



### History of hedge funds

It is widely believed that the first hedge fund was created by Alfred Winslow Jones in 1949. Whilst investigating techniques for forecasting stock markets, he became fascinated with some of the more unusual trading methods. Jones used *short selling* to protect (“hedge”) his long-only portfolio from a declining market combined with a leveraged long equity position.

Since then, with the growth of the industry, both in size and number of funds, the scope of the term “hedge fund” has expanded beyond Jones’ strategy to describe funds engaging in a range of other alternative investment strategies, not necessarily with the sole aim of protecting assets. Jones’ success at the time resulted in several investment managers setting up funds, which traded different strategies. For example, in the 1980’s, hedge fund managers such as Julian Robertson and George Soros posted extraordinary returns over long periods of time making use of macro strategies. These macro funds were not set up with the objective of protecting assets during market downturns and yet, were also “labeled” under the generic term “hedge fund”. By 1990, more than 70% of hedge funds were operating macro strategies, however, in recent years there has been a shift back to the equity long/short strategy.

# Offshore Hedge Funds

The Proliferation of hedge fund strategies and confusion with the term “hedge”?



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*Offshore hedge funds have been around since 1949*

## What is a hedge fund?

The term “hedge fund” is a generic name or description used to classify hedge funds but does not reveal how offshore hedge funds are managed or how they actually invest their assets.

Hedge funds are able to invest in almost any opportunity in any regulated market. This may sound like a very broad description for a hedge fund, but is precisely what a hedge fund is able to do. A traditional offshore investment manager invests only in conventional equity, bond, property and cash strategies, whereas a offshore hedge fund generally combines the traditional investment strategies such as buying equities, bonds, commodities, currencies and listed property with alternative strategies such as short-selling, arbitrage and leverage, to name a few. In simple terms an offshore hedge fund aims to exploit inefficiencies in the offshore markets.

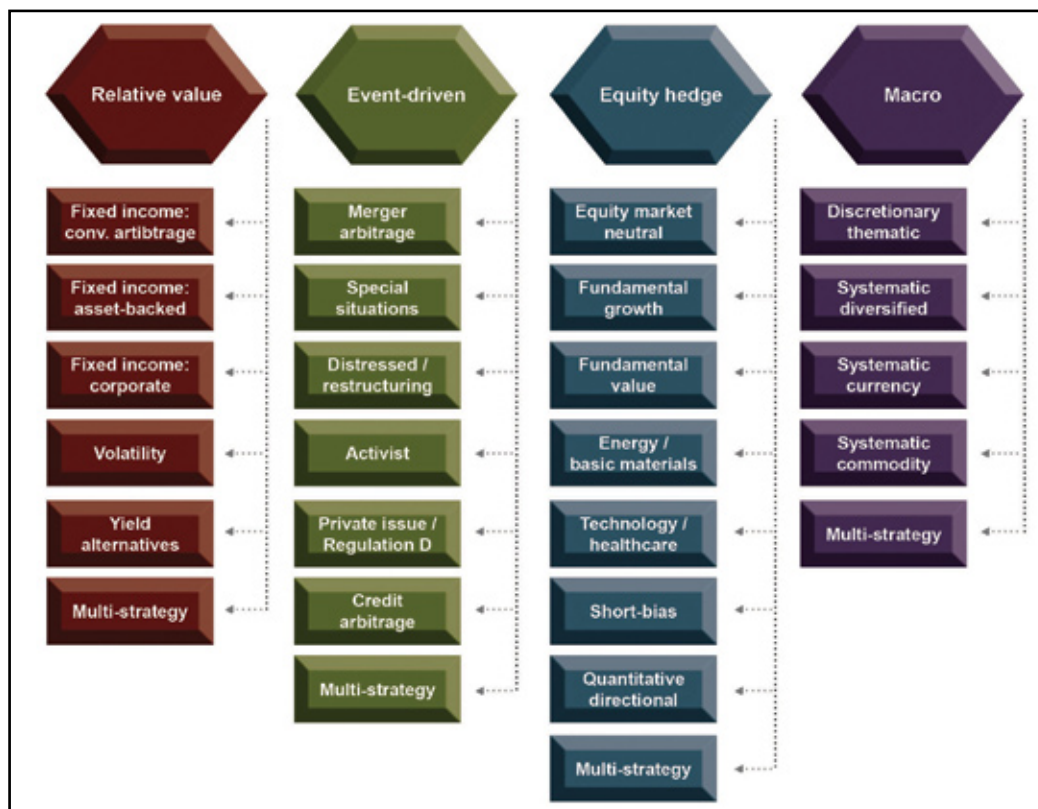
A distinguishing feature of offshore hedge funds is that they typically charge a performance fee in addition to management fees and the investment manager would typically have his or her own capital invested alongside the third party’s assets. In addition, and possibly the main differentiator between traditional funds and hedge funds, is that offshore hedge funds typically pursue absolute return

strategies rather than seeking relative out-performance of a specific market benchmark such as the MSCI World Equity or Lehman Global Bond Index.

*Offshore hedge funds have access to a broader set of “tools” than traditional investment managers*

## Hedge funds have a number of key characteristics

- **Legal structure:** offshore hedge funds are typically private investment vehicles and are not regulated. This means that the actual hedge fund investment vehicles themselves do not have to be registered with a regulatory agency such as the Securities Exchange Commission (SEC) in the US or the FSA (Financial Services Authority) in the UK. However, within the UK, the investment (hedge fund) houses managing these funds are required to be registered with the FSA. Within the US, registration with the SEC is voluntarily.
- **Investment approach:** offshore hedge funds utilise a wide range of different investment strategies. The strategies make use of a variety of financial instruments to produce returns that are less correlated to traditional asset classes.



Source: HFR Industry Report

- **Manager compensation:** offshore hedge fund fees are predominantly structured on a management fee plus an incentive or performance fee basis.
- **Alignment of interests:** hedge fund managers generally have substantial amounts of their own money invested in their funds, thus aligning their own interests with that of their trustees / investors.
- **Reporting:** the offshore hedge fund industry generally provides monthly performance results, with returns quoted net of all fees. Reporting returns on a net of fees basis is a more accurate way of reflecting the value that has been added to the portfolio by the hedge fund manager. In contrast, traditional investment managers report performance gross of fees. The initial monthly returns reported by hedge funds are typically estimates, with the final asset values / returns only available five to six weeks after month end.
- **Lock-up & liquidity:** liquidity refers to the timing ie trade date and notice period required for trustees to redeem their investment and have their money returned from the hedge fund. A lock-up period is the length of time that trustees / investors must remain invested before the initial investment can be redeemed. Offshore hedge funds typically have some form of liquidity constraint ie a notice period of 90 days must be provided and the hedge fund may only trade quarterly, in addition to the initial lock-up period.

It is important to note that not all offshore hedge funds implement a lock-up period and notice periods may range between 30 days and 120 days with trade dates being monthly, quarterly, bi-annual or annual.

### Why the name “hedge” fund creates confusion?

*Hedge: “a means of protection or defence especially against financial loss” – [www.dictionary.com](http://www.dictionary.com)*

With the proliferation of the offshore hedge fund industry and with more underlying offshore hedge fund strategies being introduced, classifying the wide range of offshore hedge fund investments under the name “hedge fund” has unfortunately, created an expectation amongst trustees / investors that hedge funds not only provide trustees with different sources of return but also protect against capital losses. Trustees and investors need to realize that there are at least fifteen broad offshore hedge fund strategies in use globally, of which only one or two are not correlated to offshore equity and bond market returns and aim to protect or “hedge” assets over shorter time horizons.

Hedge fund strategies can be classified in a number of ways.

HFR Research classifies offshore hedge fund strategies in the following four broad categories, each with their own respective sub-categories - relative value, event-driven, equity hedge and macro.

- **Relative value** – these strategies typically refer to non-directional strategies such as arbitrage and market neutral. Market exposure and market risk are typically reduced in these transactions.
- **Event driven** – event driven strategies focus on investing in securities of companies facing major corporate events such as mergers, acquisitions and spin-offs. They are typically higher risk strategies than relative value strategies and take on a level of market risk.
- **Equity hedge** – long/short equity strategies are equity-type strategies whereby managers hold a combination of both long and short positions that could at least partly reduce the impact of a market decline.
- **Macro** – these are typically “non-hedging” strategies and are usually directionally biased (ie the manager takes a view) and opportunistic in nature. These strategies on average present higher levels of potential risk relative to the other categories. Macro includes trading strategies such as managed futures and commodity trading.

*Not all hedge fund strategies “hedge” against market downturns*

### Conclusion

The strong growth witnessed in the offshore hedge fund industry over the past number of years has been accompanied by the proliferation of more, as well as different, hedge fund strategies – all “grouped” under one common name - hedge funds. This has and will continue to create confusion with trustees / investors.

It is therefore imperative for trustees to recognize that the range of offshore hedge fund strategies varies significantly and that these strategies do not necessarily aim to guarantee or protect trustees / investors 100% against short-term market downturns.

Offshore hedge fund managers typically use a combination of these underlying hedge fund strategies to construct a multi-strategy hedge fund or fund of hedge fund. Over the short to medium term, multi-strategy hedge funds have shown their ability to protect capital by diversifying between the various strategies. This may not necessarily be the case with a strategy-specific fund or fund of hedge fund, thus re-emphasizing the need for trustees to ensure that they have a good overall understanding of the various hedge fund strategies utilised in the offshore hedge fund industry. □