

KNOWLEDGE ABOUT HEDGE FUNDS IS A GOOD THING

The buzz around hedge fund investing is growing louder. In a world eager for alternatives to a mostly lackluster equity market, hedge funds seem just the ticket. With approximately 8,350 active hedge funds and almost \$1 trillion in assets, the hedge fund industry is growing its way into many individual portfolios. Having been limited for years to large and sophisticated investors, hedge funds have moved into the mainstream thanks to lower investment minimums for participation and savvy marketing. Are they right for you? Knowledge about how they work can help you decide.

The term hedge fund has evolved from its specific and narrow origins to today's generic description of a private and unregistered investment pool that often utilizes hedging and arbitrage strategies as well as leverage to mitigate market risk. By serving as a hedge to more conventional investments, they do not always correlate to a given investment cycle. This means they have the potential to produce higher returns in down markets but may produce lower returns in boom markets. The first hedge fund was set up in 1949 by an innovative private investor. The idea was to eliminate a part of the market risk involved in holding long stock positions by short-selling other stocks. Early hedge funds were the first to use short sales, leverage and incentive fees in combination. In the mid-1950's hedge funds began to be organized into limited partnerships and then multi-manager funds. In the mid-1980's Julian Robertson and George Soros, among others, ran extremely successful hedge funds that attracted many institutional investors and grew to have enormous clout in the markets. Several now famous crises in the 1990's involved hedge funds, including the 1998 Long-term Capital Management debacle that required a \$3.5 billion government bailout.

Hedge funds are not subject to the numerous regulations that apply to mutual funds for the protection of investors—such as regulations requiring a certain degree of liquidity, regulations requiring that shares be redeemable at any time, regulations protecting against conflicts of interest, disclosure regulations, regulations limiting the use of leverage, and more. This freedom from regulation permits hedge funds to engage in arbitrage and other sophisticated investment techniques to a much greater extent than mutual funds. Fewer disclosure requirements allow hedge funds to be secretive as to holdings and strategies. Many hedge funds are designed to take advantage of arbitrage opportunities or inefficiencies in the markets. Such strategies favor the 'first mover' and require big bets and nimble traders. Participation by smaller investors and recent scandals in the mutual fund industry have caused the SEC and other regulatory bodies to consider paying more attention to hedge funds. Last month saw the US Congress considering whether to require hedge funds to register with the SEC.

The business model for hedge funds is quite compelling. Managers are well compensated for the risks they assume and for the expertise required to execute the various strategies successfully. Many hedge funds charge management fees of around 2% or more and limit the timing of redemptions to maintain liquidity. In addition, hedge fund managers often keep up to 20% of profits for their trouble. With the playing field becoming crowded with talented and successful contenders, those managers able to attract the most assets tend to wield a disproportionate amount of influence on markets. Some industry watchers contend that large banks, who help hedge funds transact business and often hold large stakes in the funds, will be vulnerable to another Long Term Capital Management debacle should things go awry. Hedge funds are not for everyone, but they are worth watching.

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