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Introduction to Hedge Funds

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Reference Source: AIMA Canada Strategy Paper, Investopedia, Moneysense.gov.sg

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An illustration of the applicable risk rating of the product has been provided to guide the investors on the possible risk rating of the product. The following is a legend for the risk rating. Within each section, the possible ratings which the product may have are shaded in red.

Product Risk Rating

Risk Level	Explanation
1	Very low level of risk with potentially limited returns
2	Low to Medium level of risk with low volatility and expecting below average to average level of returns
3	Medium level of risks with medium level of volatility and expecting average expected returns
4	Medium to high level of risk and volatility and with high variance in the returns
5	High level of risk and volatility with a very high variance in returns

Reference Source: AIMA Canada Strategy Paper, Investopedia, Moneysense.gov.sg
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2. Introduction to Hedge Funds

Product Risk Rating

2.1 Introduction to Hedge Funds

Hedge funds are managed by a hedge fund manager on a pooled basis. Investors' monies are pooled and invested by the hedge fund manager in a portfolio of assets to achieve the investment objective of the fund.

Hedge fund managers actively manage investment portfolios with a target of absolute returns regardless of overall market or index movements. A hedge fund manager may use one or more investment strategies in each portfolio that it manages.

Hedge funds are typically established in offshore locations like the Cayman Islands or Luxemburg or under a UCITS structure. UCITS is a mutual fund based in the European Union. UCITS stands for "Undertakings for Collective Investment in Transferable Securities" and is a framework of the European Commission that creates a harmonized regime throughout Europe for the management and sale of mutual funds.

Investors should refer to the fund offering documents of each hedge fund for more information about the fund such as investment universe, strategy, investment restrictions, fees and liquidity.

2.2 Underlying instruments

Hedge funds may invest in liquid or illiquid assets. Investing in liquid assets may yield potential returns in a comparatively shorter period of time. Investing in illiquid assets would require a longer term investment horizon before potential returns can be realized.

Hedge funds can invest in virtually anything and everything where opportunities arise. Managers may invest in individual stocks (including long or short selling and options), bonds, commodity futures, currencies, arbitrage, derivatives, credit, loans, debts, real estate, leverage and other underlying assets.

Some of the common investment strategies used by hedge fund managers include:

- Arbitrage (e.g., Fixed income arbitrage, Merger & Acquisitions, Convertible)
- Distressed Securities
- Equity Market neutral
- Event-Driven
- Global Macro
- Long/Short Equity (L/S)
- Managed Futures or Systematic trading

Please refer to the Glossary for more details regarding the strategies listed above

Another investment strategy is a "fund of funds" ("FOF"), whereby the hedge fund holds a portfolio of other hedge funds rather than investing directly in stocks, bonds or other securities. Though FOFs provide diversification and lower exposure to market volatility in exchange for average returns, these returns may be lessened by investment fees that are typically higher compared to hedge funds that invest directly in underlying instruments as investment and management fees of FOFs include all the fees charged by the portfolio's underlying funds. After allocating the money invested to fees and other payable taxes, the returns of fund of funds investments may generally be lower compared to the profits that single-manager funds can provide.

2.3 Pricing

Investors invest in a hedge fund by buying units in the hedge fund. There is capital gain when the price of the units rises above the subscription price that the investor paid. In addition, some hedge funds pay dividends to the unitholders of the hedge fund.

The price of each unit is based on the hedge fund's net asset value (NAV) divided by the number of units outstanding. The NAV of a hedge fund is the market value of the hedge fund's net assets, comprising its investments, cash and other assets minus expenses, payables and other liabilities.

Hedge funds may be priced either by the "bid and offer pricing" method or the "single pricing" method. Generally, the single pricing method will be used for hedge funds.

Bid and offer pricing:

- Bid Price is the price at which investors sell their units
- Offer Price is the price at which investors buy units
- Spread Difference (spread) between the bid and offer prices of a hedge fund's units reflects the subscription (sales) and redemption charges (if any)
- In the "bid and offer pricing" method, the subscription charge is added to the NAV per unit, while the redemption charge is deducted from the NAV per unit

Single Pricing:

- The hedge fund provides a single quote that reflects the NAV per unit
- The subscription charges are deducted from the amount invested before the units are allocated
- Any redemption charge will be deducted from the redemption proceeds

Dealing Frequency:

- Subscription or redemption may be only be available on a weekly, bi-weekly, monthly, quarterly, semi-annually, annually, or some other time period basis
- Hedge funds usually do not have daily liquidity. The liquidity of a hedge fund will primarily depend on the underlying investment instruments' liquidity
- Some hedge funds may have a lock-up period of up to two years or longer. There are hedge funds that may offer investors early redemption with a penalty/early redemption charge (soft lock-up) whereas some hedge funds may not allow redemption during the lock-up period (hard lock-up)

Examples of purchase price calculation:

Scenario	Assumed Numbers	Bid and offer pricing	Single pricing
Buying with $1,000 investment.	(i) Initial 5% subscription charge (ii) NAV of $1.00 per unit	Offer price per unit = NAV of $1.00 + initial sales charge of 5% = $1.05 Number of units bought = $1,000/$1.05 = 952.38 **With $1,000, you buy: 952.38 units valued at $952.38**	Buy price per unit = NAV of $1.00 per unit = $1.00 Number of units bought = $950 (5% sales charge deducted from $1,000) buy price = 950 **With $1,000, you buy: 950 units valued at $950**

2.4 Fees

- All fees will be listed out in the fund prospectus/offering documents
- The below briefly describes some examples of fee charges
- Investors should always refer to the offering documents/prospectus of the hedge fund for details

(i) Fees and charges payable by you – these represent sales or redemption charges imposed by the distributor of the fund or the fund manager to subscribe or redeem in a fund

Examples of charges when one subscribe or redeem a fund.

Subscription fee or initial sales charge (also known as "front-end load")	**Redemption fee or realisation charge** (also known as the "back-end load")
Payable when you buy a fund. Ranges from 0% - 3% of your investment	Payable when you sell or redeem the fund. Ranges from 0% - 3% of your investment

(ii) Fees and charges by the fund – these are recurring fees that the fund manager, trustee and other parties charge the fund for their services and ultimately reduce your return on investment

Examples of fees and charges by a fund:

Management fee	Performance fee	Trustee fee	Miscellaneous fees
An annual fee charged by the fund manager for managing the fund May range from 1% - 2.5% per annum of the fund's NAV	Typically, a performance fee is charged if the fund achieves returns above its hurdle rate and above the high-water mark. Usually 10% - 20% of outperformance	An annual fee charged by the trustee for providing custodian services for safekeeping the fund's assets Usually 0.1-0.15% per annum of the fund's NAV	Other fees include fund administration fees and audit fees.

- Hurdle Rate: A hurdle rate is the minimum rate of return that the fund must beat before collecting performance fees
- High-Water Mark: Highest peak in value that an investment fund/account has achieved

2.5 Investor Profile

- Investor is a Professional Investor as defined under the Securities and Futures Ordinance of Hong Kong or Accredited Investor defined under the Securities and Futures Act of Singapore
- Investor wants potentially higher returns and is prepared for variable returns which include the risk of losing a substantial part of the money that the investor is investing
- Investor understands how returns are calculated, is clear about the factors and scenarios that can affect returns and understands a hedge fund's investment objective, strategy and approach
- Investor understands the risks associated with hedge funds. Some hedge funds use financial derivatives to hedge risks and/or to improve performance. Investor is aware of the risks associated with the use of financial derivatives, including the risk that the provider (or counterparty) of the financial derivatives defaults
- Investor is prepared to have its money tied up for long periods of time and has adequate financial resources so that the investor does not have to liquidate its funds during a market down turn if the investor needs the money at short notice. This is because hedge funds are exposed to market ups and downs and investors who stay invested long enough may be better able to ride out the downturns
- Investor is familiar with the hedge fund manager and hedge fund's track record

2.6 Key Risks

Each fund would bring about its own sets of risks. Below are some of the risks that are usually associated with hedge funds

Please note that this is not an exhaustive list. More information can be found in the hedge fund's official offering document

2.6.1 General Risks

Management abuses: Risk of churning or window dressing if the hedge fund manager is abusing his/her authority. Churning is the act of excessive trading in a fund, thus increasing the transaction costs and window dressing are actions performed by fund managers near the quarter or year end to improve the appearance of the portfolio. For instance, fund managers may sell holdings which have performed poorly and replace them with better performing ones to improve the appearance in the reports sent to investors. Fraud committed by the hedge fund manager in managing the hedge fund may also result in an investor losing part or the entire principal amount invested in the hedge fund.

Underperformance: Although one of the key advantages of investing in funds is professional management, there are fund managers who are unable to outperform the benchmark.

2.6.2 Market Risk

- A fund's NAV will be affected by changes in the value of the investments made by the fund. The funds' investments may, in turn, be affected by various factors such as changing economic, political or market conditions in the market(s)

2.6.3 Counterparty risk

- A fund may be exposed to the risk that the counterparty that it trades with is unable to meet its payment obligations due to a deterioration of the counterparty's financial situation or otherwise

2.6.4 Leverage Risk

- Hedge funds typically use leverage to increase their returns
- Leverage is the use of various financial instruments or borrowed capital, such as margin, to increase the potential gains of an investment. However, leverage may also amplify the losses in an investment
- As leverage increases, any negative effect in return would get magnified

2.6.5 Liquidity Risk

- Funds also face liquidity risk. Some funds may be thinly traded. This may affect the prices at which an investor can buy or sell units in the fund. This may happen, for example, if there is little interest or research coverage for the fund or the underlying market or investment theme it is exposed to
- Some hedge funds may have hard lock-up periods, during which investors will not be able to exit or redeem units in the hedge funds
- Some hedge fund managers may impose gating or a halt in trading of fund units during adverse market conditions, which would restrict redemptions during a dealing cycle
- Some hedge fund managers may separate illiquid assets from other more liquid investments into an account known as a side pocket account. The risks of a hedge fund with side pocket accounts include the hedge fund manager overvaluing the illiquid assets in such accounts resulting in the manager earning higher fees from investors, or the manager misappropriating the funds or assets from the side pocket accounts to the detriment of investors. In addition, investors who wish to exit the hedge fund may not be able to redeem their side pocket investment from the fund at the time of redemption but may only receive a share of the value of the illiquid asset when it gets realized at a later date

2.6.6 Use of Financial derivative instruments

- Hedge fund managers may use derivatives to achieve the investment objective of the hedge fund
- Derivatives are financial contracts for which prices are derived from assets and instruments with underlying such as equities, bonds, currencies, precious metals, commodities, interest rates, credit, benchmarks including indices, non-traditional asset classes, spot, forward contracts, swaps, options or any combination of the foregoing
- Derivatives are subject to high level risks (including the risk that the provider (or counterparty) of the financial derivatives defaults) which can result in losses that would affect the NAV of the hedge fund. In the worst case scenario, the investor may lose the entire principal amount that has been invested in the hedge fund

2.7 Glossary

Arbitrage involves purchasing an asset at one price for an immediate sale at a higher price. The person who buys the stock at the lower price tries to profit from the price discrepancy.

Convertible Arbitrage – the fund manager typically holds a convertible bond long, and sells short the underlying common stock. Returns come from bond coupon payments and the short rebate. There is a cash outflow as well, to cover dividend payments on the short positions.

Fixed Income Arbitrage – seeks to profit from price discrepancies in related fixed income instruments. A manager might buy long a bond he thinks is undervalued and sell short a similar bond he thinks is overvalued. One goal is to neutralize interest rate risk.

Merger & Acquisitions Arbitrage – is a type of event-driven trading, which involves exploiting market inefficiencies before or after a merger or acquisition. Arbitrage exploits the fact that Merger & Acquisitions normally involve a big price premium for the company. So long as there is a price gap, there is potential for sizable rewards.

Distressed Securities – an event-driven strategy, focusing on companies in financial trouble. Positions in debt or in equity can be both long and short. The event might be a bankruptcy, a distressed sale or some other form of corporate event for exploitation.

Equity Market Neutral – the equity market neutral manager takes both long and short positions in stocks while minimizing exposure to the systematic risk of the market. The long and short sides are equal in dollar amount (“dollar neutral”). Quantitative models may often be used to automate such a strategy.

Event-Driven – Focuses on opportunities in corporate events like a merger, acquisition, bankruptcy, reorganization, or simply some bad news about a company.

Global Macro –Leveraged directional bets are made using many of the world’s financial instruments (stocks, bonds, commodities, currencies, derivatives, etc.). Some bets can be huge and this strategy allows great flexibility.

Long/Short Equity – picks both long and short stock candidates, but does not attempt to be market-neutral. The manager may switch from net long to net short, but most long/short equity strategies have a long bias. Investors see this strategy as a way to generate returns in a rising market while reducing volatility.

Managed Futures Strategy – invests in financial and commodities futures markets. Directional bets are made with long and/or short positions. The managers are called Commodity Trading Advisors (CTAs).

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