

## Hedge Fund FAQ

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### • **What are hedge funds?**

Hedge funds are investment funds that generally have the following three features:

Typically set up as private investment partnerships.

The manager uses alternative investment techniques, such as short selling, margin investing and derivatives.

Generally, the fund pursues maximum absolute returns, no matter the direction of the market.

### • **Why is it called a "hedge" fund?**

Hedge funds were conceived as a way to generate positive investment returns regardless of market direction. To that end, hedge funds can sell short, trade in options and futures and use other strategies to hedge against market risk. However, hedge funds have become more varied in style and some, while still called hedge funds, do little to no hedging against market risk.

### • **Who manages hedge funds?**

Until recently, hedge fund managers were often entrepreneurs who would invest a large portion of their own money in one or two funds, and gather additional money from a handful of private clients.

Now, however, a few large mutual fund companies have entered the hedge fund business- partly to stem the loss of top managers to the higher pay of hedge funds, and partly to satisfy investor demand.

- **How are hedge fund managers compensated?**

Managers typically charge a management fee of 1 percent, but they can also be rewarded for how well the fund performs. In some scenarios a hedge fund manager can receive 20 percent or more of the fund's gains, so long as the fund achieves certain return goal first. And remember, hedge fund managers usually invest their own money in the fund as well -- a further reward for positive performance.

- **Who traditionally invests in hedge funds?**

There are strict restrictions on who can invest in hedge funds. Traditional hedge funds are open only to wealthy investors -- generally those who have at least \$5 million in liquid net worth -- and require a hefty minimum investment, often \$1 million or more. What's more, these hedge funds limit the number of investors.

- **What about the new hedge funds that require lower minimum investments?**

Lately, a number of hedge funds have reduced their minimum investment to as low as \$25,000 -- even lower in a few cases. Net worth requirements tend to be lower as well -- generally \$1.5 million. A handful of these new hedge funds are structured just like regular mutual funds. There are also hedge fund of funds, where one hedge fund invests in multiple hedge funds yet is still bought and sold as a single fund.

- **How are these funds able to reduce the price of admission?**

They register under the Investment Company Act of 1940, accepting more regulation and disclosure. In exchange, the fund can target a larger pool of investors, which, in turn, allows a registered hedge fund to reduce its minimum investment. Many registered hedge funds are not publicly offered or advertised -- ask your broker about availability.

- **What strategies do hedge funds use to make money?**

There are a tremendous variety of hedge funds, each pursuing its own strategy. However, some popular strategies fall into three categories:

Relative-value strategies try to profit from inefficiencies in a market or between different markets. Volatility and correlation to the stock market tend to be low. Examples include fixed-income arbitrage, convertible arbitrage and market neutral.

Event-driven strategies try to take advantage of special situations such as mergers and bankruptcies. Volatility and correlation to the market tend to be higher compared to relative-value strategies. Examples include merger arbitrage, risk arbitrage, distressed investing and bankruptcy investing.

Opportunistic strategies are directional and correlate more strongly to the market.

Examples include macro trading, short selling and emerging markets investing.

The above is for illustration purposes only, and is not meant to be an exhaustive list of strategies.

- **What are the some of the risks of hedge funds?**

The possibility of significant losses

Heavy dependence on the manager's expertise

Regulators do not scrutinize unregistered hedge funds' investments for fairness or soundness

There are few requirements for unregistered hedge funds to disclose holdings or performance

Your initial investment may be locked up for the first year—afterward you may have monthly, quarterly or annual access to your money

The potential for style drift

\* Other risks may apply.

• **What are some of the benefits of hedge funds?**

Including hedge funds in a balanced portfolio may help improve overall risk-adjusted returns

Often have a low correlation to the stock market

Managers generally employ a wide variety of investing techniques to pursue absolute returns no matter how the market performs

They may have low volatility compared to the market, except for those employing certain high-risk strategies

Managers receive incentives to perform well, which can further align the manager's interests with those of the investor

A hedge fund of funds seeks to diversify among hedge fund strategies and managerial skill, and provides details about the risks, strategies and performance of the funds it holds.

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