Hedge Funds

Upside Potential, Downside Protection

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In terms of most investments, hedge funds are a relatively new idea. Still they've been around for almost 70 years and have proven a viable option for investors looking to diversify their portfolios with a collection of investments that offer substantial upside potential as well as can achieve the goal of wealth preservation.

Essentially, a hedge fund is a partnership of investors overseen by a general partner responsible for investing their collective funds according to a stated investment strategy. Hedge funds were originally used to hedge investors' market risk. Now, with the help of less regulation, hedge funds have the freedom to invest in diverse markets such as stocks, bonds, art, fine wine, commodities, real estate and so forth. Hedge funds can employ almost any strategy including, but not limited to, derivatives, leverage, purchase of distressed debt, arbitrage, long-short and market neutral. There is a hedge fund to meet almost any investor's appetite.

HISTORY

The first hedge fund, introduced in 1949, was rooted in a classic long-short strategy where the fund holds long-term stocks they believe will appreciate more than the overall market and short positions on stocks they believe will decline in value. The general idea is to take advantage of the upside but provide balance by making money on the downside in the event of a down market. These original, conservative hedge funds proved effective in reducing potential loss and capturing the upside of the market.

In the '60s hedge funds became popular by outperforming mutual funds. But in the '70s hedge funds lost their glitter, under-performing mutual funds as managers began employing investor capital in more risky strategies, which typically would use leverage, and accompanied by a bear market. Many of the funds recorded substantial losses and closed. But the tide turned in the '80s as investing became globalized and the funds were able to implement their strategies on a broader scale. Hedge funds have continued to grow in popularity. As of the end of 2018, they accounted for $3.2 trillion of assets under management, according to the 2018 eVestment Hedge Fund Asset Flow Report.

UNREGULATED

Hedge funds are not regulated like stock and bond mutual funds. They are limited only by their stated investment policy objectives. But with increased popularity has come increased regulator scrutiny, including a Securities & Exchange Commission mandate that requires investors to be accredited — that is, have a net worth, not including a primary residence, in excess of $1 million or an annual income for at least two years previous to investing of $200,000. Hedge funds that choose to register with the SEC are subject to additional rules and regulation.

STRUCTURE

Most funds are structured according to what is known as a 2-20 formula, where the fund charges a two percent annual administrative fee and 20 percent of the profits go to the general manager. The profit sharing ratio has been criticized as excessive, but the incentive has been responsible for attracting some of the best investment minds around the world as hedge fund managers.

Many funds include a "high water mark" feature. For example, if a fund loses 10 percent in any one year it collects no incentive fee. This now becomes the high water mark. In the following year it can only collect an incentive fee on profits over and above the previous year's high water mark.

ASK QUESTIONS

Hedge funds can be productive for qualified investors. But anyone considering investing in a hedge fund should investigate the fund's investment strategy and history, and get answers to key questions. Is the general partner credible? Does the general partner have their own funds invested? Is the investment strategy well founded? Is the fund a one-year wonder or does it make money year after year? How long has the fund been around (longevity can be important)? As well, money you invest in a hedge fund is locked up for a period of time, so how long does it take to withdraw your money or any part of it? Ask your investment advisor for answers explained in terms you can understand.

A hedge fund can be an effective means of diversification. If you have room for it, it can add substantial upside potential as well as downside protection to your portfolio.

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