Hedge Funds: An Introduction

Understanding a Critical Tool in the Global Economy

Managed Funds Association

What is a hedge fund?

It’s a tool that delivers reliable returns for pensions, university endowments, and others

What is a hedge fund?

It's a tool that creates value to help fund pensions, universities and non-profits

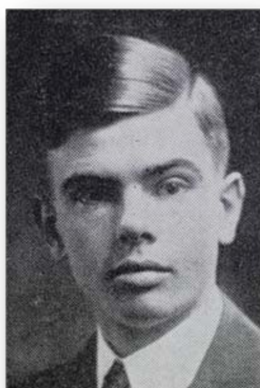
What is a hedge fund?

It's a tool that institutions and investors use to manage risk


What is a hedge fund?
It's a tool that helps
diversify investments
QUARTERS ONLY
50¢
TO OPERATE TURN HANDLE ONE FULL TURN

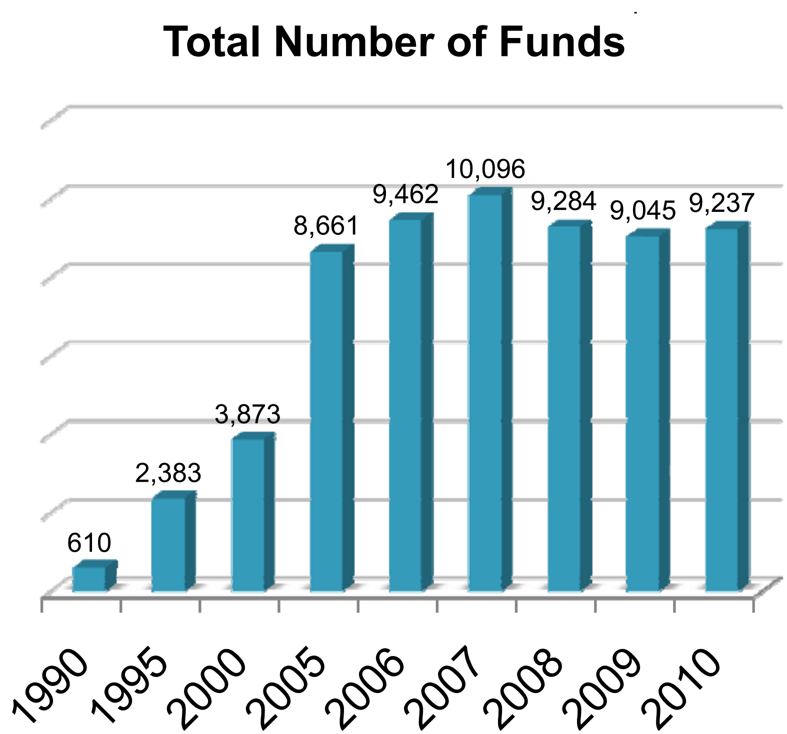

Simply put:
It's a tool that helps millions meet their financial goals and obligations

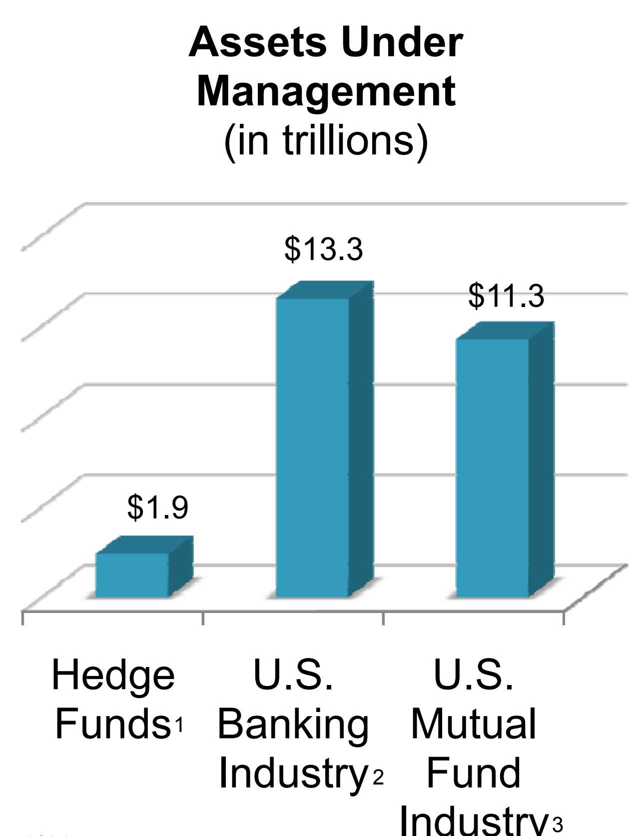
The term “hedge fund” has been used to describe private, professionally managed investment funds since 1949.



Sociologist Alfred Winslow Jones, writing on assignment for *Fortune*, bought undervalued securities and shorted other stocks as a “market neutral” approach to investing.
By combining short selling, leverage, and incentive fees in combination, Jones was able to deliver solid returns while minimizing risk. His innovative approach created the first hedge fund.

While hedge funds have grown in popularity, their size is relatively small compared to the markets where they invest.





Sources: (1) Hedge Fund Research, Inc., 12/10, (2) FDIC, 9/10, (3) ICI, 1/11

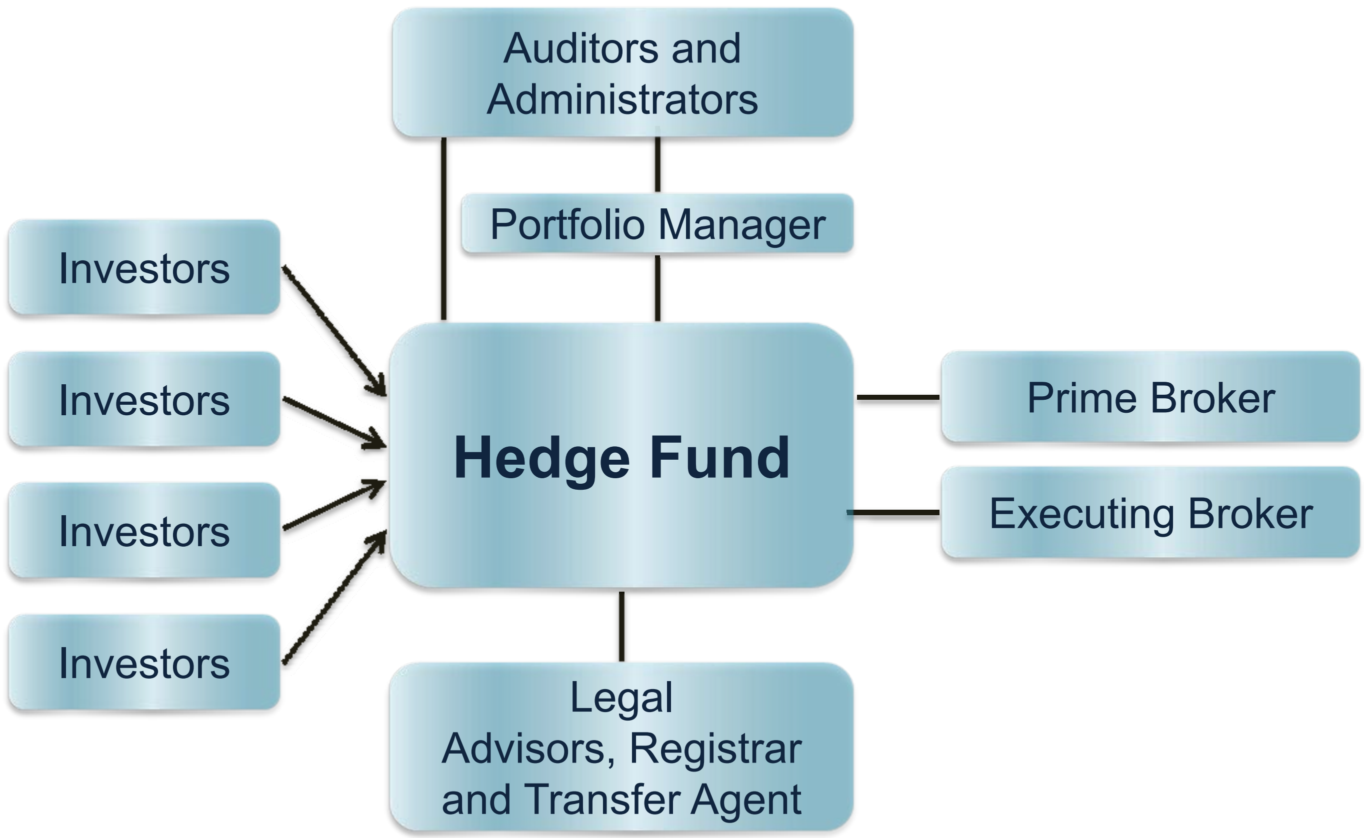
Most hedge funds are established as limited partnerships.

Investors share in the partnership's income, expenses, gains and losses; each partner is taxed on its respective share

Key Players:

Portfolio Manager(s)	Determines strategy and is invested in the fund (compensated based on fund's annual performance)
Prime Broker	Funds must secure their loans with collateral to gain margin and secure trades. In turn, each broker (usually a large securities firm) uses its own risk matrix to determine how much to lend to each of its clients, acting as a stand-in regulator.
Auditors	Ensure fund compliance; verify financial statements as required by federal law

Typical U.S. Hedge Fund Structure



Source: "Hedge Funds and Other Private Funds: Regulation and Compliance" Thomson West, 2010

Who can invest in hedge funds?

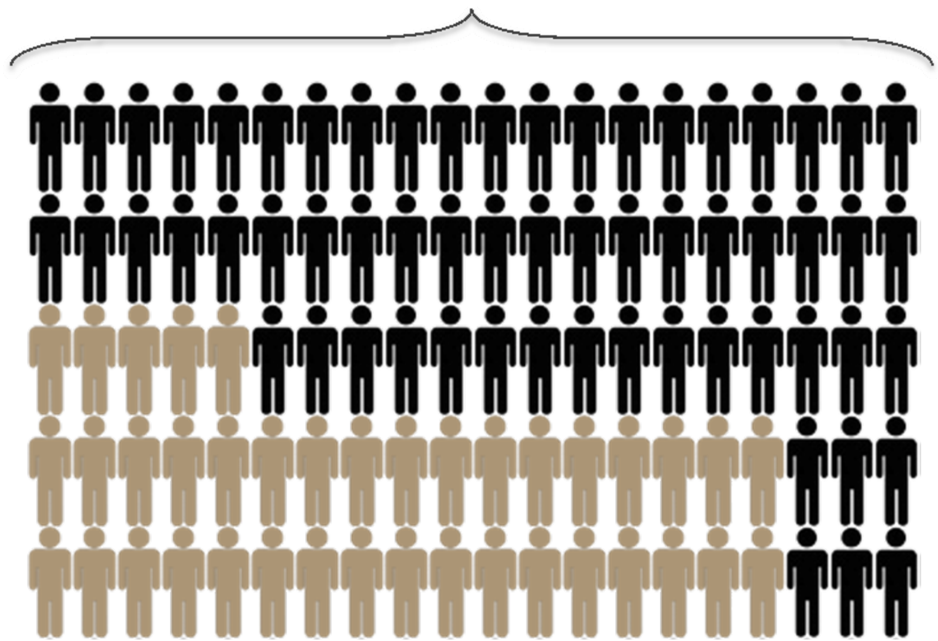
U.S. regulations limit hedge fund participants to “accredited investors” or “qualified purchasers.”

Individuals with investments in excess of $5 million; or net worth of at least $1 million; or income of at least $200,000 in last two years

Institutions with total assets over $5 million; or no less than $25 million in investments or investable assets

Who invests in hedge funds?

About 61 percent of global hedge fund assets come from institutional investors such as pension funds, and university and nonprofit endowments.



The rest comes from individual investors.

Source: Preqin Ltd., September 2010

Who invests in hedge funds?

Public Pension Plans

MARYLAND STATE RETIREMENT and PENSION SYSTEM

OPERS Ohio Public Employees Retirement System

Teachers' Retirement System of the State of Illinois

Union Pension Plans

1199SEIU United Healthcare Workers East

AFL-CIO America's Union Movement

International Brotherhood of Teamsters

Corporate Pension Plans

IBM

John Deere

verizon

Boeing

Universities

Harvard

University of Virginia

Alabama Crimson Tide

Today, 38 of the top 100 pension plan sponsors utilize hedge funds.

Their investments total $58.1 billion.

Source: *Pensions and Investments*, February 2010

Why invest in hedge funds?

Hedge funds are important tools for diversification.

They provide investors with the latitude to take investment strategies based on current market conditions in order to manage risk and maximize return.

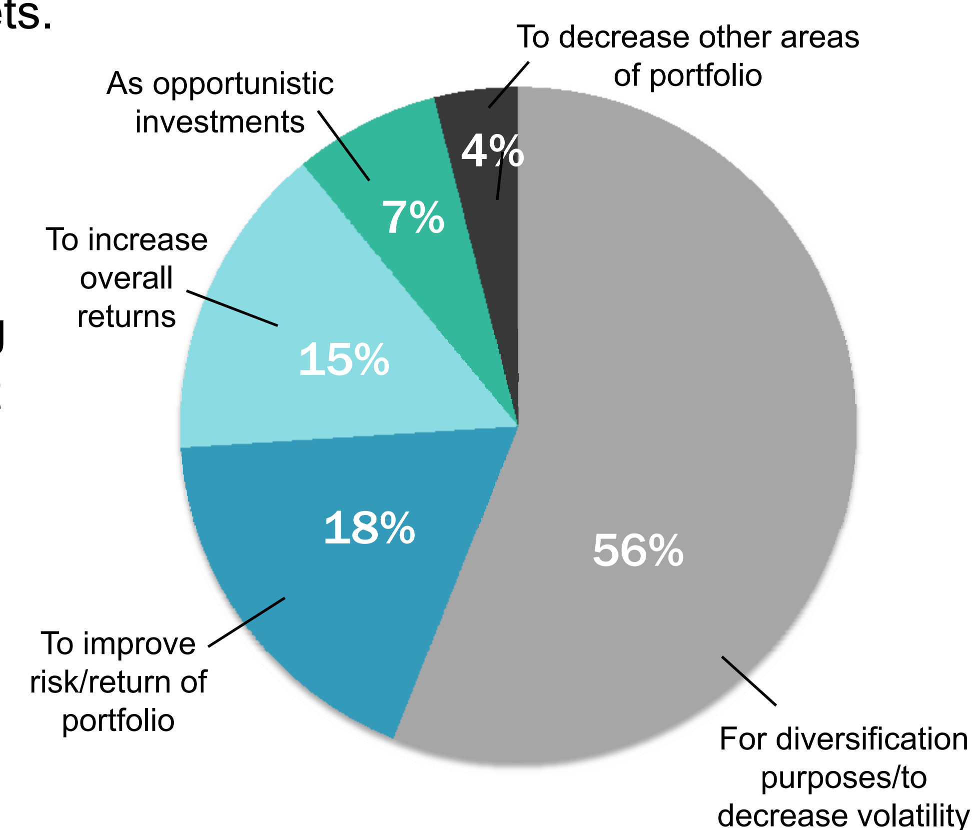
The hedge fund industry is diverse, too. Over the past 10 years, managers have employed an increasing number of new investment strategies in a broader number of markets worldwide.

Why invest in hedge funds?

Hedge funds offer shelter from more volatile markets.

It's likely this is the reason that 75 percent of institutional investors signaled they are staying the course on their asset allocation throughout the recent economic turmoil.

Primary Reason for Investing in Hedge Funds



Source: Morgan Stanley Hedge Fund Webinar Presentation, 12/10

Institutional Trends

In a 2010 Prequin study, 35%of U.S. pension funds and endowments said they expect to increase their allocation to hedge funds.

The Ford Foundation held $1.8 billion in hedge fund investments at the end of fiscal year 2009, some 18.4% of its total assets.

General Motor's pension fund increased its hedge fund investments in 2010 to $11.9 billion of its $87.8 billion portfolio.

"Our increased allocation toward hedge funds in recent years has lowered the risk exposure of our pension plans while delivering solid returns. That approach is consistent with our goals to lower GM's risk profile, strengthen our balance sheet and fully fund our pension plans."

Walter Borst, General Motors Asset Management's CEO, President and Chief Investment Officer, 2/7/11

Source: Infovest21, 2010; Pensions & Investments, 2/7/11

How do hedge funds invest?

Global Macro

Investment managers use economic variables and the impact these have on markets to develop investment strategies.

Managers employ a variety of techniques including discretionary and systematic analysis, quantitative and fundamental approaches, and long and short-term holding periods.

Strategies are based on future movements in underlying instruments rather than the realized valuation discrepancies between securities.

How do hedge funds invest?

Event Driven

Investment managers maintain positions in companies currently or prospectively involved in corporate transactions including mergers, restructurings, financial distress, tender offers, shareholder buybacks, debt exchanges, security issuance or other capital structure adjustments.

Managers pursue strategies based on fundamental characteristics (as opposed to quantitative) and specific future developments.

Position exposure includes a combination of sensitivities to equity markets, credit markets and company-specific developments.

How do hedge funds invest?

Relative Value

Investment managers maintain positions based on valuation discrepancy in the relationship between multiple securities.

Managers employ a variety of fundamental and quantitative techniques; investments range broadly across equity, fixed income, derivative or other security types.

Positions may involve future corporate transactions, but these positions are predicated on realization of a pricing discrepancy between related securities rather than the outcome of the corporate transaction.

How do hedge funds invest?

Equity Funds

Investment managers maintain long and short positions in equity and equity derivative securities.

Managers employ a wide variety of techniques to arrive at an investment decision, including both quantitative and fundamental techniques.

Strategies can be broadly diversified or narrowly focused on specific sectors and can range broadly in terms of levels of net exposure, leverage employed, holding period, concentrations of market capitalizations and valuation ranges of typical portfolios.

How do hedge funds invest?

Quantitative Funds

An investment fund that trades positions based on computer models built to identify investment opportunities.

These models can utilize an unlimited number of variables, which are programmed into complex, frequently-updated algorithms.

Quantitative funds models are used as a means of executing a number of other hedge fund strategies.

How do hedge funds invest?

Multi-Strategy Funds

Investment managers maintain a variety of processes to arrive at an investment decision, including both quantitative and fundamental techniques.

Strategies can be broadly diversified or narrowly focused on specific sectors and can range broadly in terms of levels of net exposure, leverage, holding period, concentrations of market capitalizations and valuation ranges.

How do hedge funds invest?

Managed Futures Trading (CTAs)

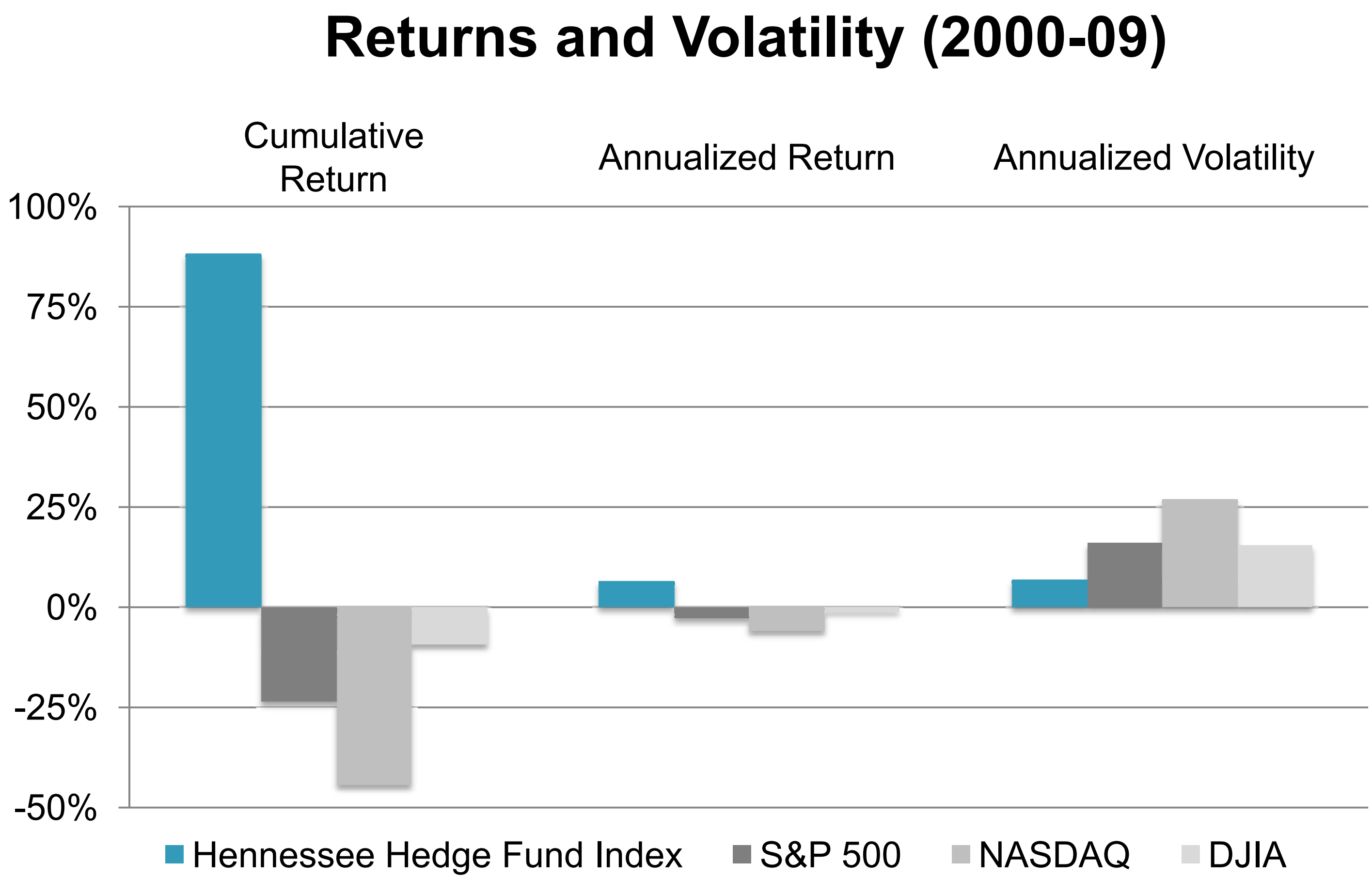
Managed futures traders–also known as commodity trading advisors (CTAs)–are able to invest in up to 150 global futures markets.

They trade in these markets using futures, forwards, and options contracts in everything from grains and gold, to currencies, stock indexes, and government bond futures.

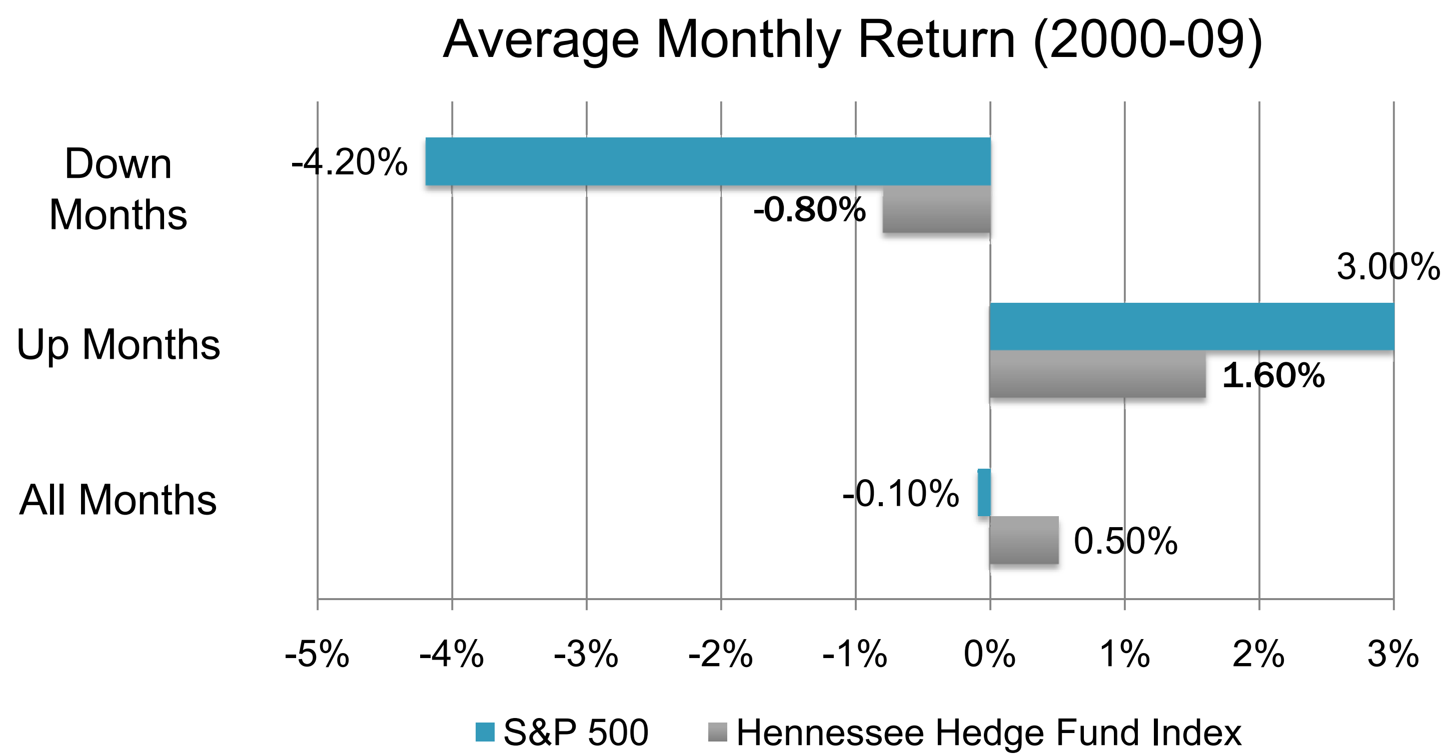
Because they can go both long and short they have the ability to make money in both rising and falling markets.

CTAs have been regulated by the Commodity Futures Trading Commission (CFTC) since 1974 and are overseen by the National Futures Association (NFA), a self-regulatory organization.

Hedge funds produce consistently higher returns with substantially less volatility.



Hedge funds provide greater upside and protect on the downside; they've only been exposed to 20 percent of market losses during down months.



Hedge fund managers are partners with fund investors; their financial interest is directly linked to fund performance.

Since every hedge fund manager is invested in his or her own fund (sometimes as much as 80% of the fund’s value), he or she has a significant amount of money at stake with every investment decision.

Managers aren’t rewarded for poor performance. Unlike corporate executives and mutual funds, managers are only rewarded when investors are rewarded.

Fee structures vary, though “2 and 20” fees are typical: 2% management fee for administrative expenses; 20% performance allocation over a specific high water mark.

Hedge funds do not pose a systemic risk:

- Their size is small compared to the broader financial services industry
- Hedge funds aren't highly leveraged
- They aren't susceptible to runs

"I would not think that any hedge fund or private equity fund would become a systemically critical firm individually."

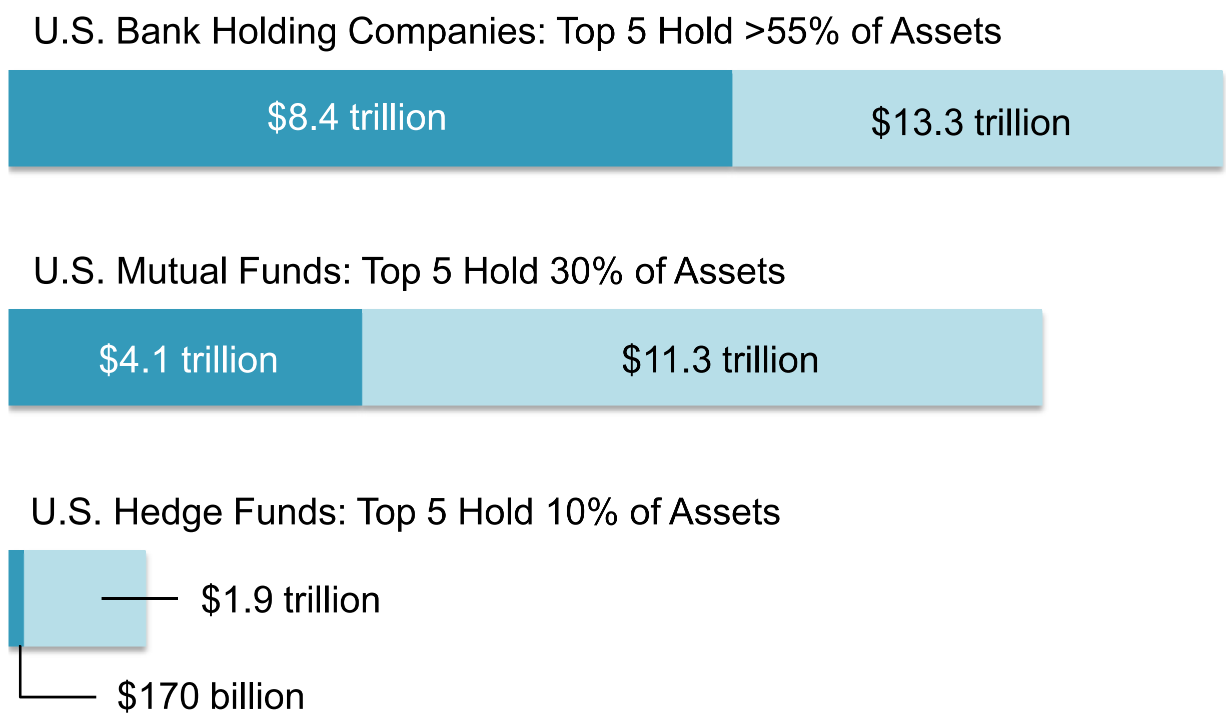
Ben Bernanke, Federal Reserve Board Chairman
Testimony to U.S. House Financial Services Committee, October 1, 2009

The "current crisis in financial markets is not a hedge fund driven event. Hedge funds contribute to market liquidity, price efficiency, risk distribution, and global market integration."

Kathleen Casey, SEC Commissioner
Hedge Fund Oversight: Final Report, June 2009

Compared to other U.S. markets, there is far less concentration among hedge funds.

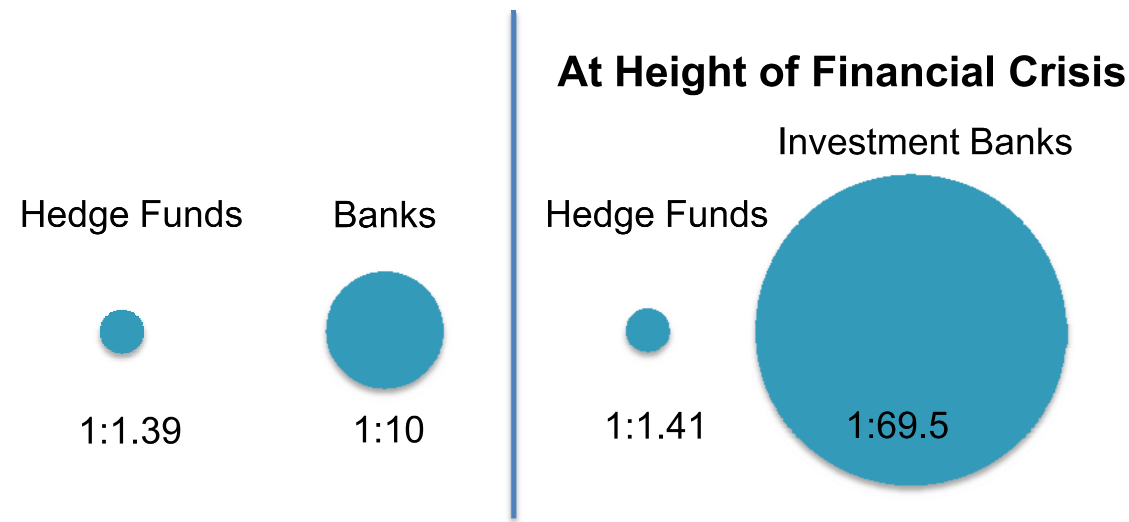
Assets Under Management
(in trillions)



Source: Lipper Performance, 12/10; Federal Reserve Board, June 30, 2010; fund websites

Hedge funds' leverage risk is low.

Hedge fund leverage is governed largely by private relationships with its prime brokers. A fund posts collateral with this prime broker to secure its trades and the broker uses its own risk matrix to determine how much to lend.



Source: Hedge Fund Survey, Bank of America/Merrill Lynch, September 2010;
A. Ang, et al, "Hedge Fund Leverage," July 5, 2010.

Since hedge funds have long lead times to return capital to investors and to adjust credit agreements with creditors, they aren't susceptible to "runs" on capital.

	Other Institutions	**Hedge Funds**
Equity	Mutual funds must be able to return capital to investors immediately	By contract, most hedge funds return capital over months or years
Debt	Banks rely on daily liquidity from deposits and commercial paper to meet depositor demands	Hedge funds' credit agreements with prime brokers are set for 30 days but can extend to two years

For more information about hedge funds and alternative investments, visit www.managedfunds.org

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