

A Primer on Hedge Funds

Hedge funds are investment vehicles that started to gain recognition in the late 1980s and experienced significant growth during the 1990s. They are “funds” in the sense that their managers pool money from investors and invest it, but their investment strategies are quite different from those of traditional mutual funds. Differences can be found in four major areas: regulation and legal status, investment strategies, performance evaluation, and fees.

Mutual funds are strictly regulated by law. They are required to register with the Securities and Exchange Commission (SEC), the United States’ official regulatory agency tasked with protecting investors and maintaining market integrity. Mutual funds have to publish a legal document called a prospectus; this prospectus states the investment objective of the fund, its strategy, risks, historical performance, fees, expenses and other information. Most mutual funds are widely available for purchase and will accept a large number of investors.

In contrast, hedge funds are not subject to the strict regulations that apply to mutual funds. Hedge funds are not required to register with the SEC, they are not legally required to publicly disclose performance and fee information, and their fees tend to be much larger than those charged by mutual funds. Hedge funds are available only to a limited number of “qualified” (read: “rich”) investors, meaning investors with assets in the million-dollar range. Many hedge funds require investors to keep their money in the fund for at least one year.

Hedge funds implement what are called alternative investment strategies (as opposed to traditional ones). There are many strategy-specific terms that get thrown around when hedge funds are discussed, such as short selling, risk arbitrage, global macro, managed futures, distressed investing, and discretionary trading. We will not describe these strategies in detail here, but the main idea is that hedge funds are much more flexible than traditional mutual funds in what their managers do with investments. One example, a traditional investor would buy stock X and hope it goes up in value. If a hedge fund manager had reason to believe stock X would drop in value, he or she would take action in the marketplace accordingly. This is called selling short, a popular hedge fund strategy—not something a regular investor would do.

Hedge funds also differ from mutual funds in the way they measure return. Mutual funds normally look at return relative to the market. For example, you hear that fund X has beaten the market by 4.3% in 2008. Hedge funds tend to look at absolute, as opposed to relative, return: they strive to earn a certain return each year (let’s say, 20%), regardless of how the market performs. Hedge fund advocates argue that absolute return is a better performance metric. If a mutual fund manager lost only 6% in a year when the market went down by 12%, he or she would be rewarded for “good” performance. If the fund manager made 20% in a year when the market grew by 30%, that would be qualified as poor performance. Not so with hedge funds. Measuring absolute return prevents this type of error—either you made money or you didn’t.

Similar to mutual funds, hedge funds charge an annual management fee calculated as a percentage of total assets. This fee is required regardless of the profitability of the fund. In addition to the management fee (and unlike mutual funds), hedge funds also charge a performance (or incentive) fee. A hedge fund manager can retain a certain percentage of all gains in the fund above a certain rate, which is known as the “hurdle rate.” For example, let’s say a fund met its hurdle rate of 10% (had a 10% return), and made \$1 million on top of that. The manager is allowed to keep his or her incentive fee of (normally) 20%—\$200,000.

This article is only intended as a brief introduction. Even if you do not meet the necessary requirements to invest in a hedge fund, it is a good idea to know what they're about. If you meet the requirements, talk to your financial advisor and be sure to obtain all relevant information before investing.

This information is provided for illustrative purposes only and should not be viewed as a recommendation to buy or sell the type of investment noted above. Please note that hedge funds often engage in leveraging and other speculative investment practices that may increase the risk of investment loss. In addition, hedge funds are not required to provide periodic pricing or valuation information to investors, involve complex tax structures, often charge high fees, and can be highly illiquid.