

## **BWMG RESEARCH COMMENTARY – Hedge Funds: What are they?**

The first hedge fund was set up by Alfred W. Jones in 1949. Since that time hedge fund assets have reached \$1 trillion spread among approximately 8350 hedge funds with the most rapid growth occurring over the last 10 years. While the number and size of hedge funds are small relative to conventional mutual funds, their growth reflects the importance of this alternative investment category for institutional investors and wealthy individual investors. Many of the brightest minds in the money management industry have moved to the hedge fund world as they can exercise more flexibility in their investment strategies and charge more lucrative investment management fees.

### **Why all the negativity?**

Clearly some investors have been attracted to hedge funds. However, many times the topic of hedge funds is met by resistance and skepticism from investors. In Canada there have been two major hedge fund blowups over the last couple of years – Portus and Norshield. In the US there have been some high profile disasters with hedge funds such as Long Term Capital Management. A hedge fund is largely unregulated, whereas a mutual fund is very highly regulated. Hedge funds therefore are allowed to engage in activities that mutual funds can not, which would lead some to believe that hedge funds are more risky, and to some degree that is true. Clearly, however hedge funds have different risks and each risk must be fully understood and managed.

### **Hedge Fund Strategies**

Mutual Funds are the general name given to investment funds purchased by the average investor. Similarly Hedge Funds can mean many things – so when the question is asked “what is a hedge fund?” there is no simple answer. There are numerous hedge fund strategies but they fall into two categories – directional (i.e. long/short) and non-directional (i.e. market neutral). We believe both categories are appropriate depending on investor needs. Before investing in any hedge fund, investors must fully

understand the investment strategy utilized by the fund.

### **Long/Short Equity**

The most fundamental investment strategy utilized by a hedge fund is long/short equity. This simply means that the investment manager buys attractive stocks (“long” stocks similar to conventional funds) and sells “short” stocks that the investment manager finds unattractive. In order to sell a stock “short”, the manager borrows the stock from another investor and then sells the stock at today’s fair market value price (\$10) which the manager considers to be overvalued. Assuming the manager is right, the stock drops in value (\$5) and then the manager buys back the same stock for \$5. The manager then returns the stock to the lender and profits by the \$5 gain less costs. There are costs involved as the manager must pay the cost for borrowing the shares and interim dividend payments on the borrowed stock. However, the manager also earns a “short interest rebate”, because the cash received from selling the borrowed stock earns interest. Investment managers must be extremely clever at short selling as the potential for loss is unlimited. If the borrowed stock increases in value from \$10 to \$100, the manager will have lost \$90 on the short trade. When a manager buys the stock “long” for \$10, the most the manager can lose is \$10 if the stock drops to \$0.



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### **Conclusion**

When managed properly, a hedge fund has the ability to reduce market risk (directional hedge funds) or eliminate market risk (market neutral hedge funds). Therefore, both long/short equity and market neutral strategies can serve a purpose in some investor portfolios. Some of the negativity regarding hedge funds is well founded and therefore proper due diligence must be performed – but finding the proper hedge fund can be rewarding. However, it is critical to understand the hedge fund strategy and risks as hedge funds can masquerade in many forms.