Coalition of Private Investment Companies

The Basics of Hedge Funds

What is a Hedge Fund?

The term "hedge fund" is without legal meaning but generally refers to privately offered, professionally managed pooled investment vehicles. Interests in these funds are sold in private offerings primarily to "qualified purchasers" (for example, institutional investors and "high net worth" individuals).[1]

Hedge funds aim to deliver positive returns under all market conditions while reducing risk and preserving capital—their source of attraction for pension funds, endowments, insurance companies, private banks, and high net worth investors. "The increased risk-sharing capacity and liquidity provided by hedge funds over the last decade has contributed significantly to the growth and prosperity that the global economy has enjoyed," according to the Government Accountability Office.[2]

Hedge funds are as diverse as the managers who run them. They may invest in or trade a variety of financial instruments, including stocks, bonds, currencies, futures, options, other derivatives, and physical commodities.

Nearly one-third (31.68 percent) of hedge fund assets are invested in **equity hedge strategies** (use long and short positions on equities to manage risks), nearly one-quarter (24.8 percent) in **relative value approaches** (invest in securities perceived to be selling at deep discounts to their intrinsic or potential worth), another one-quarter (24.7 percent) in **event-driven funds** (find opportunities created by significant transactional events, such as spin-offs, mergers and acquisitions, reorganizations, bankruptcies), with the remaining 18.9 percent in **macro funds** (identify mispriced valuations in stock markets, interest rates, foreign exchange rates, and physical commodities) as of June 2009.

Hedge funds contribute to capital formation, market efficiency, price discovery, and liquidity.

Industry More Diverse, Innovative

Over the past decade, the industry has become more diverse, innovative, and flexible.

- **More choices:** The number of strategies used has increased for equity hedge, event-driven, macro, and relative value approaches.
- **More markets:** Hedge funds have broadened the number of markets in which they operate, allowing them to shift their emphasis with market changes. Such flexibility has been partly responsible for superior returns.

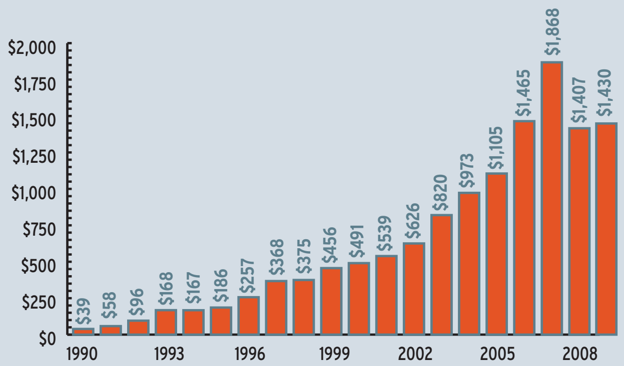
"Market participants (e.g., investors, creditors, and counterparties) impose market discipline by rewarding well managed hedge funds and reducing their exposure to risky, poorly managed hedge funds."

Government Accountability Office
January 2008

1. An individual is considered to be an "accredited investor" if they have a net worth of at least $1 million or have made at least $200,000 each year for the last two years ($300,000 with his or her spouse if married) and have the expectation to make the same amount this year. Qualified purchasers include: (a) Individuals who own $5 million in investments; (b) Institutional investors who own $25 million in investments; (c) A family owned company that owns $5 million in investments; and, (d) A "qualified institutional buyer" under Rule 144A of the 33 Act.
2. GAO, *Hedge Funds: Regulators and Market Participants Are Taking Steps to Strengthen Market Discipline, but Continued Attention Is Needed*. Report No.: 09-200. January 2008. Available at: http://www.gao.gov/new.items/d08200.pdf.

Growth of Hedge Funds

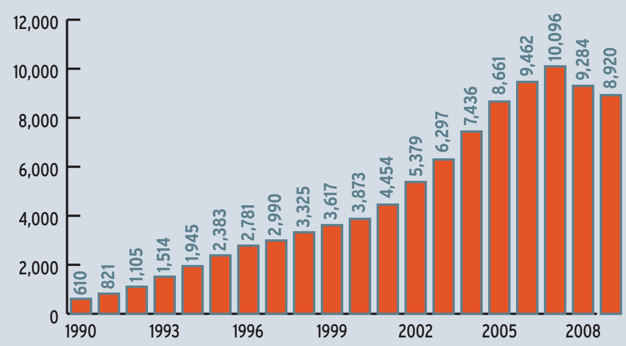
1990-2008 (billions of dollars)



SOURCE: Hedge Fund Research, Inc., *Global Hedge Fund Industry Report Second Quarter 2009*

Number of Hedge Funds

1990-2008



SOURCE: Hedge Fund Research, Inc., *Global Hedge Fund Industry Report Second Quarter 2009*

Hedge funds seek out inefficiencies in capital markets and play a valuable role in financial markets by bringing security prices closer to fundamental value.

Hedge funds manage $1.43 trillion in assets—a very small share of total global assets

More than 8,900 hedge funds manage more than $1.43 trillion in assets as of June 2009.[3] That is down 27.1 percent, or $525 billion, from the peak of $1.93 trillion reached mid-year 2008.

Hedge funds constitute a small share—one percent—of the $196 trillion invested globally in equities ($65 trillion), tradable government and private debt ($79 trillion), and bank deposits ($53 trillion), according to McKinsey Global Institute.[4]

Hedge funds allow investors to diversify portfolio risks

Since 1990, hedge funds have increased 11.82 percent (net return) on average each year, as measured by the Hedge Fund Research, Inc. Fund Weighted Composite Index. Over the same period, the Standard and Poor's 500 Index (with dividends) rose 7.31 percent (net return) yearly on average, while the FTSE 100 climbed 3.23 percent (net return) on average annually.

Hedge funds not only have generated superior returns over time, but have also delivered those superior returns with lower risk (as measured by volatility and loss measures).

During the market turbulence in 2008, hedge funds demonstrated their important role as a risk-management tool by curbing losses investors would have suffered if they had invested in equity investments, for example, that tracked the S&P 500 Index or FTSE 100. While the Standard and Poor's 500 Index fell 36.99 percent and the Financial Times Stock Exchange 100 Index dropped 31.33 percent in 2008, the Hedge Fund Weighted Composite Index was down 18.36 percent.

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3. Hedge Fund Research, Inc., *Global Hedge Fund Industry Report Second Quarter 2009*
4. McKinsey Global Institute, *Mapping Global Capital Markets: Fifth Annual Report*. October 2008. Available at: http://www.mckinsey.com/mgi/reports/pdfs/fifth_annual_report/fifth_annual_report.pdf .