

Hedge Funds

- What is it?
- How do hedge funds differ from mutual funds?
- Hedge fund strategies
- When can it be used?
- Strengths
- Tradeoffs
- How to do it

What is it?

Hedge funds are private investment vehicles that manage money for institutions and wealthy individuals. They are generally organized as limited partnerships, with the fund managers as general partners and the investors as limited partners.

How do hedge funds differ from mutual funds?

Unlike mutual funds, hedge funds are not normally offered for sale to the public at large; they are available only to a limited number of investors. Investors normally must have significant funds available to invest or have a high level of financial sophistication. As a result, most hedge funds are exempt from much of the regulation that mutual funds are subject to, and are free to engage in a wider range of investment techniques than mutual funds.

Other major differences include the required minimum investment, which is far greater for a hedge fund than for a typical mutual fund. In addition, hedge funds usually require an investor to invest in the fund for a period of one year or longer and may limit transferability, making them a less liquid investment than mutual funds.

Hedge funds employ a variety of trading techniques that are not normally used (or used only minimally) by mutual funds. Although many hedge funds purchase stocks and/or bonds like mutual funds do, they also use hedging techniques in an effort to manage the risk associated with the securities in the portfolio. Different hedge funds employ different techniques and trade different types of investments in pursuit of their strategy.

Hedge fund strategies

One of the most common hedging techniques is options trading. An option is the right to buy or sell a certain number of shares of a particular stock at a fixed price that is locked in at the time the option is purchased. In addition to options on stocks, options can be traded to hedge other risks. For example, hedge funds may trade options on stock indexes (e.g., Standard & Poor's 500 Composite Index) to hedge against swings in the U.S. stock market as a whole, or trade currency options to hedge against changes in the value of a foreign currency.

Other strategies that a hedge fund may adopt include trading on margin and selling short. Trading on margin refers to the buying and selling of securities with credit available through a relationship

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with a brokerage firm, called a margin account. Selling short is best explained using a simple example.

Example(s): An investor, foreseeing a decline in the price of a stock, "borrows" 100 shares of the stock from a broker when it's trading at \$50 a share and then turns right around and sells those shares for \$5,000. The investor then waits until the stock price drops to \$40, buys 100 shares for \$4,000, gives those shares to the broker to make good on the loan, and realizes a \$1,000 profit.

Caution: Short selling has unique risks and pitfalls to wary of. Investors can realize a return only if the stock price declines. If the stock price rises instead, the investor's losses could be unlimited. Further, the lender could recall the borrowed stock at any time. Since the short-seller has no control over this timing, he or she may have to buy securities at a higher price. Additionally, fees and interest may be charged on the transaction. These costs will diminish any potential return. Finally, short sales can impact the rate at which dividends are taxed. See Short Sales .

A hedge fund's strategy and degree of success will vary from one fund to the next. In theory, a perfect hedging strategy is one that eliminates risk altogether. In reality, however, all risk cannot be eliminated, nor is that necessarily a desirable outcome. After all, investors make investments with the intention of making at least some return on their money. If the goal were to have gains and losses perfectly offset each other, there would be no point in investing at all.

When can it be used?

Hedge funds should only be used by investors who are sophisticated enough to understand the risks and investment techniques associated with the hedge fund they choose, and are able to absorb significant losses in the amounts they invest. Carefully selected hedge funds can effectively help diversify an investor's portfolio. This is because hedge funds offer access to financial instruments and trading strategies that are not readily available to individual investors or through typical mutual funds.

Strengths

Potential for substantial returns

Because hedge funds are unregulated, hedge fund managers are able to take more volatile positions, increasing the potential for substantial returns (as well as increasing the potential for substantial losses).

Tradeoffs

Hedge funds not regulated

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Generally, hedge funds are not required to register with the SEC, although they are subject to the antifraud provisions of the federal securities laws. As a result, investors in hedge funds do not receive some of the protections that investors in mutual funds enjoy. In particular, hedge funds:

- Are not required to maintain a certain degree of liquidity
- Are not limited by how much they can invest in a single investment
- Are not limited in their use of leverage
- Are not required to disclose information regarding the fund's management, fees and expenses, holdings, or performance

Potential loss of entire investment

As mentioned previously, hedge funds are able to use higher-risk investment strategies, such as:

- Investing in derivatives
- Trading on margin
- Selling short
- Investing in distressed or bankrupt companies
- Investing in volatile international companies
- Investing in privately issued securities

Because of these risks and others, investors may lose their entire investment.

More costly than mutual funds

A hedge fund must pay a premium to purchase an option to buy or sell stock. The most effective hedges can be particularly expensive. Also, hedge fund managers generally receive a share of the gains realized by the fund, unlike mutual fund managers. These added costs are passed on to the fund's individual shareholders in the form of higher management and administrative fees when compared to mutual funds.

How to do it

As with any investment, great care should be taken when selecting a hedge fund. You will want to research which funds are suitable for your investment goals. Because hedge funds are not publicly offered, you will likely need the assistance of an investment professional when evaluating and choosing hedge funds.

When you have selected a fund or funds, make sure you understand the goals of the fund and how the fund management intends to accomplish its goals. It is important that you are comfortable with the strategies the fund employs, the types of assets the managers invest in, and the risks involved before investing in the fund.

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Final Page - Disclaimer

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