# What is... a hedge fund?

BANKTrack

**Hedge funds are funds operated by an investment company, which use very speculative strategies to obtain the highest possible return on their investments.** They invest in all kinds of very sophisticated financial assets, and then sell parts of this portfolio to investors by issuing shares, much like any other company sells shares to the public. In practice, hedge funds are only accessible for wealthy individuals and institutional investors, in contrast to mutual funds which are accessible to regular households as well.

## How they operate

There is no formal definition of hedge funds, and among the thousands of hedge funds that exist today, there are important differences. However, some general characteristics of hedge funds can be identified:

- Hedge funds get their name from the first hedge funds' strategy to **combine long-term and short-term positions**; i.e. they hold some securities for a long-term period, and sell other securities after a very short time. This combination is supposed to "hedge" the fund from risks associated with changes in market prices. However, today many hedge funds are designed to generate absolute returns, rather than actually hedge risks. The "portfolio turnover" or "churn" rate of a fund indicates how long it keeps securities. A high turnover means that hedge funds regularly change the composition of their portfolio. A 100% turnover rate means that the fund on average substitutes all of its assets with new ones in one year. In 2003, over half of global hedge funds had a turnover rate of 75%.
- Hedge funds use **sophisticated strategies** to increase the returns on their investments. They invest in all kinds of financial assets like bonds, shares and foreign currencies. In addition, they make extensive use of derivatives, financial instruments (such as futures and options) whose value is based on the performance of other financial assets. With these instruments, they speculate on financial markets with the aim of getting instant returns. Many hedge funds make these investments with borrowed money, which makes them highly "leveraged". This means that they finance their operations more by debt than by money they actually own.
- They apply **high minimum investment requirements**. Most hedge funds set extremely high minimum investment amounts, ranging from $250,000 to over $1 million. In 2003 the mean minimum investment requirement of global hedge funds was $630,414.
- **Little regulation**. Hedge funds are exempt from many of the rules and regulations governing regular investment funds. They are often managed out of an industrialized country like the U.S. or European countries, but many are 'domiciled' in offshore centres, i.e. small countries and islands where there are no/little regulations , and no taxes to be paid. Important offshore centres for hedge funds are Bermuda, the Caribbean and the Canal Island Guernsey. Thus, hedge funds, unlike other financial institutions, are not required to publish data on their trading activities and their creditworthiness.
- Customers of hedge funds pay a management fee based on the assets they have put into the fund (around 1-2%), and the performance of the fund (around 20%). Fund managers themselves also normally make significant investments in the fund. Often, hedge funds also invest in other hedge funds to increase potential returns ("fund of funds").

## Speculation and market manipulation

Hedge funds are important speculators on financial markets. Speculation means that an investor tries to make profits by gambling on changes in the price of a security or an underlying asset. When buying an asset, a speculator doesn't intent to keep it, but rather buys it in order to sell it at a higher price in the near future. Examples include currency speculation: an investor (or fund) expects the value of a certain currency (say the Euro) to increase in a month time, and therefore buys huge amounts of euros. When indeed that price has risen, he can sell the euros at a higher price. They can also pursue an opposite strategy: by entering into certain derivatives contracts or by "short selling," investors can also make money by betting on the decline of certain assets.

Because of the enormous amount of funds they manage, hedge funds often also aim to influence prices by using their market power. Hedge funds can coordinate their actions, and persuade other market actors to follow them.

Market manipulation is an illegal activity of which some hedge funds have been found guilty. It means that they try to influence prices by spreading misleading information that will probably affect other investors' demand for a security. This change in price can lead to enormous profits for the funds.

## Trends & Critical Issues

- **Industry has grown enormously**. Hedge funds have grown enormously since their rise in the 1950s. Increasingly, more traditional institutional investors like pension funds have invested in hedge funds or (less speculative) hedge instruments offered by financial firms in search of better returns than those from traditional mutual funds. (see box)
- **Adverse impact on local economies**. The impact of hedge funds on local economies can be enormous. For example, if hedge fund managers expect a currency to depreciate, they start to sell their holdings of that currency. (see box) Often, other market participants follow funds with high reputations, and this further drives down the currency's price. Central banks may not be able to counteract these speculative forces. Because their gigantic size, and their influence on other market actors, hedge funds can make or break currencies. A notorious example of this was the attack of hedge fund manager George Soros on the English pound in 1992. By speculating on a depreciation of the currency, the fund forced the British currency out of the European system of fixed exchange rates. Other examples include the speculative attack on the Thai Baht and other South Asian currencies 1997, which led to a dramatic aggravation of the Asian crisis.
- **Fraud at hedge funds**. Hedge funds have sometimes been blamed for manipulating market prices, which puts smaller investors at a disadvantage (see box). For example, they may make other investors believe a company is doing very well, causing the share price to rise. After this, hedge funds sell their holdings of these securities and make a huge profit. Retail investors are duped by this, when they see the value of their holdings plunge. There also have been cases of funds misleading their own investors.
- **Risky strategies**. Hedge often take large risks with speculative strategies, and operate in markets with sharply declining prices. Because they move billions of dollars in and out of markets quickly, they can win enormous amounts, but they might also lose them. If they lose money, they often also lose the money of banks and investors which have placed funds with them. The most notorious example of this was the 1998 failure of the US based 'Long Term Capital Management' (LTCM) fund. To avoid a systemic financial crisis, the US central bank intervened, injected $3.5 billion in the fund, and took over its management.
- **Little regulation**. As noted, in contrast to other investment funds, hedge funds are hardly regulated. After the notorious LTCM collapse, international bodies like the International Monetary Fund, the Basle Committee and the Financial Stability Forum discussed possible regulations. More recently, the SEC (the U.S. Securities and Exchange Commission) has been discussing regulation proposals. The U.S. hedge fund market represents 80% of the total volume managed by hedge funds, so the SEC's policy can be of major importance globally.
- **No sustainability indicators**. Most hedge funds do not pay any attention whatsoever in the social and environmental impacts of their investments. However, there are a few hedge funds that rely on "sustainability analysis" and enter into derivatives contracts with a strategy of betting against irresponsible corporations, and betting on ethical ones.

### More info:

www.financialpolicy.org
www.hedgeco.net

### Glossary:

**Bond:** promissory note that obliges the issuer to pay back a certain amount of money within a certain time (with or without regular payments, or 'coupons').
**Option:** a contract between two parties that offers the buyer of the option the right to buy (or to sell) an asset (e.g. a financial security) from (to) the contracting party at a agreed upon price, within a certain period of time. In practice, those the selling/buying hardly takes place.
**Future:** a contract between two parties in which the buyer of the future party is obliged to buy (or to sell) an asset (e.g. a financial security) from (to) the contracting party, at a agreed upon price, within a certain period of time.
**Leverage:** borrowing money to make and potentially increase the return on an investment.

### What is... a derivative?

A derivative is a contract between to parties whose values is based ("derived from") the performance of an underlying asset, for example gold or a bond. A common derivative is an option, i.e. the right to sell or buy an (financial) asset. It can also concern a combination of derivatives, i.e. an option on a future; then the buyer pays for the right to use a contract that enables him to sell or buy another asset at a certain time. Derivatives create leverage, i.e. they enable a firm to operate with more money than they actually own.

### The U.S. hedge fund market

| Year | No of hedge funds | Total assets (US millions) |
|---|---|---|
| 1950 | 1 | 500 |
| 1960 | 30 | 1 000 |
| 1987 | 100 | 20 000 |
| 1995 | 2 080 | 76 000 |
| 2000 | 4 000 | 324 000 |
| 2004 | 7 000 | 795 000 |

Source: SIA Research reports, 20 September 2004 (www.sia.com)

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