

CHAPTER 1

Hedge Fund Fundamentals

*Training is everything. The peach was once a bitter almond;
cauliflower is nothing but cabbage with a college education.*

—Mark Twain

This chapter provides a brief 20,000-foot-view introduction to hedge funds and provides a context for the content of this book. In this chapter I briefly cover the history of hedge funds, important definitions, the hedge fund ecosystem, media portrayal of hedge funds, five industry trends, regulations, and the future of hedge funds.

Why important: This chapter is the foundation for the rest of this book. If you have more than five years of industry experience, you may want to skim this chapter and skip to the chapter review questions to check your level of industry knowledge.

What this chapter is not: This book is not a thorough review of hedge fund investment strategies or analytics; those topics are already covered in dozens of other texts, including two that are required in the Certified Hedge Fund Professional (CHP) Designation Program. See these required books and other recommendations at HedgeFundBookstore.com.

What *is* a hedge fund? The one-sentence definition of a hedge fund is “a private investment vehicle that charges its investors two types of fees: a management fee and a performance fee.” Any more specific definition will lead to conflicts in the industry today, as it has grown in many directions. The management fee is a standard fee based on total assets under management and it typically runs between 1 and 2 percent. The second type of fee typically charged by hedge funds is a performance fee; typically this is 10 to 20 percent and is charged based on the performance achieved by the fund. If a hedge fund has 10 percent positive performance for a single year and its performance fee is 20 percent, the hedge fund’s management would get to

keep 2 percent of that 10 percent gain as part of their profits, a reward for achieving these positive returns for their investors.



BONUS VIDEO MODULE

Watch a video explaining what a hedge fund is and is not, here:
HedgeFundTraining.com/What-is-a-Hedge-Fund?

HEDGE FUND MECHANICS AND STATISTICS

It is important to know that while these fee figures just mentioned are typical, the hedge fund industry has become competitive and diverse. There are now hedge funds operating that charge a 0 percent management fee while others charge 3 percent. Wide variations in performance fee levels may also be seen. One important aspect of this dual-level fee structure is the incentive it sets in place for hedge fund managers. While many hedge fund managers have already invested their own assets in the portfolio they are managing, remunerating the managers based on positive performance and not just total assets under management rewards those who can achieve consistent year-after-year gains. This in turn leads to rich compensation for those who can outperform the majority, and it attracts the best of talent to the industry. A portfolio manager can potentially earn two to three times as much working for a hedge fund as he could working for a similar size mutual fund or long-only optimization firm.

Investments made in hedge funds are typically seen as medium to long term for several reasons. The main reason is liquidity. Most hedge funds have lock-up periods of one to two years, and many restrict redemptions for as long as three years after the initial investment is made. A lock-up period simply means that the investor may not redeem his invested funds until this period has expired. These lock-up periods are put into place so that the hedge fund may invest in various assets and will have more control and flexibility in the timing of its purchasing and selling of these assets over time. Without lock-up periods, a manager may make a long-term investment in a security, for example, and a new investor could come and request his assets back during a weak point in the markets, forcing the manager to sell the security at a loss to meet that redemption request. While lock-up periods help managers in running their funds, they are seen as a major concern and drawback by institutions and high net worth (HNW) investors. While this

book does not cover hedge fund replication or publicly traded hedge funds, these are two areas worth additional research if this topic is of interest to the reader.

There are between 100,000 and 150,000 professionals who work directly within the hedge fund industry and another 1,000,000-plus professionals who work with hedge funds in some way, indirectly or as part of a broader platform of services. There are between 10,000 and 25,000 hedge funds in existence today, depending on whose statistics and databases you trust most, and new funds are launched daily. The average hedge fund has just around \$40 million in assets under management (AUM), while many start with just \$500,000 to \$5 million, and a larger group runs over \$1 billion in assets.



BONUS VIDEO MODULE

To watch a video on hedge fund liquidity and lock-up periods, please type this URL into your Web browser: <http://HedgeFundTraining.com/Liquidity>

Additional Common Hedge Fund Terms

- *Hurdle rate*: A hurdle rate is a set performance figure that must be achieved before any performance fees will be calculated or paid to the hedge fund manager. For example, a hedge fund may have its hurdle rate set at 3 percent so that any performance above 3 percent will be considered outperformance. Hurdle rates avoid having investors pay high fees for low-single-digit portfolio performance.



BONUS VIDEO MODULE

To watch a video on the definition of a hurdle rate, please type this URL into your Web browser: <http://HedgeFundTraining.com/Hurdle>

- *High-water mark*: A high-water mark is a tool by which hedge fund managers can assure investors that they will not be charged performance

fees after portfolio losses until the fund has made up those past losses. In other words, if a hedge fund manager has a loss of 5 percent in one year, he may not be paid any performance fees in the following year until he has first regained that loss, restoring the fund to the high-water mark point. Again, the high-water mark protects investors from paying the performance fee until the manager has made up the ground he previously lost in the portfolio.



BONUS VIDEO MODULE

To watch a video on the definition of a high-water mark, please type this URL into your Web browser: <http://HedgeFundTraining.com/High>

- *Gating clause:* A gating clause allows a hedge fund manager, under certain circumstances, to restrict or completely cut off redemptions from the portfolio due to market illiquidity or specific sets of circumstances set forth in the contract. This term has been highly debated recently due to hundreds of funds “closing the gate” or enacting this clause in their agreements with investors.

For more definitions, please see the Glossary at the back of this book.

HISTORY OF HEDGE FUNDS

Financial journalist, author, and sociologist Alfred W. Jones started the first hedge fund in 1949 while working for *Fortune*. The fund was started on the belief that the movements of individual securities were due to both the performance of that specific security and the performance of the broader markets. His strategy was to address this by investing in securities that seemed to be positioned to outperform the market, while *shorting* (see Glossary) or selling those securities that seemed likely to underperform the market. The goal was to neutralize or cancel out market risk by allowing the portfolio to hedge against negative market movements. This is how the first hedge fund was created. This idea was unique in that it was designed to do well, or at least relatively well, during volatile or even bear market conditions.

This new method of managing portfolios of equities started becoming popular in the 1960s, and by the 1970s there were over 150 hedge funds

in existence managing close to \$1 billion in assets. Some early hedge fund managers were Warren Buffett, Michael Steinhardt, and George Soros. Since then hedge funds have evolved to include commodities, bonds, real estate, and other types of assets.

Over time, the term *hedge fund* took on the broader definition of a general private investment partnership, which typically includes management and performance fees as the only common denominator. Even this definition is now becoming dated as more hedge funds and firms that run hedge funds become publicly traded companies. Hedge funds are hard to understand as a whole because they are diverse and somewhat secretive. Hedge funds are secretive because of strict advertising and public offering rules as well as to keep their investment process, trading strategy, and positions from their competition. The hedge fund industry is very competitive and entrepreneurial.



BONUS VIDEO MODULE

To watch a video on the history of the hedge fund industry, please type this URL into your Web browser: <http://HedgeFundTraining.com/History>

MEDIA PORTRAYAL OF HEDGE FUNDS

Along the way there have been hedge fund blowups (that have had performance dives and made public headlines), fraud cases, insider trading, and misreporting. While the whole idea of what a hedge fund does has been growing, public knowledge of these vehicles is still relatively limited and misunderstood, and hedge funds are often in the bottom 1 percent of the industry in terms of ethics or performance that makes the headlines each day. Hedge funds are now mentioned in thousands of magazines and newspapers each month.

There are often misconceptions formed about hedge funds, which are largely caused by reading mainstream news sources on the topic. Here are the top three misconceptions caused by the media:

1. Hedge funds are large multibillion-dollar investment vehicles that can destroy companies. *Reality:* While the largest of hedge funds do control

- a large share of total assets under management, the industry is actually made up of mostly \$1 million to \$200 million size hedge fund managers.
2. Hedge funds are not regulated. *Reality:* Many hedge funds are already regulated at the asset level based on what they are investing in.
 3. Hedge funds are always committing fraud and blowing up their funds. *Reality:* Less than 0.1 percent of the industry is ever accused of any fraud claims, and a 2006 study by Capco shows that over half of all hedge fund failures are actually due to operational business reasons and not performance-related issues.



BONUS VIDEO MODULE

To watch a video called “Media Portrayal of Hedge Funds: Misconceptions and Myths,” please type this URL into your Web browser: <http://HedgeFundTraining.com/Media>

HEDGE FUND ECOSYSTEM

Hedge fund managers do not work in a vacuum where they coordinate directly with investors and receive no assistance from outside parties. Most hedge fund managers work with at least three of the five types of service providers shown in Figure 1.1.

It is important to know the function of each of these parties to understand how hedge funds operate, and how they invest and control their assets. Here are definitions and explanations for each of these service provider types:

1. *Prime brokerage.* Prime brokers provide a package of services typically within the largest business of an investment bank. The following services are sometimes offered by prime brokers: custody, securities lending, financing, customized technology, operational support, capital introduction, and other trading-related services.
2. *Fund administration.* Fund administration firms provide support and operational services to hedge fund managers. These services may include accounting services, operational/finance services, settlement of daily trades, calculation and payment of distributions, and payment of fund expenses.

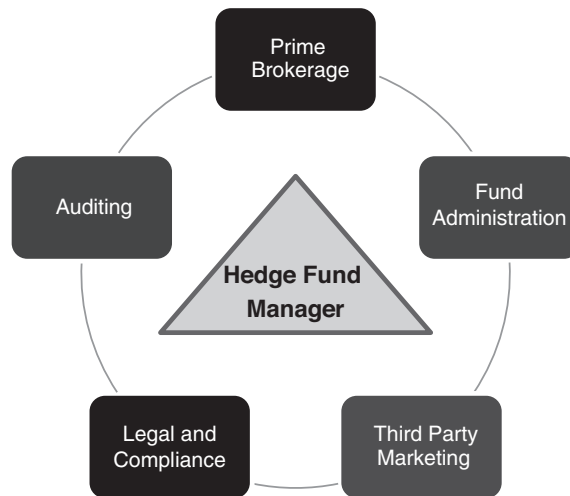


FIGURE 1.1 Types of Service Providers Used by Hedge Funds

3. *Third Party marketing.* Third party marketing firms are independent hedge fund marketing consultants who work to raise capital for two to five or more hedge funds at any one point in time for a single source of investors, or for multiple distribution channels. They typically require some sort of retainer along with sharing of 20 percent of both the management and performance fees while the funds raised stay invested.
4. *Legal and compliance.* Legal and compliance firms become more important every year within the hedge fund industry. Hedge funds use law firms for complicated formation processes, ongoing business legal considerations, and ongoing compliance work as well.
5. *Auditing.* Auditing firms are used by hedge funds on a quarterly and annual basis to verify their performance and accounting figures. Some hedge funds use auditing firms for monthly checks or to prepare for an annual audit as well.



BONUS VIDEO MODULE

To watch a video on the hedge fund ecosystem, please type this URL into your Web browser: <http://HedgeFundTraining.com/Ecosystem>

Top Four Hedge Fund Industry Trends

Understanding the hedge fund industry requires knowing what is going on now and also identifying current trends affecting how hedge funds operate, invest, form, and trade. Following are the top four hedge fund industry trends:

1. Recent poor absolute hedge fund performance and fraud has led to increasing pressure from investors for additional transparency and levels of governance. This is being done to ensure that managers adhere to their investment mandates, only restrict investor liquidity when necessary, and ensure that internal controls, checks, and responsibilities are properly carried out. Independent administration firms and directors are now required by many investors and boards of advisers.
2. The collapse of Lehman Brothers left some hedge funds in London without access to their assets, causing poor performance and in some cases fund failures. Since this event, hedge funds with over \$30 million in assets have been investigating and implementing multi-prime brokerage models, rather than invite risk by working with one single prime broker. In the past, prime brokerage firms would conduct due diligence on the soundness of their potential hedge fund clients. Now the research is done in both directions, with hedge funds screening prime brokers and vice versa. Some newcomers to the industry are now gaining strong market share because they are seen as a safe place to do business.
3. The use of outside capital-raising resources, investor databases, and third-party marketing firms is on the rise. The capital-raising environment is more competitive, and hedge fund managers are forced to evolve their investor relationship cultivation systems, capital introduction resources, and investor contacts in order to compete.
4. Investors increasingly want to work with more *institutional* hedge fund managers. This typically means hedge funds with over \$100 million to \$250 million in assets under management. More specifically, it refers to the types of operational processes, technology, risk management, trading, and governance features that tend to be in place with funds that have \$1 billion in assets under management. This has always been a challenge for emerging managers, who have limited access to high-pedigree (well respected and accomplished) team members, investors comfortable with small fund managers, and many times even the knowledge needed to create a more institutional-quality hedge fund operation.



BONUS VIDEO MODULE

To watch a video on the top four hedge fund trends, please type this URL into your Web browser: <http://HedgeFundTraining.com/Trends>

FUTURE OF THE HEDGE FUND INDUSTRY

During the financial crisis of 2008, many journalists wrote about the death of hedge funds and how the industry was about to burn to the ground. This was taken seriously by only a handful of professionals who actually worked in the industry. The future of the hedge fund industry is actually bright due to several short- and long-term factors.

The strongest argument for the strength of the hedge fund industry is the constant innovation that occurs in this industry. Hedge funds are constantly using new trading techniques, incorporating new asset classes, including additional equity markets in their scope, and taking on new financing and investing roles to expand their total market share. Most hedge funds on the edge of innovation are small, hungry teams that are driven to succeed, and they know that they will be rewarded handsomely for doing so. The combination of relatively low barriers of entry and direct financial rewards are a formula for continued growth and natural positive evolution of the industry as a whole.



BONUS VIDEO MODULE

To watch a video on the future of the hedge fund industry, please see <http://HedgeFundTraining.com/Future>

CHAPTER SUMMARY

Hedge funds have been growing rapidly over the past 20 years, and while their growth is now slowing down, they are becoming more diverse and

innovative in their investment strategies. As the industry evolves, service providers are becoming more like business partners and are vital to the business success of hedge fund managers. In the future, hedge funds are likely to develop even more investment terms, investor agreements, and performance fee structures to further align the interests of the investor with the hedge fund portfolio manager and principal.

Free Resource: The Free Hedge Fund E-Book, at HedgeFundsBook.com.

REVIEW QUESTIONS

1. What is a hedge fund?
 - a. A private investment partnership that typically includes the manager of the portfolio receiving both a management and performance fee.
 - b. A private equity fund that also employs hedging tactics using equity securities.
 - c. A private investment partnership that is 100 percent unregulated and can use leverage to produce higher absolute returns for investors.
 - d. The roles of the specific board members.
2. Which of the following is not one of the top trends affecting the hedge fund industry right now?
 - a. Investors are seeking to work with more institutional-quality fund managers.
 - b. Raising capital is becoming more competitive, so utilizing resources such as third-party marketers and investor databases is on the rise.
 - c. Most hedge fund managers are now outsourcing their portfolio management activities to leading mutual funds, who trade the actual account in the hedge fund.
 - d. Fund administrators, prime brokerage firms, compliance firms, third party marketers, and auditing firms are becoming increasingly important to the operations and effectiveness of a hedge fund business.
3. True or false: Due to the concentrated nature of hedge fund strategies, it is likely that another large market swing could eliminate the industry completely.
4. Hedge funds typically charge a _____ percent management fee and _____ percent performance fee.
 - a. 3.5, 15
 - b. 2, 25
 - c. 1, 15
 - d. 2, 20
5. True or false: A high-water mark allows a hedge fund manager, under certain circumstances, to restrict or completely cut off redemptions from

- the portfolio due to market illiquidity or specific sets of circumstances set forth in the contract.
6. True or false: Hedge funds are the one type of investment that is completely unregulated, and that is why investment into this vehicle type is restricted to institutional and accredited investors.
 7. Most of the hedge fund industry is made up of managers who manage between _____ and _____ in assets under management (AUM).
 - a. \$1 million, \$10 million
 - b. \$100 million, \$750 million
 - c. \$1 million, \$200 million
 - d. \$50 million, \$200 million
 8. True or false: Financial journalist, author, and sociologist Andrew Lo started the first hedge fund in 1949 while working for *Fortune*.
 9. A lock-up period is often put in place so that
 - a. A hedge fund may invest in various assets and will have more control and flexibility in the timing of its purchasing and selling of these assets.
 - b. A hedge fund may lock up an investor into investing only in its fund during a certain period of time, typically lasting 18 months to two years. This is put into place to protect the intellectual capital that may be shared with other managers in the industry.
 - c. An investor can lock in his investment with the hedge fund and be guaranteed additional capacity in the hedge fund for the next two to three years after his initial investment. This is most commonly used by institutional investors.
 10. True or false: Due to being highly liquid vehicles, hedge funds are often invested in for an average of six to nine weeks and offer liquidity on a weekly basis. This is why the industry has been able to quickly gain assets for institutional investors of many types.

Answers: To view the answers to these questions, please see <http://HedgeFundTraining.com/Answers>.

