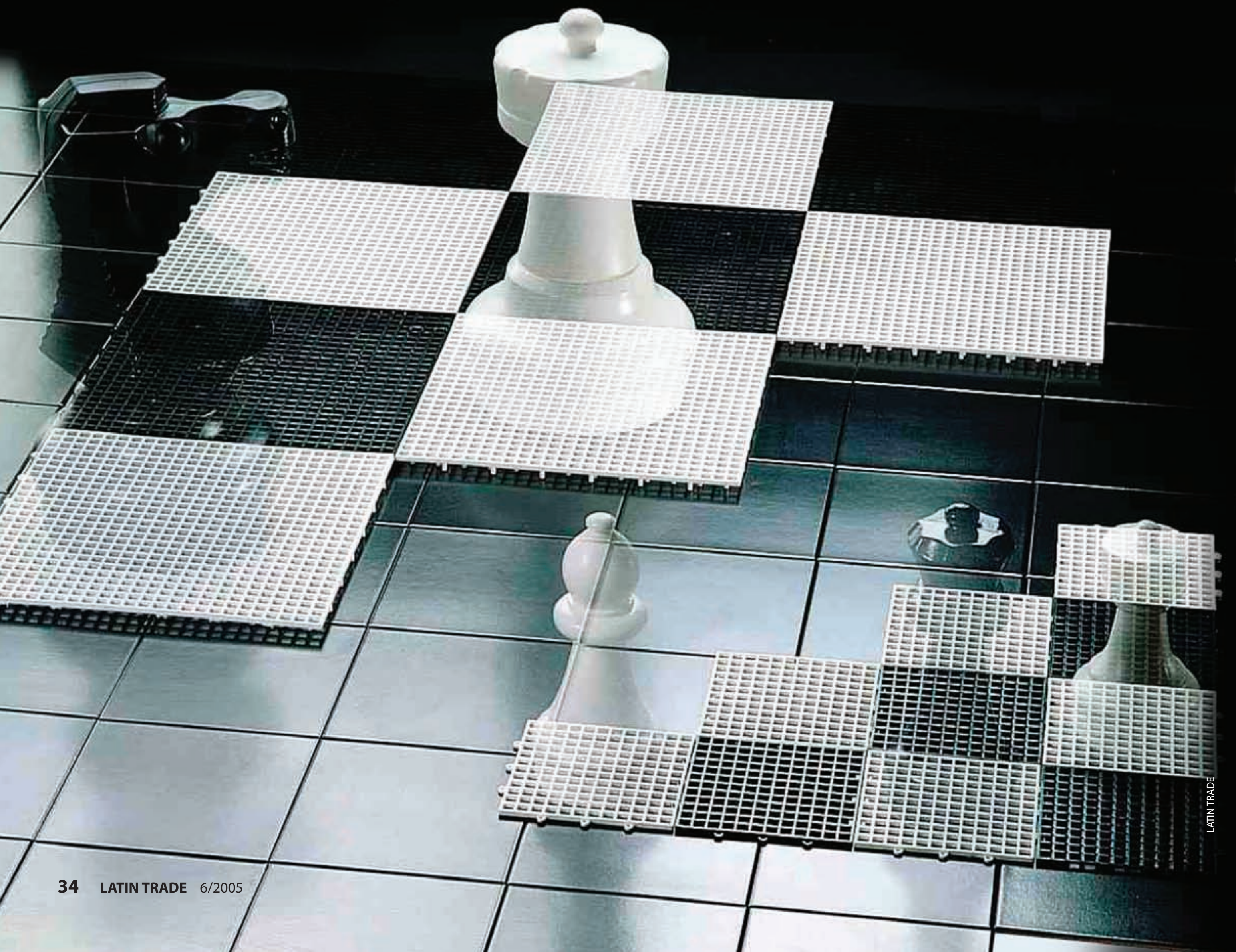
PLAYER'S CLUB

Hedge funds, once an investment alternative for the super rich, boom across the globe as investors take on risk.

FORREST JONES • MIAMI



LATIN TRADE

Hedge funds, once the mysterious financial playground of Hollywood types, globetrotting Wall Streeters and the Aspen ski crowd, are fast becoming accessible to simply high-income individuals.

Unlike an ordinary investment fund, hedge funds use sophisticated—and almost entirely unregulated, even unexplained—strategies to counterbalance simultaneous exotic trades around the planet, with the aim of being just ahead of the market. Russian currency, oil futures, shorting stocks, whatever is trading hot and fast is a target, and the brains behind the desk race to make bets and clear out before the rest of the market rationalizes whatever information is coming into the equation.

It's the financial equivalent of rocket science, highly leveraged, and can be very high risk if the bets are suddenly and disastrously wrong. Or, they can be an astounding source of nearly instant wealth. "When you invest in a hedge fund you are investing in that manager's skill," says Tom Hayden, manager of Chaparral Capital, which manages US$10 million in U.S. and offshore funds.

Throughout the past 18 years, Hayden says, markets have been bullish. Hedge funds will need talented managers to keep posting healthy returns in the coming years, he says. Whether the amount of talent is out there or not, the number of hedge funds investing across the globe shot up by more than 390% since 1994 to 8,050, according to the Hennessee Group, a consultancy for the hedge fund industry. Assets under management during that time jumped 843% to $934 billion—well above the gross domestic product of Brazil.

In five years since 1999, according to the CSFB-Tremont Hedge Fund Index, such funds have posted an average annual return of 6.29%. Dow Jones has tracked hedge funds as an index since 2001, and returns range from more than 9% to a stunning negative 20%, depending on levels of risk. Morgan Stanley Capital International's hedge index posted 8.15% since beginning in July 2003.

Meanwhile, the Van Hedge U.S. Fund Index shows returns since 1988 of 17.3%. Comparatively, the Morgan Stanley Capital International World Equity Index averaged 6.6%, while the S&P 500—a broad U.S. stock index—returned 12.4%. Plain vanilla mutual funds, the kind most ordinary people buy for retirement planning, returned 10% in that period, according to Van.

All this seems exciting compared to historic U.S. stock index returns of 7%. Of course, some funds—just like some stocks—post huge returns, and make their individual shareholders rich in the process. Others implode and leave scarred, sorry investors, to date mostly rich people who theoretically should have known better.

So who would want to put their money into such a venture? A lot of people, it seems, and that's driving hedge funds toward less-sophisticated individual retail investors. According to a 2004 study conducted by the Bank of New York and consultancy Casey, Quirk & Acito, U.S. institutional investors such as pension funds will have $300 billion invested in hedge funds by 2008.

Last year, institutional investors had just $60 billion in hedge funds. "In the past five years or so, hedge funds are becoming widely accepted by institutional investors as a core investment strategy," says David Friedland, president of U.S. investments at Magnum, an Aventura, Florida hedge fund manager with $250 million under management.

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Offshore. A hedge fund is an unregulated pool of money that can invest in pretty much whatever its managers want. The fund can operate in one country, such as the United States and be registered elsewhere, like the Bahamas. For the most part, U.S. investors invest in U.S.-registered funds, although U.S. institutions can more easily invest in offshore funds. A fund's manager crafts an investment strategy and often welcomes a limited number of investors to go in.

Unlike mutual funds, hedge funds can invest in risky assets and rely on little regulated financial tools such as short

Risk and Reward

Do you have what it takes to be a hedge fund investor? Consider this:

UNREGULATED: U.S. stock market regulators limit membership in U.S. funds, so far, to "sophisticated" investors—those with $1 million net worth and $200,000 annual income. Some basic rules are due in 2006.

UNACCOUNTABLE: Although the most famous hedge fund collapse—Long Term Capital Management's dizzying mess in 1998—resulted in a private bailout, most funds are unlikely to get help if things go sour. Not your father's mutual fund.

UNBORING: Much like stocks in the 1990s and bonds in the 1980s, hedge fund traders live on the edge and trade in a lot of macho moves to make their money. That's great, if you can manage not to watch too closely, or have an iron stomach.

selling and derivatives, once the sole province of a small group of trading pros who could take the losses if necessary. The manager is not required to disclose much information to the investors, or even to regulators. In the United States, for instance, a potential hedge investor must prove net worth of $1 million or individual income of at least $200,000 for two years, a regulation put in place by the U.S. stock market regulator, the Securities and Exchange Commission (SEC). The manager gets a chunk of the profits and often he or she has his or her own money invested in the fund.

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Despite the buzz in investing circles, the news surrounding hedge funds has not always been good. In 1998, hedge fund Long Term Capital Management—a fund with Nobel Prize winners on its board and an accompanying rock-star status among wealthy and well-known people—went under, prompting the U.S. Federal Reserve to arrange 15 private institutions to bail it out at a cost of $3.50 billion.

But it’s not all bad news. Some funds do well, really well, if the individual investor is ready to put in money he or she can afford to lose. “You’ve got a lot of offsets that a mutual fund doesn’t have,” says Howard Schachter, who manages a $50 million long-short equity fund, Schachter Capital Management.

Mutual funds are often compared against one another in terms of returns because they often manage similar operations. If a mutual fund investing in healthcare stocks is down by 11% while the industry average is down 13%, that fund has outperformed the market, despite losing money, Schachter says. Since a hedge fund operates on its own models and guidelines, its manager doesn’t have the luxury of blending in with the crowd—they should make money or get out. “If a hedge fund is down 11%, I don’t care what its peers have done because he’s done poorly,” Schachter says.

Schachter’s fund, for instance, is made up of his own money and that of five other investors. He says hedge funds can offer advantages that more traditional funds cannot, such as the ability to trade in financial derivatives—leveraged investing based on assumptions about stock or currency moves to come, in the same way a farmer might sell a crop in advance and the buyer, in this case a futures trader, either wins or loses if the price rises above or falls below the agreed price.

Also, a hedge fund can engage in short selling. In this scenario, an investor borrows shares expected to go down in value, sells them and then repurchases them after the price falls—often using little cash down, that is, in a leveraged way. Hedge funds can also engage in arbitrage, which involves buying and selling financial instruments in different markets to profit from the difference between prices.

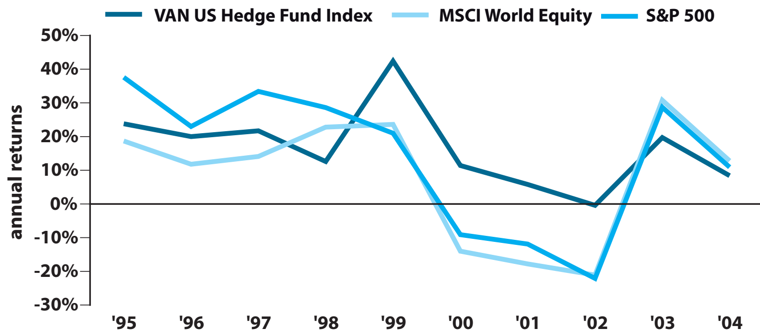
For the potential investor, research is key. The SEC warns that it will only begin to regulate hedge funds in a limited way in February 2006. Meanwhile, funds of funds—funds investing in other hedge funds—are starting to accept investors with as little as $25,000. Chances are pretty high that if your own financial advisor hasn’t mentioned them to you, he or she will soon.

Strategy. Since there is so little information to find, investors must read all fund promotional materials and prospectuses and meet with a fund’s managers, experts say. “You’ve got to do some homework,” Schachter says. “You really need to find what you want and find the manager that does what you want.”

It’s hard to get truly reliable third-party analyses of hedge fund performance. Big risk-ratings agencies such as Moody’s do not rate hedge funds. Since

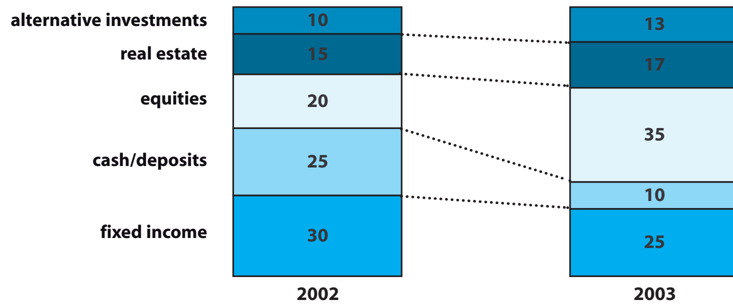
Happy Returns

Hedge funds are promising, if you can pick the right managers.



SOURCE: Van Hedge Fund Advisors International

high net worth Individuals’ asset allocations (average %)



SOURCE: Capgemini/Merrill Lynch study of wealthy Latin Americans

such funds don't have to disclose financial data, there's nothing to rate, says Lisa Tibbitts, a Moody's spokeswoman. "We can't say something on a group of entities we don't rate," Tibbitts says.

Funds can vary dramatically. Funds of funds blend risk levels of the various hedge funds inside them, with the goal of offsetting risk. The blend is designed and carried out normally by a small number of managers and is decided at the fund's inception. Whether you are investing in a hedge fund or a fund of funds, however, you are still investing in an individual strategy—and one that's not necessarily easy to predict.

Salomon Konig, a senior partner at Global Partners Group, manages such a fund of funds. Their Market Wizard XL fund, for example, reports a 13.12% rate of return, one Konig calls "safe" since it is blended: If a single hedge fund tanks, the investor in that fund alone loses big. But if a fund of funds has invested in it, it might only lose a small percentage of its total portfolio. "Investing in a single fund is a very dangerous thing to do," Konig says. Overall, Global Partners Fund manages $300 million in assets.

The Market Wizard XL fund invests in moderately risky hedge funds, those producing returns of 9% a year. A fund of funds might require a lower initial investment of $100,000; a single hedge fund, by comparison, could require as much as $5 million upfront, Konig says. Waving around $100,000 doesn't raise many eyebrows in the hedge-fund industry. Still, potential investors must listen up to find where the good returns are, because many hedge funds perform poorly. "Out of 900 funds, there are 70 good funds of funds," Konig says.

In Latin America, hedge funds are not hard to find. In Brazil, Fox Growth Fund manages $80 million in assets. Launched in 1999, it aims to produce at least a 20% annual return on investments. The fund invests in currencies and in equities in established markets such as in the United States as well as in emerging markets, including in Brazil. "We try to be local with a global view," says Orlando Pinto Coelho, chief investment officer at Fox. Coelho and partners created Fox by investing their personal savings.

Business has also been good for those servicing the industry. EquityStation, for instance, provides an online trading platform. Funds use it to connect electronically to markets around the world. The company's trading systems give hedge funds in Latin America and elsewhere the same access to markets that U.S. investors would have, says Jody Giraldo, vice president for hedge fund services at EquityStation in Boca Raton, Florida. More hedge funds investing across the globe means more business. "We have seen new managers every day," says Giraldo.

Lukewarm returns in traditional markets over the past few years have prompted investors to pump their money into hedge funds rather than traditional investment vehicles. With pension funds looking to invest more into

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hedge funds, rich individuals are going to do the same. Global investment trends show that high net-worth investors—who generally moved into conservative investments after the dot-com collapse—are now willing to take on more risk.

According to a 2004 report on wealthy investors compiled by investment bank Merrill Lynch and consultancy Capgemini, high net-worth individuals traded out of safer cash positions during 2003 for added equity investments, which bring greater risks, raising exposure to 35% of total investments from 20%. The report also found that high net-worth individuals in 2003 allocated 13% of their assets in even riskier so-called "alternative" investments, which include hedge funds, up from 10% the year before.

The Merrill Lynch study also reported that hedge fund positions held by private clients in Asia, Europe, Latin America and the Middle East saw an average return of 19%. Double digits can be enticing—if you can stomach the same in negative territory. LT