

HEDGE FUNDS: AN INTRODUCTION

**UNDERSTANDING A CRITICAL TOOL
IN THE GLOBAL ECONOMY**

Managed Funds Association
January 2013

What is a hedge fund?

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

A large crowd of graduates in black caps and gowns at a commencement ceremony. The graduates are seated in rows, and the scene is filled with the sound of many voices. The text "What is a hedge fund?" is overlaid on the image in white, bold font.

What is a hedge fund?

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

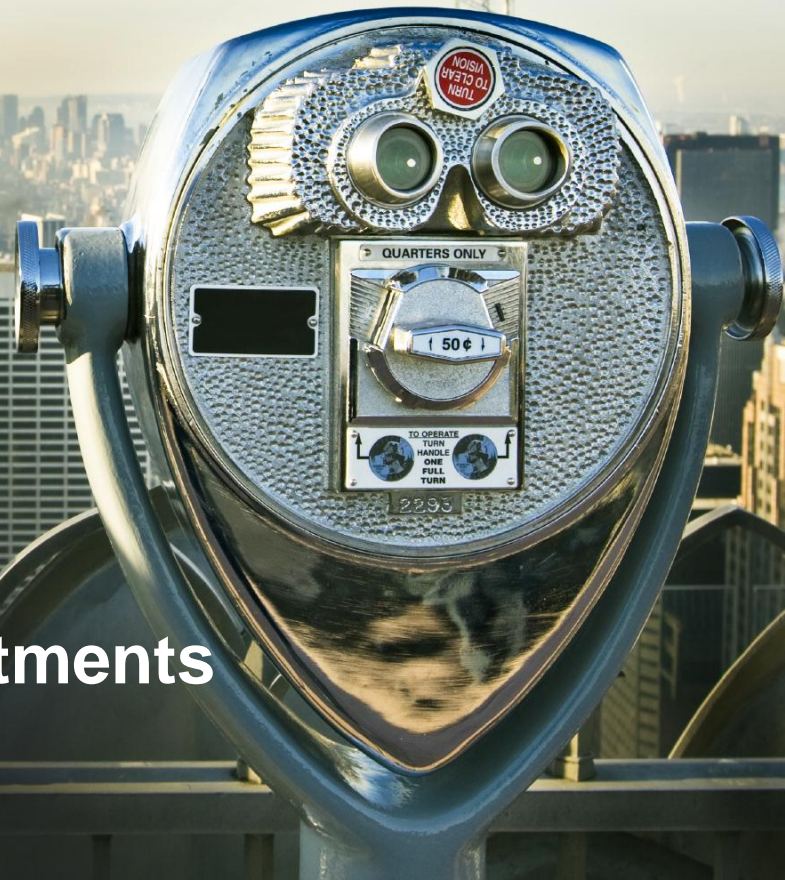


What is a hedge fund?

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





Simply put:

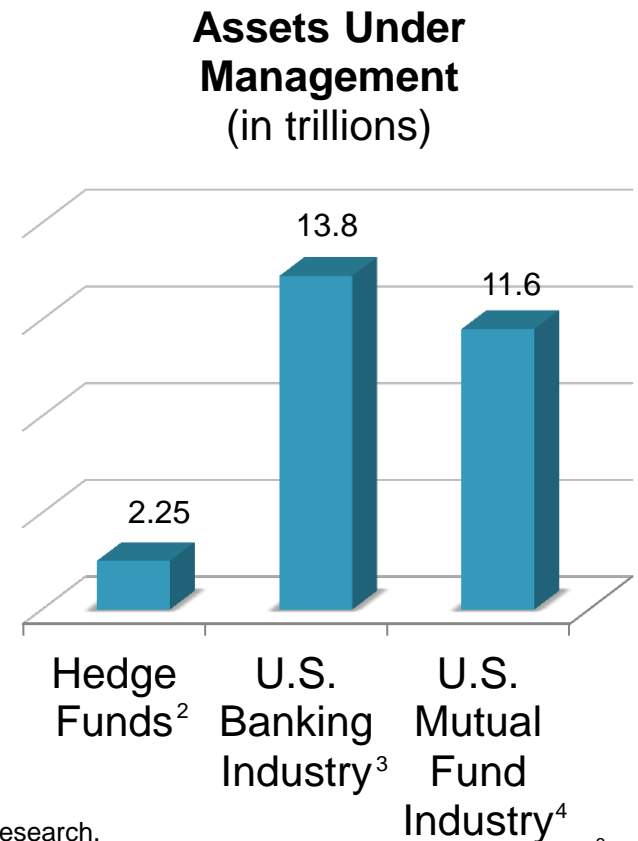
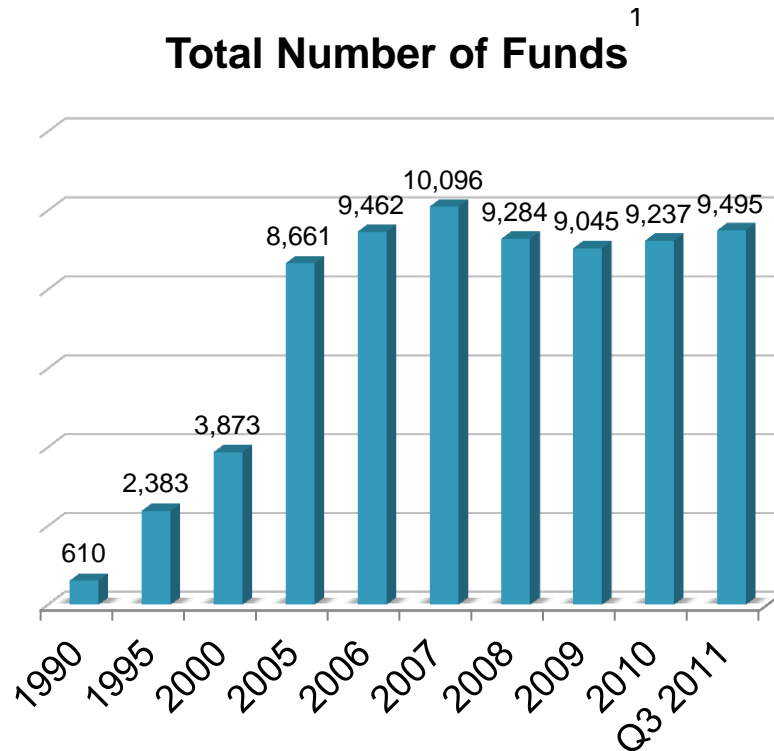
**It's a tool that helps millions meet
their financial goals and obligations**

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., Q3 2011, (2) Hedge Fund Research, Inc., 10/12, (3) FDIC, 9/11, (4) ICI, 12/11



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:

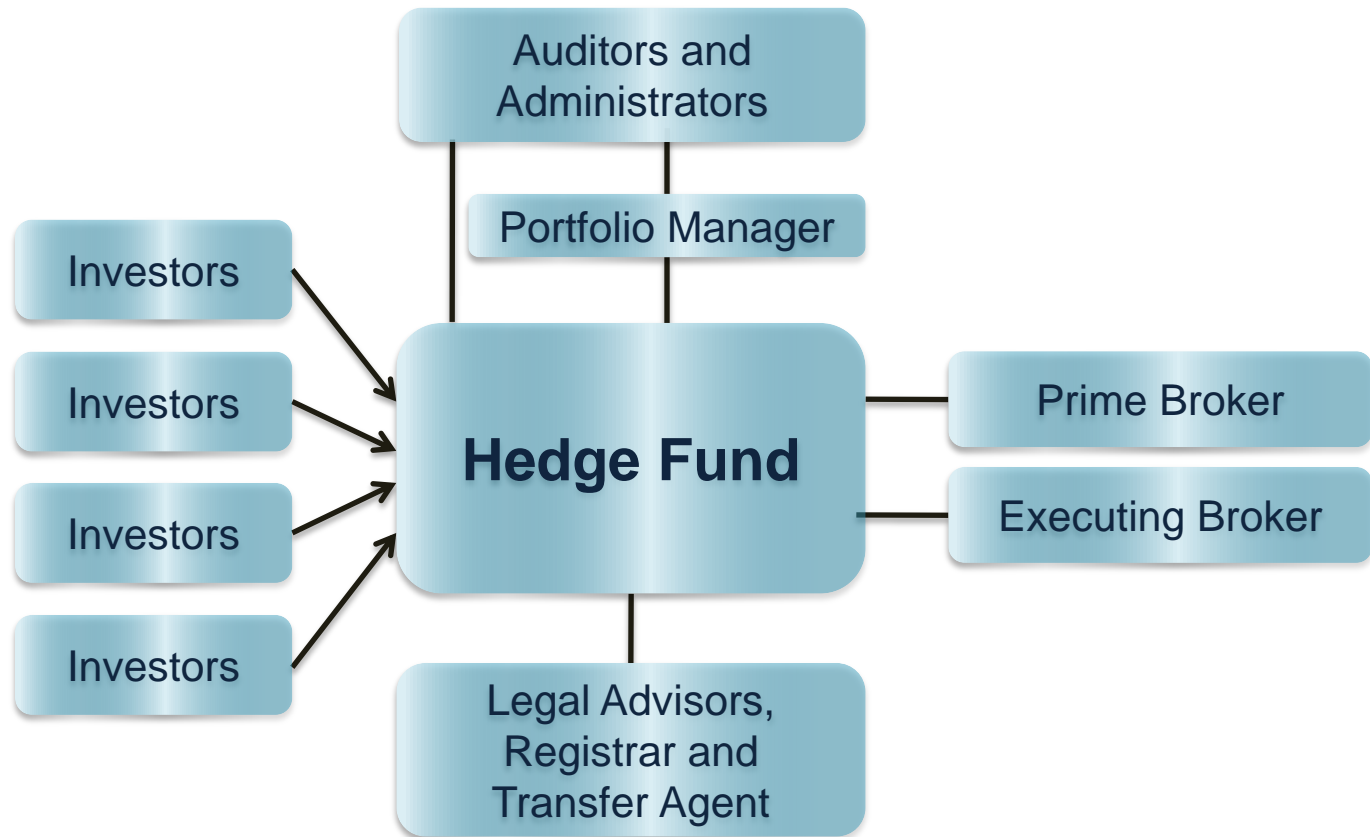
Portfolio Manager(s) Determines strategy and is invested in the fund (compensated based on fund's annual performance)

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



Who can invest in hedge funds?

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



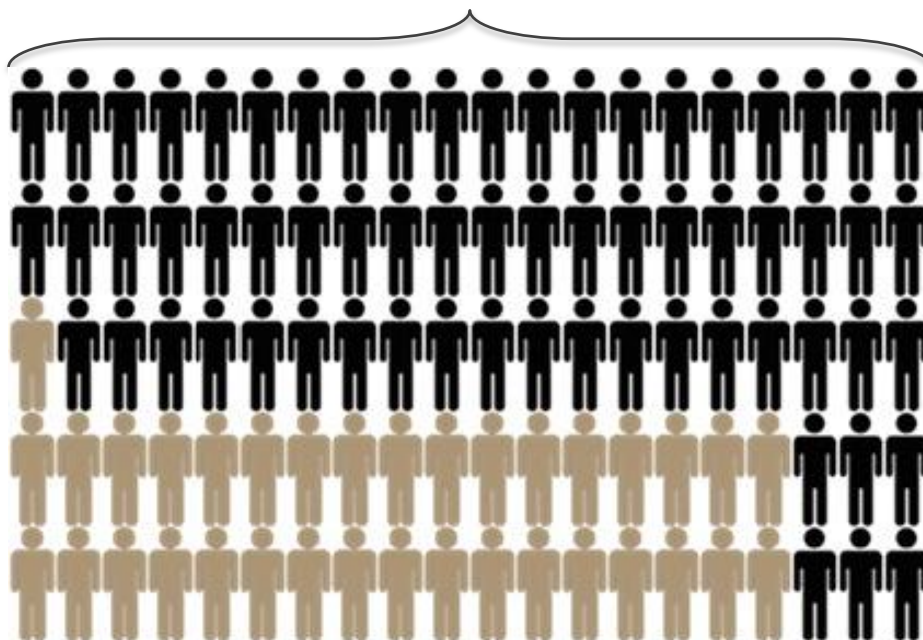
Individuals with investments in excess of \$5 million; or net worth of at least \$1 million; or income of at least \$200,000 in last two years



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

Who invests in hedge funds?

About 65 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.



Who invests in hedge funds?

University and college endowments were some of the first institutional investors to partner with hedge funds to help meet their financial needs and expand educational opportunities nationwide.

According to a recent NACUBO-Commonfund study, endowments allocate - on average - 38% of their alternative asset portfolio to marketable alternative strategies, including hedge funds.

Hedge funds are of particular importance to smaller institutions. Endowments with less than \$25 million in assets allocate an average of 60% of alternative investments with various hedge fund managers and strategies.

Source: 2011 NACUBO-Commonfund Study of Endowments



Who invests in hedge funds?

Pension plans across the U.S. and around the world invest in hedge funds to help diversify their portfolio, manage risk and deliver reliable returns over time. These investments help build retirement security for hundreds of millions of workers and retirees.

According to a study by Citi Prime Finance, pension plans accounted for 53% of institutional investor assets held by hedge funds – a total of \$594 billion – as of March 30, 2011.



Source: Citi Prime Finance

Who invests in hedge funds?

Public Pension Plans



Union Pension Plans



Corporate Pension Plans



Universities



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

Their investments total \$58.1 billion.



MARYLAND
STATE RETIREMENT
and PENSION SYSTEM



Teachers' Retirement System
of the State of Illinois



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.

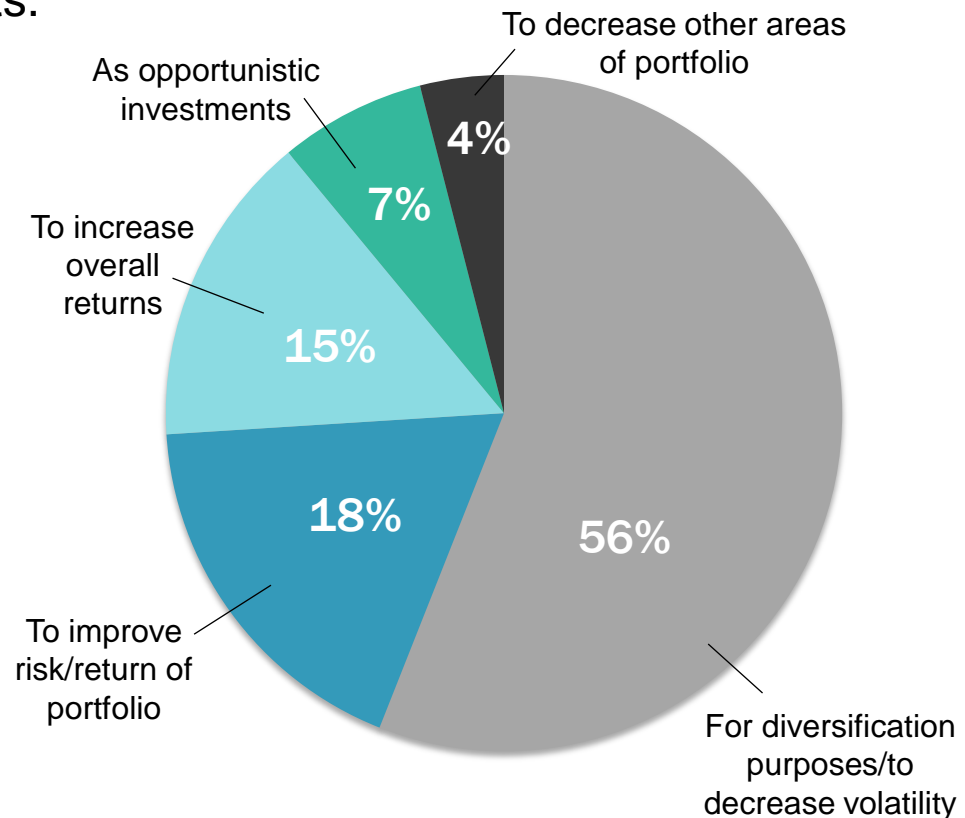


Why invest in hedge funds?

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



Institutional Trends

In a 2011 Preqin study, 38% of investors said they expect to increase their allocation to hedge funds in 2012.

The Robert Wood Johnson Foundation held nearly \$1.2 billion in hedge fund investments at the end of Fiscal Year 2010, approximately 13% 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



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.

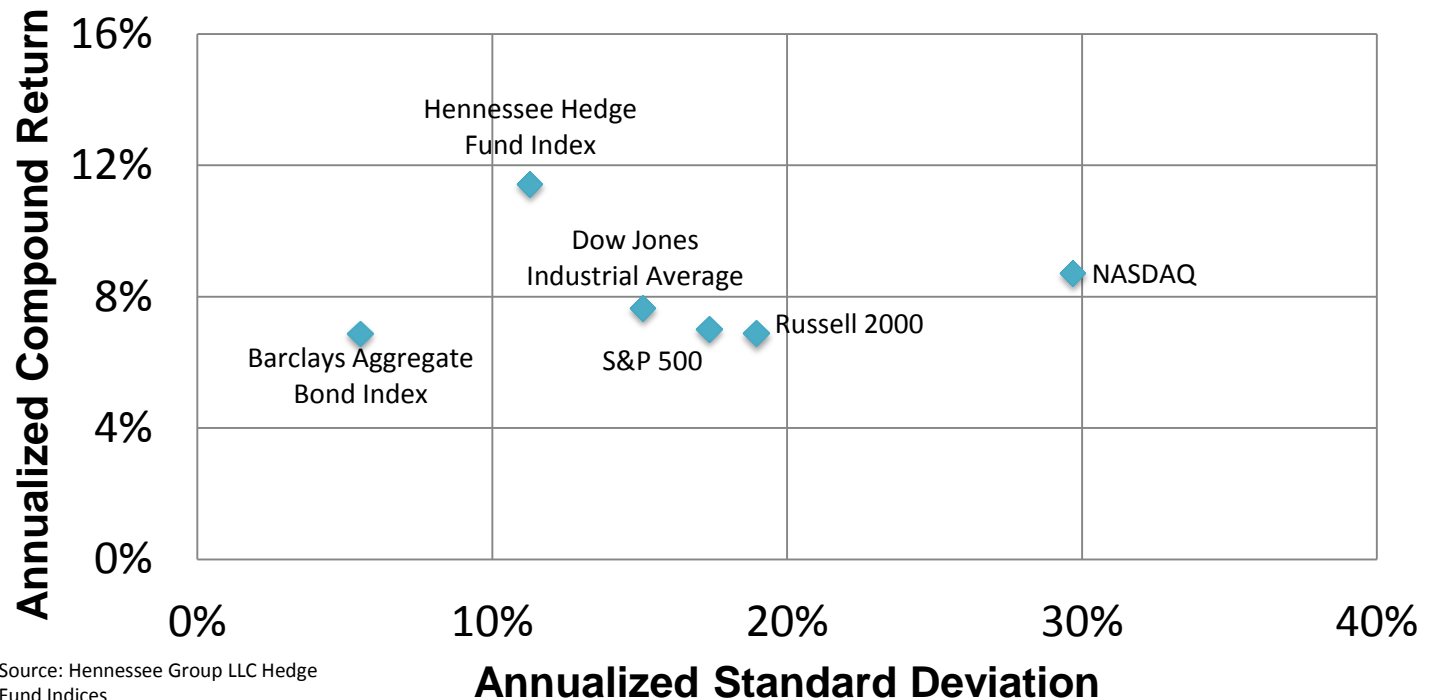
Because they can go both long and short they have the ability to make money in both rising and falling markets.

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.

Risk vs. Return
Hennessee Hedge Fund Index vs. Benchmarks
(1987-2011)

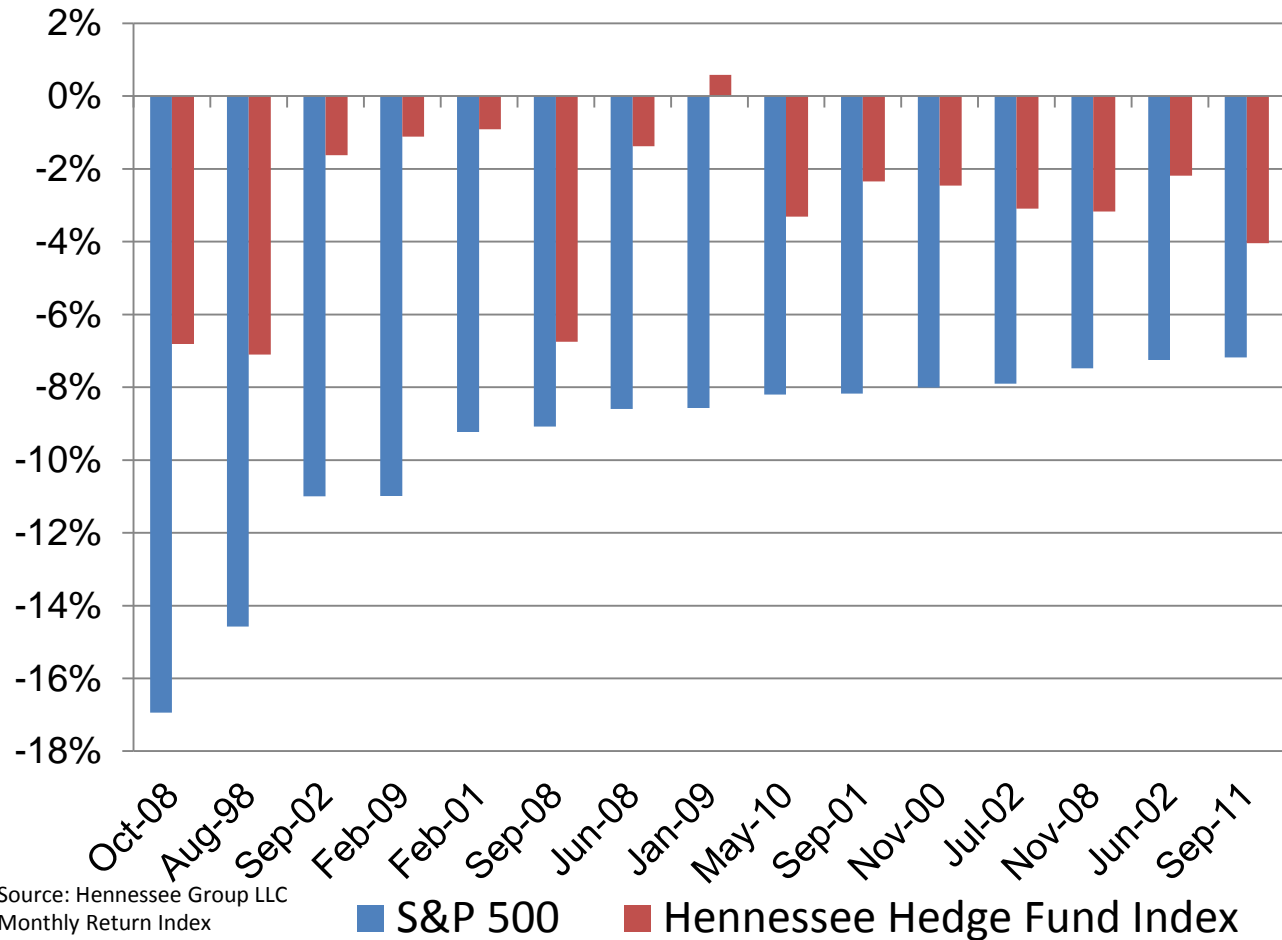


Source: Hennessee Group LLC Hedge Fund Indices



Hedge funds protect on the downside.

Hennessee Index in the Worst 15 Months of S&P Decline (1993-2011)



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)

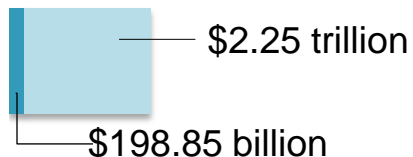
U.S. Bank Holding Companies: Top 5 Hold >60% of Assets



U.S. Mutual Funds: Top 3 Mutual Fund Families Hold >35% of Assets

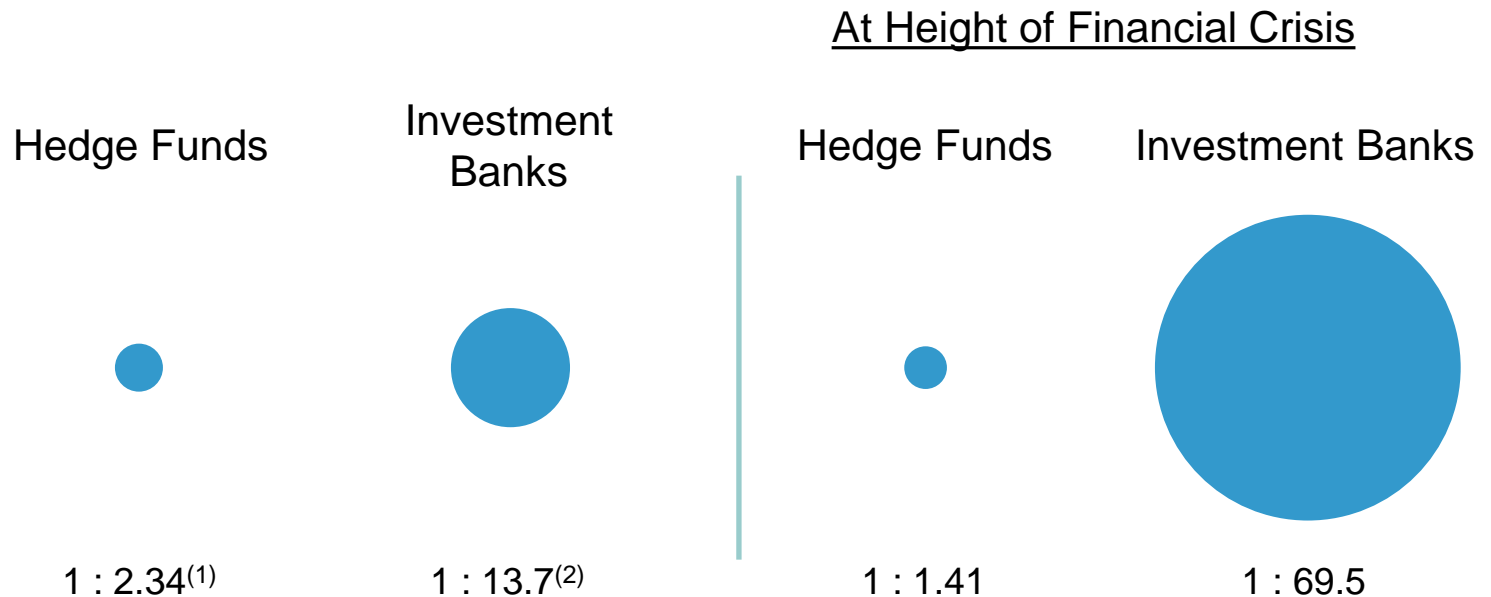


U.S. Hedge Funds: Top 5 Hold 10% of Assets



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.



(1) "Hedge Fund Market Update," Bank of America Merrill Lynch Global Markets Financing & Futures, December 2011.

(1) Forbes.com



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**



**MANAGED FUNDS
ASSOCIATION**