Hedge Fund: Heads we win, Tails you lose

Hedge fund, one of the categories of alternative investment funds and a collective investment scheme that invests private capital speculatively by adopting aggressive and advanced investment strategy, can be structured in trust, partnership, LLP (limited liability partnership), PLC (private limited company), etc. It generally creates wealth for the people who run it. It is a private investment fund, promising great reward to people who are willing to take risks and therefore, suitable only for aggressive investors. The author in this article discusses the regulations as issued by the Security and Exchange Board of India (SEBI) while clearing the air on hedge fund strategy and recommends on the subject. Read on…

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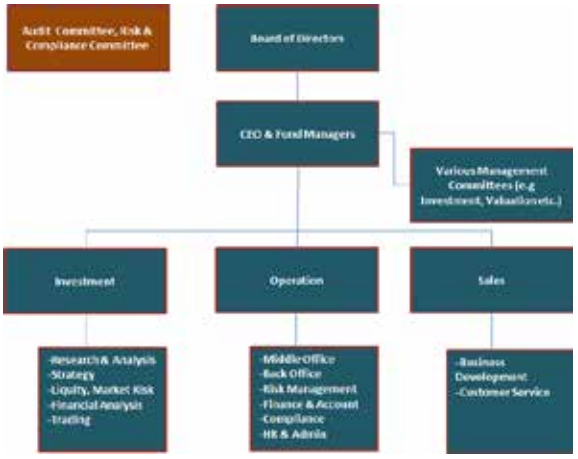
Hedge funds generally create wealth for the people who run it. Some of them might do spectacularly well. This fund is a private investment fund, that promises great rewards to the people who are ready to take great risks. It is a novice in the Indian capital market, but a matured avenue of investment in the western countries. Optimum balance portfolio of investors generally contains stocks, cash, gold, mutual fund, real estate and what are known in financial circles as *alternative investments*. This last category includes approximately 10,000 plus hedge funds having nearly $ 3 trillion assets worldwide, according to an estimate. There are various investment categories under the umbrella of *alternative investment* fund, which means any fund formed as trust, company,

LLP or body corporate which privately pool money from investors with an objective of investing in various avenues, as agreed and disclosed to investors in placement memorandum. Based on the objective of each category, investment patterns are followed.

Hedge fund is one of the categories of *alternative investment* fund and is a collective investment schemes that invest private capital speculatively, by adopting aggressive and advanced investment strategies. This can be structured in trusts, partnerships, LLPs (limited liability partnerships), PLCs (private limited companies), *etc*. Hedge fund is suitable only for those investors who have an appetite for aggressive risks.

Investors are categorised based on their risk profiles, *viz*. conservative, moderate and aggressive. Hence, an investment in hedge fund is permitted only to the restricted number of investors and that number of investors in a scheme, net worth of the investors, *etc*., are governed by the regulations of respective countries. Passive investment vehicle to hedge fund is called fund of hedge fund that is an investment strategy by investing in several different hedge funds spreading risks.



Broader Organisational Structure of Hedge Fund

Why Hedge Fund and How They Make So Much Money?

Adding hedge fund in portfolio gives an opportunity for overall risk reduction and portfolio diversification, and picks the opportunity from market beforehand. This is one of the investment options for investors having high-risk appetite to generate superlative returns in short-term. One may like to find out how hedge fund firms with less than 100 employees can make as much profit compare to tens of thousands of employees in typical service or manufacturing organisation. The probable answer could be: they place very risky and speculative bets, enter and exit out of markets at lightening speeds. One perception about hedge funds is that they bet with illegal insider tips (*e.g.* case of Galleon Capital), front-running trades, sneaking in trades after markets close and so on.

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Fund of Hedge Fund

This is similar to fund of fund scheme in Mutual Fund, where one scheme invests in the other scheme of same mutual fund or other mutual fund as per the scheme document. Fund of hedge fund works similarly where investment is made in various individual funds. Investors can take advantage of the umbrellas of hedge fund strategies of those funds, if fund diversification is properly performed.

Hedge Fund Investment Strategy

Performance is the only survival, let it be hedge fund or mutual fund. Investment strategy should be such that generates returns as envisaged by the fund manager. There is no complete list of hedge fund strategy but broadly it can be classified into the following categories:

- Equity Hedge
- Global Macro
- Relative Value Arbitrage
- Convertible Arbitrage
- Distressed

Hedge fund strategies are more complicated than the way it appears above, since fund managers apply various permutations and combinations linked to strategy. Each strategy is evaluated based on sectoral performance, government policies and regulatory changes, macro environments, *etc.* Hence, it is very important for fund managers to hit the timing for investments in order to generate the expected returns.

Difference between Hedge Fund and Mutual Fund

Hedge Fund	Mutual Fund
Hedge funds are available to investors meeting eligibility conditions stipulated by regulators of the country of the fund.	Mutual fund investment scheme allows participation to all types of investors.
Hedge funds are aggressively managed and allowed to take speculative positions, trading in derivatives, short selling of securities *etc.* Leverage is allowed upto specified limit.	Mutual funds are not allowed to take speculative positions, short sell or leveraging. It is safe investment with limited returns.
Fees of the hedge fund are paid to the fund managers based on performance and it can go as high as, say, 40% of the returns generated.	Asset management fees is restricted by regulator and linked to the assets under management (AUM).
Mildly regulated business	Strictly regulated business
More diversified product in portfolio with high risk-return.	Diversification is limited as per scheme document.
Potential conflict of interest between fund manager and client as fund managers have too much incentive for risk taking, because they take a portion of profits but suffer not very much losses.	Possibility of such conflict is very low as fund manager reward, though majorly determined by performance of the schemes, not directly linked with the performance. Further, asset management company cannot charge more than management fees to the scheme.
Process of full or partial Shadow Accounting is in vogue and adopted by various hedge funds.	Such adoption is not economically viable for mutual funds.

SEBI Regulation on Hedge Fund

The Security and Exchange Board of India (SEBI) issued *Alternative Investment Fund Regulation* on 21 May 2012 categorising alternative investment as Category I, II and III based on fund objectives and investment patterns. Accordingly, regulation defines *Category III Alternative Investment* Fund which employs diverse or complex trading strategies and may employ leverage including through investment in listed or unlisted derivatives such as hedge fund.

Other key features of regulation on *Category III Alternative Investment Fund* include:

- Continuing interest of manager or sponsor in the alternative investment fund not less than 5% of the corpus or Rs. 10 crore, whichever is lower.
- Category III Alternative Investment Fund can be open ended or close ended as per placement memorandum.
- Investment of not more than 10 % of the investible funds in one investee company.
- Allowing to engage in leverage or borrow subject to consent from the investors in the fund and subject to a maximum limit, may be as specified by the Board.
- Mandatory appointment of custodian irrespective size of the corpus.
- Calculation of net asset value (NAV) is independent from the fund management function.
- Disclosure of NAV to the investors at intervals not longer than a quarter for close-ended funds and at intervals not longer than a month for open ended funds.

SEBI also issued a circular on 19th June 2014 containing guidelines on disclosures, reporting and some clarification that include:

a. Disclosure on fees and charges and litigations on sponsor/fund manager;
b. Intimation process whenever changes are incorporated in placement memorandum and provision of exit option to investor (similar to a scheme of mutual fund);
c. Provisions of sharing of loss; and
d. Submission of compliance test report, etc.

Conclusion

Globally, critics of hedge funds say that hedge fund is *heads-we-win, tails-you-lose* value proposition for the investors. Irrespective of market movements, it is money generating machine for the people who run it. This product is new in the Indian capital market. Investors may take time to understand and digest the same. Even mutual fund industry could not penetrate the respected numbers of investors albeit decades old and now in consolidation stage. *Hedge fund business is the best business globally unless you are a client!* ■