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AN OVERVIEW OF THE HEDGE FUND INDUSTRY

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Abstract

Hedge funds, as an alternative investment vehicle, have enjoyed healthy growth in recent years and continue to increase in popularity. The term 'hedge fund' is not defined or separately addressed in any securities or commodity laws. The term has undergone a considerable amount of mutation to represent what it is today compared to what it meant when it first originated in 1949.

In the short history of fifty years, interest in hedge fund and their performance has waxed and waned. Hedge funds invest in variety of liquid assets just like mutual funds, but are quite different from mutual funds. For example, under current federal law, the former do not have any management limitations. There are virtually no limits on the composition of their portfolios, and no mandatory disclosure of information about the holdings and performance.

AN OVERVIEW OF THE HEDGE FUND INDUSTRY

I. Introduction

The dictionary meaning of hedge is to take precautions, play safe, or take out insurance. In finance industry terminology, this should translate to the process of protecting oneself against unfavorable changes in prices. The term 'hedge fund' is not defined or separately addressed in any securities or commodity laws. The term has undergone a considerable amount of mutation to represent what it is today compared to what it meant when it first originated in 1949.

Hedge funds, as an alternative investment vehicle, have enjoyed healthy growth in recent years and continue to increase in popularity. Hedge funds first became famous by their philosophy of trying to outperform the overall market through individual stock and security selection, and by taking market neutral positions in an effort to protect financial capital in times of market volatility. Today, hedge-fund managers have broadened their investment latitude by using equity, commodity and hybrid instruments for 'unhedged' speculative gain.

Currently, hedge funds are considered to be investment vehicles that are organized to avoid the application of most securities laws. The term hedge fund now generally denotes a limited partnership, offshore fund or other unregistered commingled investment vehicle that relies upon individual security selection to achieve superior

performance. There is no known governing body that publishes comprehensive, reliable statistics about the overall hedge fund market, though various published sources estimate that there are between 3,000 to 5,000 hedge funds globally.

II. Evolution of Hedge Funds

The origin of hedge funds in the United States dates back to the late 1940s. While many hedge fund characteristics have changed significantly, many fundamental features have remained the same. Moreover, hedge funds are no longer unique to the U.S. markets, but exist in many areas around the world. In the United States, they normally offer their shares in private placements and have less than 100 high net-worth investors, to make use of exemptions to the regulations under the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of l940. Hedge funds are managed on a fee-for-performance basis. This fee normally comprises a one-percent management fee and twenty percent take on profits, though management and investment fees do vary. Moreover, most funds require shareholders to provide advance notification if they wish to withdraw funds. The notice can vary from 30 days for funds with more liquid investments to three years for other funds.

The term ‘hedge fund’ is currently applied to a wide variety of funds, and prevailing opinion of hedge funds is that they are highly leveraged investment vehicles. This is quite in contrast with the risk-averse hedgers. A risk-averse hedger uses future market to minimize the risk in his or her business, whereas a highly leveraged strategy,

like hedge funds, works like a double-edged knife. Leverage provides an opportunity to enhance returns from borrowed funds, but in doing so, particularly at high ranges, it also enhances the chance for a total loss of equity. Today's hedge funds are generally trying to maximize returns, with little attention to lowering risk. This is the difference between conventional hedging and 'hedge fund.' As we shall see below, the term hedge fund is highly misleading, and since it has undergone mutation to reach to its present state, it is useful to begin with a little history.

II.A. A. W. Jones hedge fund

In 1949, A.W. Jones established in the United States what is regarded as the first hedge fund. The goal of his fund was to generate profits through superior stock picking, using the unique investment practices of leverage and short selling. Jones realized that there were two distinct sources of risk in equity investment: from individual stock selection (diversifiable or non-systematic risk) and from general market risk (nondiversifiable or systematic risk). He maintained a basket of shorted stocks as a required asset allocation, to protect a portion of his portfolio against adverse market movements. Thus controlling the diversifiable market risk, he used leverage to magnify his portfolio's returns.

The strategy was to be long on stocks that were 'undervalued' and short on those that were 'overvalued.' This strategy when implemented properly would lead to positive returns regardless of the direction in which the market moved. The fund was considered

"hedged" to the extent that the portfolio was split between stocks that would benefit if the market went up, and short positions that would gain if the market went down and hence the name 'hedge fund.' Jones valued stock picking over market timing, but he did increase or decrease the net market exposure of his portfolio based on his forecast for the market. As equity prices have a positive long-term trend, Jones was generally 'net long'. Jones also designed a merit-based compensation arrangement in which he was paid a percentage of his profits generated from his clients' assets.

Subsequently, this fund type began to employ several advisors, who simultaneously managed portions of fund capital, to achieve the benefits of manager diversification. Each advisor had a certain degree of freedom in making investment decisions. Centralized management ascertained that each advisor's strategy was in agreement with the overall investment policy. This structure was formalized later into a true fund of funds, which is still widely used today.

An important characteristic of the first hedge fund was that the general partner, who also served as the investment manager, invested a significant amount of his own money. Today, this remains a common practice as it demonstrates the manager's dedication to achieve superior performance. As mentioned earlier, another significant feature of Jones's fund was an incentive fee structure. The fees payable to the general manager were set at 20 percent of realized profits. Unlike mutual funds, there was no asset-based management fee.

II.B. Growth of hedge funds

Despite an excellent track record, this partnership and its early replicas operated in relative anonymity until the late 1960s. The publication in April 1966 of an article in *Fortune* magazine on Jones' fund, vividly describing his rates of return, led to widespread growth of hedge funds. Jones' fund had a return that exceeded those of the most successful mutual funds. The fund had a return (net of fees) that exceeded the Fidelity Trend Fund by 44 percent over the previous five years, and the Dreyfus Fund by 87 percent over the previous ten years. While no data are available on the number of hedge funds that were established in the subsequent period, a survey by the Securities and Exchange Commission (SEC) found 215 investment partnerships for the year 1968, inferring that 140 were hedge funds, with the majority having been formed in that year.

The rapid growth of hedge funds occurred at the time when the equity market was rising relentlessly. This made it difficult and costly for managers to hedge a portfolio with short sales. Therefore, many managers started using high margin strategies to leverage up their long equity positions, with only symbolic hedging.

The 1970s and the early 1980s was a time of economic slowdown, and this slowdown spiraled into decreased demand for hedge funds. Once again, hedge funds took a back seat in the minds of the investment community. The decline in the equity market (1969-70) almost ruined the industry. It is reported that for the 28 largest hedge funds in the SEC survey at the end of 1968, assets under management declined by 70

percent (from losses and withdrawals) by the end of 1970, while five of them were closed (Caldwell,1995).

The decline of hedge funds lasted over 15 years, with the bull market of mid to late 1980s acting as an inflection point in the life cycle of hedge funds. Several factors other than the bull market contributed to this revival namely, increased investments by individual American investors, positive media coverage and the evolution of the derivatives market. The market began to standardize the exchange-traded futures contracts.

In particular, the bull market of the late 1980s created more number of high net-worth investors. These investors, looking for enhanced returns, started to invest in hedge funds. The renewed interest in hedge funds that began in the late 1980s has not vanished Hedge funds are not required to report any performance statistics to regulatory agencies. Hedge funds are also barred from advertising. They report voluntarily to database providers. Voluntary reporting means that all statistics suffer from a self-reporting bias, as hedge fund managers have an incentive to report results in a favorable light. A fund manager's choice to start reporting may not coincide with the date of its inception, and this distorts the statistics available on the growth in the number and size of funds.

In 1990, there were about 600 hedge funds worldwide with assets of approximately $38 billion. According to industry publications, at the end of 1998, despite the publicized collapse of Long Term Capital Management, there were some

3,300 hedge funds with assets of approximately $375 billion. All estimates suggest that the hedge fund industry has experienced tremendous growth since mid 1980s, measured either by the number of funds or by assets under management. The growth appears to be uninterrupted as yet. The number of hedge funds in the Zurich Capital Markets/Hedge (formerly, Mar/Hedge) database has increased consistently from a total of 127 in 1990 to 1,115 by the fourth quarter of 1997, to reach 2,467 hedge funds by July 2001. There is no known governing body that publishes comprehensive, reliable statistics about the overall hedge fund market, though various published sources estimate that there are between 3,000 to 5,000 hedge funds globally. Additional investments in the hedge fund industry in years 2000 and 2001 were 40 billion USD and 80 billion USD respectively and the present size of the industry is about 500 billion USD.

The near failure of Long-Term Capital Management (LTCM) in 1998 does not appear to have slowed down the growth of and interest in hedge funds. The LTCM debacle has rightly led to more caution from the regulatory authorities and investor interest groups.

II.C. LTCM debacle

Long-Term Capital Management was formed in February 1994 with equity of $1.3 billion. Around $100 million of this money was contributed by LTCM's general partners. LTCM required a minimum investment of $10 million and, no withdrawals for three years. It charged an annual fee of 2 percent of assets, and 25 percent of new

profits. The fund had a return of 19.9 percent after fees in 1994, 40.8 percent in 1996, and 17.1 percent in 1997. By late 1997, its equity had grown to over $7 billion. In December 1997, the fund returned $2.7 billion to its investors because of diminished investment opportunities. LTCM had equity of about $4.8 billion at the beginning of 1998.

LTCM was primarily engaged in 'market neutral arbitrage.' It had long positions in bonds that it considered undervalued and short positions in bonds that it considered overvalued. LTCM borrowed more than $125 billion from banks and securities firms against its equity of just about $5 billion. It thus had a leverage ratio of 20-to-1, high by any standard. LTCM got into difficulties when it thought that the high spread between prices on long-term Treasury bonds and long-term corporate bonds was too high, and bet that this "anomaly would disappear and the spread would narrow. In the wake of the collapse of the Russian financial system in August 1998, the spread between corporate and treasuries rose rather than narrowed as LTCM had predicted. The result was that LTCM took big losses on its positions, destroying much of its equity position.

II.D. Development of the industry

The development and innovation that has occurred in the hedge fund industry since the 1980s, indicates that interest in hedge funds is here to stay for a long time. Table 1 describes the milestones in the evolution of hedge funds.

Table 1. The Evolution of Hedge Funds.

Period	Event
1949	First hedge fund in the United States.
1952	First hedge fund reorganizes into a limited partnership.
1966	Publication of, "The Jones Nobody Keeps Up With," Carol J. Loomis, *Fortune*, April 1966, which creates positive press and significant interest in the hedge fund as a viable alternative investment.
1966-1969	Several hundred hedge funds enter the marketplace.
1970-1985	Economic recession and poor hedge fund performance significantly curtail hedge fund interest
1986	Renewed hedge fund interest is generated from Wall Street press, a bull market and further evolution of the derivatives market
1996	Section 3(c)(7) of the Investment Company Act of 1940 is enacted, providing increased hedge fund flexibility. Formation of the first hedge fund registered under the Investment Company Act of 1940.
1998	Hedge funds and lenders reexamine investor exposure from heavily financed funds.
1999	In the wake of the Long-Term Capital Management crisis, the U.S. Congress proposes legislation to regulate hedge funds.
2000	Hedge Fund leaders publish 'Sound Practices for Hedge Fund Managers' a report compiling recommendations of the President's Working Group on Financial Markets.
2001	Hedge Funds post a strong positive return despite global economic slowdown and lower consumer confidence.

Hedge fund investment practices and strategies have evolved and expanded over time. The ancestral hedge-fund managers utilized leverage in the form of margin and short sales to achieve their investment objectives. On the other hand, the hedge-fund managers of today do not always include 'leverage' in their primary investment

strategy. Today hedge funds are organized using a variety of legal and tax structures, utilize a continuum of investment strategies, remunerate managers using several different methodologies, and vary as to investor reporting practices.

III. Defining a Hedge Fund

Hedge funds are private investment pools. In the United States, they typically offer their shares in private placements and have less than 100 high net-worth investors. The distinction between what *is* and what *is not* a 'hedge fund' is fuzzy, with different vendors employing alternative definitions, which results in varying estimates of the universe of hedge funds. Following paragraphs present some extant definitions of what entitles a fund to be called a 'hedge fund.'

Mar/Hedge (Managed Accounts Report) defines a hedge fund as one that: 'charges a material incentive fee (usually in the 15 to 25 percentage) and meets at least one of the following criteria: the fund invests in multiple asset classes; in the case of a long-only fund, uses leverage; or the fund uses hedging techniques within its portfolio.'

HFR (Hedge Fund Research) includes in its universe of hedge funds 'a structure that is normally a private investment partnership or offshore fund that charges a performance fee, and that encompasses a broad definition of investment strategies. Investment strategy ranges from the non-leveraged, hedged and arbitraged to highly leveraged and directional.'

VHFA (VanHedge Financial Advisors) defines U.S. hedge funds as: 'limited partnerships or limited liability companies invested primarily in public securities or in financial derivatives.' While VHFA does not explicitly take into account whether or not the fund hedges its portfolio, it is estimated that over 90 percent of the U.S. funds in that database actually hedge. For offshore funds, VHFA's universe includes 'mutual fund companies domiciled in tax havens which can utilize hedging techniques to reduce risk.'

President's Working Group (PWG) has recommended an encompassing definition of a hedge fund. PWG is comprised of the Secretary of the US Department of the Treasury and the respective chairs of the Board of Governors of the Federal Reserve System, the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission. PWG defines hedge funds 'as a pooled investment vehicle that is privately organized, administered by a professional investment management firm and not widely available to the public'. In general, the term 'Hedge Fund' is used to describe a wide range of investment vehicles, which can vary substantially in terms of size, strategy, business models and organizational structures, among other characteristics.

IV. Hedge Fund Structure

It is important to distinguish between hedge fund structure and hedge fund strategy. The investment structure is the legal entity that allows investment assets to be

pooled and permits the hedge fund managers to invest in them. The investment approach that the manager takes is known as hedge fund strategy. The structure establishes such things as the method of manager compensation, the number and type of investors, and the rights and responsibilities of investors regarding profits, redemption, taxes and reports. The elements that make up the strategy include how the manager invests, which markets are used, and which opportunity and return source is targeted. While the distinction between hedge funds and other commingled investment vehicles hinges primarily on investment styles and strategies, hedge funds are also unique in terms of organization and certain functional areas.

Hedge funds are usually structured as private investment pools. The actual legal entity (limited partnership, corporation, trust, mutual fund) depends on where the fund is domiciled (legally located) and the type of investors that it targets. Hedge funds that are domiciled outside the United States are called ‘offshore’ funds. Both onshore and offshore managers do not typically disclose the contents of the fund’s portfolio to their investors, although access to this information, called transparency, is increasing and is demanded by many investors. Managers report performance to investors on a limited basis, which means that it is monthly for most funds and quarterly for some.

IV.A. Organization of ‘onshore’ (U.S.) funds

A U.S. ‘hedge fund’ usually is a U.S. private investment partnership invested primarily in publicly traded securities or financial derivatives. As these funds are

private investment partnerships, the SEC limits U.S. hedge funds to 99 investors, at least 65 of those must be 'accredited.'

An accredited investor is an individual who has made $200,000 a year in income for the past two years and has a reasonable expectation of doing so in the future: one who, together with a spouse has an income of $300,000 per year; or one who has a net worth of $1 million, excluding home and automobile. Generally this would include corporations, partnerships, limited liability companies and other entities with total assets in excess of $5 million.

Usually, the investment manager is the general partner who also invests capital into the partnership. The General Partner of the fund usually receives 20% of the profits, in addition to a fixed management fee, usually one percentage of the assets under management. The majority of hedge funds employ some form of hedging, which may include shorting stocks, utilizing 'puts,' or other devices. In the U.S. market, funds are organized in one of the following five ways.

a. Section 3(c)(1) funds

Section 3(c)(1) of the 1940 Act permit hedge funds to organize as a private placement, free from the 1940 Act's rules and regulations. It exempts a fund from 1940 Act registration provided that the fund admits not more than 99 investors and that all investors meet the eligibility requirements of an "accredited investor" as defined in Regulation D of the Securities Act of 1933.

b. Section 3(c)(7) funds

The National Securities Markets Improvement Act of 1996 enacted Section 3(c)(7). Section 3(c)(7) defines ‘qualified purchasers’ as:

A natural person or family owned company with $5 million of investments or a trust, partnership or corporation that was not solely established to invest in a fund/partnership, with investable assets of at least $25 million. Although similar by definition to the accredited investor, the qualified purchaser must demonstrate higher levels of net worth and ability to sustain risk.

c. Registered hedge funds

This fund type registers with the SEC under the 1940 Act as a closed-end mutual fund, but operates as an investment partnership. A registered hedge fund targets “middle market” accredited investors by providing the benefits of smaller minimum investments, an unlimited number of partners and, correspondingly, the ability to achieve critical mass uncommon with other hedge fund products. Since these funds are 1940 Act registered mutual funds, they must adhere to all of the 1940 Act’s applicable rules and regulations. This structure is best suited for fund managers who do not intend to use high amounts of leverage to achieve an investment objective (since the 1940 Act restricts leverage to one third of fund assets).

d. Master/Feeder structures

This structure became popular during the early 1990s. The master/feeder fund is a two-tiered structure permitting the separation of investment functions from distribution

functions, and allowing critical mass to develop in a central repository (the ‘master’) from various distribution channels (the ‘feeders’).In this structure, a master fund is created in which a portfolio of securities is held. Feeder funds invest all or most of their assets in the master fund, thus deriving their performance primarily from the performance of the master. Typically, a master fund is organized as a partnership in which feeder funds are the partners and a master’s investment income and gains/ losses are periodically allocated to its associated feeders. In the United States, master funds are often registered under the Investment Company Act of 1940. Their associated feeders may also be registered under the 1940 Act or may be unregistered products.

There are several features associated with the master/feeder structure that provides versatility to the structure to serve various distribution channels:

- The structure permits feeders, which are organized in various jurisdictions, to participate in a single pooled investment vehicle.
- Each associated feeder may have a different legal structure, e.g., a 1940 Act mutual fund, a partnership and a collective trust could all participate in the same master.
- Each feeder may have a different fee or capital structure.
- Each feeder may have its own governing board, which represents the specific interests of the group of investors holding a particular feeder.

e. Fund-of-funds

These are investment vehicles that invest solely in other investment funds. Unlike an actively managed fund that utilizes the expertise of one investment advisor to build

and manage a unique portfolio of individual securities, fund-of-funds managers achieve their investment objectives by investing in unaffiliated funds, each of which is managed by a separate advisor. Fund-of-funds may be organized as partnerships or corporate entities, and they may be registered or unregistered. In the United States, fund-of- funds may register under Section 12(d)(1)(G) of the 1940 Act or seek exemption pursuant to Section 12(d)(1)(J), and they may be open-end or closed-end in nature.

The main advantage of the fund-of-funds structure is its ability to benefit from the expertise of several different investment managers in an efficient manner. These managers may all employ the same strategy or they may use different strategies. As a result, a fund-of-funds may be able to blend the strategies of many managers to produce more benefits to the investors than those investors could achieve on their own.

IV.B. Organization of 'offshore' (non U.S.) funds

Many global jurisdictions provide more tax advantages to a corporate entity as compared to an investment partnership. Hence, offshore funds are usually organized as corporations, including limited liability companies. They are typically established in the Caribbean tax havens. Investors purchase shares in the corporation in the same way as they would purchase shares in the mutual fund, but the minimum required contribution is much higher. They have no legal limits on numbers of non-U.S. investors, but many funds limit the number of contributors. Some meet requirements of the U.S. Securities and Exchange Commission, which enables them to accept U.S. investors. This

corporate structure generally offers shares, and to process subscriptions and redemptions on a monthly basis.

A frequently used jurisdiction is the Cayman Islands. Cayman Islands law permits limited partnerships. Yet, the more common organizational structure is that of a corporation, usually an exempted company whose business is conducted outside of the islands. Investment funds, including companies, unit trusts and partnerships, are subject to the Cayman Mutual Funds Law. Cayman law requires that companies have a registered office on the islands, and that at least one director's meeting be held annually on the islands.

Another popular Caribbean jurisdiction is the Bahamas. Bahamian law also permits limited partnerships, but the more commonly used structure is that of a corporation. The Bahamas has legislation for the regulation of particular investments. The Mutual Funds Act specifies three classifications of companies.

- A 'regulated mutual fund' requires a license to conduct business.
- An 'authorized fund' is a fund that requires a minimum investment of 50,000 Bahamian dollars from future shareholders. This fund "may not be subject to the approval process of a regulated mutual fund. An authorized fund must still meet other filing and registration requirements.
- An 'exempt mutual fund' may have no more than 15 investors and is exempt from many of the requirements imposed on the first two classifications of funds.

In Bermuda, another Caribbean jurisdiction, companies can be formed as mutual funds. Companies formed under the general company law are not permitted to purchase

their own ordinary shares (as would be done when a fund investor redeems shares at their net asset value). Therefore, mutual funds must be formed under a certain act that specifically allows for these types of purchases.

V. Type of Investor and Investments

Hedge funds receive very little regulatory oversight. The Securities and Exchange Commission has set up general guidelines for the hedge funds. The managing director and the legal advisors of each fund have the onus of following these general guidelines. The freedom from strict regulatory oversight also puts a limit on the number and type of investors. This in turn forces the manager to put restrictions on investment size, contribution and withdrawals.

V.A. Type of investor

Under the Investment Company Act of 1940, hedge funds either qualify as 3(c)(1) or 3(c)(7) investment partnerships, which are unregistered and do not receive the same regulatory scrutiny as mutual funds. In order to maintain the3(c)(1) status and continue to avoid the scrutiny that the mutual fund industry receives from regulatory agencies, these investment partnerships must limit the number of investors to 99, of which 65 must be accredited.

An investor must be either an institution or an individual classified as ‘accredited’ or higher. This restriction makes it necessary for a manager to set a higher minimum investment in order to accumulate a reasonable amount of assets. Minimum investments

usually range from $100,000 to $5 million. Investors who cannot meet the minimum investment size for a domestic or offshore fund can participate through a feeder fund structure or wrap fee program. These arrangements enable pooling of multiple investors to meet a minimum investment size target.

In April 1997, the SEC adopted rules introducing the 3(c)(7)-investment partnership, resulting in more flexibility for hedge funds by increasing the number of eligible investors beyond 99. The 3(c)(7) rule took effect in June 1997. In order for a hedge fund to operate as per3(c)(7) rule and have an unlimited number of investors per fund, each individual investor must qualify by having a net worth of at least $5 million. For institutional investors, the net-worth minimum requirement is $25 million. There is however a margin for manager discretion within the 3(c)(7) guidelines that allows so-called 'knowledgeable employees' of an investment partnership to invest under an exemption to the $5 million net-worth rule.

Section 3(c)(7) places no limit on the number of investors permitted in a hedge fund. When a domestic hedge fund has 500 or more investors it becomes subject to an increased level of Commission governance, including 10K and 10Q filing requirements. In case of an offshore hedge fund operated by a U.S. manager, a fund operating under 3(c)(7), the hedge funds become subject to similar SEC oversight once it has 350 investors.

V.B. Investment size, contributions and withdrawals

Minimum investments are usually larger for onshore funds, because regulations limit the number of investors. In the initial stages, it normally offers lower minimums and more flexibility in order to attract investors. As the number of investors in the fund increases, managers are less likely to waive the minimum. In many cases funds actually raises the minimum for new investors and in some cases close out smaller accounts in order to make room for larger allocations. Many hedge fund strategies attempt to exploit temporary price inefficiences or discrepancies between securities or markets. Financial markets are semi-strong form efficient and so the proprietary hedge fund investment strategies probably have diseconomies of scale. Thus, many managers limit the size of any one investor to ensure a diversified client base.

Open-end mutual funds permit purchases and redemption of fund shares on a daily basis, based upon calculated net asset value per share. Most hedge funds permit contributions and withdrawals at varying frequencies ranging from monthly to periods of several years. While many mutual funds seek to provide liquidity while pursuing an investment objective, hedge funds by contrast, do not typically strive to provide liquidity to their investors. Furthermore, many hedge fund strategies are long term and involve investment in restricted or illiquid securities. Accommodating frequent admissions and withdrawals can be disruptive to these types of investment strategies. Hedge funds require a notice period that ranges from thirty to ninety days.

To manage capital outflows, hedge funds also frequently impose lock-up periods. A lockup period is the length of time that investors must remain invested before their investment can be redeemed or becomes subject to the standard liquidity provision. The lockup period for hedge funds varies from six months to five years, but the lockup in U.S. funds is usually one year.

VI. Fees and Expenses

In general, hedge funds charge two types of fees: asset management fee and incentive fee. The asset management fee is based on percentage of assets in the fund, usually 1 or 2 percentage points per year. This includes legal, audit, administrative, and other expenses. It is paid monthly or quarterly and may be due at the beginning or end of each period. The fee is automatically deducted pro rata from each investor's account.

The incentive fee or the "carried interest" is the hedge fund manager's share in the fund's profit. Usually this is 20 percent and is paid annually in the United States, but for offshore hedge funds it is calculated monthly or quarterly. It is important to get familiarized with two terms prevalent in the hedge fund fee structure. They are the *hurdle rate* and *high water mark*.

A hurdle rate is a compensation feature, whereby fund performance must exceed that of a commonly recognized market index or rate for a given period of time in order for the manager to earn incentive compensation. When a fund's performance exceeds an

established hurdle rate, incentive compensation is determined as a percentage of the calculated excess. The Treasury bill rate is often used as the hurdle rate.

A high water mark is a feature within an incentive compensation structure whereby losses are accumulated in a 'loss recovery account' against which future gains are applied in calculating incentive compensation. This feature ensures that incentive compensation is only derived from net positive performance on a cumulative basis. Most hedge funds have high water marks but not hurdles.

Performance-based fees originated first with U.S. products, these characteristics are now common with offshore funds also. In the current market, while the traditional '1% and 20%' (1% asset management fee and 20% incentive fee) structure remains common, other combinations of management and incentive fee rates are also in existence.

For a hedge fund structured as a company that issues shares and publishes a net asset value (NAV), the performance fee calculation becomes difficult. There are several options for structuring performance fee. Many funds choose to apply the performance fee at the fund level. This can result in an investor being charged performance fees for performance that does not correlate with that investor's return while in the fund. To overcome this, many funds have developed a method of equalization. This ascertains that performance fee charged is in accordance with the performance of the individual investors. There are many different ways to accomplish equalization. Three most common ways are described here.

a. Equalization shares approach

This approach offers separate series of shares with each fund opening. Each series is tracked separately from all other series, thus enabling the calculation of the exact amount of performance fee for the series. Generally, when the performance fee is payable, the various series issued throughout the period are converted to an initial or master series of shares at the net value of the initial share series. This conversion is only performed if an individual series is above the relevant series' high water mark.

b. Equalization/Depreciation deposit approach

This approach uses a fixed NAV across the entire fund. An adjustment is made to the price at which each individual shareholder buys into the fund. If an investor enters the fund at a time when the fund's gross asset value is greater than the prior high water mark, the investor will pay an equalization factor. This factor is then tracked until such time that the fund's performance fee becomes payable or the investor leaves the fund. If an investor enters the fund at a time when the fund's gross asset value is lower than the previous high water mark, the investor agrees to pay a performance fee if the fund recovers.

c. Equalization adjustment approach

This approach simply adjusts the shares outstanding to each investor at the time the performance fee becomes payable through the issuance of additional shares or the mandatory redemption of shares.

VII. Differences between Mutual Funds and Hedge Funds

Mutual funds and hedge funds differ in many ways. The areas of greatest difference between the two are regulatory requirements, approaches to fee structure, leveraging practices, pricing and liquidity, investor characteristics, and disclosure of information. U.S. mutual funds are among the most strictly regulated financial products. They are subject to numerous requirements designed to ensure that they are operated in the best interests of their shareholders. In contrast, a hedge fund is a private investment pool that is subject to far less regulatory oversight. Table 2.2 outlines the main differences between mutual funds and hedge funds.

Table 2. Differences between Mutual Funds and Hedge Funds.

Criterion	Mutual Funds	Hedge Funds
SEC Regulation	Four federal laws	Anti-fraud and anti-manipulation provisions
IRC Regulation	Requirements regarding portfolio diversification and distribution of earnings	None
NASD Regulation	Oversees advertisement and sales material	Prohibited from advertisement
Use of Financial Instruments	Restrictions exist	No restriction
Disclosure	High level, all information publicly available	Very minimum; must register with CFTC when trading in commodities
Fees	NASD rules	No limit, ‘1% and 20%’ is the norm
Leverage	Limited to less than one -third	No limit
Pricing	NAV	No specific rule
Redemption	Any time	Lock-up period

VII.A. Regulatory requirements

Mutual Funds: Mutual funds are investment companies that must register with the U.S Securities and Exchange Commission (SEC) and, hence, are subject to strict regulatory oversight. Almost every aspect of a mutual fund's structure and operation is subject to strict regulation under four federal laws: the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, and the Investment Advisers Act of 1940. The SEC oversees the mutual fund industry's compliance with these regulations. The Internal Revenue Code (IRC) sets additional requirements regarding a fund's portfolio diversification and its distribution of earnings, and the National Association of Securities Dealers Inc. (NASD) oversees most mutual fund advertisements and sales materials. In addition, mutual funds must have directors who are responsible for extensive oversight of the fund's policies and procedures, and at least 40 percent of those directors must be independent of the fund's management.

The Investment Company Act is the cornerstone of mutual fund regulation. Its core objectives are to make sure that investors receive adequate and accurate information about the fund, and to protect the integrity of the fund's assets. Mutual funds are subject to regulations concerning the extent to which they may invest in certain types of securities. A major aspect of fund regulation is disclosure to shareholders of specific information about the fund's management, holdings, fees and expenses, and performance.

Hedge Funds: Hedge funds are unregistered, private investment pools bound by the investment agreement (contract) that investors sign with the sponsors of the hedge fund. Hedge funds must satisfy certain disclosure obligations in the offering of securities. Hedge funds are subject to the SEC's anti-fraud and anti-manipulation provisions and, depending on an individual fund's exposure to commodities, the managers may be required to register the fund with the Commodities and Futures Trading Commission.

Hedge fund managers can also avoid SEC scrutiny by not registering as investment advisors. To do this, a fund manager must have fewer than 15 "clients" over any 12-month period. Because each hedge fund (regardless of the number of investors) is counted as single client, it is possible to operate up to 14 hedge funds at a time without registering as an investment advisor with the SEC.

The sponsors of a hedge fund do not have any limitations in the management of the fund under the federal law. There are virtually no limits on the composition of their portfolios, and no mandatory disclosure of information about the holdings and performance.

VII.B. Fees

Mutual Fund: Federal law imposes a fiduciary duty on a mutual fund's investment adviser regarding the compensation it receives from the fund. The mutual fund sales charges and other distribution fees are also subject to specific regulatory limits under NASD rules. Mutual fund fees and expenses are disclosed in detail, as required by law,

in a fee table at the front of every prospectus. They are presented in a standardized format, so that an investor can easily understand them and can compare expense ratios among different funds.

Hedge Funds: There are no limits on the fees a hedge fund can charge its investors. Typically, the hedge fund manager takes a fee of 1 or 2 percent of net assets, plus 20 percent of annual return. Some have front-end sales charges, as well.

VII.C. Leveraging practices

Mutual Funds: The Investment Company Act severely limits a mutual fund's ability to leverage or borrow against the value of securities in its portfolio. The SEC requires that funds practicing certain investment techniques, including the use of options, futures, forward contracts, and short selling, must "cover" their positions. The effect of these constraints has been to strictly limit leveraging by mutual fund portfolio managers.

Hedge Funds: Leveraging and other higher-risk investment strategies are a hallmark of hedge fund management. For example, the multi-billion dollar hedge fund run by Long-Term Capital Management nearly collapsed after using borrowed money to speculate in high-risk trades in global markets.

VII.D. Pricing and liquidity

Mutual Funds: Mutual funds are valued daily with a published net asset value (NAV). In addition to providing investors with timely information regarding the value

of their investments, daily pricing is designed to ensure that both new investments and redemptions are made at fair prices. Mutual funds also are required by law to allow shareholders to redeem their shares at any time.

Hedge Funds: There are no specific rules governing hedge fund pricing. U.S. hedge funds provide investors only a monthly estimate of percentage gain or loss. Offshore funds may offer NAV form reporting, although it is usually on a monthly basis.

VII.E. Characteristics of investors

Mutual Funds: The only qualification for investing in a mutual fund is having the minimum investment to open an account with a fund company, which is typically around $1,000, but can be lower. After the account has been opened, there is generally no minimum additional investment, and many fund investors contribute relatively small amounts to their mutual funds on a regular basis as part of a long-term investment strategy. The typical fund investor is a middle-income, middle-aged individual.

Hedge Funds: A minimum investment of $1 million or more is often required of hedge fund investors. Under the National Securities Markets Improvement Act of 1996, hedge funds can accept investments from any individual who holds at least $5 million in investments. This measure is intended to help limit participation in hedge funds and other types of unregulated pools to highly sophisticated investors. Hedge funds can also

accept other types of investors if they rely on other exemptions under the Investment Company Act or if they operate outside the United States.

VIII. Summary

The term hedge fund is said to have originated in 1949 when Alfred Jones combined a leveraged long stock position with a portfolio of short stocks in an investment fund with an incentive fee structure. Hedge fund investment practices and strategies have evolved and expanded since then. Some of today's hedge funds satisfy all the three criteria of Jones' fund; namely long/short positions, leverage and incentive-based fees. With no legal definition of a hedge fund, any fund that satisfies two of the three criteria is identified as a hedge fund. There are even some so-called hedge funds that do not hedge at all. There is no known governing body that publishes comprehensive, reliable statistics about the overall hedge fund market, though various published sources estimate that there are between 3,000 to 5,000 hedge funds globally.

In the short history of fifty years, interest in hedge fund and their performance has waxed and waned. In the recent years, however, hedge funds have enjoyed healthy growth and appear to continue to increase in popularity. Hedge funds invest in variety of liquid assets just like mutual funds, but are quite different from mutual funds. For example, under current federal law, the former do not have any management limitations. There are virtually no limits on the composition of their portfolios, and no mandatory disclosure of information about the holdings and performance.

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