**Hedge Funds**

* What is a hedge fund?
  + Any private investment pool that’s not registered as an investment company with the SEC
  + Not being registered doesn’t mean they’re totally exempt:
    - Any investment manager using US Mail or means of instrumentality of interstate commerce in the course of business with at least $100 million under management must disclose its holdings quarterly on Form 13F
* Caution: relying on fund disclosures
  + Under the 13F disclosure rule, the SEC has discretion to delay disclosure that’s necessary or appropriate in the public interest or for the protection of investors
    - Investors often request this treatment, allowing them to omit certain holdings
  + Hedge funds make up 30% of filers, but they make 56% of these requests
    - Of those granted confidentiality, hedge funds tend to hide ~1/3 of their portfolio vs. the average 1/5 for other filers
* Mutual fund limitations—Misconceptions
  + Hedge funds face few, if any limitations while mutual funds face several
  + Commonly cited restrictions are that mutual funds cannot:
    - Short stocks
    - Use derivatives
    - Use leverage
  + These are not strictly true
  + While some of these do obligate the mutual fund to provide additional reporting or are limited, they are allowed to do so
* Actual limitations on mutual funds
  + Can only borrow from banks
    - Must maintain 300% asset coverage
  + May invest no more than 15% of fund assets in illiquid securities
    - Securities without readily available quotes
    - Restricted securities
    - Investments that can’t be sold at/near carrying value within 7 days
  + At least 50% of fund assets must be diversified
    - No more than 5% invested in a particular issuer’s securities
    - Cannot own more than 10% of the issuer’s voting shares
    - IRS requirement that applies even to non-diversified funds
      * Diversified funds have at least 75% of their assets that satisfy this condition
  + Funds that use derivatives must maintain liquid assets with a market value at least as high as the firm’s currently calculated obligation
    - Marked-to-market each day
    - Segregated (earmarked for this particular purpose)
  + If a fund wishes to focus on a particular industry, it must declare as a concentrated fund
    - If it does, it must maintain at least 25% in that industry
    - If not, its allocation in any one industry must be below 25%
  + Mutual funds cannot own more than 10% of the voting shares in an insurance company
  + Their ownership of other investment companies is also limited
    - No more than 3% of the target firm’s voting shares
    - Cannot invest more than 5% of the fund’s assets into a particular firm
    - Their total holdings of other investment companies cannot exceed 10% of the fund’s assets
    - Investments in ETFs are generally exempt
  + Limited with respect to broker-dealers (who sell fund shares)
    - No more than 5% of target firm’s equity
    - Cannot own more than 10% of target firm’s outstanding debt
    - Cannot invest more than 5% of the fund’s assets into a particular firm
  + Governance regulation on mutual funds
    - All intended to protect unsophisticated investors in these funds
* Investing in a hedge fund
  + Hedge funds not allowed to sell securities to everyone
    - Must qualify as an accredited investor under Rule 501 of Regulation D
    - Accredited investors assumed to be sophisticated enough to understand the risks of the fund
  + Accredited investors include (but are not limited to):
    - Banks
    - 501c3 organizations with assets greater than $5 million
    - Director, officer, or partner in the hedge fund itself
    - Individuals who satisfy one of two conditions:
      * Net worth of at least $1 million
      * Income of $200,000 in each of the last 2 years and expected to continue
* Types of fees
  + Management fees
    - Flat fees
    - Identical to mutual fund management fees
    - Generally 1-2% of assets under management
  + Incentive fees
    - Fees charged on returns
    - Range from 20-50% of net trading gains (20% is common)
  + Fees generally quoted as X and Y (e.g. 2 and 20)
    - X is the management fee
    - Y is the incentive fee
* Incentive fees
  + Funds will generally offer one of three types of offsetting considerations when calculating management fees
    - Soft hurdle rate: incentive is calculated on the total return if the hurdle rate is reached
      * If the hurdle rate is 5% and the fund gets 7%, the fee is charged on the entire 7%
    - Hard hurdle rate: incentive fee is calculated only on returns above the hurdle rate if the hurdle rate is reached
      * If the hurdle rate is 5% and the fund gets 7%, the fee is charged on the 2% excess
    - High water mark: the fund will only charge incentive fees on performance above the investment’s previous highest value
      * Prevents investors from paying twice for the same performance
      * If your position was previously $1 million, you’ll only pay incentive fees on gains above $1 million
* Notes on incentive fee calculations
  + Most hedge funds charge incentive fees on the value of your holdings net management fees
    - We will assume this treatment for simplicity
    - Careful: some funds will charge incentive fees based on your holdings gross of fees
  + Most hedge funds use a high water mark
    - 97% if them
    - Hurdle rates are much less common, but not negligible
      * 30% of them use
* Calculating the return on a hedge fund
  + Easiest to break it down into a 5-step process:
    - Take out the management fee
      * VNet Mgmt Fee= Ending Value x (1 – Mgmt fee)
    - Calculate the net trading gain
      * Don’t make this negative, replace with 0
      * Net trading gain = VNMF – max (High water mark, Beginning value)
    - Incentive fee
      * No hurdle rate
        + Incentive fee = Net trading gain x Incentive fee %
      * Soft hurdle rate
        + Find out what gain the fund needed:

Hurdle = hurdle rate x beginning value

* + - * + If the net trading gain was less than this, then there are no incentive fees owed
        + If the net trading gain was greater than this, then the incentive fees will apply. Since it’s a soft hurdle, it applies to the entire gain:

Incentive fee = Net trading gain x Incentive fee %

* + - * Hard hurdle rate
        + Hurdle = hurdle rate x beginning value
        + If the net trading gain was less than this, then no incentive fees are owed
        + Incentive fees will only apply to the gain above the hurdle”

Incentive fee = (net trading gain – hurdle) x fee %

* + - Take out the incentive fee
      * VNet Fees = VNet Mgmt Fee – Incentive fee
    - Calculate return
      * rNet Fees = (VNet Fees – Beginning Value) / Beginning Value
* Example: Hedge Fund Return (Hard Hurdle): HF Investments has a 1 and 30 fee structure with a 10% hard hurdle rate. At the end of last year, your position in the fund was valued at $500,000 net of fees. At the end of this year, your investment has increased to $575,000. What is your return net of fees?
* Example: Hedge Fund Return (Soft Hurdle): Medium Term Capital has a 2 and 20 fee structure, with an 8% soft hurdle rate. At the end of last year, your position in the fund was valued at $200,000 net of fees. At the end of this year, your investment as increased to $240,000. What is your return net of fees?
* Example: Hedge Fund Return (High Water Mark, No Hurdle Rate): BA II Financial has a 2 and 40 fee structure, with a high water mark policy. Over the past 5 years, the value of your position in the fund has ranged from $150,000 to $300,000. At the end of last year, your portfolio was valued at $280,000. At year end, it is now worth $315,000. What is your return for this year net of fees?
* Exiting a hedge fund
  + Mutual funds often charge loads, which are fees to leave the fund
  + Hedge funds have more options:
    - Withdrawal fees
      * Most equivalent to back-end loads on mutual funds
      * May be 1-10% but typically 2-5%
      * May phase out over time
      * May be charged only on withdrawals above a certain amount
    - Lock-up periods
      * A minimum amount of time must pass before the investor may withdraw money from the fund
* Effects of withdrawals on other fees
  + Hurdle rates and high water marks are adjusted for the effects of withdrawals
  + Rates are generally pro-rata based on the timing of the withdrawal
    - So withdrawing on July 1st would cut the hurdle rate in half
  + High water marks are pro-rata based on the % withdrawn
    - Withdrawing 1/3 of your capital reduces the high water mark by 1/3