

An Alternative Investment in Reducing Volatility

The term **hedge fund** is commonly used to describe any fund that isn't strictly a conventional investment fund. Although a relatively new term amongst retail investors, hedge funds have been around for more than 50 years as a conservative approach designed to enhance returns and protect capital from market downturns. They form an increasing group of alternative assets which include venture capital, commodity funds and other innovative products designed to enhance portfolio returns while managing risk.

As the 1990's market boom becomes a fond memory and economists forecast a decade of lacklustre share market returns, the challenge for investors now is to find where they will be able to extract the best returns for a designated level of risk.

So what are Hedge Funds?

In the U.S., the term "hedge fund" usually refers to a private investment limited partnership that is not regulated and only available to professional investors. These funds are sometimes domiciled in countries like Bermuda and Cayman Islands for their low or zero tax benefits.

The aim of the hedge fund is to achieve a positive return irrespective of market conditions. They attempt to do this by using strategies that go beyond the normal buying of shares and bonds that a traditional fund manager would undertake in a typical managed fund. Performance results depend primarily on the manager's abilities rather than market movements. There are over 25 different strategies that can be utilised each with their own risk/return characteristics. They include, short selling, complex use of options and futures, leverage and other flexible investment strategies.

Hedge funds are very different to managed funds, as their key objective is not to lose money. The focus on preservation of capital means that returns are measured in absolute and not relative terms. Mainstream managers try to beat the index and their performance is measured *relative* to that index. So if the market fell 15% and the manager fell only 8%, that is considered a good result. The client however, may have a different view. A hedge fund manager's focus is to avoid negative returns altogether and attempts to make money in market downturns.

Let's take an example of a hedge fund. A Long/Short fund simply buys the stocks it likes and sells (shorts) the stocks it does not like. Being "long" a stock simply means that you own it or have bought it. By short selling, you plan to sell the share (which is borrowed from a fund manager or broker) and later buy it back at a lower price when it has fallen thereby profiting from the decline and not losing from it.

Some investors may remember the success of the fund manager BT during the 1987 October crash. The reason for this success? They took out hedging positions (selling index futures and buying put options) that saved the fund from the horrific falls and made BT the premier fund manager for many years after that. Kerr Neilson was responsible for the Australian share fund at the time and later Paul Moore until 1998. Each of these two have left BT and started their own investment companies in, you guessed it, hedge funds!

Demystifying Hedge Funds

Investors should not be scared of the term hedge funds as the investment reality is very different from client perceptions. Yes, there have been infamous examples that have caused some trepidation with clients such as the Long term Credit Management (LTCM), the winding down of the Soros' Quantum funds and Robertson's Tiger Asset Management. To liken all hedge funds to LTCM is like saying all Australian shares are like FAI and HIH.

Hedge funds should not be ignored. There are many well-known fund managers that have introduced or are about to introduce hedge funds to the market. They include Deutsche, Colonial First State, Challenger and AXA in addition to Hedge Funds of Australia (HFA) which has been in operation the longest in Australia.

Characteristics of Hedge Funds

Some of the characteristics of hedge funds include:

- The investment managers typically have a large part of their own wealth tied up in the fund with your money.
- Operating with secrecy and lack of transparency is part of the investment set-up as the success of the fund is dependent on the market not knowing the actual positions taken
- Use of short term strategies that may profit from both positive and negative market conditions. They are opportunistic and have a free choice of investment styles and use of derivative instruments
- Remuneration is also derived from performance fees. The manager is therefore more driven to provide good results for clients unlike some managed funds which are more concerned about growing the size of funds under management than performance.
- Leverage (borrowing) can be an essential part of their strategy. This does not mean however that all hedge funds leverage. According to Van Hedge Fund Advisors, 80% of hedge funds use no or low levels of borrowing.
- Size is a critical factor in the performance of hedge funds as it is important to be nimble and responsive to investment opportunities, which is difficult to achieve being a large fund. 60% of all hedge funds are between \$3million and \$500 million in size. Quality hedge funds as a result, are only open to investors for a limited time.

Returns for the periods ending 31 August 2002

	1 month (%)	3 months (%)	6 months (%)	1 year (%)
S&P/ASX All Ordinaries Acc Index	1.81	- 6.67	- 6.77	- 1.15
UBS Warburg Composite Bonds Index	1.03	3.37	3.68	5.16
MSCI World Index (US\$)	-0.03	- 14.25	- 13.89	- 18.58
S&P 500 Index (US\$)	0.49	- 14.16	- 17.23	- 19.19
Hedge Funds				
HFA Diversified Investments Fund (Hedged in A\$ currency)	0.40	1.21	3.50	5.98

Source: Hedge Funds of Australia and Morningstar

* Returns are after all fees and expenses for the HFA Diversified Investments Fund.

The main points to note in the above table within the period selected is that it has been a difficult period for equity markets, in particular overseas shares. In the downturn periods over the last 12 months, you will notice that the hedge funds hold their own. Hence, the diversification benefits of these types of investments during periods of volatility.

Some considerations when investing in hedge funds

Most fund of fund hedge funds available in Australia invest in offshore specialist managers which means that they are exposed to Foreign Investment Fund (FIF) tax legislation. This legislation means that the capital gains generated by these funds will be treated as income in the hands of Australian investors. All returns are deemed to be fully assessable income with no tax rebates or credits attached. To help offset this potentially

negative impact, hedge fund investments can be made more attractive via the inclusion in superannuation where tax is lower compared to personal marginal tax rates.

A second consideration is the less liquid redemption structure that most hedge funds impose on investors in comparison to traditional investments. A large percentage of hedge funds offer minimum redemption liquidity as monthly or quarterly. Usually hedge fund managers look for medium term stability in their investment capital as to allow them to access more investment opportunities without the risk of capital reductions.

Why invest in Hedge Funds?

Hedge funds provide the potential to improve portfolio returns while having the capacity to lower risk within the portfolio. The strong diversification benefits arise because they behave differently to traditional assets like shares and bonds. Most hedge funds seek to make consistency and stability of return their main priority, rather than simply the magnitude of the return.

Hedge funds can provide a viable alternative to investors concerned about the future volatility and overall returns from mainstream investments. Hedge funds are expected to outperform a share portfolio in a flat or falling market. They are a good complement to your portfolio and should be considered in the asset allocation process.

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