WHAT ARE HEDGE FUNDS?

Hedge funds are investment instruments that usually take the legal form of a fund.

The verb 'to hedge' means 'to cover'. You might be tempted to think that the whole purpose of these funds is to neutralise risk. In fact, the opposite is the case. The term 'hedge fund' covers a number of funds that invest in very different asset classes with very different risk levels. It is difficult to come up with a precise definition of a hedge fund.

Features

Generally, a hedge fund is an investment instrument with the following general characteristics:

- The fund manager wants to achieve an **absolute level of return**, and so detach the fund from the general market trends. To achieve this, the fund makes use of a very broad swathe of investment instruments (including derivatives such as options and futures), and often it will also use very illiquid instruments.
- The fund allows for the option to **short** securities, which allows value to be created if the manager believes that the price of a security will fall in the near future (they sell the security and buy it back cheaper a little later), or where the market risk for the portfolio as a whole can be reduced by balancing the relative amounts of purchased to (fully or partially) shorted assets.
- Frequent use is made of **leveraging**. With an eye on this, the fund can take out loans to finance investments that it thinks are of interest.
- Hedge funds generally are subject to **less strict regulations** than 'normal' funds, and have a large amount of freedom in how they invest.
- Hedge funds do not compare their results to a benchmark. Their **goal** is to achieve a positive return, whatever the market may be doing. A hedge fund in fact targets the achievement of an absolute performance, not a relative performance (which would mean compared to a market index such as BEL20, the Dow Jones or the MSCI).
- In addition, hedge funds generally show only a **weak correlation to the traditional share and bond markets**, which makes them excellent instruments for diversifying an investment portfolio. If the stock market prices fall, then the hedge funds' returns will usually drop less than the rest of the market. Hedge funds can therefore offer protection in a falling market. This does not rule out potential negative results.

Risks

- **Exchange risk:** depends on the currency in which the hedge fund is listed and the currency in which the assets in the fund are denominated. For a European investor from the euro zone, this risk is irrelevant if the listing and the underlying assets are restricted to the euro zone. For other currencies, on the other hand, it is considerable.
- **Liquidity risk:** the investments in hedge funds are never very liquid. There is often a **lock up period**; during this time the hedge fund cannot be sold.
- **Volatility risk:** can be substantial and lead to a loss of value. The volatility also depends on the strategy that is adopted.
- An important risk factor is the **lack of transparency** in relation to the investment policy.
- Hedge funds are generally to be found in countries where there is **little or no supervision** by the authorities, which means they are much more at risk to fraud, not delivering on the investment strategy or threatening the financial structure.
- The extensive number of instruments that are used, including derivatives, and the possibility of borrowing to create leverage, make this type of investment riskier as soon as the manager makes the **wrong decisions**.
- The choice of less liquid and less conventional underlying values can mean that, in the event of a **financial crisis**, it can be difficult to impossible to determine a correct value for the hedge fund. In some cases, it is no longer possible to sell your hedge funds.
- The **time between the sale of the holdings in the hedge fund and crediting the income from the sale** can vary between a few weeks to several months, depending on the product selected. A distinction needs to be made here between 'open' and 'closed' funds. Open funds buy holdings back at their asset value. For closed funds, the institution is not allowed to buy back holdings. The investors need to go to a secondary market in order to sell their holdings.

Costs and taxes

If you buy or sell units in a fund, you also have to allow for the costs and taxes you need to pay. These also affect the return on your fund units.

COSTS

Custody fee: most banks will charge you fees to hold your units on a custody account.

Ongoing charges: the ongoing charges include, among others, management commission and performance commission. These costs are not paid at the time you purchase the fund. They are deducted from the returns each year.

Commission and redemption fees: commission is a one-off initial cost when buying units in a fund. They are usually expressed as a percentage of the capital you are investing. You do not pay any exit fees when you resell your units.

TAXES

Stamp duty on stock exchange transactions (TOB): for most funds you have to pay exchange stamp duty when selling units in the fund.

Withholding tax on dividends: withholding tax must be paid on dividends on distribution units.

Withholding tax on capital gains: the capital gains on the funds that invest more than 25% in debt instruments (such as bonds) are also liable to withholding tax.

Want to know more about hedge funds?

Read our *Financial instruments information sheet* on our website at www.bnpparibasfortis.be.

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