



## MONEY DUE REWARDS:



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### Hedge Funds – A Brave New World

If you have been reading the financial pages lately, you will have seen the term “hedge funds” bandied around fairly often. It’s one of those fashionable terms people who are “in the know” seem to throw into the conversation just to intimidate you. There are now about 70 hedge funds in Australia, with over \$3 billion of investors funds to play with. But what on earth are they? More importantly, as investors, should we be investing our hard earned cash into them?

The answer is not altogether straight forward. One complication is that there are a number of markedly different types of investment fund, all of which fall under the general category of “hedge fund”. I will describe a few of the more popular ones, to give you an idea.

The main type of hedge fund employs the “long/short equity” strategy. Here, the manager runs a normal share portfolio, but is also allowed the freedom to “short sell” shares if he feels it is appropriate. This entails borrowing the shares, and selling them in the expectation that the price will fall, so that he can later buy them back more cheaply and make a profit. This is more risky than normal short-term share trading because the loss is unlimited if the stock rises. Transaction costs are also higher. The idea of the strategy is to be able to make money in falling markets as well as rising ones.

Another sort of hedge fund is called the “arbitrage” fund, which specialises in finding pricing anomalies in various financial markets, and making money out of them. For example, BHP shares trade on both Australian and London stock exchanges, sometimes at different prices. By selling in one place and buying in another, a hedge fund manager can earn low returns but with very little risk. Arbitrage funds often have high levels of debt funding to improve the rate of return to investors.

A third type of hedge fund seeks to make money out of specific corporate events, such as takeovers or near-insolvency. An example would be where a takeover bid is announced, hedge fund managers will often try to take a stake in the target company, with a view to forcing the bidder into offering a higher price. A fourth type of hedge fund uses economic analysis to guide its investment strategy, and effectively makes bets on future movements in currencies and markets. Finally, there are also multi-strategy hedge funds which may employ or invest in two or more of the above varieties.

The strategies aren’t simple by any means, but there are a few common features which apply to all of the above and are worth remembering. First, they are all highly dependent on the skills of the manager to be able to execute the strategy effectively. As a result of this, hedge funds typically charge management fees which are much higher than other funds, often including significant performance fees for beating their targets.

Secondly, they are generally illiquid. This means that if you want your money back, you will usually have to fill in a form and then wait until the end of the quarter for the cheque to arrive.

Lastly, they all aim to provide to investors stable returns which are independent of the usual investment market cycles, and it is for this reason that so much money has been invested in them in the last few years. The idea of constant returns regardless of the markets is certainly appealing. The main question in my mind, however, with vast amounts of cash presently chasing a limited supply of suitable managers and strategies, is whether or not this “absolute return” will be much better than the cash rate.

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