



A guide to hedge fund investing

from Pinder Fry & Benjamin Limited

Most investors employ a stockbroker, bank or other financial adviser to look after their money. Why? Because they believe their adviser will do a better job than they will do themselves.

What do they want the adviser to do? They want him to make a profit for them. They don't want him to invest in assets which go down in value. They want him to make money regardless of whether markets in general are rising or falling, in whatever market he chooses, whether it be equities, bonds, property, commodities or anything else.

That is what hedge funds do. They are pools of money managed, more often than not, by highly skilled, highly paid moneymakers. Their only purpose is moneymaking and many of the managers of hedge funds are good at it.

So why are hedge funds often treated with such caution? This guide addresses this issue in a series of Questions and Answers.

Q1 Why are they called “hedge funds”?

A1 Because originally, when the first of them started in the late 1940s, that is what it did. Rather than just buying shares, the managers also “hedged their bets” by selling other shares, thus protecting the fund from a general market fall. This, believe it or not, was a revolutionary idea at the time and the instigators of the idea made more money over time than their competitors who just bought shares in a conventional way. As a consequence, over two hundred “hedge funds” were set up in the US during the 1960s, including those of Warren Buffett and George Soros.

The way money is made by selling shares involves borrowing shares which the fund doesn’t own, selling them and then buying them back at a lower price than they were sold at. This is known as “shorting” or “selling short”.

Q2 So how did all these new funds perform?

A2 Some well, some not so well. They were learning and the 1970s worldwide stockmarket slumps caused many to give up. By the mid-1980s fewer than one hundred survived.

Q3 Why are there so many hedge funds now?

A3 Because the 1990s saw many large swings in the currency, share and other markets and this presented opportunities for some spectacular gains (eg, Soros’s profit from the Sterling crisis in 1992). Today, even after the 2000/2001 stockmarket shakeouts, there are around 7,000 funds worldwide billed as “hedge funds”.

Q4 So how do I determine which hedge fund to invest in?

A4 With great difficulty. Past performance is a guide (provided the individual fund manager hasn’t changed), the reputation of the manager is important, consistency scores, size matters and the level of risk taken in the fund has a bearing. Quite frankly very few private investors can pick a good fund because it is such a complex task.

Q5 So what is the answer?

A5 As with many investments, the answer is to spread your bets. In the last few years, many “funds of funds” (funds made up of investments in other funds) have sprung up to allow investors to do just this.

Q6 OK. But how do I pick a good fund of hedge funds?

A6 Another good question. Again, it is not easy. Every manager will say that they are experienced, informed, well

connected and good at their job. Some will be. Perhaps the best way of choosing a manager is to look for one who has a lot to lose reputationally (because of involvement in other investment areas).

Q7 Should I compare closely the charges made by managers?

A7 You should: charges do make a difference to performance. All hedge fund managers charge an annual fee (usually between 1% and 2%) and a performance fee (typically 10% to 20% of profits). Fund of hedge fund managers then charge further fees. What you must think about above all is the performance potential of the fund after fees. If such factors as a fund's past performance and investment strategy suggest that strong future returns, after all fees, are a realistic possibility, then that fund may well be an attractive investment.

Q8 That's all very well, but aren't all hedge funds risky?

A8 The idea that all hedge funds are "risky" is a myth perpetuated by those who don't know much about them. Some individual hedge funds are risky in that they use borrowing (of one, two, three or more times the invested capital) and some take large positions in volatile markets. But the majority of funds look to make good steady profits with the minimum of risk. Many are much less risky than an investment in an equity unit trust. Some hedge funds are even less risky than bonds.

Q9 So how do you suggest I invest in hedge funds if I haven't done so before?

A9 Talk to your financial adviser and choose a fund of hedge funds (to give a spread) run by a manager with a good reputation.

Q10 Is there a way of guaranteeing against loss?

A10 Yes. Many funds of hedge funds guarantee the return of capital after a set period of, typically, seven to twelve years. You may think that this guarantee is likely to be superfluous, given the nature of the investment, but, if this is your first investment in hedge funds, you may feel more comfortable with such a fallback guarantee.

You may also worry that the cost to the fund of a capital guarantee is likely severely to undermine investment performance. No capital guarantee is costless; however the good news is that, using modern investment management techniques, a guarantee can now be secured much more cheaply than was the case even as little as a decade ago.

Q11 Are hedge funds regulated?

A11 Generally, they are based offshore and are lightly regulated compared to UK funds, although for those that are distributed in the UK, the distributor is normally subject to regulation by the Financial Services Authority. Regulation can provide some protection for investors (although it didn't do much for those who lost huge sums when technology shares crashed in 2000/2001 or those who suffered from the excesses of split capital investment trusts). Lightly regulated hedge funds benefit from much greater freedom to try to make money using borrowing, derivatives and the flexibility of investing in any and every market.

Q12 Is the manager's interest in hedge funds aligned with mine?

A12 Yes. First, because they make money if you do – from their performance fee and, second, because many managers invest large sums of their own cash in the funds they manage.

Q13 You haven't explained the various areas in which hedge funds invest. Why not?

A13 Because it won't particularly help you to decide whether to invest in hedge funds or not. Do you want to know what is involved in hedge fund strategies such as "Global Macro", "Managed Futures", "Convertible Arbitrage", "Fixed Income Relative Value" etc? The managers want to make you money. Leave them to decide how and where to do it. If you really want to get to know about the different strategies and management styles, information is readily available.

Q14 What sort of investment performance can I expect?

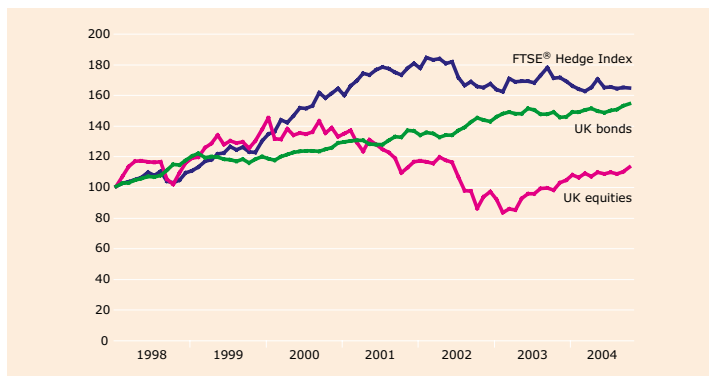
A14 For a typical hedge fund to state an "expected" or "anticipated" or even a "target" return is probably as misleading as it would be for a conventional equity unit trust to do the same. Hedge fund returns, like equity market returns, are generally not predictable. What we can say is that most hedge funds have tended to outperform traditional asset classes over recent years. Also, because hedge funds have much more investment flexibility than, say, an equity unit trust, they can make money in unconventional ways and can prosper whether financial markets are rising or falling. So, hedge funds have the potential to continue to outperform in the future, as they have in the past.

For a first time investor in hedge funds, it is probably

best to go for a fund of hedge funds, possibly with a capital guarantee. If you opt for a guarantee, it might make sense for you to choose a fund with a somewhat more aggressive investment strategy or a higher level of borrowing (or "gearing") than you would if there was no capital guarantee. In this way, you may have more upside potential, but with the comfort of protection against a loss.

An aggressive single hedge fund using a high level of borrowing might produce higher returns (many have delivered 15% pa to 20% pa or even more in recent years), but this would probably involve more risk and the fund would, typically, not have a capital guarantee.

The graph below shows the relative performances of hedge funds, UK equities and UK bonds over the past seven years.



See notes 1 and 2 on page 9.

Q15 How do I measure the riskiness of a hedge fund?

A15 "Volatility" is a term often used in relation to hedge funds to describe their riskiness. It is a statistical measure, expressed as a percentage, of how much the returns of a fund (or a share or a bond or anything else) vary over time. Imagine a graph showing the performance of a fund over time: if the graph was very bumpy, it would be said that the fund had high volatility; if it was smooth, the volatility would be low.

The higher the volatility of a fund, the greater will be the range of possible returns for that fund over time. The ideal investment is one which offers the prospect of high returns with low volatility. A good fund of hedge funds can do this and can deliver returns that are higher than those from equities, with a level of volatility that is lower than that of equities.

Q16 What is the tax position for a UK individual investing in a hedge fund?

A16 Direct investment by a UK individual taxpayer into a hedge fund usually results in any profit being taxed at the investor's top rate of Income Tax. This is one of the reasons why hedge fund products in the UK are sometimes structured as shares in an investment company. The company structure is designed to deliver investment performance in line with the performance of the underlying investment; but any profit for UK individual investors is treated as a capital gain and so is subject to Capital Gains Tax and benefits from Taper Relief.

Q17 Can a hedge fund investment produce an income for me?

A17 No. An investment of a substantial sum directly into a hedge fund could enable an element to be sold each year to produce an "income"; but, generally, a hedge fund is not a suitable investment to provide a regular income.

Q18 How much of my investment portfolio should I put in hedge funds?

A18 This depends on your circumstances and your financial adviser can help you to decide. However, there is an important feature of most hedge funds which makes them particularly valuable in a portfolio: this is that they tend to have a low level of correlation with other financial markets like equities and bonds.

"Correlation" means the extent to which the performance of one asset tends to be linked with the performance of another asset. For example, international equity markets tend to be correlated – if the US stockmarket is in a bear (downward) phase, the UK market will tend to be too.

The strategies followed by most hedge funds tend though not to rely on particular stockmarkets (or indeed other financial markets) moving in any particular direction, up or down. Therefore, hedge funds can make money whatever is happening in other markets.

A consequence of this lack of correlation is that adding a hedge fund investment to a traditional portfolio of equities and bonds can both increase the overall return and reduce the volatility of the portfolio. The table below illustrates this point. It shows the average annualised performance and annualised volatility over the past seven years of a hypothetical portfolio, invested 80% in UK equities and 20% in UK bonds, to which has been added, at the outset of the period, differing proportions of investment in a hedge fund index.

Hedge fund index proportion	0%	5%	10%	20%	30%
Annualised performance of entire portfolio (pa)	2.9%	3.1%	3.4%	3.9%	4.4%
Annualised volatility of entire portfolio	11.6%	11.1%	10.6%	9.8%	9.2%

See notes 2 and 3 on page 9.

Q19 What happens if I want to encash my investment in a hedge fund?

A19 Most hedge funds allow for monthly or quarterly redemption at the net asset value of the fund. Where the investment is structured as shares in an investment company, there is usually the same facility; additionally, you may be able to sell shares through the stockmarket but, as with investment trusts, the market price may be at a discount to the net asset value and there may be limited marketability.

If you invest in a fund with a guarantee it is important to realise that the guarantee usually only applies if the fund is held for the specified period and, on earlier encashment, no guarantee applies. The existence of the guarantee at a point in the future will though underpin the value of the investment, even on earlier encashment.

Q20 Is there a hedge fund index that I can invest in?

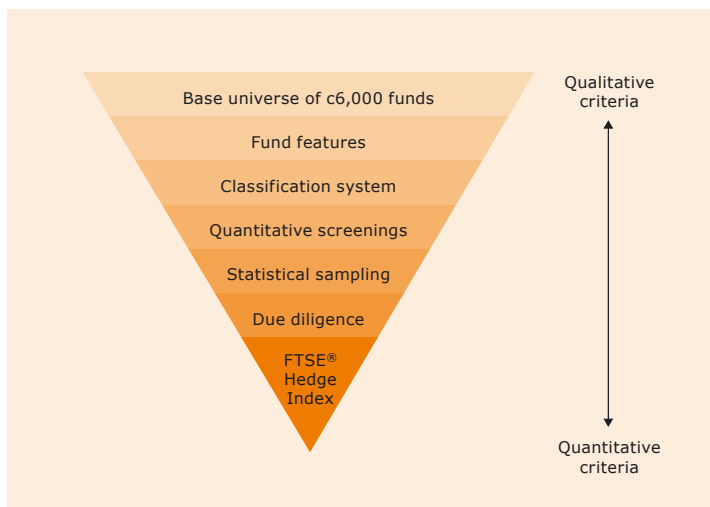
A20 Yes. There are a number, but perhaps the one with which a UK investor might be most comfortable is that run by FTSE®, whose stockmarket indices are recognised around the world.

Q21 What is the FTSE® Hedge Index?

A21 It is an index that tracks the performance of a carefully selected range of hedge funds which, between them, are representative of the broad universe of hedge funds that are open for new investment. Funds are selected for inclusion in the FTSE® Hedge Index by an assessment process that whittles down a universe of around 6,000 funds to the forty or so constituents of the Index.

The process involves both quantitative and qualitative assessments of each fund – but it starts with filtering out all funds which do not meet some basic criteria. These are that each fund in the Index must (i) have at least US\$50 million under management, (ii) have a minimum two year track record, (iii) provide liquidity for investors at least quarterly, (iv) report to investors at least monthly, (v) have independently audited financial statements, (vi) be

open to new investment and (vii) be unlikely to close due to oversubscription in the near future. The diagram below illustrates the assessment process.



An investment in a fund that gives exposure to the FTSE[®] Hedge Index may be an attractive way for many investors to access the hedge fund sector. The Index is effectively a fund of hedge funds where the underlying investments have been selected through a rigorous process established and monitored by FTSE[®] itself.

Q22 How do I invest in a fund of hedge funds?

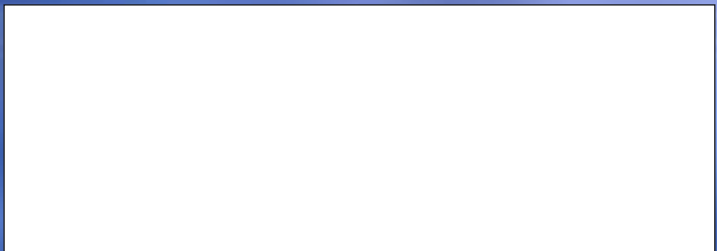
A22 Because of the restrictions on promoting hedge funds in the UK, some of them are structured as offshore companies with their shares quoted on a recognised stock exchange. An investment may be made by subscribing to a new issue share offer. Your financial adviser can advise you on how to do this and when an issue he considers to be attractive is available.

This guide provides only a brief overview of hedge funds. In particular, it simplifies many of the complex issues involved in this area. Your adviser will be able to help you to understand these in sufficient detail to make an informed decision about a possible investment.

Notes

1. The "Hedge fund index", "UK equities" and "UK bonds" figures relate, respectively, to the FTSE® Hedge Index, the FTSE® 100 Index and the JPMorgan Government Bond Index (UK). The FTSE® Hedge Index was constituted in June 2004. The information presented in relation to the performance of the FTSE® Hedge Index for the period from December 1997 to May 2004 has been simulated by FTSE®. The simulation is based on the assumption that the current underlying hedge fund constituents of the Index had been the constituents throughout the period covered by the simulated data (except during the period before a given fund existed when only the other funds then existing were included in the simulation calculations). Employing such a simplifying assumption introduces biases that are likely to mean that the simulated performance data shows better performance than would have been shown by the Index had it existed and been calculated during the simulation period. Also, the FTSE® Hedge Index is a US Dollar denominated index: accordingly, for the purposes of the information presented in this document, each index level has been converted into its Sterling equivalent at the spot Sterling/US Dollar rate applicable on the corresponding date. In this document, all return and volatility data relating to the FTSE® 100 Index data has been restated to reflect the reinvestment of an assumed constant gross dividend yield of 3.5% pa, in order to create a synthetic total return index comparable to the other indices referred to herein.
2. "FTSE®" is a trade mark of the London Stock Exchange Plc and The Financial Times Limited and is used by FTSE International Limited("FTSE") under licence. All rights in and to the FTSE® Hedge Index and the FTSE® 100 Index are vested in FTSE. All information is provided for information purposes only. Every effort is made to ensure that all information given in this publication is accurate, but no responsibility or liability can be accepted by Pinder Fry and Benjamin Limited or FTSE International Limited for any errors or for any loss from use of this publication.
3. Figures relate to the period since December 1997. The "UK equity", "UK bond" and "hedge fund index" components of the portfolio are assumed to perform in line with, respectively, the FTSE® 100 Index, the JPMorgan Government Bond Index (UK) and the FTSE Hedge® Index. See note 1 above regarding (a) the simulation of the FTSE® Hedge Index data for the period prior to June 2004, (b) the US Dollar denomination of the FTSE® Hedge Index and (c) the restating of the FTSE® 100 Index data. Volatility figures quoted relate to monthly data.

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Issued by Pinder Fry & Benjamin Limited
Authorised and regulated by the Financial Services Authority
2 Cavendish Square, London W1G 0PU

T 020 7291 7700 F 020 7291 7720
E info@p-f-b.com W www.p-f-b.com