

What Are Alternative Investments And How Big a Market Do They Represent?

The following article belongs to a series of three articles on alternative investments. While this covers background information on hedge funds, where they stand today and what the outlook for the near future is, the next editions of our newsletter will cover some of the trading applications of hedge funds and an overview on the German hedge fund market.

Alternative investments, hedge funds or non-traditional investments have become increasingly popular since the slump of the equity markets in March 2000. They represent a universe of alternatives for the institutional investor who has traditionally been restricted to equity and fixed income allocation investment programs. A few characteristics alternative investments have in common is their flexibility to use financial instruments, such as futures and options, either not allowed or restricted to regular investment programs like mutual funds, and their freedom from many types of regulatory and compliance oversight. Investors are assumed to have a sophisticated understanding of finance, as well as high net worth or assets under management. Hedge funds often, but not necessarily, use leverage and performance-based incentive fees are charged in addition to the typical fixed fee mutual fundtype management charge.

The term, hedge funds, is not necessarily indicative of the strategy used within the various hedge funds and does not simply refer to the common practice of "hedging", although many funds do hedge against downturns in the markets. Hedge funds earned their name by taking market neutral positions in an effort to protect their investments from market volatility. However, today they have broadened their investment scope, using equity, commodity and hybrid instruments for unhedged speculative gain. Nevertheless, the primary aim of most hedge funds is to reduce volatility and risk while attempting to preserve capital and deliver positive returns under all market conditions. This is why many hedge funds have objectives of consistent returns and capital preservation rather than magnitude of returns.

History of Hedge Funds

The first known hedge fund was created in 1949 by a US-based Australian named A.W. Jones who operated in relative anonymity for nearly ten years. Jones clearly subscribed to the theory that within the universe of a supposedly efficient market, there exist at any given time considerable pockets of inefficiency which can be profitably exploited without incurring unacceptable risks. Even though his investment model represented an innovation for his time, by today's standards it seems quite simple. His goal was to generate profits through superior stock picking, and he opted to use two speculative techniques, short-selling and leverage, to protect a portion of his portfolio against market risk and to magnify the portfolio's returns. He also designed a merit-based compensation arrangement whereby he was paid a percentage of the profits generated from his clients' assets. This is also known as an incentive-based fee.

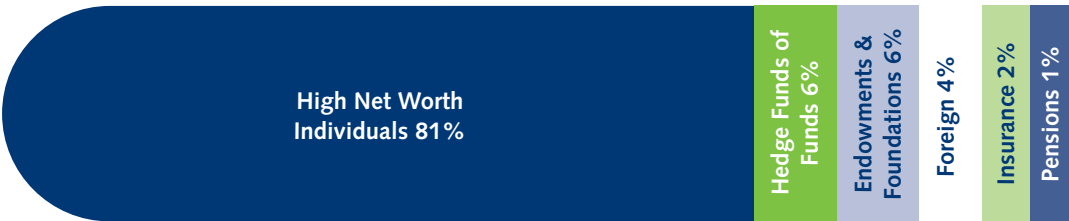
Hedge Fund Managers Today

Today, hedge funds charge a management as well as an incentive fee. Whereas the management fee, based on the year’s net asset value, usually varies between one to three percent, the incentive fee, also called performance fee or upside profit commission, usually accounts for 15 to 25 percent of the net profits of the fund. Unlike many mutual fund managers, most hedge fund managers invest in a significant portion of the funds they run and share the rewards as well as risks with the investors. This demonstrates their commitment to growing the fund.

The investment approach of a hedge fund is specific to each fund. Minimum investment can vary from USD 25,000 to 25,000,000 and normally falls within the USD 500,000 to 1,000,000 range. Thus, hedge funds mainly target high net-worth individuals and, especially in the past few years more and more institutional investors. In recent years, given the stock market conditions, there has even been a trend toward more retail-oriented hedge funds with lower entry investment requirements.

Assets Invested in Hedge Funds by Investor Type

1992



2002



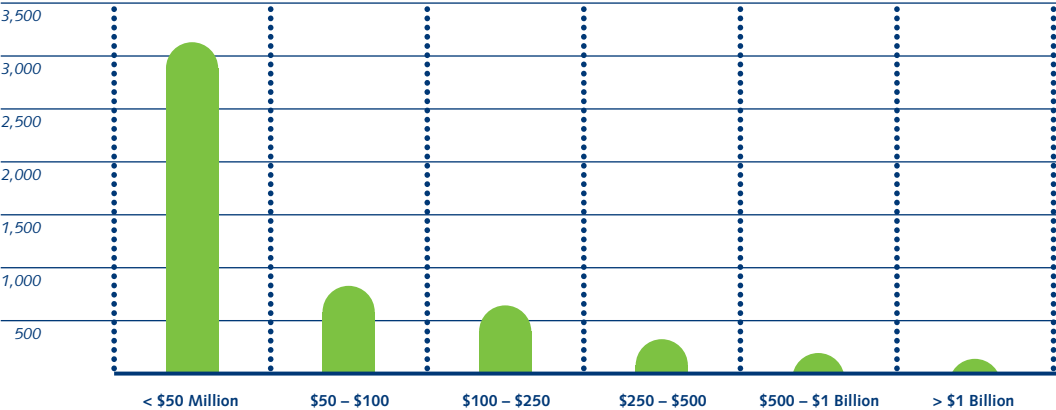
Source: Women in Hedge Funds

As shown in the graph above, the investor structure has dramatically changed. Whereas ten years ago cash flows into hedge funds were predominantly from high net worth individuals and families, institutions have become the primary decision-makers investing in hedge funds. Indeed, pension funds, endowments, insurance companies and private banks invest in hedge funds to diversify and thus minimize overall portfolio volatility and enhance returns, since certain hedge funds returns have a low correlation to the S&P 500 or the Dow Jones EURO STOXX 50SM and are high in absolute terms. The other growing investor sector has been "hedge funds of funds". The latter simply represent a fund of hedge funds, spreading the risk of the investor into many strategies.

Size of Hedge Funds

Estimates by industry experts about the total number of hedge funds vary from 5,000 to 7,000 worldwide. Goldman Sachs's view was that approximately 80 percent of hedge fund assets were in the US, 15 percent in Europe and the rest in Asia. The estimates of the total amount invested in hedge funds vary from USD 500 to 600 billion with signs of increased growth. However, unlike the mutual fund business, where flows are typically concentrated into a small number of industry participants, the hedge fund sector is dominated by small funds.

Number of Hedge Funds Sorted by Investment Volume



Source: Women in Hedge Funds

Future Trends

It is expected that the increase in the number of hedge funds will continue. Especially institutional investors, such as pensions funds, insurance companies and endowments are keen on diversifying their portfolios and looking for enhanced returns in a downside market. According to industry specialists, a further institutionalization of hedge funds is also taking place. This can be seen by both the institutionalization of the client base, as shown above, but also through the transition of small entrepreneurial or boutique-style firms into financial services institutions. Last but not least, this process is also supported by the increasing number of traditional investment management firms offering hedge funds to retain talent and attract assets.

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