Investcorp Bank BSC
Treasury Department

Hedge Funds

Done by:

Abdulla Eid
Trainee
aeid@investcorp.com

Supervised by:

Jonathan Minor
Head of treasury, principle
jminor@investcorp.com

Table of Content

Introduction:

Hedge funds have become the focus of a great deal of attention over the past five years, both from investors and regulators. For investors, hedge funds have become investment vehicles synonymous with high returns.

Everyone wants to invest in hedge funds once they are convinced that the term is synonymous with 25 percent-plus annual returns. Regulators sometimes act as if they believe that any investment vehicle earning extraordinarily high returns must either extraordinary risk or crooked. So, the reasoning goes, investors, especially the less wealthy ones particularly eager for high returns, must be protected from investing in hedge funds. We will start this paper by defining what is the hedge funds.

Hedge Funds:

A **hedge fund** [1] generally refers to a lightly regulated private investment fund sometimes characterized by unconventional strategies (e.g., strategies other than investing long only in bonds, equities or money markets) and its employed sophisticated hedging and arbitrage techniques to trade in the corporate equity markets.

Today, the term "hedge fund" refers not so much to hedging techniques, which hedge funds may or may not employ, as it does to their status as private and unregistered investment pools.

As we said above hedge fund is private investment limited partnership that invest in variety of securities, there are two types of partners in hedge fund: a general partner who starts the hedge fund and limited partners who supply the most of capital investment.

Fund of Hedge Funds:

A diversified portfolio of generally uncorrelated hedge funds and it may be widely diversified, or sector or geographically focused seek to deliver more consistent returns than stock portfolios, mutual funds, unit trusts or individual hedge funds. Preferred investment of choice for many pension funds, endowments, insurance companies, private banks and high-net-worth families and individuals. Provide more predictable returns than traditional investment funds

Comparison between Hedge funds and Private Equity:

Hedge funds are similar to private equity funds, such as venture capital funds, in many respects. Both are lightly regulated, private pools of capital that invest in securities and compensate their managers with a share of the fund's profits. Most hedge funds invest in very liquid assets, and permit investors to enter or leave the fund easily. Private equity funds invest primarily in very illiquid assets such as early-stage companies and so investors are "locked in" for the entire term of the fund.
Hedge funds often invest in private equity companies' acquisition funds.

Comparison between Hedge Funds and Mutual Fund:

Like hedge funds, mutual funds are pools of investment capital. However, mutual funds are highly regulated by the SEC (U.S. Securities and Exchange

[1] The term “hedge fund” has no official definition.

Commission). One consequence of this regulation is that mutual funds cannot compensate managers based on the performance of the fund, which many believe dilutes the incentive of the fund managers to perform.
Traditionally, hedge funds also distinguished themselves from mutual funds by investment strategy (i.e. merger arbitrage, equity market neutral, but many mutual funds are now offering non-traditional investment styles

Hedge Fund Managers are able to

(1) Invest in any type of Asset in any market.
(2) Use many investment strategies at the same time.
(3) Switch investment strategy very quickly.
(4) Borrow money or (/and) use leverage without being subject to investment company leverage limits.

Historical Note:

The first hedge fund was started in 1949 by Alfred Winslow Jones, an Australian-American sociologist and financial magazine editor who decided to try his hand at investing. His unique investment strategy was to buy stocks with half his investors' money, and sell short with the other half. Short selling a stock is betting that it will go down in value rather than up. By buying some stocks while simultaneously short selling others, Jones was in effect hedging his bets (hence the name.) If the entire market experienced a downturn, Jones could at least recoup some of his losses or ideally turn a profit. With hedge funds, the skill and luck of the manager became the only determining factor in how much money could be made, irrespective of the state of the market.

Hedge Fund Strategies:

1- Convertible arbitrage:
Purchase and sale strategy i.e. purchase convertible securities and at the same time sale the underlying equity.

2- Distressed Securities:
Buys equity, debt, or trade claims at deep discounts of companies in or facing bankruptcy or reorganization, with a view to capturing returns from mispricing of improved cash flow or value.

3- Hedge equities:
Long or short investments in equities and their derivatives and it may be global or country specific, hedging against downturns in equity markets by shorting overvalued stock.

4- Macro:
Aims to profit from changes in global economies typically brought about by shifts in government policy which impact interest rates, in turn affecting currency, stock, and bond markets.

5- Income:
Invests with primary focus on yield or current income rather than only on capital gains. May utilize leverage to buy bonds and sometimes fixed income derivatives in order to profit from principal appreciation and interest income.

6- Equity Market Neutral:
Using statistical techniques and valuation models to capture fundamental inefficiency in equity markets.

7- Risk Arbitrage (Merger Arbitrage):
Trading in equities of companies likely to undergo some merger and acquisition activity and there are two principle types of arbitrage: cash merger and stock merger.

8- Multi-strategy:
Investment approach is diversified by employing various Hedge Fund strategies simultaneously to realize short- and long-term gains.

-Regulatory Environment:

Of course financial regulators have pressed to increase their oversight of hedge fund activities as hedge funds have become more popular and more accessible to less wealthy investors. Most large hedge funds have elected to register with SEC perceiving that the SECs' somewhat onerous regulatory requirements constitute a barrier to entry an industry where such barrier are become increasingly desirable to the owners of existing successful hedge funds.
Ironically, the regulators have arrived to protect small investors from the hedge funds that no longer exist as vehicle yielding extraordinary returns. The typical small American investors wish he could invest in a hedge fund because he has heard that they earn 25 percent a year rather than the 5 to 10 percent available annually from mutual funds. The truth is that most hedge funds no longer earn 25 percent a year and those that do have achieved that result by returning investors money rather than seeking additional investors.

A- SEC:
Investment companies registered with the U.S. Securities and Exchange Commission (SEC) are subject to strict limitations on the short-selling and use of leverage that are essential to many hedge fund strategies. For this and other reasons, hedge funds elect to operate as unregistered investment companies. As a result, interests in a hedge fund cannot be offered or advertised to the general public, and are limited to individuals who are both "accredited investors" (those who have total incomes of over US$200,000 per year or a net worth of over US$1,000,000) and "qualified purchasers" (who own at least US$5,000,000 in qualified investments). Further, any one hedge fund is limited to 499 investors ("limited partners"). For the funds, the trade off is that they have fewer investors to sell to, but they have few government imposed restrictions on their investment strategies. The presumption is that hedge funds are pursuing more risky strategies, which may or may not be true depending on the fund, and that the ability to invest in these funds should be restricted to wealthier investors who are presumed to be more sophisticated and who have the financial reserves to absorb a possible loss.

In October 2004, the SEC approved a rule change, finalized in December, final rule and rule amendments[2], implemented on February 1, 2006, that requires most hedge fund advisers to register with the SEC as investment advisers under the Investment Advisers Act. The requirement will apply to firms managing in excess of US$30,000,000 or more and open to new investors. The SEC has stated that it is adopting a "risk-based approach" to monitoring hedge funds as part of its evolving regulatory regimen for the burgeoning industry. This rule has been

[2] Because of the huge amounts of rule amendments please visit http://sec.gov/rules/final/ia-2333.htm for further information

subject to challenges by U.S. courts: In June 2006, the U.S. Court of Appeals for the District of Columbia overturned it, and sent it back to the agency to be reviewed.

B- ECB[3]:

Banks surveyed with significant exposures to hedge funds usually had specific internal rules or controls covering their dealings with hedge funds. Other banks with less strong links to hedge funds generally relied on various risk committees and established policies to oversee their dealings with hedge funds. In some countries, parent institutions were responsible for the risk management of investments in hedge funds. In some cases, the specific policies were broader and covered either all highly leveraged institutions or all alternative investment vehicles. In those cases where specific guidelines were not in place and banks did not express an intention to develop them, supervisors might consider reviewing banks' connections with hedge funds in order to ascertain whether the scale of hedge fund-related activities warrants any specific internal rules in line with the recommendations of the Basel Committee on Banking Supervision.20 Guidelines usually included a general description of (funds of) hedge funds, due diligence procedures, credit and counterparty risk policies, the risk monitoring framework and legal documentation requirements. In some cases, such documents also included broader information on the hedge fund industry and the bank's position within it or a general business strategy vis-à-vis hedge funds. Some banks also had a dedicated risk management unit within their risk management columns.

In those cases where hedge funds were primarily scrutinised by various risk management committees in the framework of general risk policies, the credit or counterparty risk management units were always involved before and after engaging in lending or trading relationships. New investments often had to be approved by senior management and/or product committees. Moreover, some banks specifically highlighted that they had caps, minimum diversification, maximum concentration requirements or maximum risk levels with respect to investments in hedge funds or other hedge fundrelated activities.

-Where is Investcorp Bank BSC in the Hedge Funds market?[4]

Investcorp, the asset manager specializing in alternative investments, has won the Hedge Fund of Funds Leader of the Year award at the prestigious Alternative Investment News hedge fund industry awards organized by the international publication Institutional Investor.

---

[3] This article is taken from http://www.ecb.int/pub/pdf/other/largeeubanksexposureshedgefunds200511en.pdf

[4] This article is taken from http://www.ameinfo.com/90955.html and it is provided without any statistical issues.

Investcorp's hedge fund team beat four other highly regarded fund of funds on the short list.

The award was presented in New York this week at a ceremony that celebrated the achievements of the hedge fund industry. The awards were judged by a panel of experts from leading institutions including JP Morgan, Goldman Sachs and Bear Stearns. The judges cited Investcorp's penetration of the U.S. institutional market, its growth in assets under management and its new single manager platform as the critical success factors.

Deepak Gurnani and Ibrahim Gharghour, co-heads of Asset Management at Investcorp, both expressed their delight at receiving this recognition.

Deepak Gurnani said:

"It is a great tribute to be recognized by our industry peers as well as by the premier awards in the hedge fund industry. This is testament to the long term achievements of Investcorp's hedge fund business over the past nine years and our success in building a strong business, not least in establishing leading risk management processes to set us apart from other providers.'

Ibrahim Gharghour added: 'This award also recognizes our substantial recent progress in the United States, where we have attracted substantial US institutional money into our programme. In addition, last year, we set up a single manager platform and have already partnered with two high profile groups, Interlachen Capital Group and Cura Capital Management, in order to provide our investors greater variety and access to leading specialist funds.

Investcorp is one of the leading institutional investors in hedge funds with approximately $4.6 billion under management, of which $1.7 billion is proprietary investment.

-What is the latest news about Hedge Fund market?

Early results indicate that hedge funds suffered less damage in June than originally predicted. Of the six strategies in the *Dow Jones Hedge Fund Strategy Benchmarks Index*, only equity long/short suffered a relatively severe fall, down 1.6% on the month, while convertible arbitrage was off by a paltry 0.1%. Distressed securities was flat, but the other three all inched up following May’s fall, with merger arbitrage up 1.1, event driven up 0.3%, and equity market neutral up 0.8%. The strategies made something of a comeback at the tail end of June, but the past month has taken a toll on the 52-week returns, with equity long/short falling from 8.9% at the end of May to 6.3% at the end of June. Four other strategies recorded 52-week drops, except for merger arbitrage which rose 0.8% for the period. Hit hardest in the 52-week returns are convertible arbitrage (down 2.1%), event driven (down 1.2%) and distressed securities (down 1.5%). Meanwhile, Merrill Lynch says hedge funds lost an average of 0.65% in June – about half the May losses, but HFs are still well ahead of the S&P 500 index year to date, 3.8% to 1.8%.[5]

[5] This article is taken from http://www.dailyii.com/article.asp?ArticleID=1042153&LS=EMS79290.

1-Market overview: Structure and Size

a) Hedge Fund Market Structure:

i) Operational Structure:

Hedge funds are usually not operated in-house by their employees. They are just investment vehicles owned by investors and sponsors (or limited and general parents) and rely on external service providers to conduct the funds day-to-day business, including managing the fund portfolio and providing administrative services. So for this type of operation structure, hedge funds establish relationships with all the necessary industry service providers:

1- The sponsors and the investors:
The sponsor is the creator of the fund and he will typically hold a member of the founder shares in the fund; that is as we talked early (page 1) the sponsor will be the general partner and the investor will be the limited partner.

2- The Manager or Management Company:
He/she is responsible for office overhead, and is usually established in a major onshore financial center as London or New York.

3- The Investment Adviser:
The role of investment advisor is simply to give professional advice on the funds investment in a way that is consistent with the funds investment objectives and policies, the investment adviser may be a part of the same overall organization as the hedge fund he serves, or he may be unrelated to it.

4-The board of directors:
The board of directory is responsible for monitoring the overall operations of the fund.

5-The fund administrator:
His primary task is to ensure accurate calculation of the net asset value at regular time interval called break periods.

6- The Custodian:
The custodian's primary responsibilities include safekeeping of the fund's assets, clearing and settlings all trades and monitoring corporate actions such as dividend payments and proxy-related information.

7- The legal advisor or lawyer:

The legal adviser or lawyer assists the hedge fund with any tax code and/or legal matters, and ensure compliance with domestic investment regulations as well as with regulations of countries where the fund is distributed.

8- The auditors:
The auditors' role is to ensure that the hedge fund is in compliance with accounting practices and any applicable laws, and to verify the annual financial statement, if any.

9- The registrar and transfer agent:
He/she keeps and updates a register of shareholders of the hedge fund. He also processes and takes necessary actions for subscriptions and withdrawals of shares in the fund, as well as for the payment of any dividends and distributions.

10- The Prime Broker:
The role of prime brokers goes beyond just replacing the hedge funds back office. Rather, they should be seen as full service providers across the core functions of execution and operation for example:
- Clearing the trades.
- Acting as global custodian.
- Margin financing.
- Securities lending.

Terminology:
"Soft dollar" and "hard dollar" refer to the payment of services by investment advisers. When the payment is made using the adviser's own funds, the industry talks of hard dollars. When investors subsidize these payments, the industry talks of soft dollars.

ii) Organization Structure:

Hedge funds also need to set up efficient organizational structures.

1- Side-by-side and master/feeders:
In side by side structures, also called mirror funds or clone funds, several funds having identical or substantially similar investment policies invest in parallel in a group of cloned portfolio. These portfolios usually share a common investment adviser, portfolio managers and a custodian or administrator, and the cloning process essentially consists in facilitating bunched trades among the cloned funds and rebalancing cloned funds that have experienced different cash flows.

The master/feeder structure is an efficient alternative to side-by-side funds. In this structure a series of funds (called feeders) sell shares to investors under the terms of their prospectus and contribute their respective proceeds to another fund (called the master fund) rather than investing directly.

2- Managed accounts.
3- Umbrella funds.
4- Multiclass/Multiseries Funds.[6]

b) Hedge Fund Market Size:
If we are going to talk about how big is the hedge fund industry, then it will definitely a question without an accurate answer because as we know that SEC doesn't regulate hedge fund i.e. hedge fund are not required to register but the SEC estimates, however, that there are between 6,000 and 7,000 funds that manage approximately $600 to $650 billion in assets. The report predicts that in the next five to 10 years, the assets invested in hedge funds will exceed $1 trillion.

And that is wonder us to know why hedge fund is exempt from SEC regulations, the answer is simply is of the hedge funds are only offered to wealthy individuals and institutions. A combination of statutory provisions and rules under the 1933 Act and the Investment Company Act for private rather than public offerings allow for them — and the securities they issue to investors — to remain unregistered. Many funds use the safe harbor in the 1933 Act that allows them to sell to "accredited investors." These are individuals with an annual income of $200,000 or more, married couples with a joint income of $300,000 or more, or individuals with a net worth of $1 million.

[6] For further information please consult *Hedge funds* by Lhabitant

2- Key Players

We can divide the key players in two categories, buyers of hedge funds and provider of hedge funds.

a) Buyers of Hedge Funds:
Current ownership is divided between Wealthy individuals (High Net Worth Individuals or HNWI) and institutions. And it is divided as follows:
- US HNWI and Europe HNWI.
- US Insurance, US Pensions, Europe insurance, Europe Pensions and US non-profit.

Now let us have a close look for wealthy individual,

Wealthy individual:
Wealthy individuals (High Net Worth Individuals or HNWI) – individuals with assets in excess of US$ 1 million - account for over 60% of the approximately $600bn invested in hedge funds. There are signs that hedge funds are becoming a standard element in HNWI – not just super wealthy – portfolios.

b) Provider of Hedge Funds:

1- Very high fees and very high profitability. The typical hedge fund manager charges a management fee in excess of 1% (versus 40-50 bp on the typical long only portfolio) and usually is entitled to 20% of the profit if a certain target return is exceeded.

2- The vast majority of hedge fund managers are located in North America – largely in the New York and Los Angeles areas. But in Europe – London particularly- a large number of companies are starting up. Anecdotal evidence suggests US managers are opening in larger scale in London.

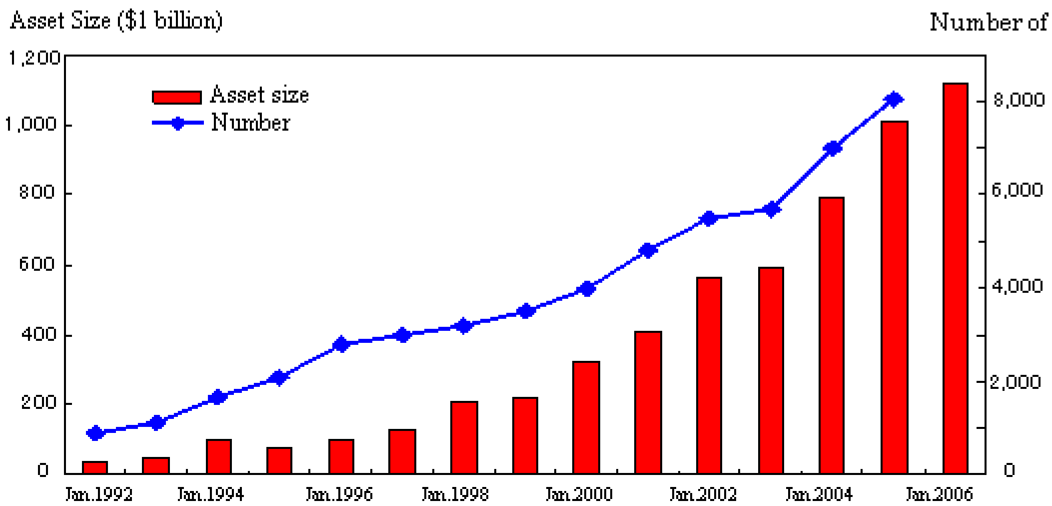
3- Most advisors noted a specific life cycle for hedge funds. New start ups, to be viable, had to raise about $20m. If performance is good the fund re-opens 12 months later and grows to $60-100m. If performance is sustained, a further 12 months on, the fund can re-open and grow to $300-600m. But in practice few funds grow beyond the $25-30m size.

4-The credibility of the investment decision making process is critical to fund-raising. The investment managers must have considerable experience and those with good reputations can raise $250m at launch. Experience in short selling is critical as are robust risk control measures. There are signs that with the amount of institutional money facing the market, standards and expectations on managers are falling.

Also we can consider the players in the previous section as key player in Hedge fund even though some of them are not directly involved in such things.

3-Competitive Positioning

The hedge fund market has been growing dramatically in recent years. According to the survey conducted by an American hedge fund research company, the size of hedge fund market--which was worth US$324 billion in early 2000--exceeded US$1 trillion for the first time by early January 2005, and is still growing **(refer to the following figure)**.



(Source: Hennessee Group LLC. Data on the number of funds in Jan. 2006 is yet to be obtained.))

Risk of Hedge Funds:

1- Political risk. When an investment is made in a foreign nation and under the laws and sovereignty of that nation, the risk is loss due to possible nationalization.

2- Transfer risk. This occurs when a foreign government restricts the delivery of a foreign currency.

3- Settlement risk. A dispute between the parties to a contract could prevent the fulfillment of the contract in accordance with its stated terms.

4 -Credit risk. This happens when the counter party to a contract does not perform due to insolvency.

5- Legal risk. This occurs when the contract is declared unenforceable due to legal problems.

6 -Market risk. Market movements can cause losses.

7 -Liquidity risk. This occurs when a market dries up and it becomes impossible to liquidate a position.

8- Operations risk. Clerical errors can cause risk.

1-Top companies in Hedge funds:

Goldman Sachs. (The biggest hedge funds)
JP Morgan Asset Management Fund of hedge funds - JPMorgan Chase.
DB Hedge Fund Group vs. BSAM - Deutsche Bank.
Morgan Stanley Bank

Examples:

1- Morgan Stanley Bank:

Balance Sheet and Other Operating Data:	**05**	**04**	**03**	**02**	**01**
Total assets	$ **898,523**	$ 747,334	$ 602,843	$ 529,499	$ 482,628
Consumer loans, net	22,916	20,226	19,382	23,014	19,677
Total capital[3]	125,891	110,793	82,769	65,936	61,633
Long-term borrowings[3]	96,709	82,587	57,902	44,051	40,917
Shareholders' equity	29,182	28,206	24,867	21,885	20,716
Return on average common shareholders' equity	17.3%	16.8%	16.5%	14.1%	18.0%
Average common and equivalent shares[2]	1,049,896,047	1,080,121,708	1,076,754,740	1,083,270,783	1,086,121,508

2- Deutsche Bank:

Balance Sheet in € m.	**2005**	2004	2003	2002	2001
Total assets	992,161	840,068	803,614	758,355	918,222
Loans, net	151,355	136,344	144,946	167,303	259,838
Liabilities	962,225	814,164	775,412	728,364	878,029
Total shareholders' equity	29,936	25,904	28,202	29,991	40,193
Tier I risk-based capital (BIS)	21,898	18,727	21,618	22,742	24,803
Total risk-based capital (BIS)	33,886	28,612	29,871	29,862	37,058

3- Goldman Sachs:

Balance Sheet in $ m.	**2005**	2004	2003	2002	2001
Total assets	706,804	531,379	403,379	355,574	312,218
Long term borrowing	100,007	80,696	57,482	38,711	31,016
Liabilities	678,802	506,300	382,167	336,571	293,987
Total shareholders' equity	28,002	25,079	21,632	19,003	18,231

2- Top money manager in Euro[7]:

RANK		FIRM	TOTAL ASSETS UNDER MANAGEMENT (€ MILLIONS)	
2004	2003		2004	2003
1	1	**UBS**	**€1,457,640**	€1,416,853
		(Zurich, Switzerland)		
		UBS Global Asset Mgmt	386,669	368,744
2	3	**BARCLAYS GLOBAL INVESTORS**	**1,002,042**	846,930
		(London, U.K.)		
3	2	**ALLIANZ GROUP**	**977,586**	*950,388*
		(Munich, Germany)		
		RCM	83,091 [4]	—
		Nicholas-Applegate Capital Mgmt	10,642	14,418
4	4	**AXA GROUP**	**869,000**	775,000
		(Paris, France)		
		Axa Financial	438,428	404,922
		Axa Investment Managers	346,405	292,369
5	5	**CREDIT SUISSE GROUP**	**823,793**	769,295
		(Zurich, Switzerland)		
		Credit Suisse Asset Mgmt	250,514	253,347
6	6	**DEUTSCHE ASSET MGMT**	**536,100** [7]	566,930
		(Frankfurt, Germany)		
7	7	**ING GROUP**	**491,853**	462,665
		(Amsterdam, Netherlands)		
		ING Investment Mgmt Americas	163,151	166,957
		ING Investment Mgmt Europe	123,358	196,376
		ING Investment Mgmt Asia/Pacific	56,659	43,115
		ING Real Estate	32,967	28,326
		Baring Asset Mgmt	25,411	27,891
8	8	**AVIVA**	**385,626**	339,996
		(London, U.K.)		
		Morley Fund Mgmt	182,130	157,431
		Delta Lloyd Asset Mgmt	47,000	41,044
9	9	**IXIS ASSET MGMT**	**370,958**	314,575
		(Paris, France)		
10	16	**CRÉDIT AGRICOLE ASSET MGMT**	**355,100** [8]	216,696

3- Top money manager in US:

RANK			TOTAL ASSETS UNDER MANAGEMENT ($ MILLIONS)	
2004	2003*	FIRM	2004	2003
1	2	Barclays Global Investors (San Francisco, CA)	$1,361,949	$1,070,200
2	1	State Street Global Advisors (Boston, MA)	1,347,760	1,100,264
3	3	Fidelity Investments (Boston, MA)	1,035,126	963,986
4	4	Capital Group Cos. (Los Angeles, CA)	1,020,750	814,006
		Capital Research and Mgmt Co.	703,431[1]	532,345

[7] All the statistic is from http://www.dailyii.com/rankingsGateway.asp?pageID=269 and any other ranking can be easily found there with is statistics and for short we will just put these 3 examples.

		Capital Guardian Trust Co.	162,136	146,147
		Capital International Ltd.	81,038	61,296
		Capital International Inc.	48,046	47,407
		Capital International S.A.	13,980	16,437
		Capital International K.K.	12,119	10,374
5	7	J.P. Morgan Asset Mgmt (New York, NY)	791,185	558,998
6	8	AXA Group (Paris, France)	654,038[2]	547,069
		Alliance Capital Mgmt	538,764	474,747
		AXA Rosenberg Investment Mgmt	56,024	38,814
7	6	Mellon Financial Corp. (Pittsburgh, PA)	640,738	588,968
		Standish Mellon Asset Mgmt	207,103	188,973
		Dreyfus Corp.	124,498	133,818
		Mellon Capital Mgmt Corp.	114,772	95,835
		Boston Co. Asset Mgmt	49,554	36,356
		Mellon Private Wealth Mgmt	47,654	47,408
		Newton Capital Mgmt	42,095	38,030
		Franklin Portfolio Associates	26,641	21,197
		Mellon Equity Associates	20,100	19,459
		Pareto Partners	3,535	—
8	5	Citigroup (New York, NY)	615,632	608,985
		Citigroup Asset Mgmt	513,667	521,488
		Travelers Life & Annuity	45,972	41,171
		Citigroup Alternative Investments	28,020	22,711
		SB Portfolio Mgmt Group	27,971	23,614
9	9	Vanguard Group (Valley Forge, PA)	582,082	503,347
10	12	Northern Trust Global Investments (Chicago, IL)	571,883	478,600

4-Top 10 in Equity Hedge Funds:

2005	2004	overall	
1	2	1	Lehman Brothers
2	1	5	Morgan Stanley
3	7	4	Bear, Stearns & Co.
4	6	2	Merrill Lynch & Co.
5	3	3	Citigroup
6	4	6	Credit Suisse
6	5	7	Goldman, Sachs & Co.
8	10	10	Banc of America Securities
9	9	8	UBS
10	8	—	J.P. Morgan Securities

4-Key Opportunities and Challenges

For US market, the period after the NASDAQ market collapse in March 2000 witnessed the start of the largest growth era for hedge funds. With investors disillusioned with the stock market, real estate and hedge funds became the new darlings. For most middle-class American households, real estate dominated. Us tax laws had been changed in 1997 so that a household could keep, tax free, up to a half million dollars of capital gains on the sale of a house. That process could be repeated every two years with the result that many American households have elected, with the help of favorable tax treatment not only on capital gains but interest expense on owner-occupied housing, to use real estate as their major vehicle of wealth building.

Outside of real estate, pension funds have been charged with building and preserving the wealth of a huge baby boom generation approaching retirement age. The financial assets of American households, or total assets excluding real estate and durable goods, stand at about $38 trillion, having grown by a multiple of 2.6 at an annual rate of nearly 7 percent since 1990.

While real estate assets have outstripped financial assets in terms of their rate of return over the past five years, there will probably be lower returns on real estate going forward in view of the fact that house prices relative to income are two to three standard deviation (standard deviation is define as the average distance between any data to the mean of that data and it is equal to

$\sigma = \sqrt{\frac{\sum_{i=1}^{n}(x_i - x_{avg})^2}{n}}$)above normal in many real estate markets. With the US stock market rising only at a moderate rate managers of financial assets including hedge funds, are seeking ways to earn 8 to 10 percent returns on the huge $38 trillion pool of financial assets owned by American households.

Unfortunately, hedge funds have been labeled by many as the vehicle that will provide high returns on this hedge body of investable wealth. Yet hedge funds are limited in their ability to accommodate such large asset holding while preserving higher returns. It is in this sense that the very existence of hedge funds, as originally constituted, has disappeared under the weight of their extraordinary growth over the past five years. Today, hedge funds are estimated to be managing about a total of $1 trillion or about <u>7%</u> of total US financial net worth: less when it is recalled that many foreign investors are included in the $1 trillion hedge funds total. Still, return to large hedge funds, those with over $3 billion under management , are averaging between 10 and 15 percent annually, still high relative to current low single-digit returns on US equity markets, but really just a reflection of the hedge funds' aggressive inclination to invest in more rapidly rising foreign stock and bond markets.

Some of the most successful hedge fund managers (in the business since the 1980s) have reduced their overall funds to manage $5 to $10 billion. The result is that hedge fund managers are electing to earn a higher rate of return for themselves and their investors. Taking in more money essentially dilutes the return available to hedge fund managers on their own accumulated wealth, which sometimes amounts to more than half of the money under management. In one case, James Simon, a remarkably successful hedge fund manager employing mathematical technique, has returned all of his investors' money, apparently believing that he can maximize his own wealth by applying his strategies only to the substantial amount of capital that he owns. The reason: the rate of return falls as the amount of money under management rises above some level, say $5 billion. So, if you have $5 billion of your own money to invest in your own hedge fund, there is no reason to invest on behalf of other investors.

References:

1- Francois-Serge Lhabitant. *Hedge Funds*, John Willy and sons LTD. 2002.
2- http://en.wikipedia.org/wiki/Hedge_funds
3- *Hedge Funds: Origins and Evolution* by John H.Makin .AEI may 15, 2006.
4- SEC regulations about Hedge Funds can be found here
http://www.sec.gov/news/studies/hedgefunds0903.pdf
5- http://www.abanet.org/buslaw/blt/2004-05-06/reid.shtml
6- http://www.magnum.com/hedgefunds/abouthedgefunds.asp#hedgefund
7- The differences between Hedge Funds and Mutual funds
http://www.ici.org/funds/abt/faqs_hedge.html
8- www.dailyii.com
9- Annual Report 2005, Goldman Sachs:
http://www.gs.com/our_firm/investor_relations/financial_reports/annual_reports/2005/pdf/Page_23-103_Comp_Fin.pdf
10- Annual Report 2005, Morgan Stanley Banks:
http://www.morganstanley.com/about/ir/annual05/form10k.html
11- Annual Report 2005, Deutsche Bank:
http://annualreport.deutsche-bank.com/2005/ar/supplementaryinformations/fiveyearrecord.php
12- http://www.uiowa.edu/ifdebook/faq/Hedge.shtml
13- http://www.imf.org/external/pubs/ft/fandd/2006/06/basics.htm
14- http://www.imf.org/external/pubs/ft/issues/issues19/index.htm
15- http://www.law.harvard.edu/programs/pifs/pdfs/tony_hanlon.pdf
16- http://www.hedgefundtips.org/overview.htm
17- http://www.marketwatch.com/News/Story/Story.aspx?dist=newsfinder&siteid=google&guid=%7B342BDBF1-E40E-4F6B-A57E-B1001D9BBFFC%7D&keyword=

Useful Websites:

1- www.investcorp.com
2- SEC US Securities and Exchange Commission, http://www.sec.gov
3- ECB European Central Bank www.ecb.int
4- London Stock Exchange www.londonstockexchange.com
5-Deutsche Bank www.db.com
6-The Mexican Financial Crisis in
http://www.uiowa.edu/ifdebook/ebook2/contents/part3-III.shtml
7- http://library.findlaw.com/2006/Feb/10/246331.html
8- www.wikipedia.com
9- www.thehfa.org
10- www.wikipedia.com