OVERVIEW OF THE HEDGE FUND INDUSTRY

HILLSDALE
INVESTMENT MANAGEMENT INC.

Definition

The term 'hedge' is defined as a protective maneuver. In the investment industry, a hedge is a transaction intended to reduce the risk of loss from an adverse price fluctuation of an asset. A hedge fund is a pooled investment portfolio that aims to hedge or to be largely insensitive to market fluctuations.

Size and Scope

Regulations are largely silent on the topic of hedge funds and as the industry enjoys a tremendous amount of discretion in its operations, use of investment vehicles and selection of investment strategies.

Given the limited regulations and the ease of entry, the industry is characterized by small entrepreneurial firms with fund managers who typically have a substantial amount of their own personal wealth invested in their products. While the barriers to entry for the industry are low, the initial investment requirements are not. An initial minimum investment of $ US 1 million is common, industry wide minimums are usually no lower than $ US 150,000.

The initial emphasis of the industry was on equity focused funds. Today, managers utilize bonds, convertible bonds, mortgage-backed securities, options, warrants and an ever-expanding array of derivative products to manage their funds. Most also utilize leverage to further enhance overall returns.

While the majority of managers reside in the United States, several are located overseas or offshore. Due to limited regulations and the complex nature of some investment strategies, fund reporting whether asset, performance or financial can be irregular. Additionally, fund managers tend to closely guard their investment strategies and holdings, making it difficult for clients to identify or monitor how assets are being deployed. Industry figures estimate that there are over 3500 funds in operation worldwide with assets of over $US 300 billion. Over the past ten years, asset growth has been counter cyclical to equity returns.

Market

The largest single category of investors, representing over 60% of the market, has been high net worth individuals. Fund of funds and pensions and other qualified plans, each representing approximately 15% are the next largest categories of investors. Today, pension plans and endowments have significantly increased their allocations to hedge funds, with one of the largest pension plans recently increasing its maximum exposure to 25%. As the institutional segment grows in size, clients are beginning to demand greater transparency and more formal performance and risk reporting.

Objectives and Categories of Hedge Funds

A hedge fund offers investors five differential features: higher returns, consistent return profiles, consistent risk profiles, non-correlated return profiles and / or profit opportunities in a down market. Despite recent press coverage, most are not wildly speculative instruments. Often hedge funds have less risk than that of the market as a whole. Importantly, unlike index or more actively managed funds which follow markets and are largely correlated, hedge funds offer investors an opportunity to build a portfolio that has a non-correlated return profile and hence a very different risk profile. Most hedge funds have a performance benchmark that is unique to the fund and is derived directly from its objective and investment strategy.

Hedge funds can be grouped into five broad categories.

1) Equity Based: An equity based hedge fund will use equities, options, warrants, derivatives and short selling to derive a profit
2) Short Seller: A short selling hedge will utilize only directional short selling to derive a profit.
3) Global / Macro: A global / macro hedge will utilize equities, futures, options, currencies or debt instruments in local or global markets to derive a profit
4) Relative Value / Arbitrage: A relative value/arbitrage hedge will utilize mergers, bond hedging, convertible arbitrage and long/short equity to derive a profit.
5) Event Driven / Opportunistic: An event driven or opportunistic hedge will seek to profit from a specific event, either current or anticipated to derive a profit. An event could be an active takeover, expected rate increase, change in commodity price, anticipated change in governing party, etc…

Categorization of Equity Hedge Funds:

Equity hedge funds can be grouped into three categories:

Market Neutral: A market neutral fund will run two equally weighted portfolios, one long and one short, in an attempt to neutralize the impact of the market on the fund.

Directional: A directional hedge runs with a bias of either net long or net short to the market depending on which direction the manager believes the market is moving.

Sector: A sector fund will run either neutral or directional within one or a very limited number of industry groups.

For any of the above, a manager may overlay a trading strategy or use option and derivative instruments.