Cohen, Jim Simons, etc. But, still, I believe it is good to know, especially for someone who works in this industry.

There are 2 persons who can claim credit to the founding of hedge funds. The more well-known is an Australian named Alfred Winslow Jones, and the other, an American called Karl G. Karsten. Interestingly, both of them were not finance professionals to start with.

Karl G. Karsten

Karl G. Karsten was a statistician and economist. In the course of his research work, he developed certain "barometers" to forecast business conditions. These included measures on volume of trade, interest rates, wholesale price level, building activity etc. In the 1930s, he applied these "barometers" to the stock market by starting a private fund using his and his colleagues' money. He set the foundation then, perhaps for the first statistical arbitrage fund, where he bought a group of stocks that are predicted to do best and shorted another that are predicted to do worst. According to records, his fund did very well. In less than 6 months, it was up 78%, and it displayed desirable characteristics such as the ability to make large gains while keeping losses low. It also exhibit a return profile that is independent of the market it trades. However, his sole objective is to test out his theory. There was no intention on his part to ever evolve this into a commercial for-profit fund.

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Alfred Winslow Jones

Alred Winslow Jones was born in Australian, but moved to the United States at the age of 4. He is also acknowledged as the "father of the hedge fund industry". Prior to his involvement in hedge funds, he had worked as a diplomat and journalist. He also subsequently earned a doctorate in sociology. So why was he given this title? Because after that, he pioneered the first commercial for profit hedge fund in 1949 with a significant amount of his own money using a partnership structure. This partnership structure helped him circumvent the restrictive Securities and Exchange Commission (SEC) regulations, allowing him more flexibility in his choice of investment strategies. He also took a 20% cut of the profits on the fund and charged no fees if he did not make any money.

He based his strategy on 2 simple principles: (1) he believed he has superior stock picking skills, (2) but he is unable to predict broad market directions. So what he did is also similar to what Karl G. Karsten did, he bought stocks that he thinks will do well, and shorted those that he thinks will do badly, albeit using different proportions and means to select the stocks. The shorts are what constitute the concept of a hedge and hence the name "hedge funds". The net result is a portfolio that was less sensitive to broad market movements and with profits that were highly dependent on his ability to pick the right stocks. In addition, he took on leverage to amplify his returns, by using the proceeds from his short sales to increase the positions of the stocks he bought. What he did then is still very much relevant today.

16 Questions To Test What You Know About Hedge Funds

2. What are hedge funds?

This might disappoint you, but a simple definition does not exist. You can easily look up the websites like **Investopedia** or **Wikipedia** or read from books. Most of the answers will be along lines that hedge funds are alternative investments, pooled funds, lightly regulated, accessible only to accredited investors, pursue aggressive strategies (e.g. shorting, concentrated bets, use of derivatives, leverage etc), illiquid, and measured on absolute returns and so on. These are all correct but rather restrictive definitions.

You cannot rely on the literal meaning of "hedge" as well. Modern day hedge funds, even though they are still called "hedge funds", have evolved to do all sorts of different things other than what Karl G. Karsten or Alfred Winslow Jones started. The concept of a hedge may not be as strong, or even just outright not applicable to some of these funds. Even the boundaries between hedge and mutual funds are blurring. For example, long-short strategies use to be associated only with hedge funds. Today, you can also find special long-short mutual funds such as the 130-30. On the regulation side, hedge funds, meeting certain criteria, can also be offered to retail instead of only accredited investors. So do not be too obsessed with finding a perfect definition.

3. How much assets are held by Hedge Funds?

As at 1st quarter of 2018, the Assets Under Management (AUM) for hedge funds stands close to USD 3 trillion. You can visit Barclayhedge.com to see the latest information. The AUM has steadily increased from year 2000, only to suffer a huge drop during the 2008 financial crisis. But as of today. it has broken the prior records.

16 Questions To Test What You Know About Hedge Funds

4. What is the relationship between the Investment Management Company (IMC) & Hedge Fund?

People often use certain terms of a hedge fund structure loosely in a casual conversation. This can often lead to confusion later. For example, some refer to the hedge fund and its investment management company interchangeably. This is especially when their names bear close similarities, which is frequently the case. For example, you can have ABC Capital Pte Ltd which manage ABC long-short equity fund and ABC global macro fund.

The fund is a separate entity set up to hold money and make investments according to the fund's offering documents. The investment management company (IMC) is a licensed entity that is appointed to manage the fund's investments. It does the research, makes the investment calls, size up the positions, execute trades, monitor risks, does the marketing and handles investor relations etc. In majority of the cases, this company is also the one that sponsors and sets up the fund. The IMC, together with other service providers engaged by the fund, carry out most of the work. Other than a board of directors, the fund has no employees. Such an arrangement is not unique to hedge funds. You will find similarities within the more well-known mutual fund industry.

The portfolio manager is the person in the IMC that manages investments for the fund. This person can be an employee, but more often than not, he/she is also a stakeholder in the IMC and has a personal investment in the hedge fund itself.

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Investment Management Company

- Manage the hedge fund's investments.
- Sponsors and sets up the hedge fund (mostly).
- Performs investment management activities i.e. research, makes investments calls, size positions, monitor risks etc.
- Markets the hedge fund.
- Partners or stakeholders of the company usually have a personal investment in the hedge fund.
- Portfolio managers are often partners of the company

Hedge Fund

- A separate legal entity from the investment management company.
- Can be domiciled in an offshore country, usually a tax haven like Cayman Islands.
- Set up for specific investment purposes outlined in the offering documents.
- Holds cash and investment assets.
- Appoints the investment management company and other service providers to run the fund.

16 Questions To Test What You Know About Hedge Funds

5. Why do we need a separate fund entity? Why not just do everything within the IMC?

The segregation of the fund from the IMC benefits both the IMC and the investors. In such an arrangement, investors can participate in the fund's profits without taking on business risks associated with the IMC. The fund pays a management fee to the IMC but is not liable for expenses incurred by the IMC such as office rental, computer infrastructure, utility, and manpower costs. If the IMC were to go bust for whatever reason, creditors will also have no claim over the investor's assets in the fund, except for the IMC's own investment in it, if any. The IMC in turn gets full discretion over the management of the fund and is able to fully concentrate on investment management to deliver on its returns. If there is any perceived downside, it would be that investors in the funds have no voting rights or say in the management of both the IMC and the funds. They can, however, exit the fund by way of redemption according to the terms stated in the offering documents.

16 Questions To Test What You Know About Hedge Funds

6. What is a pooled investment and are there any implications?

The concept is simple. Let's say you are good at investing and would like to help your family and close friends make some money. So you raise money from them and put it all into a single broker account under your name to trade or invest on their behalf. In this scenario, you might want to note that while the broker holds the money, it does not how much belongs to who. As far as they are concerned, it all belongs to you. Thus, the onus is going to fall on you, or someone else that the people who parked their money with you can trust, to maintain proper records of all the transactions and keep track of how much each person holds in the account.

Sounds like common sense? Yes, that is the gist of it. But in an institutional setting like hedge funds, you are not just going to be dealing with your family or close friends who have absolute trust in you. You will need to have proper legal structures and safeguards in place. For that purpose, most funds engage external service providers such as fund administrators to perform this function. This gives assurance that the IMC cannot freely manipulate the numbers.

There are benefits to such a set up. A pooled arrangement provide investors, even smaller ones, with economies of scale such as lower trade commissions, lower borrowing costs, better broker services, ability to diversify more widely across different assets, regions or strategies etc. It is also easier for the portfolio managers operationally, since they just have to focus on managing a single pool of money without concerns on conflicts of interests.

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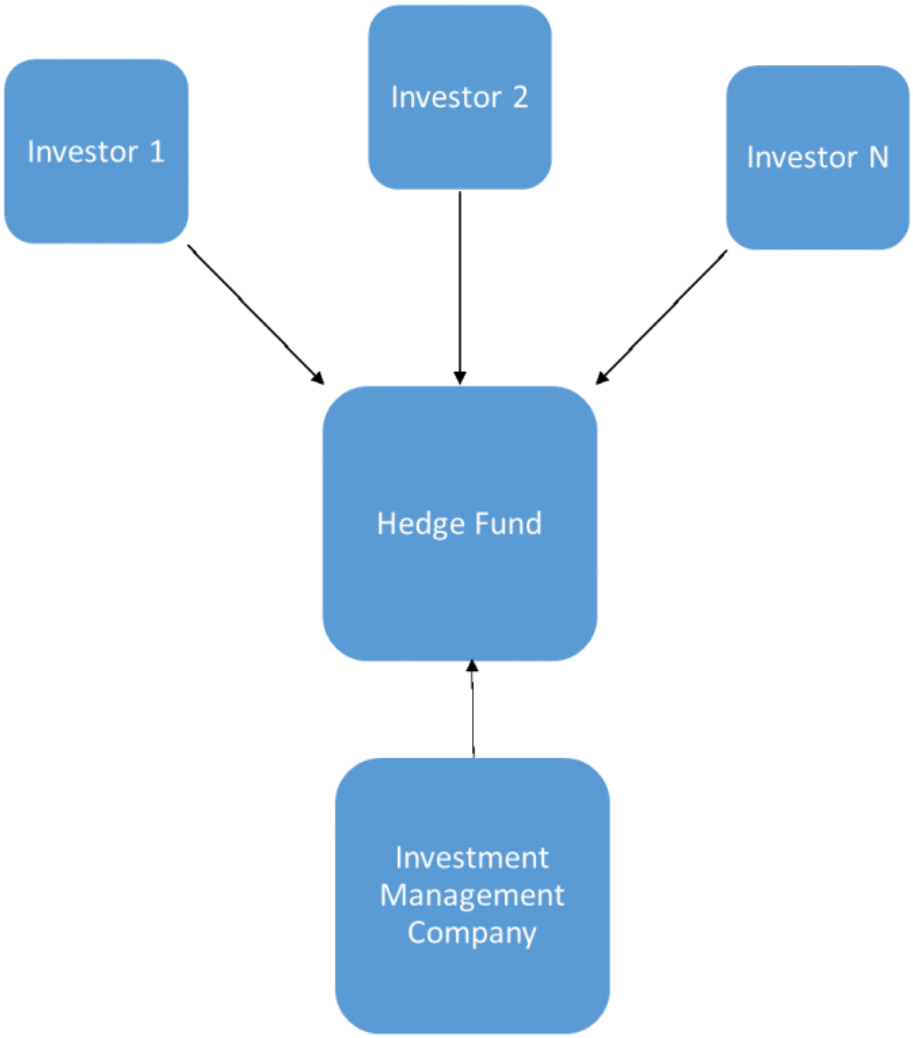

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7. Are there other alternative besides a pooled fund?

Some IMCs do offer what is often called managed accounts as an alternative to a pooled structure. In that case, a separate hedge fund entity is not needed. What are managed accounts?

Let me use back the previous example. So instead of pooling all the money into an account under your name, you ask each one to open their own personal broker account and fund it. After that, both parties will agree on terms like performance targets, risks and compensation etc. Then your family and friends will authorize you to trade on their broker accounts. Basically, that is it.

Hedge fund managed accounts operate in a similar way. This type of arrangement is actually gaining favor among investors as there are various advantages. It is gives psychological security since the money remains with the investor. Investors have greater flexibility and control to tailor the investment solutions to their needs. They have full transparency on their account to know what is happening to their funds. On top of that, large investors can often negotiate better terms, e.g. lower fees, for themselves. However, managed accounts can be operationally taxing for the IMC since they would have to juggle conflicts of interests, trading and record keeping among multiple accounts. In addition, if the account is too small, it may not be feasible to implement certain strategies. Hence, hedge fund managers usually require managed accounts to be of a certain size before they think it is worth taking on.

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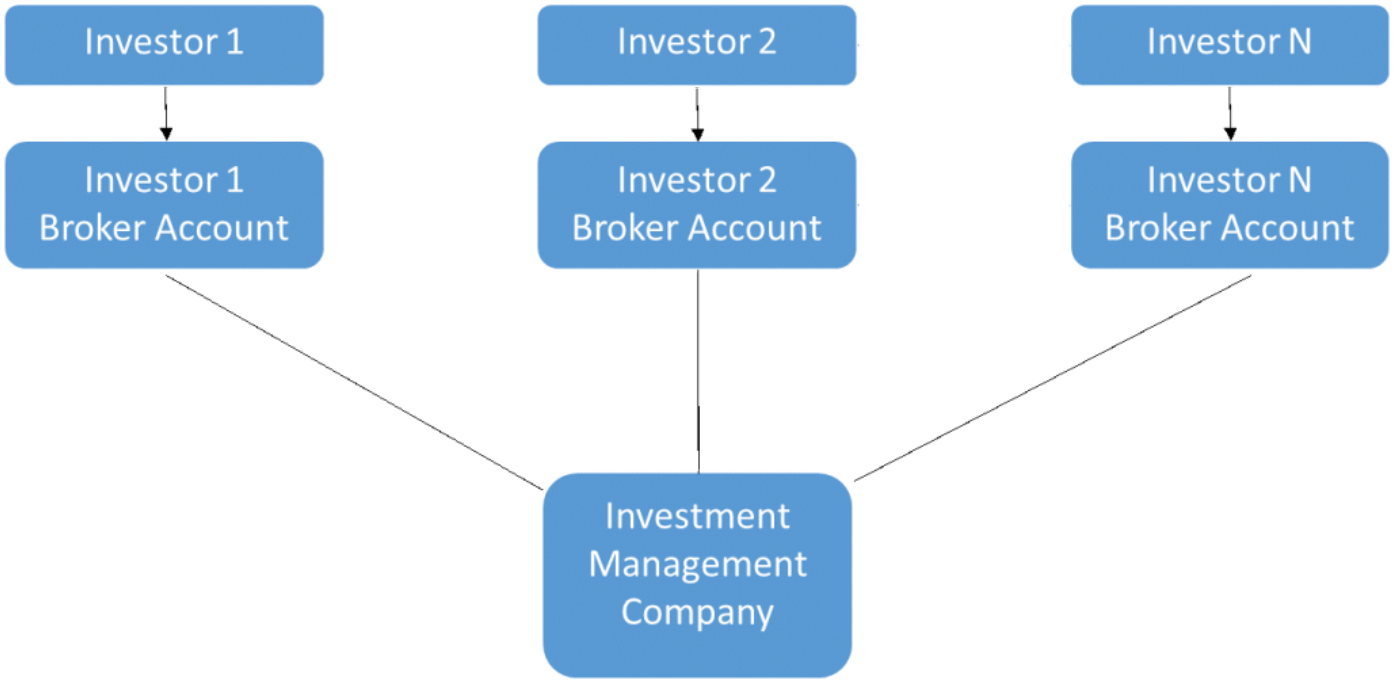

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8. Why is there an onshore and offshore version of the same fund?

If you have followed news or readings on hedge funds, you will most certainly come across funds that seem to have an onshore and offshore "version". I was baffled too when I first encounter these terms while trying to compile performance data about a few hedge funds I was researching on. That was more than a decade ago.

Onshore funds are domiciled in the local jurisdiction and offshore funds are funds domiciled in other foreign jurisdictions. As it turns out, tax implications are the impetus behind the use of an offshore fund which is typically incorporated in a tax haven such as Cayman Islands. And do not be mistaken, this is not some shady tax evasion plan. It is entirely legitimate and sensible. These offshore fund caters to foreign investors and other tax-exempt entities so that they will not be subject to any inadvertent tax from the local jurisdiction of the onshore fund. For example, if you are a non-US investor and you invest in a US onshore fund, you might find yourself subject to certain US taxes such as income tax if the fund engage in specific activities, and estate tax upon death.

The solution to this is to park your money with the offshore fund instead. To cater to global investors, many US funds adopt a master-feeder structure, with an onshore US feeder fund for US investors, an offshore feeder fund for foreign or tax exempt investors, and an offshore master fund. The 2 feeder funds will invest everything into the offshore master fund. All investment activities are carried out in the master fund.

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9. Who can invest in hedge funds?

Hedge funds in most jurisdictions are lightly regulated. This frees them to implement non-traditional strategies that would not have been possible, say, in a mutual fund. But this flexibility comes at a price. Most hedge funds are only allowed to be marketed and sold to accredited investors.

Someone who is accredited is assumed to be sophisticated enough to understand and undertake the risks involved. What does it take to be "Accredited"? For individuals, the yardstick to qualify as one is rather superficial. On most part, you just got to show that you are rich. How rich? That depends on the regulations governing where the fund is offered. In the United States, you would need a net worth of USD 1 million excluding the value of your primary residence or have an annual income of USD 200,000 or more in the last 2 years. In Singapore where I am, you will need to have a net personal assets of at least SGD 2 million or have an income not less than SGD 300,000 in the preceding 12 months.

For institutions, licensed and regulated entities such as banks, fund of funds, sovereign wealth funds, pensions or listed companies are all eligible as investors. You can look up a compiled list of what it takes to be accredited in different countries on **Wikipedia**.

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10. What kind of strategies can hedge funds use?

Hedge funds can use non-traditional strategies to make money. This is in contrast from most mutual funds that are mostly long-only. Long-only funds can only pick and buy securities. Hedge funds can short-sell, trade on margin (leverage), use derivatives, take on concentrated bets, buy and trade physicals such as real estate/gold/oil and much more. This greatly widens their latitude to make money in different market conditions, thereby producing a different return profile from mutual funds. This is their major selling point as another asset class to own for diversification benefits.

There are a whole multitude of different hedge fund strategies today ranging from equity long-shorts, activists, sector specialist, distressed investing, event driven, convertible arbitrage, merger arbitrage, global macro, multi-strategy, volatility to fund of funds and more. A few can technically be classified under the umbrella of a broader strategy. But do not be too fixated on these strategies as I will not be touching on them here. It is good enough to have a flavour of how diverse the hedge fund strategy landscape looks.

16 Questions To Test What You Know About Hedge Funds

11. What are hedge fund's benchmark and how does it differ from mutual funds?

For mutual funds, it is more straightforward to see if the manager is adding any value through his active management. Since their scope revolves very much around their designated market, you can compare how the fund did against its benchmark (usually some market or composite index). You can call this the relative returns approach. A good active mutual fund will be able deliver stable and consistent excess return (after fees and expenses) above their benchmark. To achieve this, the mutual fund manager would have to be a star performer in picking both good stocks to overweight and bad stocks to underweight. The difficulty to outperform the benchmark is compounded by fees which over time can take a hefty chunk out of the returns. For the same reason, passive mutual funds or index funds, which are simply set up to replicate a market index, will always underperform its benchmark.

Hedge funds are measured based on absolute returns as opposed to relative returns used by mutual funds. Absolute return is like a fixed or range of target returns which the hedge fund will aim to deliver regardless of market conditions. Why adopt such a measure? First of all, a key motivation behind early and many modern hedge funds stems from being independent of the market. Secondly, it is difficult to set a meaningful benchmark for hedge funds. Even funds among the same class of strategy can be radically different. For example, both a long-volatility fund and a short volatility fund would be grouped as volatility funds and perhaps be compared against a volatility hedge fund index. But because most volatility hedge funds are short-volatility, the index will be heavily skewed towards short-volatility. It would not then make much sense to compare a long-volatility fund against it.

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12. Do hedge funds really make money in all conditions since they pursue absolute returns?

Personally, I do not fully agree with the definition of hedge funds aiming to deliver regardless of market conditions. Modern day hedge funds are much more diverse and there are some with very specific focus. For example, there are long-only hedge funds and these funds are not immune when the bear hits. There are also dedicated short-bias funds and long volatility funds that specialize in being a hedge for tail events. These funds keep a slow-bleed on most of the time since market is usually on an uptrend and volatility keeps decaying over time.

You might be thinking who would want to run such a fund. Would anyone even invest in them? The answer is yes. Because when the big crash comes along and trounce most people out there, these guys jump through the roof and have their last laugh. So they fill an important gap in the portfolio of large institutional investors who allocate capital to these funds to get the protection they need during bad times.

Hence, we should not take the definition of absolute return as a one size fits all. All strategies have will their own strengths and weaknesses. What is more important is for the investor to do his/her own due diligence to understand and find out what each fund is made out to do before plunging in.

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13. How transparent is a hedge fund?

Most hedge funds are shrouded in secrecy. In the first place, they are not allowed to market publicly so it is no wonder not much is known about them. Unlike mutual funds which published a lot more information on their reports such as country, sector, industry exposure and their largest holdings, hedge funds are not required to do so. There are no governing standards on the reporting format. What is reported will differ from fund to fund. But most hedge fund reports will display basic metrics such as month-to-date return, year-to-date return and a commentary. If investors require full transparency, they are better off opting for a managed account if it is available.

16 Questions To Test What You Know About Hedge Funds

14. How liquid are hedge funds?

Liquidity is how readily you can buy or sell something. For example, actively traded large-cap stocks are highly liquid. You can buy or sell the stock in large quantities during trading hours without materially impacting the price of the stock. Mutual funds are also considered liquid investments since you can subscribe or redeem from it on a daily basis. Hedge funds, however, are a lot less liquid in comparison.

The liquidity terms among hedge funds can vary a great deal. It is really up to the fund's sponsor, usually the IMC, to define the terms in the offering documents. To a large extent, it depends on the strategy of the fund. A short term trading fund with holding period of days to weeks may provide monthly liquidity or better, meaning you can subscribe or redeem every month. An equity long-short fund that invests over a long term horizon may provide quarterly or semi-annual liquidity, and quite often, also impose a lock-in period of a year or more. Lock-in is a stipulated period where the investor is unable to redeem (hard lock-in) or can redeem but with a penalty (soft lock-in). On the other end of the spectrum, funds that deal with private equity or hard to liquidate assets can lock your money in for as long as 5-10 years.

16 Questions To Test What You Know About Hedge Funds

15. What are the fees and expenses associated with investing in a hedge fund?

Let's look at the more well-known and debated one first – fees. Hedge funds generally charge what is known as 2 and 20 in the industry. This means an annual 2% management fee and 20% performance fee. These fees are paid to the IMC. The 2% management fee is calculated and deducted monthly (pro-rated). This is to pay the IMC for their investment management service. It goes to cover running costs and salaries of the employees in the IMC. The performance fee may follow a different schedule, say, quarterly, semi-annual or annual. At the end of each scheduled period, if the fund's value rises above the previous high water mark (previous high made at the end of each scheduled period), it takes a 20% cut of the profits. If the AUM of the hedge fund is large, this payout can be substantial.

The fund also incur expenses which are deducted off directly from the fund. These are not included in the fees. For example, the initial set up costs of the fund is usually borne by the initial investors. The fund also pays a host of other things such as fees to the fund administrator, fund auditor, fund legal counsel, fund custodian, regulators, distributors as well as trading related costs such as market data, broker commissions, etc. While these expenses can be material for a starting hedge fund with little assets, it becomes a lot more manageable if the fund size grows huge and it is spread out over more assets.

Overall, hedge fund fees and expenses are higher than mutual funds whose expense ratio which can be as low as 0.25% (passive index funds) or more than 2% (active managed funds) and it covers pretty much everything. This glaring difference pressured many hedge funds into lowering their fees especially with increasing competition and lackluster performance in recent years.

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16. Can I use hedge fund type strategies on my personal trading account?

The answer is both yes and no. You can have the expertise but that is not all there is to it. While some strategies like equity long/shorts can certainly be replicated on smaller accounts, there are others that are simply out of reach for the average person. As an example, a hedge fund that trades a diversified portfolio of futures contracts such as e-mini S&P 500, Nikkei 225, 10 Yr Treasuries Note require a certain size to implement (without taking ridiculously high leverage) as each contract is currently valued at more than USD 100,000 each notionally. High frequency trading strategies are also beyond the means of most people due to the high set up cost. Activists funds are also not for the typical Joe, as it requires you to buy huge stakes into the company to steer and influence management decisions.

That's all for now. Hope this gives you a better idea of what hedge funds are, how and why they operate as they do, and some of their distinctive features.

Which Is A Better Investment

Hedge Funds Vs Equity Market

Written By

Eng Guan Lim (E.G.)

Which Is A Better Investment - Hedge Funds Vs Equity Market

People like to compare. I guess it is just human nature. But many times, the basis for comparison may not make a lot of sense. If you are a fund manager, you might encounter people that frequently compare your fund against the stock markets regardless of what the fund strategy is. For example, I will not be surprised if an investment manager who runs a dedicated short bias fund receive questions like "Why did your fund not make any money? This is one of the best bull market in history!"; or a long-only manager getting quizzed on why he failed to deliver a positive return during a huge market crash. On the positive side, more often than not, this stems from a lack of understanding of the product's strategy rather than being unreasonable.

In this piece of writing, I am also doing a comparison. I will be pitting hedge funds against the global equity markets. I will admit it is not really comparing apple to apple. But you could see them in news every now and then anyway. Hedge fund performance have, in particular, come under close scrutiny after the subprime meltdown in 2008. Why? Because equity markets have steadily rose, especially US, after rounds and rounds of global quantitative easing flushed the system with cheap money. Hedge funds as a group, on the contrary, lagged far behind during this period. Index fund proponents and hedge fund critics, including renowned investor Warren Buffett, were quick to lambast the industry's poor performance, high fees and question its value.

But have hedge funds really lost its shine? Let's look further.

Which Is A Better Investment - Hedge Funds Vs Equity Market

Who Are The Participants?

Let me first introduce our participants in this little study:

1. **HFRI Fund Weighted Composite (HFRI FWI)** – A USD-denominated index net of expenses and fees, comprising of 1500 equal weighted hedge funds (excluding Fund of Hedge Funds), each of which have at least USD 50 million assets under management (AUM) and 12 months track record.
2. **HFRI Fund of Funds Composite (HFRI FOF) –** A USD-denominated index net of expenses and fees, comprising fund of hedge funds i.e. fund that invests in multiple hedge fund managers for diversification. Criteria for inclusion into the index is similar to the HFRI FWI. This index should be less susceptible to certain biases that plagues the HFRI FWI, but of course there are other tradeoffs which I will touch on later.
3. **HFRI Equity Hedge (HFRI EHI)**– A USD-denominated index net of expenses and fees, comprising equity long short funds. Criteria for inclusion into the index is similar to HFRI FWI. This index is probably the most similar to MSCI World, asset class wise, as it derives its returns from equities.
4. **MSCI World (MSCI WL)** – A market cap weighted index that captures large and mid-cap companies in 23 developed markets. I am using the USD denominated value of the net index i.e. the index includes dividends less taxes. Note that this is a passive equity index and hence no expenses or fees are involved.

The data used are of monthly resolution as HFRI only provides monthly data.

Which Is A Better Investment - Hedge Funds Vs Equity Market

Important Things To Note

I have said this earlier. This is not going to be an apple to apple comparison. But as with many instances in life, unlike a highly controlled science experiment you did back in school, you can never establish perfect comparisons. You will just have to make do with what you have, but at the same time, be cognizant of existing issues that may skew the findings.

Which Is A Better Investment - Hedge Funds Vs Equity Market

Here are some points to take note of:

1. **Hedge fund indices suffer from numerous biases such as selection and survivorship bias**. It is not mandatory for a hedge fund to report performance to any index providers. Thus, managers can opt to start reporting only when they have good performance. This is a form of selection bias. Fortunately, HFRI does not backfill the data of the new manager into its index. It only starts including it henceforth, meaning only future performance of the manager is taken into account.

   Funds that have shuttered mostly due to performance reasons may also stop reporting to the index provider way before the fund even close, omitting a period of bad performance which would otherwise drag the index down. This leaves only surviving funds, which tend to be the good performers, thereby putting an upward bias on the index performance. This is called survivorship bias. However, aside from poor performance, there are also funds that did very well, but cease reporting because they are no longer taking in money. So while the former produces an upward bias, the latter creates a downward bias which reduces this effect.

   To mitigate some of these biases, I included the HFRI fund of funds index. All managers managed by the fund of funds will be accounted for in the returns submitted to the index provider regardless of whether their performance is good or bad. Individual managers would not have the choice to opt out of reporting in this scenario. They are left out only when they are no longer invested by the fund of funds. But of course, one can argue that there are active selection by the fund of funds to pick good managers and drop bad ones as well. The representation may also be less comprehensive as fund of funds have a tendency to go for more established managers. To top it off, they charged an additional layer of fees complicating matters.

Which Is A Better Investment - Hedge Funds Vs Equity Market

2. **HFRI indices are equal weighted**. The index is rebalanced annually and equal weight is applied to all funds. That inherently suggest an active mechanism where winners are sold and losers are bought to maintain the weights. One can also contest that the results can be skewed upwards as emerging managers, which receive the same weightage as established managers, tend to deliver higher returns in the long term**.**
3. **HFRI indices have no equivalent investable products.** There are investable products such as ETFs and index funds that are replicated after MSCI WL. HFRI indices, however, have no such investable equivalents. Its underlying funds are investable though. But it will take an enormous resource to allocate capital to 1500 hedge funds. It is, at this moment, an index used mostly for benchmarking and tracking broad hedge fund performance.
4. **HFRI FWI and HFRI FOF are not pure equity indices**. HFRI FWI and FOF cuts across many asset classes, geographical regions, strategies and time frames. MSCI WL, on the contrary, is a pure equity index. That is why I included HFRI EHI, the equity hedged (long-short) index for hedge funds, in our comparison.
5. **Volatility is used as the risk measure here**. Despite its prevalent use and being adopted in modern portfolio theory by Harry Markowitz, volatility as a proxy for risk has been controversial. Because, it does not measure how much you can lose (in a more permanent sense), based on exposure to some specific factors. Technically, it is nothing more than just an indication of how much the value of a security or fund can move from an expected average, both upwards and downwards over time.

Which Is A Better Investment - Hedge Funds Vs Equity Market

Advocators see it as the shortfall risk you may experience should you need to liquidate at an inopportune time. Others will contest that an investor with a long-term horizon would render this reasoning less compelling. And the list goes on. But I am not here to debate this. Yes, everyone has a point. Volatility is not perfect. It is indeed not a good proxy for many types of risks e.g. tail risks, counterparty risks, fraud risks, liquidity risks etc. But at present we have no means to adequately quantify some of these risks, much less to unify them into a single sensible statistic. And if we are talking about large diversified portfolios, as is the case in this exercise, then some of these risks may be dramatically reduced. And to show a slightly better picture, I have also included other metrics like maximum drawdown into this exercise.

Round One – Bull and Bear Let's Compare

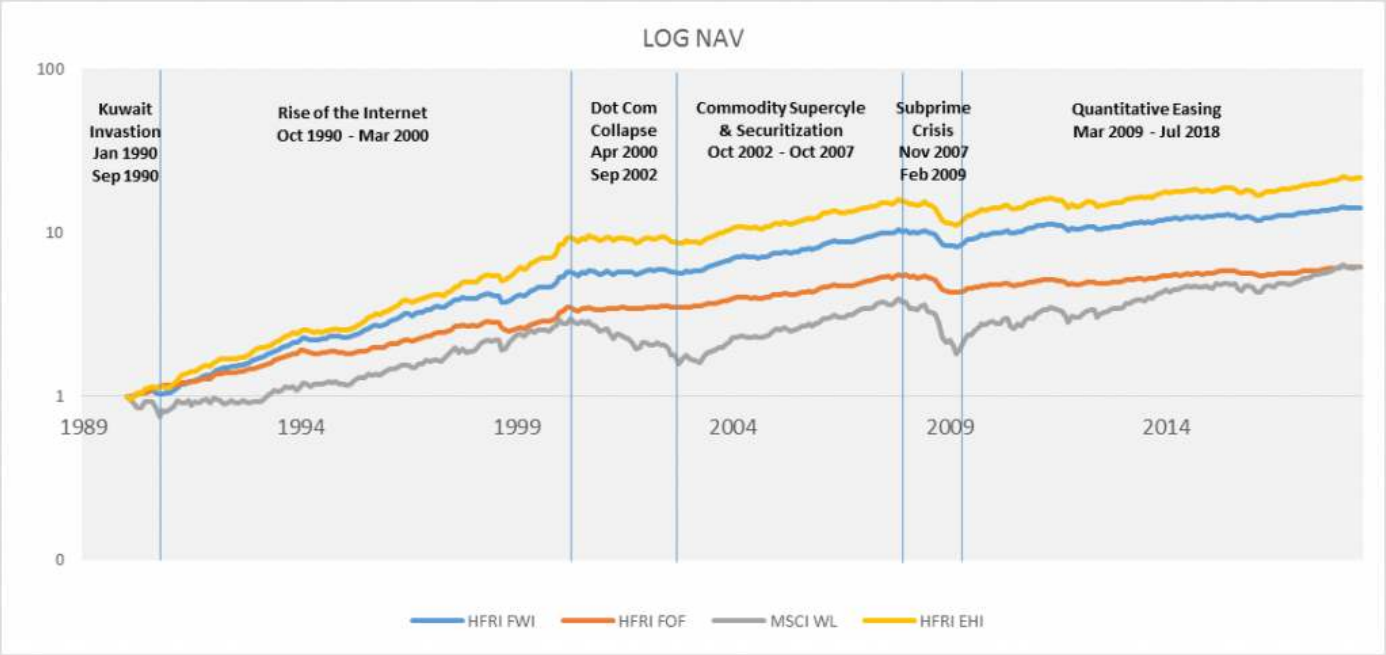
Much of the flak directed at hedge funds in recent years arise from their relatively poor performance after 2008. Since the worst of the subprime crisis in early 2009, we have witnessed one of the longest bull market marked by record low volatility in history, thanks to the central banks for their relentless money printing. This lead to a sharp contrast in performance, casting a bad light on hedge funds. But to be fair, we should look further back in history and cover more market cycles instead of just cherry picking post 2008 period for comparison.

Which Is A Better Investment - Hedge Funds Vs Equity Market

I have taken data as far back as 1990. This is the earliest for HFRI indices. But it should suffice as we have 3 bear and 3 bull phases to examine over this period of approximately 29 years. I define any bear market here to be a drop of more than 20% on the MSCI WL. Let's have a look at the returns and the maximum drawdowns generated by the indices over each bull and bear period. For the chart, I have presented it in log scale, else we would not be able to see the different curves clearly in the earlier years.

				Total Returns			
Phase	**Theme**	**Start**	**End**	**HFRI FWI**	**HFRI FOF**	**HFRI EHI**	**MSCI WL**
Bear	**Kuwait Invasion**	Jan-90	Sep-90	3.7%	15.5%	15.0%	-24.3%
Bull	**Rise of the Internet**	Oct-90	Mar-00	456.4%	202.7%	**720.3%**	293.9%
Bear	**Dot Com Collapse**	Apr-00	Sep-02	-2.1%	-0.4%	-8.8%	-46.8%
Bull	**Commodity & Securitization**	Oct-02	Oct-07	84.3%	59.8%	85.3%	148.9%
Bear	**Subprime Crisis**	Nov-07	Feb-09	-21.4%	-22.0%	-30.6%	-54.0%
Bull	**Quantitative Easing**	Mar-09	Jul-18	74.3%	42.4%	96.0%	248.5%

				Maximum Drawdown			
Phase	**Theme**	**Start**	**End**	**HFRI FWI**	**HFRI FOF**	**HFRI EHI**	**MSCI WL**
Bear	**Kuwait Invasion**	Jan-90	Sep-90	-5.3%	0.0%	-3.3%	-24.3%
Bull	**Rise of the Internet**	Oct-90	Mar-00	-11.4%	-13.1%	-9.0%	-13.5%
Bear	**Dot Com Collapse**	Apr-00	Sep-02	-6.4%	-4.9%	-10.3%	-46.8%
Bull	**Commodity & Securitization**	Oct-02	Oct-07	-2.4%	-2.7%	-3.4%	-9.7%
Bear	**Subprime Crisis**	Nov-07	Feb-09	-21.4%	-22.2%	-30.6%	-54.0%
Bull	**Quantitative Easing**	Mar-09	Jul-18	-9.0%	-7.7%	-13.2%	-19.6%



Which Is A Better Investment - Hedge Funds Vs Equity Market

1. **Almost all HFRI indices underperform MSCI WL during bull markets,** except during the rise of the internet in the 90s. In terms of trend, it would seem that the disparity is getting wider with each bull market. The worst for hedge funds is post 2008. One reason is persistent low volatility, particularly since 2013. Quantitative easing fueled excess liquidity and stock market optimism, propping up asset prices. During this period, you hardly see any major surge in volatility. A few notable ones are Brexit in 2016 and the more recent collapse of the XIV ETF in February 2018. These blow-ups, while spectacular, are short lived. Hedge funds pursue a wide spectrum of strategies, some of which are uncorrelated to the general market but depended on a certain level of market volatility to thrive. Many hedge funds also had in place short positions, whether as a hedge to guard against market sell-offs, or for profit purposes. Over the long run, these impose a drag on their overall performance during market rallies.
2. **All HFRI indices outperform the MSCI WL during bear markets** and by no small margins. This strongly suggests we should not discount hedge funds yet. It is worth noting that during the Kuwait invasion (Jan 1990 – Sep 1990), hedge funds actually made quite a fair bit of money, and during Dot Com Collapse (Apr 2000 – Sep 2002), they lost no more than 10%. This is in sharp contrast with MSCI WL which lost 24.3% and 46.8% respectively in the same periods. Even during the latest subprime meltdown (Nov 2007 – Feb 2009), hedge funds managed with about half (or less) of what MSCI WL loses. These are significant outperformance during critical times.

3. **All HFRI indices consistently experienced a lower drawdown in all the periods, regardless of whether market is in a bull or bear phase**. In fact, the drawdowns are much lower in most of the periods. This means an investor in hedge funds will lose much less, historically speaking, even if he has chosen the worst possible time to invest and redeem.

Which Is A Better Investment - Hedge Funds Vs Equity Market

Round Two – Let's Look Longer Term

So how about longer term performance? Let's see how the HFRI indices stack up against the MSCI WL.

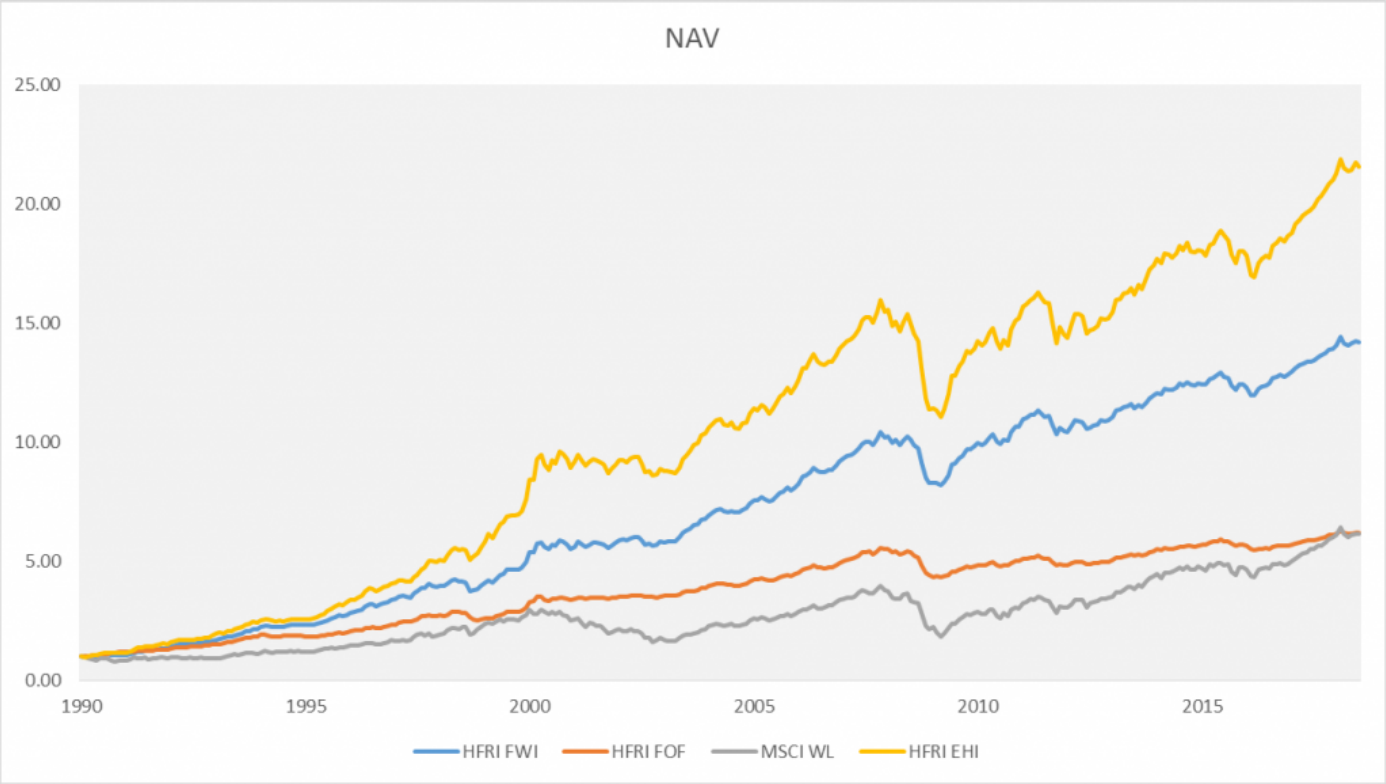
1. **Annualized returns** – In terms of annualized returns, HFRI FWI and EHI still holds the upper hand against MSCI WL if we take results since 1990 and 2000. HFRI FOF, however, underperformed here. If you noticed, the FOF seems trail both MSCI WL and its 2 other brethren. I did not dive deep enough to explore this phenomenon. Manager selection skills can play a part, though I would think a larger portion of this underperformance may be attributed to an additional layer of fees. MSCI WL, on the other hand, clearly held the lead in the period since 2009.

	ANNUALIZED RETURNS			
Period	HFRI FWI	HFRI FOF	HFRI EHI	MSCI WL
Since 2009	5.8%	3.8%	6.9%	11.6%
Since 2000	5.4%	3.5%	5.2%	4.2%
Since 1990	9.7%	6.6%	11.4%	6.7%

2. **Total Returns** – For the periods since 1990, HFRI FWI and EHI deliver more than twice and almost 4 times the total returns of MSCI WL respectively. Let's rebased the indices to start at $1 from Jan 1990. If you had held a dollar worth of HFRI EHI, it would be worth more than $21 today, and a dollar of HFRI FWI would be $14. HFRI FOF and MSCI WL looks more comparable, at about $6 each today.

	TOTAL RETURNS			
Period	HFRI FWI	HFRI FOF	HFRI EHI	MSCI WL
Since 2009	72.0%	42.9%	90.0%	185.5%
Since 2000	166.6%	89.4%	157.8%	114.3%
Since 1990	1325.9%	518.6%	2068.9%	532.2%

Which Is A Better Investment - Hedge Funds Vs Equity Market



3. **Annualized Volatility** – In terms of annualized volatility, all HFRI indices are significantly less volatile than MSCI WL. Volatility is a common proxy for risk. It gives an indication of how much we can deviate from the expected returns.

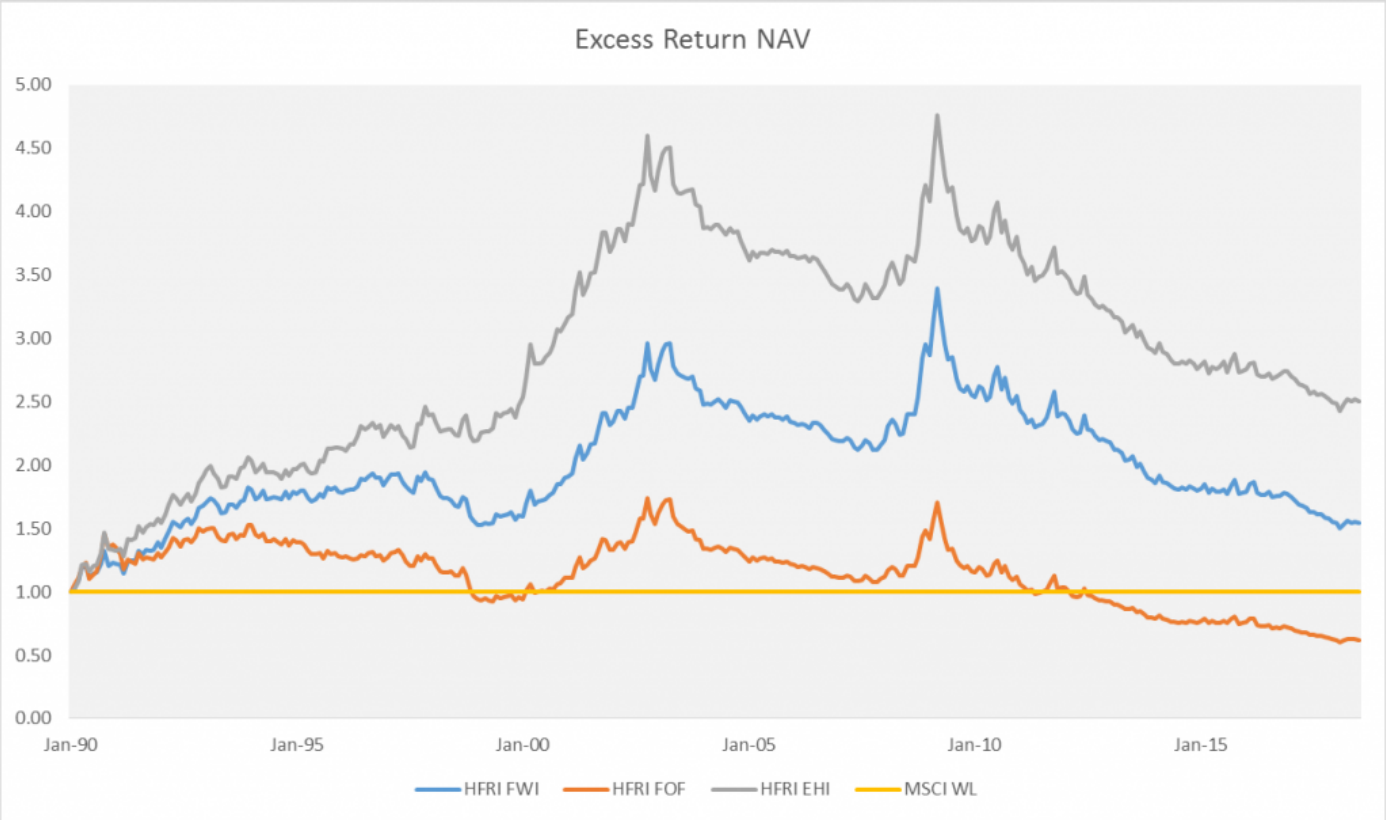
	ANNUALIZED VOLATILITY			
Period	**HFRI FWI**	**HFRI FOF**	**HFRI EHI**	**MSCI WL**
Since 2009	4.9%	3.8%	7.1%	14.1%
Since 2000	6.0%	4.9%	8.2%	15.2%
Since 1990	6.5%	5.4%	8.6%	14.8%

4. **Sharpe Ratio** – It is never complete to look only at returns or risk in isolation. A good fund would be able to give you more bang for the buck in terms of more returns per unit risk taken. Sharpe Ratio measures this. For simplicity, we will just take the returns divide by volatility to get their respective Sharpe Ratios. After adjusting for volatility, all HFRI indices deliver more returns per unit volatility over all the periods considered, even for the period since 2009.

Which Is A Better Investment - Hedge Funds Vs Equity Market

	SHARPE RATIO			
Period	HFRI FWI	HFRI FOF	HFRI EHI	MSCI WL
Since 2009	1.18	1.00	0.97	0.82
Since 2000	0.91	0.71	0.64	0.28
Since 1990	1.50	1.21	1.32	0.45

5. **Excess Returns over MSCI WL** – A key contention is that hedge funds performance have deteriorated over time. It would indeed appear so from the data thus far. To get a more precise picture, I computed the excess return of each HFRI index over MSCI WL each month. Then I build an equity curve for each based on their monthly excess returns. You can see that the HFRI excess returns fall during bull market periods and then it catches up rapidly during bear markets. But since 2009, these excess returns have been falling steadily for a protracted period. While HFRI FWI and HFRI EHI remains above water, FOF have dipped into negative territory i.e. below MSCI WL. It is, however, still premature to decide conclusively how this will unfold in the future .



Which Is A Better Investment - Hedge Funds Vs Equity Market

6. **Other metrics** – Let's take a look at some other metrics computed for the period since 1990. HFRI indices all experienced significantly less drawdowns than MSCI WL. Their average monthly upside is also more than the downside, with their best and worst month giving comparable returns. Overall, this is a desirable outcome. MSCI WL, on the other hand, has a less favorable performance here.

Since 1990	HFRI FWI	HFRI FOF	HFRI EHI	MSCI WL
Max Drawdown	-21.4%	-22.2%	-30.6%	-54.0%
Max Month	7.7%	6.9%	10.9%	11.2%
Min Month	-8.7%	-7.5%	-9.5%	-19.0%
Avg Up Month	1.7%	1.3%	2.2%	3.2%
Avg Dn Month	-1.4%	-1.2%	-1.8%	-3.5%
Avg Month	0.8%	0.5%	0.9%	0.6%
% Positive Months	71%	69%	68%	62%

Which Is A Better Investment - Hedge Funds Vs Equity Market

Warren Buffett's Decade Long Bet (Dec 2007 – Dec 2017)

I thought of sharing my views on this **famous bet**. Warren Buffett have always been a hedge fund critic. In Dec 2007, he placed a million dollar bet that an index fund would outperform hedge funds over the next 10 years. And he won. For the same period, MSCI WL delivered a total return of 63.4% beating all 3 HFRI indices. But that is only if you look at absolute returns. On a risk adjusted basis, using Sharpe Ratios, hedge funds still have a slight lead. Moreover, if he had picked a longer period or any other 10 year cycle that exclude post 2008 period, the results might have been radically different. Still, I have to give him the credit of choosing right time to make the wager. A win is a win. In the meantime, we can wait and see how things turn up in another 10 years.

Warrent Buffet Bet	HFRI FWI	HFRI FOF	HFRI EHI	MSCI WL
Total Returns	37.4%	11.3%	36.8%	63.4%
Ann Returns	3.2%	1.1%	3.2%	5.0%
Ann Vol	6.0%	5.1%	8.5%	16.3%
Max Drawdown	-21.4%	-22.2%	-30.6%	-54.0%
Sharpe Ratio	0.5	0.2	0.4	0.3
Max Month	5.2%	3.3%	6.4%	11.2%
Min Month	-6.8%	-6.5%	-9.5%	-19.0%
Avg Up Month	1.2%	0.9%	1.7%	3.3%
Avg Dn Month	-1.4%	-1.3%	-2.1%	-3.9%
Avg Month	0.3%	0.1%	0.3%	0.5%
% Positive Months	64%	64%	63%	61%

Which Is A Better Investment - Hedge Funds Vs Equity Market

Parting Thoughts – Hedge Funds Still Has An Edge

The results looks quite clear. Hedge funds still has the edge over the long term.

Even though hedge funds may appear to have deteriorated after 2008, I would say this is not out of expectations. Hedge funds tend to underperform the stock market during bull phases. And this has been an exceptionally long bull market. If the current bull market continues raging on without signs of abating, I would expect hedge funds as a group to lag even further behind, and any buffers that hedge funds have accumulated since 1990 could possibly be eroded away.

To many, it seems like a no-brainer to make money. All one has to do is to buy a low-cost index fund or ETF and hold it. Why bother investing in hedge funds and pay costly fees to someone who can't even beat the market? But all parties will come to an end, and we should not forget that hedge funds have delivered significant outperformance during all the previous downturns. I believe hedge funds still has a place as an attractive alternative investment.

Until then, let's see if the buffer runs out before the bear comes.

Drowning In Expenses Hedge Fund Startups

Written By

Eng Guan Lim (E.G.)

Drowning in Expenses : Hedge Fund Start Ups

Many years back, I was searching for information on how to set up and run a hedge fund. Can I start one myself? That was my thought then. However, I was sorely lacking in information. In particular, I want to know how much it is going to cost. It was not an easy task. I managed to gather bits and pieces from the internet and friends in the industry. But like solving a giant puzzle, there are always missing pieces. Pieces which you know you are missing, and pieces which you don't know you are missing. And costs are one of those.

I guess I could have talked to a fund lawyer. But it was not a firm thought then. I was not some pedigreed portfolio manager looking to go start his own fund. Neither am I rich to begin with, nor do I have wealthy sponsors lining to back me up. I don't want to go to a fund lawyer sounding stupid, looking less than half-committed, and end up wasting both side's time. Anyway, to cut the long story short, I did not end up starting a hedge fund. Instead, I joined a start-up hedge fund several years later. Only then did all the pieces fall into place. Not surprisingly, I have way underestimated what is needed.

For those who are contemplating starting and running one with the investment management company based in Singapore, there are a few things you might want know.

Drowning in Expenses : Hedge Fund Start Ups

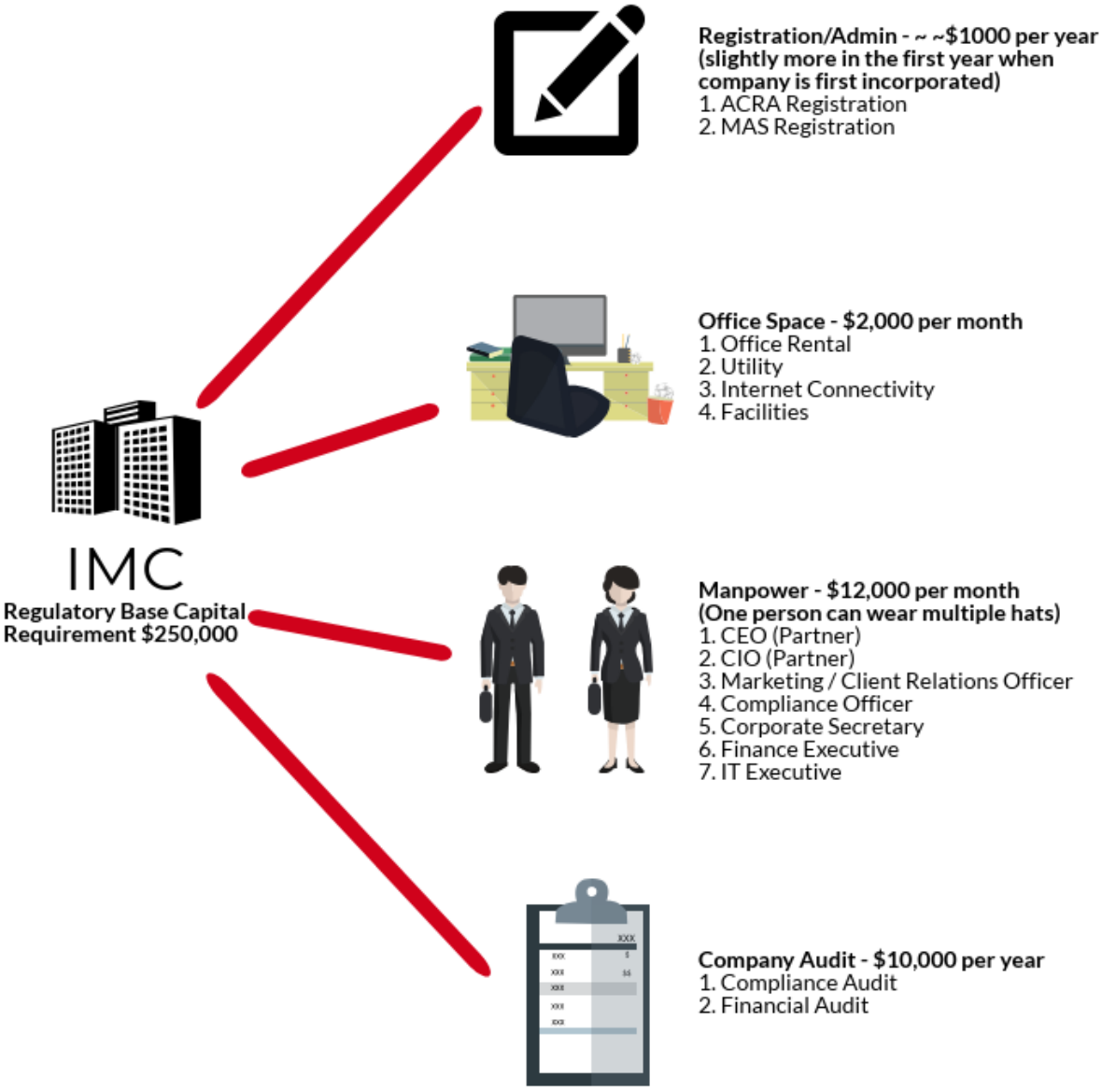
Managed Account Or Fund Structure?

We often use the term “hedge funds” loosely. It is just a broad term. And some “hedge funds” actually do not have funds. Instead of pooling all the money they raised into a fund, they managed separately the individual private accounts of their clients. We call these managed accounts. There are advantages to this approach, such as lower costs, since that does away with the need for a separate legal entity. However, this may not always be feasible if the individual accounts are too small to achieve economies of scale or to execute your investment strategies.

In this post, I will focus on the more typical fund structure approach. There are 2 entities involved. First, you need to incorporate an Investment Management Company (IMC). After that, you need to create a Hedge Fund (HF). The HF holds the pooled assets of all its investors and engages the IMC to manage these assets. It sounds kind of roundabout, but this elaborate arrangement is necessary. It segregates the investors’ assets and isolate them from business risks associated with the IMC. For more generic information about hedge funds, you can read up an earlier article I wrote 16 Questions To Test What You Know About Hedge Funds.

Drowning in Expenses : Hedge Fund Start Ups

Investment Management Company (IMC)



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Incorporating the IMC: $300-$400

The IMC is a private company you can easily incorporate with the Accounting And Corporate Regulatory Authority (ACRA) for a few hundred bucks. You can see the list of applicable fees on ACRA's website.

Registering with Monetary Authority of Singapore (MAS): $1,000 per year

Before you can conduct money management business, you need approval from the Monetary Authority of Singapore (MAS). For a start, you are likely to do just a basic registration instead of applying for a capital markets license. That makes the IMC a Registered Fund Management Company (RMFC). Going forward, you just need to comply with the rules and pay an annual admin fee of like $1000. RFMC are subject to slightly less onerous rules and requirements than its licensed counterparts. But it comes with certain restrictions, e.g. the IMC cannot manage more than $250 million. The good news is you can upgrade to a Licensed Fund Management Company (LFMC) anytime subject to approval of course. For details, I suggest you you refer to the guidelines on MAS's website.

Maintaining the base capital: $250,000 at all times

As a RFMC, you have to comply with a host of rules. One of the rules require the IMC to maintain a base capital of $250,000 at all times. This is a mandated buffer set aside to meet financial obligations. A breach is serious, and recalcitrant offenders can have their registration or license revoked. This means internally you have to set a higher threshold, say $350,000, so that you would not inadvertently breach below the regulatory level. While this is not an expense, it is still something you have to prepare and set aside.

Drowning in Expenses : Hedge Fund Start Ups

Getting a physical office: $2,000 per month

You will need an office space. And sorry to disappoint you, your bedroom or study room is not going to make the cut. You can work anywhere you want, but you are required to have a proper physical office. And for compliance reasons, the space has to be segregated and protected from non-authorized personnel. Do also bear in mind that this is a place many prospective clients would like to see. So it should look sufficiently adequate. An easy option is to rent a small room in a serviced office. That takes care of many things e.g. essential facilities, utilities, internet connectivity etc. Depending on where the office is located, the rental can be vastly different. For office space near central area for 3-4 people, we can be looking north of $2000 per month.

Getting the manpower you need: $12,000 per month

This is potentially the largest chunk of the company's expenses unless it is entirely operated by business partners. MAS dictates that you have minimally 2 directors, each having at least 5 years of relevant experience. And one of them must be a full-time employee resident in Singapore. Technically, you can appoint any employee directors. But in most IMCs, the Chief Executive Officer (CEO) and Chief Investment Officer (CIO) are the ones fulfilling this criteria.

Besides your CEO & CIO, ideally, you should also have a corporate secretary, finance officer, a compliance officer, an IT personnel, and a marketing person. But there is no rule to say you can't hire someone who is both IT savvy and good at finance, or the CEO/CIO can't double up as the marketing director. It is fairly common for people in startups to wear many hats. Compliance, however, is a full time dedicated function. And due to conflict of interests, you can't have the CEO/CIO wearing this hat. You are, however, allowed to outsource this function to an external service provider.

Drowning in Expenses : Hedge Fund Start Ups

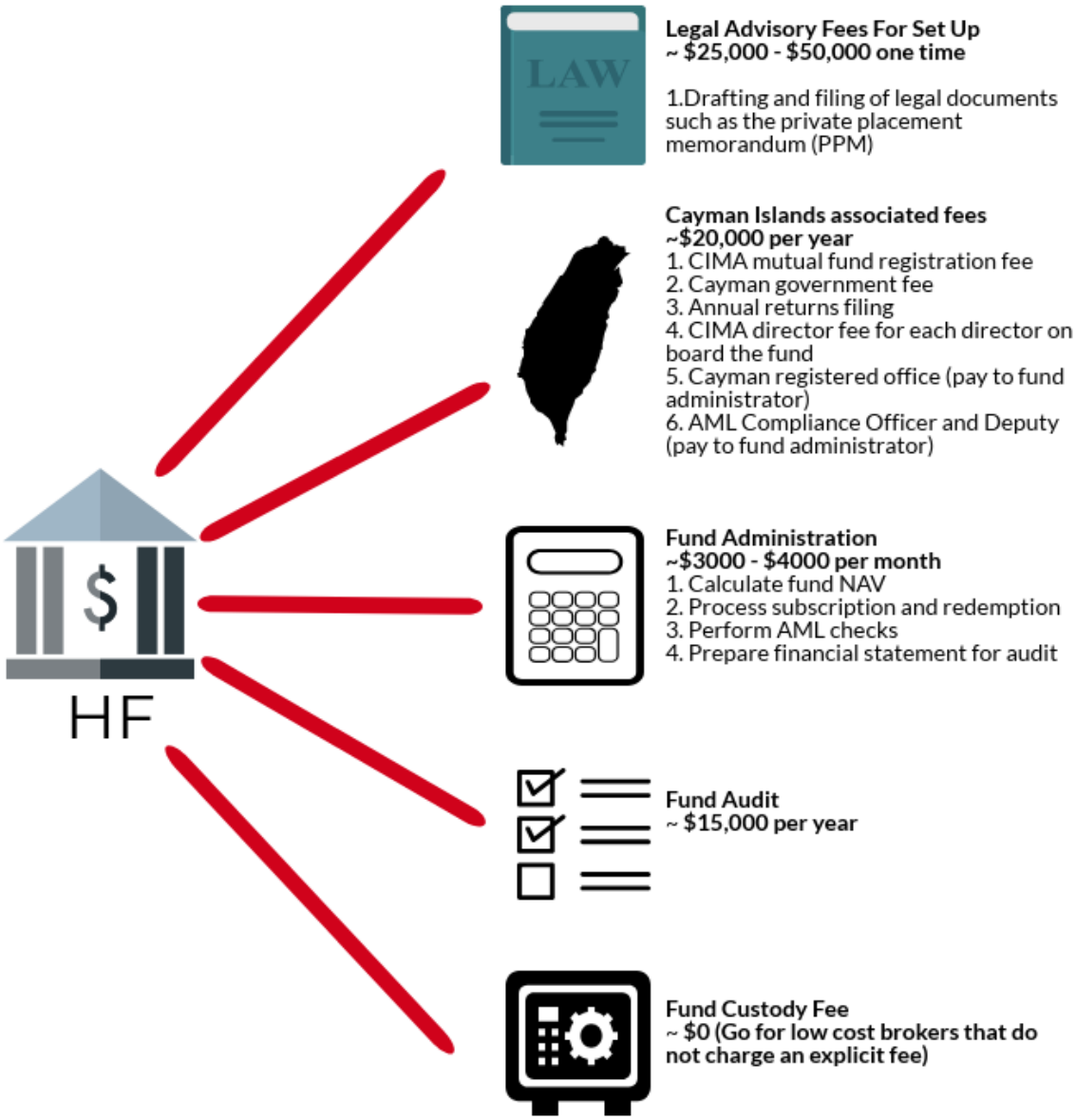
What if you can't pay? Then the only alternative is to find trusted partners who share the same passion with you. And they must have sufficiently deep pockets to see themselves through the next couple of years. Else this venture is almost guaranteed to fail. It is, however, by no means easy to find that many partners. So let's just assume you are the CIO, and the CEO/Marketing is your business partner. Both of you hire another 2 people to fill the roles of a finance/IT and compliance officer. It is highly unlikely you want to hire senior professionals from large institutions unless you can pay really generously. Let's go for 2 junior hires and budget about $12000 a month.

IMC Audit: $10,000 per year

As a regulated entity, the IMC have to engage an external auditor to perform an annual audit. The IMC is not eligible for audit exemption even if the annual revenue is below $5 million. The auditor will scrutinize everything from your company processes to the financial statements. Audit fees can vary significantly between auditors. You go for the BIG four auditors, then you get BIGGEST four invoices. Forget about such branding when you are still trying to make ends meet. You might be able to negotiate with a lower tier auditor to do the job for under $10,000.

Drowning in Expenses : Hedge Fund Start Ups

Hedge Fund (HF)



Drowning in Expenses : Hedge Fund Start Ups

Contrary to what many people may think, the hedge fund actually does not have any direct hires other than a board of directors for oversight. But that does not mean its expenses are low. Because it engages the service of many third party providers. And these services do not come cheap. Typically, these expenses are deducted from the fund. But when the fund is small, as is usually the case for unknown start ups, there are implications. An annual expense of say $100,000 on a fund with an AUM of $1 million means you got to make 10% first before your fund will show any profit. That is a killing blow to any track record you want to build. It is also unfair for early investors to bear such a big burden. In such instances, it makes more sense for the IMC to bear these expenses on behalf of the fund before it grows to a reasonable size.

Cayman islands offshore fund associated and other regulatory fees: $20,000 per year

Let's say you incorporate an offshore fund in Cayman Islands – one of the tax havens. There are probably lower cost options like British Virgin Islands (BVI), but I am only familiar with Cayman Islands, so I will go with that. Cayman Islands is also the choice of domicile for most offshore funds, accounting for more than half of all offshore structures.

There are of course fees to pay to set up and maintain a fund in Cayman Islands. Very briefly, you will need to pay on a yearly basis – mutual fund registration fee, Cayman government fee, Cayman registered office fee, annual returns filing fee, CIMA director fee for each director on board the fund etc. And just last year in 2018, the Cayman Islands Monetary Authority (CIMA) introduce a new rule requiring all regulated funds to appoint an Anti-Money Laundering Compliance Officer (MLRO) and a deputy MLRO. If you do not have suitable candidates, you can outsource this function to the fund administrators for a fee. Cayman-based financial institution are also to subject to FATCA reporting obligations for tax purposes. It is beyond me to explain. But suffice to know you need to pay to get others to do the reporting for you.

Drowning in Expenses : Hedge Fund Start Ups

As a ballpark figure, all these stuffs might set you back easily by $20,000 or more per year.

Legal Advisory Fees: $25,000 –$50,000 one time set up expense

You will need lawyers to draft and file all the legal materials for the HF. The most important document is the private placement memorandum (PPM). This document details everything from the portfolio managers, the investment mandates, strategies, risks, fund terms to service providers etc. And you will need 2 groups of lawyers:

1. A Cayman fund lawyer as the lead lawyer because your HF is domiciled in Cayman Islands.
2. A Singapore fund lawyer to review, edit and add to the document because the IMC is incorporated in Singapore.

Needless to say, your costs has only one direction to go – UP. Again, charges can differ significantly. Let's budget between $25,000 – $50,000. This setup cost can be charged to the fund. And while not in line with accounting standards, it is common practice for small funds to amortize it over a maximum of 5 years. This helps to distribute the costs so that early investors are not unduly penalized. This is to be fully disclosed in the PPM and financial statements. Alternatively, the IMC can absorb this set up costs.

Fund Administration: $3,000 – $4,000 per month

Would you put money in a hedge fund where the PM himself does the calculation and confirms the NAV? I don't think so. The process is inherently flawed as the PM can manipulate performance data without independent oversight. Not to say that he will, but without proper process, he can.

Drowning in Expenses : Hedge Fund Start Ups

This is where the fund administrator steps in. They track all the positions and trades of the fund and reconcile them against the broker statements at the end of each month to arrive at the official NAV. This leaves no room for tricks. Besides this, they also process investor subscriptions and redemptions, perform Anti Money Laundering (AML) checks, and prepare the fund's annual financial statement for audit purposes etc.

Fund administration is one of the largest expense. They charge a monthly fee, usually a couple of basis points based on the size of your fund subject to a minimum. Again, prices vary according to the complexity of your fund and administrators. But as a rough estimate, put aside $3,000-$4,000 per month.

Fund Audit: $10,000 – $15,000 per year

Yes, the fund also needs to do its own annual external audit. And it can be a tad more expensive than the IMC audit. 2 groups of auditors are involved. A local auditor that does all the groundwork, and another auditor registered with CIMA to review and do the final sign off. Budget $10,000-15,000.

Fund Custody Fees: $0

Big banks and prime brokers safekeep the fund's assets on their behalf. In return, they charge a custody fee. It is usually a very small percentage of the total assets in their care per month subject to a minimum. But if you are not that brand conscious, you can opt for brokers that do not charge custody fees, or at least not explicitly. These brokers recover the custody costs through the trade commissions earned. So if you trade infrequently, you may incur an inactivity fee on your account. That, however, is insignificant compared to the custody fees you pay the branded guys. In any case, you can forget about opening a prime broker account at bulge bracket investment banks if your fund do not have like a $100 million.

Drowning in Expenses : Hedge Fund Start Ups

Putting The Pieces Together

Now, if we piece everything together, expense for the first year can be close to $300,000 and a bit lower thereafter without the initial set up costs. And this still excludes the $250,000 base capital you need to maintain. And as I mentioned earlier, you might have to aim for a higher threshold of $350,000 instead so you don't keep pissing MAS off. Of course, if your company is generating a healthy profit since day one, then this might not be that much of a concern. But I doubt.

Assuming your running expense to be $300,000 per year, to break-even on just a management fee of 2%, you require a fund the size of $15 million. Too high? Sorry to disappoint you again, that is an optimistic scenario. With fees trending down generally, you probably would not get a single cent as a start up charging 2% management fee. It is highly likely you have to give up more upside and do a 1% or lower. On a more positive note, the fund can probably stand on its own and absorb the expenses in stride when it is large enough i.e. IMHO deduct less than 0.5% from the fund. And I have yet to include performance fee. But do expect rough patches where you will need the management fee to help you tide through.

Concluding Remarks

Note what I mentioned is not exhaustive. For example, I have not included expenses on things like web domain, website development, emails, secured cloud servers, backup power supplies, laptops, name cards, design and printing of marketing materials, professional indemnity insurance etc. The set up also cannot be used to solicit US monies. That will require a master feeder fund structure comprising a US onshore feeder, a Cayman offshore feeder and a Cayman Master Fund. 3 sets of financial accounts. More work for auditors. Complicated tax reporting. And on top of that, you need a US fund lawyer to draft another PPM for the US investors. Basically, expect to pay a lot more.

Drowning in Expenses : Hedge Fund Start Ups

There are other paths one can take though. One way is to start with an incubator fund instead of a full fledged hedge fund. Another is to look at joining a hedge fund platform who have the expertise and economies of scale to negotiate better deals with the service providers. I did not explore those paths so I will not comment much here. In any case, anyone serious about it should do their own homework and consult the relevant professionals. However, I do hope this post let you have a glimpse into how hedge funds work and some of the challenges that start up hedge funds faced.

Illusory Chase For The Best Hedge Fund

Written By

Eng Guan Lim (E.G.)

We constantly strive to look for the best in everything. The best partner, best employee, best deal, best career, best education, best investment, and the list goes endlessly on. And the world has as many categories of “BEST” awards as you can think of. Similarly, when someone goes out hunting for a hedge fund to invest, he wants to know which is the best. Somehow, our DNA is hardwired to seek out the optimal solution to whatever we need. The focus is sharp and simple. The behavior is also entirely rational. However, like many things in life, the answers are never as clear.

Are You The Best?

This simple question often has no satisfactory answer. Just use IQ tests as a reference. Is the person with the top IQ score the most intelligent in the whole world? He is definitely very gifted in a way, but I would not go as far to claim the latter. Why? Many reasons. For one, not everyone takes IQ test. Someone better can always be out there. And what really defines intelligence? Is the test comprehensive enough? Are we just measuring a certain aspect of logic reasoning and neglecting others? Does being at the top now means he will continue to be where he is in the future?

Answers to a singular question almost always become a complex multi-dimensional issue. And the search for the best hedge fund is no different. In fact, posing a direct question of “Are you the best in what you do?” to a hedge fund manager is outright pointless. Because the only truthful answer is “I don’t know.”. And if they don’t know the answer themselves, why would anyone else know.

Illusory Chase For The Best Hedge Fund

Why Is It That Difficult To Select The Best?

Illusory Chase For The Best Hedge Fund

1. More than you can chew – 10,000 hedge funds

According to eVestment, there are an estimated 10,000 hedge funds managing an estimated USD 3.2 trillion in 2017. Not all hedge funds are captured, so the actual number is likely to be significantly higher. Even assuming 10,000 is the correct figure, do you think you have what it takes both in terms of time and expertise to conduct proper due diligence on each of them? Sure, majority may not be worth the trouble and you can filter out a bunch of names according to some criteria. But even if you whittle it down to a few hundred candidates, that is still an extremely daunting task. Not to mention that you are also likely to throw away uncovered gems among the names you weeded out.

2. Many are outside the radar

Not all hedge funds are out in the open. They can't publicly market due to regulatory constraints. News you see or hear are often about large funds and celebrated managers. Hedge funds are also not required to submit their information to public databases like BarclaysHedge, Eurekahedge or eVestment. This is entirely on a voluntary basis. Beyond that, your chance of knowing the existence of any particular fund may be through word of mouth, referrals, a random internet search landing on their site, friends in the industry, or a chance encounter.

3. Dearth of information

Hedge funds are well known for its secrecy. They are not your publicly listed companies. Getting to know its existence can already be a challenge, and extracting information out of it can be no less grueling. Hedge funds do not follow a standard marketing or reporting template. Their pitch deck or monthly reports can range from a comprehensive one covering all aspects to a black box containing nothing other than some fancy stories or a set of elementary information.

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During my earlier career in the role as fund of hedge funds analyst, I have personally come across monthly reports that print nothing other than the month to date (MTD) and year to date (YTD) figures. Of course, you can always ask for the info, but getting it is another story. I have talked to funds who fiercely guards everything beyond what they put on the pitch deck as some "If I tell you, I have to kill you" type of secrets. And there are funds that have grown so big and complicated that unless you are talking to the partners, the rest does not know the whole picture.

4. Even the strong can fall

Hedge fund is an extremely competitive industry. Closures are common. Every year, there are at least a couple of hundred closures. And in bad times like 2008, well over a thousand can bite the dust. While I do not have the numbers, I expect at least as many hedge fund closures in history, if not more, as the number of hedge funds still standing today. Unfortunately, even established hedge funds managed by veterans do not wield immunity against a vicious market. Nobody does. Recent "deceased" funds include multi-billion dollar names like Tourbillon Capital, Highfields Capital and Eton Park Capital.

5. Best is just a transient state

There are competent mangers. No doubt about it. But even then each have its own strengths and weaknesses. The best at any particular period is more a function of being the right people having the right skills, running the right strategies at the right time and place. The best today can be the worst tomorrow and vice versa.

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David Einhorn, a prominent billionaire hedge fund manager, who manages Greenlight Capital was a star until 2015. He was plagued by subpar performance and struck a heavy blow in 2018 where his fund tumbled more than 30%. And that is after his fund lost more than 20% in 2015 and is still in the midst of recovering.

He is not alone. Many hedge fund strategies are hammered after 2008 for lagging behind the markets. Why? We can only surmise e.g. change in market dynamics from excessive central bank meddling; and/or thinning alpha as a result of intensified competition. But not all are suffering. Long-only managers running equities or risk parity type strategies flourished during this period from a flood of easy money.

6. Compare Apple to Apple? Sure, you find me the other Apple

Why not compare hedge funds against their benchmarks just like what we do for mutual funds?

As a matter of fact, the industry is already doing it. But unlike mutual funds, which has a very clear and narrow mandate, hedge funds have no such constraints. Hedge funds are typically grouped into strategy silos, say equity long/short, global macro, event driven, relative value, fixed income/credit, volatility etc. And within each silo, you can further break it down into many other sub-strategies.

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However, there are potentially so many variations that the full spectrum cannot be fully represented. Even funds within each sub-strategy are likely to be doing things differently from the rest. You can have a long/short equity fund that decide to create a side pocket for illiquid opportunities; or a credit fund specialized in extending privately negotiated loans; or a volatility fund biased on the long side while majority are net short. Hence, unless you know the specifics, the right Apple is hard to come by, or there may simply be no other comparable Apple.

7. You think you are better than the experts?

If anyone has an edge in picking the best funds in the business, they got to be the fund of hedge funds. These guys conduct in depth research on hedge funds and pick managers day in and day out for a living. And if they can consistently pick the "top" managers within each strategy, they should be showing some serious outperformance.

In an article I wrote earlier: Which Is A Better Investment – Hedge Funds Vs Equity Market, fund of hedge funds delivered 6.6% annualized returns between 1990 to 2017. So was this higher than what hedge funds generate in average? No, not by a thousand miles. In fact, it is actually quite a bit lower than the aggregate hedge fund annualized return of 9.7% over the same period. Sure, fund of hedge funds has an additional layer of fees that drags them down. But if they can can keep picking and switching into aces, the added fees should not be an issue. To be fair, they face more challenges than just the fees, but let's leave this for another time.

In short, even when armed with such resources and expertise, the bulk of the the professionals can't quite hack it. What makes you think you have an edge against them?

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Picking Hedge Funds Is Like a HR Job

When you pick a hedge fund, you are essentially picking people, with the core ones being the investment team. In a sense, it is not that different from a HR function where a company goes through the process to hire someone to fill up specific roles. You will never have access to the entire pool of candidates out there. You can rely on internal job rotations, referrals, work with recruitment firms or advertise externally, but there are only that many you will reach. And among those that respond, you have to look through their CVs, check out their background and credentials. Then you have to ascertain through interviews on other aspects as to whether they will be a good fit for the role and company. Aside from what could be verified on paper, the rest boils down to some form of qualitative assessment which invariably entails a good dose of uncertainty. He or she, for a multitude of reasons, may still not turn out not to be that ideal candidate you are looking for.

The same principles applies for picking hedge funds. You have to know clearly what you want in the first place. Search and filter out a pool of candidates. Do your investment due diligence: understand the managers, their strategies, risk management methodologies etc. Then do your best to pick those you think fits your purpose, and accept the risks that come with your choice. Manage your portfolio and just leave the decision of who is the BEST at any point in time in hands of fate.

Hedge Fund Terms Explained In English

Written By

Eng Guan Lim (E.G.)

Hedge Fund Terms Explained In English

An investment into any hedge funds require an understanding not just on its strategy and associated risks. Aside from that, an investor should also familiarize themselves with basic terms often found on a hedge fund's Private Placement Memorandum (PPM) or fact sheet. These are terms stating the fees, expenses and any special terms with regards to an investment in the fund. While the PPM do explain what these terms meant, they are written by lawyers. Well, suffice to say, it is in English but yet not quite your English or my English.

In this post, I want to run through these terms. But do take note that there are many different variations within the hedge fund industry today. Nevertheless, by and large, they don't deviate much from these.

Clearing Up The Air Before Proceeding

To avoid confusion later on, we need to be clear that the Hedge Fund and its Investment Manager are separate entities. The Hedge Fund is nothing but a vehicle to hold assets on behalf of its investors similar to a mutual fund. As an illustration, Franklin Templeton is an Investment Manager and it has multiple funds under its management. These funds, in turn, pay Franklin Templeton fees for its services. For the rest of the article, you may see me mentioning "Hedge Fund pays this and that". If you are confused by who is paying who and what you are paying, all you need to remember is YOU PAY WHAT THE HEDGE FUND PAYS. Because anything that is deducted from the Hedge Fund is taken from the money you put in.

If you are interested in knowing more about hedge funds in general, you can look up one of my earlier post about hedge funds.

Hedge Fund Terms Explained In English

1. Fund Expenses

For those who think operating a hedge fund should not be any more costlier than trading his or her personal account at home, it is time to wake up. I shared this in my prior post on Hedge Fund Startup Expenses. Fund expenses cover items such as commissions, regulatory fees, withholding taxes, interests on borrowed funds, stock loan fees for shorting, fund administration fees, fund audit fees and legal fees etc. In fact, management and performance fees are also fund expenses from an accounting perspective. But they are separately calculated after netting off all other expenses for the fund which you will see later. Hence, when I refer to "expense" in this article, it includes everything a Hedge Fund pays other than management and performance fee.

2. High Water Mark (HWM)

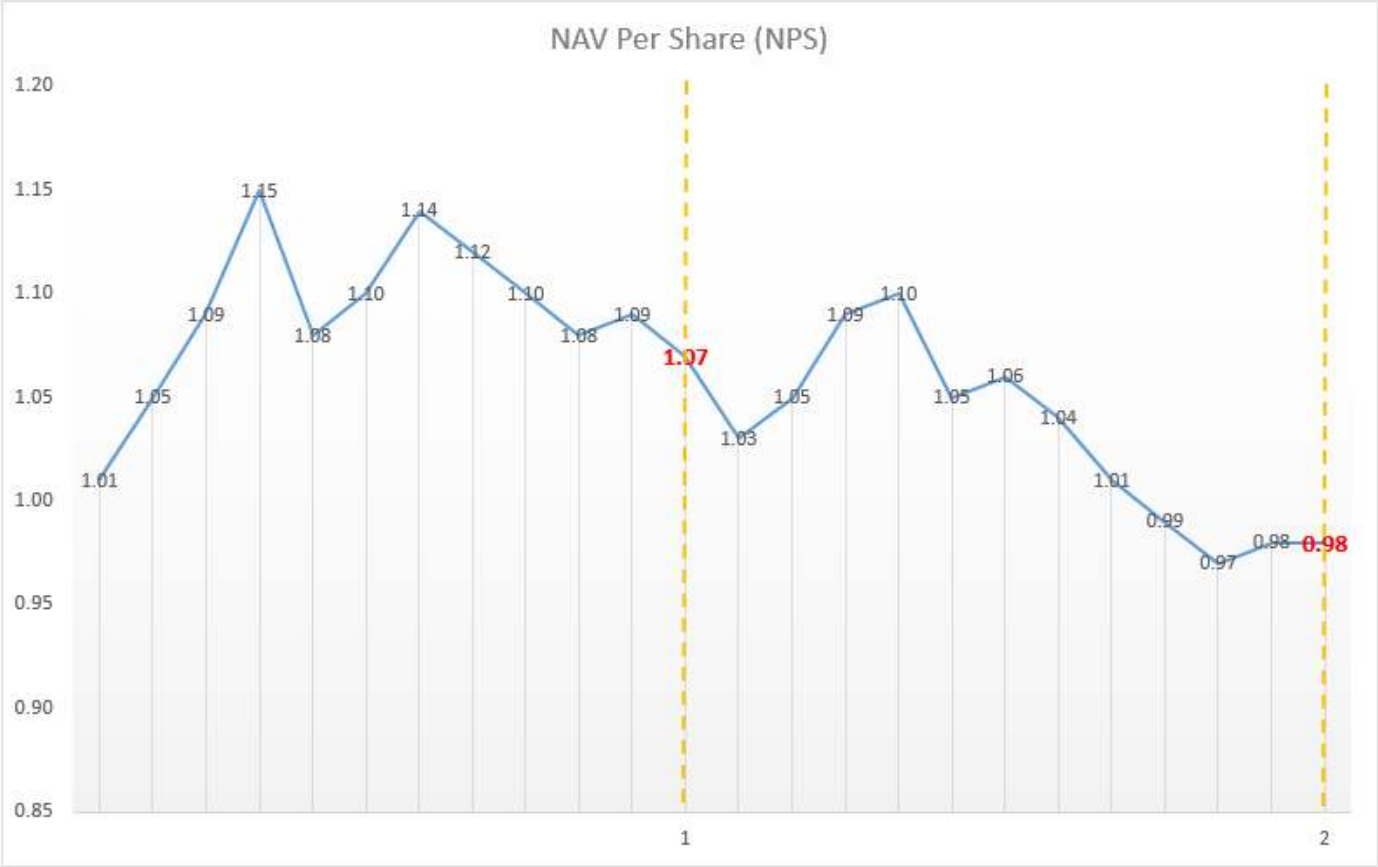
A High Water Mark (HWM) is the highest NAV Per Share (NPS) a fund achieved when sampled at predefined periods. And many hedge funds do that on a calendar yearly basis. So it does not matter how high a Hedge Fund's NPS reach intra-year, as the only time of interest for the HWM is, in this case, at the end of each year.

As an example, I attached a table showing a Fund's NPS over 2 years. Let's assume the NPS starts at 1 which also implies a starting HWM of 1. Thereafter, at the end of Year 1, the NPS of 1.07 is above the prior HWM of 1.0. So the new HWM is set to 1.07. And you might also noticed that while the NPS hits a high of 1.14 in July, that does not matter. Finally at the end of Year 2, as the Fund's NPS of 0.98 did not exceed the prior HWM, the HWM remains at 1.07.

Hedge Fund Terms Explained In English

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Year 1	1.01	1.05	1.09	1.15	1.08	1.10	1.14	1.12	1.10	1.08	1.09	1.07
Year 2	1.03	1.05	1.09	1.10	1.05	1.06	1.04	1.01	0.99	0.97	0.98	0.98

Year 1 HWM : 1.07 Year 2 HWM : 1.07



HWM is a very important metric for both the Investment Manager and Investors because it is used to determine the performance fee. Both follow a common frequency where the HWM is reset at the end of each performance period. So if the performance fee is calculated and paid at the end of each year, your HWM will be reset at the end of each year. But should the performance fee follows a quarterly schedule instead, the HWM will be reset on a quarterly basis.

We will see HWM in the calculation of the performance fee later.

Hedge Fund Terms Explained In English

3. Hurdle Rate

Not all hedge funds have hurdle rates. Hurdle rate, when applicable, means the Investment Manager is only entitled to a performance fee on profits they made for the fund over and above the hurdle. Anything below the hurdle are not eligible for performance fee. As a quick example, lets say an investor puts $10,000,000 into a Fund that has a hurdle rate of 5% and charges 20% performance fee. At the end of the year, the fund makes 20% or $2,000,000 before performance fee for the investor. Without the hurdle, the Investment Manager will get a 20% cut of the $2,000,000 profit which works out to be $400,000. However, with a 5% hurdle, the Investment Manager cannot charge the 20% fee on the first 5% or $500,000 of the profits. Instead, the 20% performance fee is applied only on the next $1,500,000 profit to give $300,000.

4. Management Fee (MF)

A hedge fund pays a management fee to its Investment Manager for managing its underlying investments. This fee goes to cover expenses incurred by the Investment Manager. It includes many things such as rental, utilities, infrastructure, and manpower etc. Historically, majority of the Investment Managers charge a 2% management fee. However, it can range anywhere from a ultra low 0% to an outrageously high 5%. Renaissance Medallion Fund, long closed to outside investors, charged a 5% management fee. That said, with their eye popping performance, they have no lack of investors who will rush to put their money in despite the exorbitant charge. But for the industry in general, hedge fund fees have trended lower as it came under pressure from mediocre performance after the 2008 financial crisis.

Hedge Fund Terms Explained In English

So how do we calculate management fee? It is based on the fund's Gross Asset Value (GAV) at the end of each month. GAV is the value of the fund net of expenses incurred during the month. Let's look at a case of 2% management fee applied in January.

Example

End Of January	Mathematical Operation	Value
Gross Asset Value (GAV)		$10,500,000
Management Fee (MF)	2% x 31/365 x GAV	$17,836

There are a few things to note here. First, we use the GAV as at the end of the month, not the start or some time weighted average. Second, GAV as mentioned earlier, is net of expenses (other than management and performance fee). Finally, we use the actual number of days in the month over the number of actual days in the year as a proportion to to compute the management fee for that specific month. Exact terms can vary among funds, so always refer back to the PPM.

5. Performance Fee

This is one of the more distinct features that differentiates hedge funds from mutual funds. Aside from management fee, a hedge fund also pays its Investment Manager a performance fee if targets are met. That can differ from fund to fund, but in most cases, it just means making a profit over the high water mark for the investor. When that happens, the Investment Manager receives a share on the profits made, typically 20%, although that is also on the decline. This fee is adjusted every month but cast in concrete and deducted only at the end of the applicable period. It is termed the performance period and is usually a calendar year. But it can be longer or shorter depending on the fund's strategy.

Hedge Fund Terms Explained In English

Example

End Of January	Mathematical Operation	Value
High Water Mark (HWM) x #Shares	HWM x #Shares	$10,000,000
Gross Asset Value (GAV)		$10,500,000
Management Fee (MF)	2% x 31/365 x GAV	$17,836
GAV Less MF	GAV – MF	$10,482,164
Performance Fee (PF)	20%x MAX [0, GAV Less MF – (HWM x #Shares)]	$96,433

In this example, the Fund has starts the year with a HWM value (HWM x #Shares) of $10,000,000. It makes $500,000 net of expenses for the first month in January giving us a GAV of $10,500,000. After deducting the applicable management fee of $17,836, the fund is left with $10,482,164 which is $482,164 above the HWM value. This translates to a performance fee of $96,433 at the end of January. This amount is held back but not actually deducted. It is subject to further adjustments till the end of the performance period (end of the year). To see how this works, let's say the Fund subsequently loses $400,000 including expenses in February.

Hedge Fund Terms Explained In English

End Of February	Mathematical Operation	Value
High Water Mark (HWM)	HWM x #Shares	$10,000,000
Gross Asset Value (GAV)	Subtract $400,000 from November's GAV Less MF	$10,082,164
Management Fee (MF)	2% x 28/365 x GAV	$15,469
GAV Less MF	GAV – MF	$10,066,696
Performance Fee (PF)	20%x MAX [0, GAV Less MF – (HWM x # Shares)]	$13,339

So at the end of February, the Performance Fee attributable to the Investment Manager reduces to $13,339 and the fund releases back $83,094 of the performance fee accrued. This process continues till end of the year where any applicable performance fee is crystallized and paid to the Investment Manager. For example, if this is the month of December instead, the $13,339 will be locked in and paid to the Investment Manager. A new HWM is then locked in with the performance fee back to zero and the game begins again for the new year.

Hedge Fund Terms Explained In English

6. Liquidity

You probably seen or heard about the term “liquidity”. Investment professionals and the media like to carry it on their mouth wherever they go. But not to worry, it is not something awfully complex. In short, it means how easy one can get in and out of an investment. And in our context, that explicitly refers to the subscription and redemption terms of a hedge fund, or more specifically, an open-end hedge fund. Majority of the hedge funds are open-end funds that issue shares to buyers and redeem shares from sellers. So as far as an investor is concerned, the hedge fund is their only counterparty. In contrast, a closed end hedge fund is listed and traded on an exchange just like a stock.

Subscription

Subscription is about how frequent you can invest in the fund, that is, if the fund is not already closed to further subscriptions. Typically, subscription tends to be more “friendly” than redemption if we discount the Know Your Customer (KYC) and Anti Money Laundering (AML) checks for onboarding new clients . You can usually subscribe at least as frequently as you can redeem, if not more. The more common terms I seen are monthly or quarterly subscription frequencies. And unlike mutual funds, you cannot just subscribe today and expect the transaction to be done the following day. You have to submit an subscription application form and wire the money over before a subscription deadline for the transaction to be completed at the start of the following month or quarter.

Redemption

Buying things is always easy. All you need to do is pay up and you can walk away with the product. Now, try asking for a refund and see if it is that straightforward. The best you can get, and rarely so, is at most as easy you bought the item. But these added difficulties may not be without rationale.

Hedge Fund Terms Explained In English

Investment Managers prefer “sticky” money and for good reasons. As the name implies, these are money that sticks around. This is ideal as managers can then concentrate on managing the investments rather than spend time dealing with redemptions from investors who flee from the first sight of “blood”.

Redemption frequencies in hedge funds are usually lower than subscription and tied with more onerous conditions. On top of that, ample advance notice have to be given through a redemption notice, and failing that, you may have to wait for the next window. Redemption terms are typically justified through the underlying strategies. For example, an equity long short with long term view horizon will have a lower redemption frequency or even lock ups (we will see later) than a fund trading liquid futures.

Lock Ups

Hedge funds pursuing less liquid or long term strategies often impose a lock up period. This can be a hard or soft lock up. In a hard lock up, investors cannot redeem during the lock up period. And for a soft lock up, investors can redeem but either in limited amounts and / or with a penalty. A lock up period of 1 year is fairly common among equity long short funds. On the higher end, lock ups can go as far as 5 years or more for funds that deal in private equity.

Gate

This is a special provision that a hedge fund, which has it in its PPM, can exercise should the need arise. Its intent is to act as a brake when redemption exceeds a certain level at any point in time. For large hedge funds in particular, this provide for orderly exits with minimal impact to the market in the event of massive redemptions.

Are Hedge Funds Risky?

Written By

Patrick Ling

It is a common perception that hedge funds are risky or at least riskier than traditional mutual funds. This is understandable as there have been many examples of hedge funds blowup. The most famous example is perhaps LTCM. On the other hand, we seldom hear about mutual funds blowup. However, hedge funds should be less risky than mutual funds if they truly live up to the word hedge. The reason is because hedge funds practice what is called risk control. Alfred Winslow Jones started the first modern hedge fund with risk control in mind. He wanted to insulate himself from the vagaries of broad economic conditions so he came up with the long/short equities approach. That way, even in a terrible bear market, his long/short portfolio should still be able to generate returns if his longs perform better than his shorts. On the other hand, a long-only mutual fund would be suffering huge losses.

Why Do Hedge Funds Blowup Then?

The short answer is overconfidence. The more nuanced answer is that risk cannot be completely hedged away. Often times, you are merely converting one type of risk into another. Blowups happen when the manager either thinks that the risk has been completely hedged or thinks that the new risk is negligible. That leads him to think that he can leverage up to the hilt to generate exceptionally high returns. Let's look at ways to hedge certain risk and how things can still go wrong.

Equity Market Risk

Alfred Winslow Jones wanted to neutralize equity market risk when he set up his hedge fund. This is the risk that a broad economic recession arise and decimate stocks across the board. To hedge against broad equity market risk, you can short the same dollar amount of a stock with very similar characteristics to the stock that you own. Obviously, you must hold the view that the stock that you own has better fundamentals than the one that you short. A fictional example is to buy Goldman Sachs shares and short JP Morgan shares.

Are Hedge Funds Risky?

Putting aside the fact that it cost more to short, you have exchanged absolute market risk for relative market risk. This is the risk that the company that you shorted may outperform drastically for whatever reason while the company that you bought under-performs. An extreme case is that the company you are long decided to take over the company you shorted at a huge premium. This would lead to the share price of the acquiring company dropping while the target company's share price rises to the takeover price. This is a double whammy since both legs of the long/short pair is losing at the same time.

Market Cycle Risk

Risk parity is a popular asset allocation strategy in recent times. The story goes that Ray Dalio was thinking about how to construct an appropriate portfolio for his family trust which is robust under all kinds of market conditions. He thought about the various asset classes and how each behaved in different parts of the market cycle. The outcome of the brainstorming was a risk-weighted combination of the asset classes such that at least some asset classes would do well while others might do less well under a particular stage of the market cycle. This strategy became so successful that he offered it as a separate fund for his clients and that fund now manages billions.

This style of hedging market cycle risk is now becoming commoditized. Even some big robo-advisor in the US is offering it to retail clients. However, some hedge funds have taken things to the extreme by employing high leverage on risk parity to generate exceptional returns. In this instance, they have exchanged market cycle risk for correlation risk. This is the risk that all asset classes goes down together at the same time. The diversification benefit disappears and the portfolio suffers a deep draw-down. It might even lead to ruin on an over-leveraged portfolio.

Are Hedge Funds Risky?

Weapons Of Mass Destruction

When one talks about hedging, derivatives naturally comes to mind. In fact, the futures and options market came about because of the need for hedging. However, significant market events in the past have been linked to derivatives. This led to Warren Buffett describing derivatives as weapons of mass destruction. One of the most notorious example was the 1987 stock market crash. On Monday, October 19, 1987, the Dow Jones Industrial Average crashed 23% in a single day. Although it was never proven, an arcane risk management technique known as portfolio insurance was widely credited as being the cause of the crash.

Portfolio insurance became seen as the magic bullet that will ensure a portfolio will never experience a loss beyond a comfortable limit. Many people including institutions began to load up on stocks because of having portfolio insurance in place. However, they either forgot or they ignored gap risk as well as over-crowding risk. Gap risk is the risk of a sudden discontinuous drop in price resulting in the inability to hedge in time. Over-crowding risk is the risk that too many people are employing the same technique and trying to hedge at the same time.

Calendar spreads are very popular as a “low-risk” way of putting on bets. Theoretically, futures contracts with expiration dates that are close together should move pretty much in lock-step. However, it is an imperfect hedge. There can be instances where the spread can deviate significantly. This is known as basis risk. An example of a hedge fund that blew up because of a spread play gone wrong is Amaranth. Actually, the fund wouldn’t have blown up if not for over-confidence on the part of Brian Hunter who doubled down on a losing trade.

Are Hedge Funds Risky?

Does It Mean That Hedge Funds Are Risky?

It is better to answer this question with another question. Are cars dangerous? The answer would invariably be that it depends on the driver. It is the same with hedge funds. It really depends on the fund managers responsible for running the hedge fund. However, having said that, I do think that the general investing public also has a role to play.

Let's face it. A hedge fund is also a business that is fighting for investor dollars. A responsible fund manager can do the right thing based on realistic expectations of risk and return but if investors have unrealistic expectations, their money would flow to those managers who dare to promise those unrealistic returns regardless of the risk involved. In the end, the responsible fund manager would not be able to survive simply on pure economics. It is sad but true. In all instances of those spectacular hedge fund blew ups, the managers walked away rich while the investors suffered losses.

The Upshot

Unfortunately, this is the way things are and it would be unrealistic to expect investor behavior to change anytime soon. At the individual level though, before you say categorically that hedge funds are risky, ask yourself whether you have realistic expectations in the first place. Do you accept the need for risk control which acts as a natural limiter on returns or do you only look at returns without regards to risk?

Are Hedge Funds Risky?

For hedge fund managers, the point about risk control is to be conservative. If you are a discretionary player, multiply the worst draw-down you have ever experienced in the past by 1.5 times and assume that is the worst draw-down you have yet to encounter. For a systematic player, do the same for either live or back-test period whichever contains the worst draw-down. If you cannot survive such a draw-down, then you are using too much leverage. And by surviving, I do not only mean avoiding a blowup. A draw-down of 20% can often mean the end for a hedge fund.

Of course, the best risk control is having the humility to know that you can always be wrong.

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