

Hedge Fund Investing

Is It a Suitable Investment for You?

Low market returns have prompted broker-dealers to offer customers alternative investments, such as hedge funds and funds of hedge funds, as a way to obtain above average market returns. The popularity of these investments has grown exponentially in recent years, spreading from a small group of wealthy, sophisticated investors to a wider segment of the investing public. But do all investors fully understand the riskier characteristics of hedge funds as they pursue potentially greater returns?

What are hedge funds?

Hedge funds are primarily private partnerships managed by a professional investment manager. They are not registered as mutual funds nor are their securities registered under federal securities laws. As a result, they are subject to little regulatory oversight and are not required to disclose significant details about their operations and holdings. Hedge funds solicit investors' money and employ sophisticated hedging and trading techniques using long and short positions, leverage and arbitrage; and often trade multiple investment products. They also charge higher fees—generally two percent of assets under management and 20 percent of trading profits—and employ trading strategies that may increase volatility across all types of assets classes, not just stocks and bonds.

Although there is no standard legal definition, hedge funds often share several characteristics:

- They invest in pools of securities and other assets that may not be required to register as securities offerings with the U.S. Securities and Exchange Commission.
- They are generally not required to register as an investment company under the Investment Company Act of 1940.
- Adviser compensation is based upon a percentage of the hedge fund's assets and capital appreciation.
- The fund often includes significant amounts of the manager's own money in the hedge funds that they manage.

Hedge fund investors, until recently, were nearly all wealthy and financially sophisticated, thereby meeting the SEC definition of "accredited investor" or "qualified purchaser." These qualifications implied that traditional hedge fund investors understood the investment strategies and risks common to hedge funds.

However, as investor income has increased over the years, the dollar threshold of the accredited investor has not, nor have the standards for the qualified purchaser changed. Among those included as accredited investor are: (1) a person with individual net worth, or joint net worth with a spouse, that exceeds \$1 million; (2) a person with income exceeding \$200,000 in each of the two most recent years or joint income with a spouse exceeding \$300,000 for those years and a reasonable expectation of the same income level in the current year. Qualified purchaser thresholds generally are higher.



Funds of Hedge Funds

A fund of hedge funds wraps a number of selected hedge funds inside a registered investment company, or mutual fund. Like all mutual funds, it is registered and sold by prospectus only. However, there are some significant differences that investors should fully appreciate. Because these products are sold as mutual funds, customers may bring incorrect expectations or understandings reflective of their experience with other mutual fund products. Also, funds of hedge funds have significantly higher costs than stand-alone hedge funds and are usually tax-inefficient for mutual fund investors. This is because regular hedge fund strategies typically generate ordinary income and short-term capital gains, thereby resulting in highly taxed returns.

Funds of hedge funds also charge an extra layer of fees that a regular mutual fund does not charge, which further lowers profits. The fees associated with a fund of hedge funds may be significantly higher than those of a conventional mutual fund. In addition to the management fees of the mutual fund manager and the expenses of the fund, the fees calculated for this product include those normally paid to hedge funds, which, as discussed previously, typically involves two percent of the funds under management and a performance fee, which is a portion of any gains made by the hedge fund, typically 20 percent.

When discussing the risks of hedge funds or funds of hedge funds investors should pay particular attention to the fact these funds:

- often hold financial investments that can be illiquid
- engage in leverage and other speculative practices
- are not required to provide information to investors such as regular financial reports,
- may raise complex tax issues
- often charge high fees, and
- frequently place limitations upon an investor's ability to withdraw funds.

Questions to Ask

Here are some questions you should ask yourself and the hedge fund representative, investment advisor or registered representative:

Q: Does the hedge fund manager or adviser have a significant financial investment in the hedge fund?

A: Sophisticated/accredited investors often require the hedge fund manager to have significant financial investment in the hedge fund, which serves a number of purposes including reducing the possibility of the manager taking undue risks.

Q: Is the hedge fund registered or unregistered?

A: Securities that are not registered with the SEC lack the range of protections that come with registration. There is generally no public information filed with the SEC on unregistered hedge funds. This is why traditionally these types of investments were offered only to accredited or qualified investors. Investors should be aware that some information and protections, like prospectuses and regular reports, are not required for unregistered securities.

Q: Does the hedge fund use affiliated service providers?

A: The use of affiliated broker-dealers could give the manager an incentive to place trades more actively than it might otherwise in order to generate additional credits with executing broker-dealers. Excessive trading fees can result in a lower return on your investment.

Q: What is the hedge fund's recent performance record?

A: Hedge fund assets have risen from \$400 billion to \$1 trillion in the last four years. This increase in assets and the subsequent increase in the number of fund managers pursuing similar strategies may act to reduce future investment returns. As always, past performance is no guarantee of future results.

Q: Has the hedge fund provided you with a private placement memorandum ("PPM")?

A: Because hedge funds are generally not registered investment companies, they often do not provide disclosure documents such as a prospectus. A hedge fund's PPM, however, generally will disclose potential conflicts of interest to investors, frequently under the heading of "risk factors." It will also outline the risks of investing in the product.

Q: Does the PPM discuss conflicts of interest so that you understand them?

A: Generally, a hedge fund's valuation practices give rise to an inherent conflict of interest because the level of fees that the investment adviser earns is based on the value of the fund's portfolio holdings as determined by the fund's manager. Also, potential conflicts arise from the manager's multiple accounts, including the hedge fund, private accounts, proprietary accounts and registered investment companies. This may lead to inequitable allocation practices among the accounts. A hedge fund may also have conflicts in allocating certain investment opportunities among its clients. Some PPMs spell out allocation policies with respect to limited investment opportunities in great detail, while others may list, and only briefly discuss, the factors on which such allocations will be decided.

Q: If you are an accredited investor as defined under Regulation D under the Securities Act, do you have to go through a suitability determination when your brokerage firm recommends an investment in a hedge fund?

A: If your brokerage firm is a NYSE member organization it must fulfill the due diligence obligations under NYSE Rule 405 that requires member organizations to ascertain the following minimum customer information: age, income and cash flow needs, net worth, tax status, investment objectives and experience, occupation, marital status, number and age of dependents, risk tolerance and general financial situation and needs.

Q: Didn't the U.S. Securities and Exchange Commission recently require hedge funds to register with the Commission?

A: The Commission has adopted rules to require most hedge fund advisers with assets in excess of \$25 million to register with the SEC, unless the hedge fund advisers require investors to "lock-up" their investments in the hedge fund for two years. Those rules were effective on February 10, 2005. Advisers required to register under the new rules must do so by February 1, 2006. Remember, however, that securities offered by hedge funds are exempt from registration under the Securities Act of 1933.

Q: Has your advisor discussed the liquidity of your investment with you?

A: Many financial products that are purchased by hedge funds are not registered with the SEC. Therefore, they are not traded on an exchange or in the over-the-counter markets. These investments may be more difficult to value and are less liquid and may not be able to be sold without a holding period. This could cause delays in providing you access to your funds.