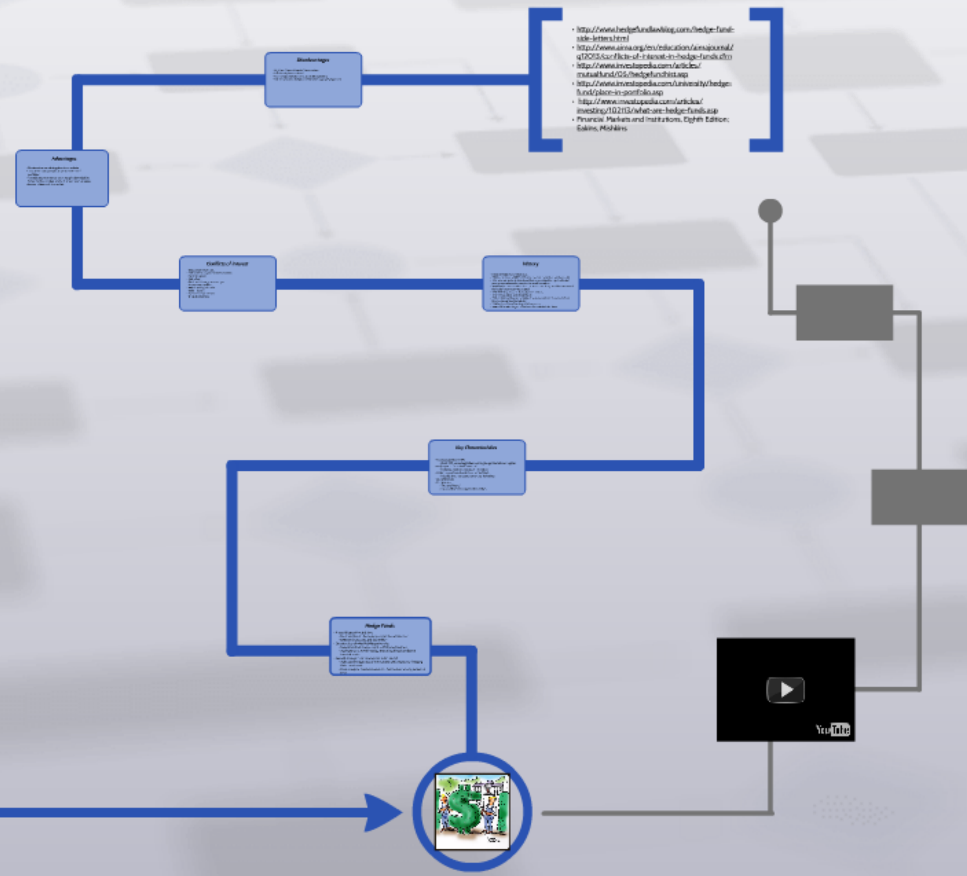
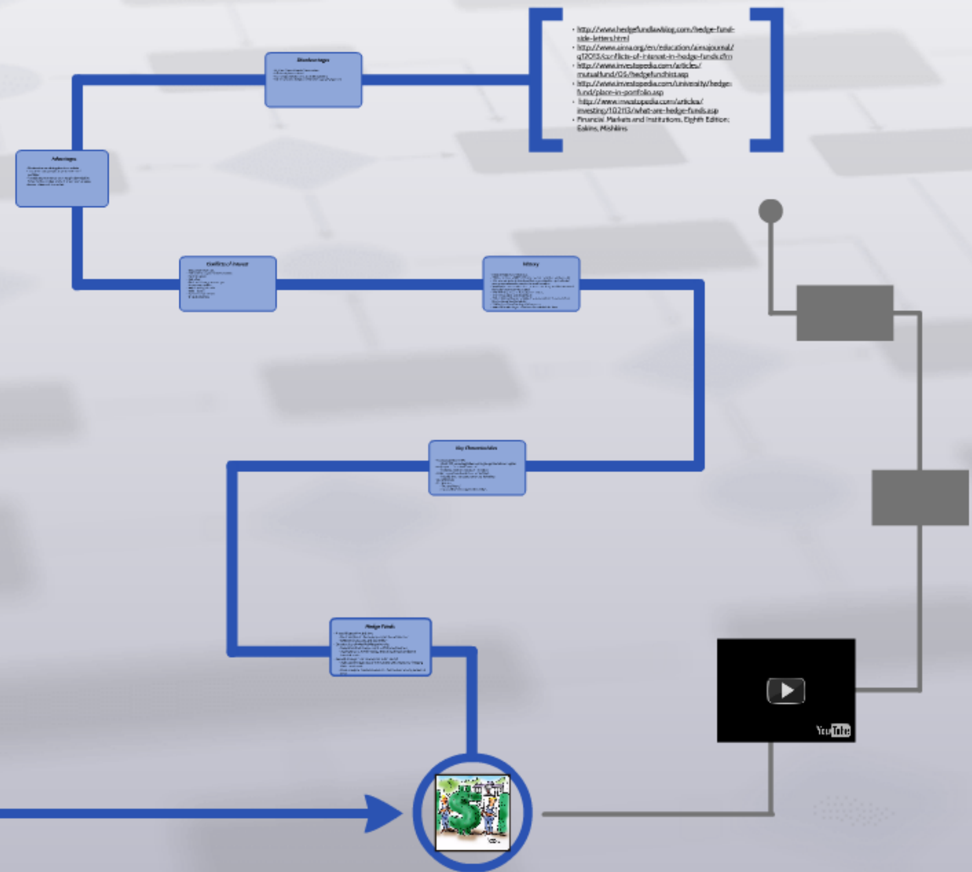
TheCaseSolution.com



Hedge Funds

Layla Freig, Whitney Boiteau,
Andris Palaschuk

TheCaseSolution.com



Hedge Funds

Layla Freig, Whitney Boiteau,
Andris Palaschuk

Hedge Funds

- A special type of mutual fund
  - Pools and invests the money of a number of investors
  - Between $100,000 and $20 million
- Structured as a limited liability partnership
  - Federal law limits hedge funds to 99 limited partners
  - May have up to 499 limited partners if each has $5million in invested assets
- General strategy: maximize returns, minimize risk
  - Make a profit regardless of the market's performance by "hedging" their investments
  - Usually require investors to commit their money for long periods of time

Key Characteristics

- Not regulated by the SEC
  - 2006: SEC passed regulation requiring hedge fund advisers register
- Only open to "accredited" investors
  - In the US, minimum net worth= $1 million
- Wider range of investments than mutual funds
  - Includes: land, real estate, currencies, derivatives
- Use of leverage
- Fee Structure
  - "Two and Twenty"
  - Causes different management incentives

History

- Father of Hedge Fund: Alfred Jones
- 1948 he first invested $100,000 using the classic long/short equities model
- 1952 Jones converted his investment from a general partnership to a limited partnership and added an incentive fee as compensation.
- 1966 Fortune wrote an article about the success of a hedge fund investment and the hedge fund industry was created
- 1969-1970 huge losses in the hedge fund industry
- 1973-74 mass closures for hedge funds
- 1986 Institutional Investor highlighted the success of Julian Robertson's Tiger Fund and recaptured the industry
- 1998 bailout of Long Term Capital Management
- 2004 SEC made changes to The Investment Advisor's Act 1940

Conflicts of Interest

- Cross and principal trades
- Side by side management/trade allocation
- Incentive systems
- Side letters
- Onshore/offshore governance gap
- Director level conflicts
- Order bundling/allocation
- Broker relations
- Investment management
- Group level conflicts

Advantages

- Consistent returns during downturn markets
- Long term strategy works to protect investors' portfolios
- Portfolio return enhancement through a low volatility hedge fund or a hedge fund with a high return strategy
- low correlation with the market

Disadvantages

- High fees: "Two and Twenty", incentive fees
- Low liquidity due to lock ups
- Poor transparency due to the lack of SEC regulations
- Not immune to risk (ie. bailout of Long Term Capital Management)