



AIMA SOUTH AFRICA  
HEDGE FUND BOOKLET

2006 - 2007

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AIMA South Africa gratefully acknowledges the work done by ASSIRT and AIMA Australia in producing their publication on hedge funds, and AIMA Canada on producing their primer on hedge funds. Both publications form the basis for this document, to which information pertaining to the South African context has been added.



## PURPOSE OF THE AIMA SOUTH AFRICAN HEDGE FUND BOOKLET

South African investors, both institutional and individual, are increasingly aware of the advantages of investing in hedge funds. The AIMA South Africa Hedge Fund Booklet is designed to assist the financial community and investors in their understanding of hedge funds. What follows is a background on hedge funds, an overview of the various strategies employed and a discussion of the risk and return characteristics of hedge funds.

## ALTERNATIVE INVESTMENT MANAGEMENT ASSOCIATION (AIMA)

The Alternative Investment Management Association (“AIMA”) was established in 1990 in the UK as a non-profit organisation for the alternative investment industry. It specifically includes hedge funds, managed futures and managed currency funds.

### AIMA'S OBJECTIVES ARE TO:

- Increase investor education, transparency and promote due diligence and related best practices,

AND

- Work closely with regulators and interested parties in order to better promote and control the use of alternative investments.

## AIMA SOUTH AFRICA

Domestic industry participants formed the AIMA South Africa Chapter in 2003, with 21 founding members and an elected committee, and membership has since quickly expanded with the current membership standing at 42. The chapter gets together regularly to hear international guest speakers, and the board updates its members at bi-annual meetings coupled with on-line newsflashes.

## AIMA SOUTH AFRICA MEMBERS

Abante Capital  
ABSA Corporate and Merchant Bank  
Advantage Asset Managers  
Alpha Asset Management  
AMB Advisory Services  
Atlantic Hedge  
Blue Ink Investments  
Brait  
Breakwater Capital  
Cadiz Specialised Asset Management  
Caveo Fund Solutions  
Cidel Financial Group  
Clade Investment Management  
Deutsche Securities  
eComply Consultants  
Edge Capital  
Edward Nathan Sonnenberg's  
Ernst & Young  
Fairtree Capital  
First World Trader trading as Global Trader  
Firststrand Bank  
Futuregrowth Asset Management  
Gryphon Asset Management  
IDS Alternative Fund Services  
Investec Securities  
Investment Solutions  
Legae Capital  
Mallinicks  
Nedgroup Investments  
N-e-FG Fund Management  
Novare Investments  
Old Mutual Asset Managers  
Orange Capital  
Peregrine Investment Managers  
PriceWaterhouseCoopers  
Prime Administration  
Sygnia Asset Management (formerly African Harvest Alternative Investments)  
SYmmETRY Multi-Manager  
Stanlib Wealth Management  
T-Capital  
Werksmans Attorneys  
WWC Asset Management

# CONTENTS

## 1.0 BACKGROUND

- 1.1 History of the Hedge Fund Industry
- 1.2 The Size of the Hedge Fund Industry

### 1.3 Who Invests in Hedge Funds?

- 1.4 The Landscape of Hedge Funds and Investing in South Africa

## 2.0 WHAT ARE HEDGE FUNDS?

- 2.1 Hedge Funds Defined
- 2.2 Comparing Hedge Fund Managers to Traditional Investment Managers
- 2.3 Characteristics of Single Manager Hedge Funds
- 2.4 Structure of Hedge Funds
- 2.5 Some Practicalities of Investing in Hedge Funds

## 3.0 STRATEGIES AND EXAMPLES

- 3.1 Relative Value Strategies
  - 3.1.1 *Convertible Arbitrage*
  - 3.1.2 *Fixed-Income Arbitrage*
  - 3.1.3 *Long-Short Equity Market Neutral*
- 3.2 Event driven
  - 3.2.1 *Merger Arbitrage*
  - 3.2.2 *Distressed/ High Yield Securities*
- 3.3 Opportunistic Strategies
  - 3.3.1 *Long/ Short Equity*
  - 3.3.2 *Dedicated Short-Bias*
- 3.4 Global Macro

### 3.5 Emerging Markets

### 3.6 Managed Futures

- 3.6.1 *Systematic Trading*
- 3.6.2 *Discretionary Trading*

## 4.0 HEDGE FUND RISK/RETURN DRIVERS

## 5.0 INVESTING IN HEDGE FUNDS

- 5.1 Why Invest in Hedge Funds?
- 5.2 Single Strategy Funds and Funds of Hedge Funds
- 5.3 What Portion of an Investor's Portfolio Should Be Allocated to Hedge Funds?
- 5.4 Factors to Consider Before Investing

## 6.0 GLOSSARY

## 1.0 BACKGROUND

### 1.1 History of the Hedge Fund Industry

The first official 'hedge fund' was created in 1949 by an Australian named Alfred Winslow Jones. Jones realised he could effectively use two speculative tools - short selling and leverage - to protect his portfolio of stocks in a falling market. The result was not only preservation of capital but also an enhancement in returns. His strategy proved so successful that Jones outperformed the best equity mutual funds during the 50's and 60's. In spite of his success, hedge funds did not reach significant levels of profile until Fortune magazine published an article in 1966 on Jones, entitled 'The Jones that no-one can keep up with.'

The 1960's bull market encouraged many of the hedge funds that emulated the Jones model to use leverage on their long portfolio but to forego short-selling, a development that led to the decimation of the industry during the bear markets of the early 1970's. To illustrate, the S&P500 fell by 14.5% and a further 1.1% in 1969 and 1970, and a massive 19% and 29% in 1973 and 1974. The Johannesburg Stock Exchange, as it was still called then, fell by 10.8% in 1969, and 26.4% in 1970. The Quellos Group estimates that there were only thirty hedge funds in existence in 1982, and after the carnage of the 1970's hedge funds went 'underground' again, back to quietly making steady returns.

The first fund-of-hedge funds appeared in 1969, started by Georges Karlweis in Geneva, closely followed by the second, started in the United States by Grosvenor Partners in 1971. During 1984 the original hedge fund manager, Alfred Winslow Jones, re-organised his multi-manager hedge fund into a formal fund-of-hedge funds structure.

The growth in the industry accelerated throughout the 1990's during which time the

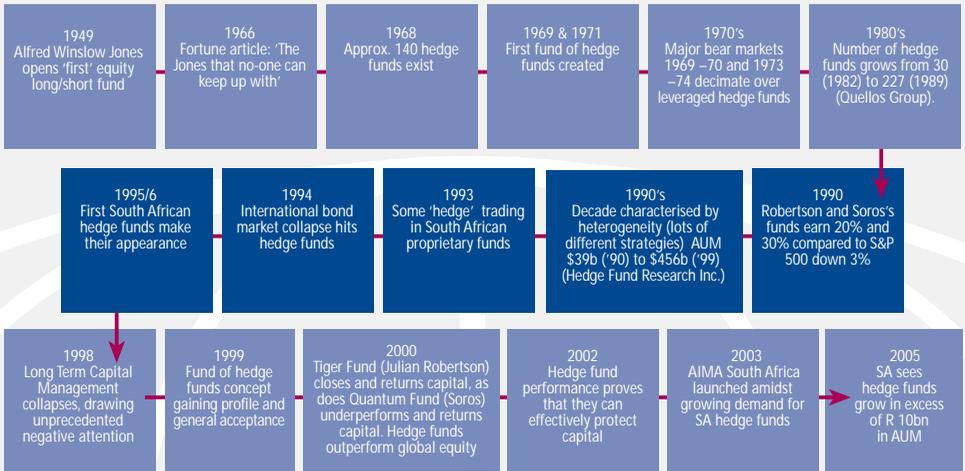
increase in the number of new financial instruments combined with evolving technology facilitated the development of sophisticated investment strategies without the need for backing by large investment houses[1]. In addition, the much-publicised success of high-profile managers such as George Soros, Julian Robertson and Stanley Druckenmiller led to highly-skilled entrepreneurial investment professionals leaving large investment houses to start their own hedge funds, some with initial backing from their former employer and many with their own funds.

The global bond crisis in 1994 caused real damage to some high-profile hedge funds, including the legendary Quantum Fund managed by George Soros. The crisis was the result of multiple causes including hedge funds and conventional funds being massively invested in the bond markets. An unexpected 0.25% increase in US interest rates, interpreted as signalling increasing inflation and therefore interest rates, sparked rumours about the financial stability of a significant banking institution (Bankers Trust), a political assassination in Mexico and a liquidity crisis. South African bonds lost 9.1% in 1994, its second biggest loss in more than 100 years. In the desperate search for someone to blame, hedge funds were in the spotlight and strong calls were made for regulations.

In 1998, Long Term Capital Management (LTCM), a massive and very public hedge fund involving Nobel Prize winners and respected industry leaders crashed, ultimately losing \$4.4 billion. The fund was eventually bailed out by a consortium of major banks, facilitated by the US Federal Reserve, and finally effectively liquidated in 2000. By 1999, the year after the LTCM disaster, and possibly as a response to it, the fund-of-hedge funds concept had become a generally accepted means of managing the risks of investing in a single hedge fund.

[1] Editorial: *Dealing with Myths of Hedge Fund Investment*, Thomas Schneeweis; *The Journal of Alternative Investments*, Winter 1998.

## HEDGE FUND INDUSTRY DEVELOPMENT TIMELINE 1949 – 2005



### 1.2 The Size of the Hedge Fund Industry

Estimates on the size of the hedge fund industry vary, as many successful and closed funds are not included in the various hedge fund indices and surveys, approximately 1/3 of funds overlap across the leading surveys, and there is a measure of double-counting between single strategy funds and funds-of-funds.

“Most commentators agree that 2001 was the pivotal year for the hedge fund industry. According to Hennessee Group LLC the hedge fund industry grew by 38% in 2001 to a total estimated size of US\$563 billion from US\$408

billion in 2000. It was the first time a bear market was met by a mature hedge fund industry where investors recognized hedge funds as a realistic alternative investment for the purpose of diversifying portfolios, capital appreciation and managing downside risk.”

Estimates of assets under management in the hedge fund industry totalled \$1.13 trillion at year end 2005, with the number of funds increasing 6% to reach around 8,500. Research conducted by TowerGroup predicts that hedge fund assets will grow at an annualised rate of 15% between 2006 and 2008 while the actual number of hedge funds is likely to remain relatively flat.

### Hedge Funds: Number of Funds & Dollars Under Management 1999-2005

	1999	2001	2003	2005
Number of Funds	6,200	7,000	8,100	10,000
Assets under Management (\$ Billions)	\$480	\$600	\$820	\$1,200



### 1.3 Who Invests in Hedge Funds?

Historically, high-net-worth investors such as family offices have been the main investors into hedge funds. In their 2003 “Hedge Fund Investor Survey”, the Hennessee Group reported that the largest investors in hedge funds in the US continued to be individuals and family offices, representing 47% of capital in the industry. More recently, in the 2005 survey, results indicate that there is a much broader investor base into the hedge fund arena. Investors are becoming far more comfortable with hedge funds as an asset class, and the Hennessee Group believe it is becoming common practice to consider hedge funds within a stock and bond allocation.

More institutional investors are increasing their allocation to hedge funds as they seek out investments that offer low correlations to traditional portfolios of cash, bonds and equities. Strong demand has also seen the SEC and other regulations turn their attention to facilitating access to retail investors through a move from a loosely regulated environment to jurisdiction specific guidelines, e.g. Hong Kong, Singapore, Germany, Italy, Ireland, and soon South Africa.

### 1.4 The Landscape of Hedge Funds and Investing in South Africa

Many domestic institutions and pension funds have been investing in offshore hedge funds, usually funds-of-hedge funds, for some time. However, the development of the local scrip lending market

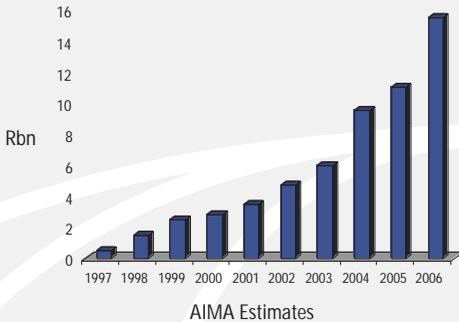
throughout the 1990's, facilitating short selling, led to the launch of several South African long-short equity hedge funds in the late 1990's.

Due to the lack of a regulatory framework the South African industry was initially characterised by niche players catering for specific investors. However, given the global growth and demand for absolute returns due to the post-2000 NASDAQ led bear market, a large number of hedge fund managers and service providers have emerged in the past 3 years.

By 2000 approximately 28 hedge funds or managers were operating in the South African market with an estimated R2.5bn in Assets Under Management (AUM), and at the end of 2003 the estimated number of funds had grown to 60 and the AUM to R6bn. By the end of 2005, industry AUM exceeded R10bn with around 120 funds in operation. The local hedge fund industry is nevertheless still considered to be in its infancy as the majority of hedge funds are yet to establish track records lengthy enough to attract institutional investors.

In the South African hedge fund industry, leading hedge fund managers and service providers recognised the need to research, educate, and where necessary, lobby the Regulator, to ensure an understanding of hedge funds in the South African context. The South African Chapter of the Alternative Investment Management Association (AIMA) was formed in 2003, and currently represents 42 members.

## South African Industry Growth: Assets Under Management 1997 – 2006



Following on from a lobby initiative launched by AIMA SA's predecessor, the Hedge Fund Association (HFA), various interested parties such as the Association for Collective Investments (ACI), independent managers, service providers and current AIMA board members have made good progress towards establishing the parameters for a domestic regulatory framework. This has been necessitated by the fact that Regulation 28 of the Pension Funds Act does not explicitly cater for hedge funds (nor many other modern financial solutions that have emerged in response to market demands). Following representations and workshops involving the Financial Services Board (FSB), AIMA and the ACI, a White Paper was presented to industry for comment, and responses are currently under review. It is envisaged that AIMA SA's leading role in representing industry interests will culminate in the necessary regulatory clarity that will support considerable growth in the domestic hedge fund industry.

In addition to the niche investment houses, several large brand name managers, and asset consultants have recently shown interest in launching hedge funds or advisory services relating to domestic hedge funds, and potentially solutions to the retail market in the near future as regulation permits.

At least four surveys exist to provide investors with varying forms of peer review, and all indications are that the market awaits regulatory certainty for meaningful growth in assets.

## 2.0 WHAT ARE HEDGE FUNDS?

### 2.1 Hedge Funds Defined

The term "hedge" is generally associated with the practice of covering an investment position (long) with an investment that will act as an opposite position (short), thereby nullifying any market risk imbedded in the original investment decision. The hedge may be in the form of a similar asset type to hedge market risk (e.g. equities) or a different security of the same issuer (e.g. equity/ bond). The degree by which a fund is "hedged" in the traditional sense varies markedly across managers. Still, there is no universal definition of a hedge fund, other than that they typically share some of the following common characteristics:

- *The funds utilise some form of short asset exposures, or short selling, to reduce risk, preserve capital or enhance returns.*
- *Some form of leverage is used, measured by gross exposure of underlying assets exceeding the amount of capital in the fund.*
- *Derivatives instruments of varying degrees of complexity are employed.*
- *The managers of the funds charge a fee based on the performance of the fund relative to an absolute return benchmark such as inflation or call interest rates.*
- *Investors are typically permitted to redeem their interest only periodically, e.g. quarterly or semi annually.*
- *Often significant 'own' funds are invested by the manager alongside those of investors.*

## 2.2 Comparing Hedge Fund Managers to Traditional Investment Managers

Hedge fund managers differ from traditional active managers (benchmark relative funds) in a number of ways. The two most significant are the approaches to risk and return.

### (a) Risk

Most hedge fund managers define risk in terms of potential loss of invested capital (total risk) whereas traditional active managers define risk as the deviation (tracking error) from a stated benchmark. The risk associated with hedge funds is therefore highly dependant on the skills of the individual manager, both in implementing the chosen strategy successfully and in the running of their business.

### (b) Return

Hedge fund managers aim to deliver a total return unrelated to a benchmark or index that is, therefore, independent of the general direction of markets. A traditional active manager largely aims to deliver relative returns (returns above a related benchmark). This relative return may be negative if the benchmark return is negative. Therefore, the generation of returns by hedge funds is reliant on the skill of the manager, whereas traditional strategies primarily reflect the return of the underlying asset class.

CHARACTERISTIC	TRADITIONAL INVESTING	HEDGE FUND INVESTING
1. Return Objective	Relative returns	Absolute returns
2. Benchmark	Constrained by benchmark index	Unconstrained by benchmark index
3. Investment Strategies	Limited investment strategies. Take long-only positions Do not use leverage	Flexible investment strategies. Take long and short positions May use leverage
4. Market Correlation	High correlation to traditional asset classes	Generally, low correlation to traditional asset classes
5. Performance	Dependent on market direction	Often independent of market direction
6. Fees	Tied to assets under management, not to performance	Tied primarily to performance
7. Manager's Investment	Manager may or may not co-invest alongside investors	Manager generally co-invests alongside investors
8. Liquidity	Good liquidity	Liquidity restrictions and initial lock-up periods
9. Investment Size	Small minimum investment size (e.g. R1,000 minimum)	Usually large minimum investment size (e.g. R250,000 minimum, depends on prospectus exemption)
10. Structure and Documentation	Set up as a trust or investment company Often sold by prospectus	Set up as a private investment, limited partnership or a trust. Usually sold by offering memorandum
11. Regulation	Highly regulated; restricted use of short selling and leverage High disclosure and transparency Can market fund publicly	Less regulated: no restrictions on strategies Less mandated disclosure, and limited or no position level and risk exposure transparency Marketing restrictions apply.

## 2.3 Characteristics of Single Manager Hedge Funds

- Hedge funds are typically organised as limited partnerships, limited liability companies, unit trusts or listed entities as private investment pools.
- Internationally, many hedge funds are domiciled in offshore tax havens such as the Cayman Islands to neutralise tax effects for effectors.
- Performance related compensation is prevalent, typically with a high-water-mark and hurdle rate to ensure a manager will only take incentive fees on profit generated by positive investment performance above a certain level.
- Typically, a proportion of the partner's or principal's wealth is invested in the funds,

hence aligning their interests with the performance of the fund.

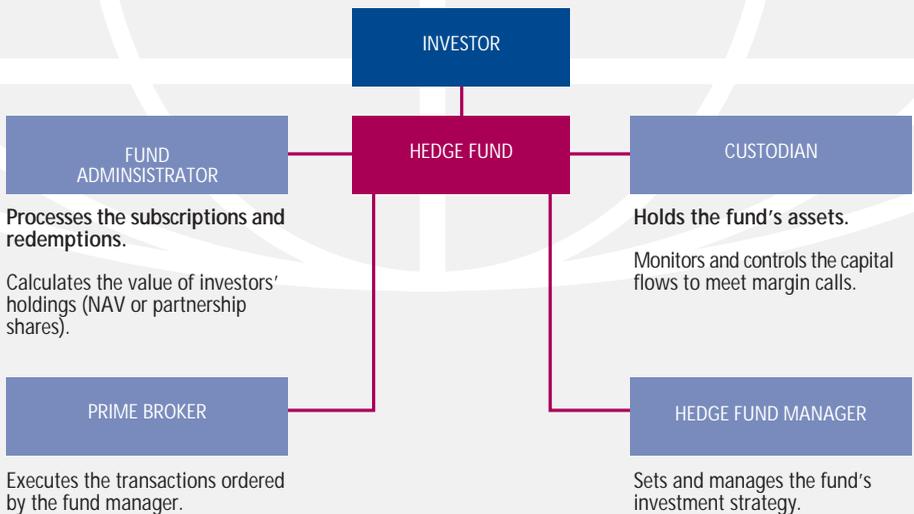
- Limited in size to preserve investment returns.
- High minimum investment levels, typically R1,000,000 or higher.
- High expected risk-adjusted returns.
- Low correlation with traditional asset classes and other skill based strategies.

## 2.4 Structure of Hedge Funds

The structural make-up of a typical hedge fund is depicted in Chart 2.1.

This diagram displays the component service providers of hedge funds and their roles and relationships.

Chart 2.1: Typical Structure of a Hedge Fund Offering



## 2.5 Some Practicalities of Investing in Hedge Funds

- *Many hedge funds value assets monthly or quarterly. Therefore, unit prices will only be available when assets are re-valued. This may make it difficult for investors that require daily unit pricing to include hedge funds in their investment plans.*
- *A lock-up period may apply, restricting the liquidity of investors' assets. Monthly and quarterly unit pricing may also impact fund liquidity. Some redemption policies may also require a long notice period (e.g. 60 days notice).*
- *The investor should be aware of the level of gearing permitted within a fund.*
- *Some hedge funds may distribute income infrequently (annually) or in some cases not at all.*
- *While some hedge funds stay open to new investment for many years, or remain open only to select fund-of-hedge funds operators, others may close to new investors altogether.*
- *Critically, investors should establish the maximum potential loss or liability that an investment could result in.*

## 3.0 STRATEGIES & EXAMPLES

There are a multitude of strategies employed by hedge fund managers. Most funds can be classified into strategy categories depending on process, asset class, geographical location or return drivers. As such, there is no standard classification system and there are numerous hedge fund indices developed by financial services companies (e.g. S&P, MSCI, HFR, etc), each with different characteristics and classification methodologies.

The most consistent classification is based upon the process or strategy that a fund employs and the asset class used. This classification has limitations and difficulties when comparing across regions or industries, but the returns generated in hedge funds are primarily driven by the skills of the investment managers in the particular strategies or processes employed. Process describes the methodology that managers follow when creating positions and managing their portfolios and investment risk. Generally these strategies can be further divided into directional and non-directional strategies.

These strategies are explained in more detail below.

*[5] This document draws heavily (specifically with regard to strategies and glossary terms) on the AIMA and ASSIRT Hedge Fund Booklet published 2002.*



## 3.1 Relative Value Strategies

When using relative value or arbitrage strategies, a manager generally seeks to profit from perceived mispricing in a specific asset or security. With each position held in the portfolio, the manager attempts to isolate and capitalise on a feature of an asset (or combination of assets) that is mispriced relative to a theoretical fair value or equilibrium relationship. The most common relative value strategies include convertible arbitrage, fixed-income arbitrage, and equity market neutral. The degree of leverage used in arbitrage strategies varies depending on the strategy and the portfolio objectives, but is usually between 2x and 10x the underlying equity value.

### 3.1.1 Convertible Arbitrage

A convertible arbitrage strategy aims to profit from mispricing opportunities within convertible bonds and other hybrid debt/ equity securities. (Note: A convertible bond is a bond with an embedded call option on the company's stock). Convertible securities are a combination of various instruments, and the parcel as a whole may have a different price than the sum of the component parts. If the price is different, there is an opportunity to buy (sell) the parcel and sell (buy) the various component parts to lock in a profit. Therefore the generation of "alpha" is independent from the general direction of markets.

A typical investment is to buy the convertible bond and sell the common stock of the same company, to take advantage of the stock's price volatility. Positions are designed to generate returns from both the bond and the short sale of stock, while protecting principal from market moves. The fund uses the short stock position to protect against declines in the bond's principal value.

### Convertible Bond Example:

Here the manager believes a convertible bond

to be undervalued relative to its current market price and at the same time views equity of the company to be overvalued, expecting the market price of equity to fall. The manager will buy the convertible bond and short the stock of the same issuer to eliminate the stock price risk embedded in the convertible bond. When executing a strategy of long convertible bonds and short equity, the manager will need to consider the credit risk associated with the trade. Asset swaps can be used to strip out the credit risk from convertible bonds.

### 3.1.2 Fixed-Income Arbitrage

Fixed-income arbitrage managers aim to profit from price anomalies between related interest-rate securities. Most managers trade globally, with a goal of generating steady returns with low volatility. A fixed-income arbitrage strategy includes interest-rate swap arbitrage, US and non-US government bond arbitrage, forward yield curve arbitrage and mortgage-backed securities arbitrage. Leverage will depend on the types of portfolio positions, which include basis trading, inter-market spreads, yield curve trading, relative-value option strategies and financing strategies.

### Fixed-Income Arbitrage Example:

A simple example of a fixed-income arbitrage strategy is a basis trade. This trade involves the purchase or sale of an interest-rate futures contract and a concurrent offsetting sale or purchase of a fixed-income security that is deliverable into the futures contract. This can be illustrated with the following transaction:

*Purchase a government bond  
Simultaneously  
Sell a futures contract on that bond*

*Profit Opportunities: Uncertainty in the composition*



*of bonds required in the delivery option of the bond futures*

*= Shift in the supply and demand for the underlying bonds*

### 3.1.3 Long-Short Equity Market Neutral

An equity market-neutral strategy is designed to exploit equity market inefficiencies, and usually involves long and short matched equity portfolios of the same size. The manager aims to position the portfolio to be cash or beta neutral, or both. Typically the portfolio will exhibit a small or nil net market exposure. Well designed equity market-neutral portfolios typically control for industry, sector, style, market capitalisation, currency and other exposures, which results in a near 50:50 balance of long and short positions. Leverage is often applied to enhance returns.

#### Equity Market-Neutral Example:

An example of a typical equity market-neutral trade is a pairs trade in two listed companies with similar underlying economics. This strategy involves buying one company's stock and selling short the stock of another company in the same sector.

*1) Buys shares in one class Company A, Class C, listed in the UK*

*2) Sells shares in another class Company A, Class D, listed in South Africa*

*Profit Opportunity: The manager expects Class C stocks to rise in price and Class D stocks to fall based on some change to Company A's capital structure.*

There is no market or sector risk as the two stocks are based on the same economic entity, but happen to deviate in price.

## 3.2 Event Driven

An event-driven strategy is designed to capture price movements generated by a significant pending corporate event, such as a merger, corporate restructuring, liquidation, bankruptcy, or reorganisation. Two sub-categories in event-driven strategies are: merger or risk-arbitrage (non-directional), and distressed/ high yield securities (directional).

### 3.2.1 Merger Arbitrage

Merger arbitrage managers exploit merger activity to capture the spread between the current market values of securities and their values in the event of a merger, restructuring, or other corporate transaction. Managers consider a transaction once an announcement has been publicly made. Most merger arbitrage managers exploit both cash-only deals and stock deals.

Before entering into a merger arbitrage strategy, the manager will analyse the probability of the deal closing, the bid price, and the timeframe to the closing date. The probability of the takeover's success directly influences the size of positions the manager will take, as the profitability of the trade depends on the success of the merger. If the deal involves a regulated industry (such as banking), regulatory risk is factored into the deal.

#### Merger Arbitrage Example:

In mergers where the target company's shareholders are offered stock in the acquiring company, the spread is the difference between the current values of the target company's stock and the acquiring company's stock. The spread is captured where the arbitrageur buys the stock of the target company and shorts the stock of the acquiring company. This is depicted in the following illustration:

ACTION	COMPANY A (ACQUIRER)	COMPANY B (TARGET)
1. Takeover Announcement:	Company A is the acquirer	Company B is the target
2. Offer:	Company A makes an offer to acquire Company B	The offer is at a 20% premium of Company B's current market price
3. Market's Reaction:	Company A's stock price typically declines or remains flat	Company B's stock price appreciates by 10%
4. Manager's Expectation:	Company A's stock price will decline or remain flat	Company B's stock price will rise
5. Manager's Response:	Manager sells short Company A's stock	Manager buys Company B's stock
6. Position will Profit if:	Takeover completed successfully and stock prices converge, so that Company A's stock price declines and/or Company B's stock price rises. <b>OR</b> Another suitor, Company E (the new acquirer) makes a bid for Company B (the target) for a higher price than offered by Company A. The manager then switches the short position from Company A to Company E.	

### 3.2.2 Distressed/High Yield Securities

Managers involved in distressed or high-yield securities are active in bond and equity markets, where the strategies focus on actual or anticipated events, such as a bankruptcy announcement or corporate reorganisation as a result of debt default. Distressed or high-yield securities are generally below investment grade, and require a high level of due diligence to take advantage of the low prices at which they trade. Investors in distressed securities seek capital appreciation of the debt rather than an income stream.

Performance depends on how well the managers analyse event-specific situations, rather than on the direction of the stock or bond markets. Managers investing in distressed or high-yield securities will vary in terms of the level of capital structure in which they invest (debt or equity, and ranking of the security), the stage of the restructuring process, and the degree to which they become actively involved in negotiating the terms and management of the restructuring.

### Distressed Debt Example:

In a typical situation depicted below:

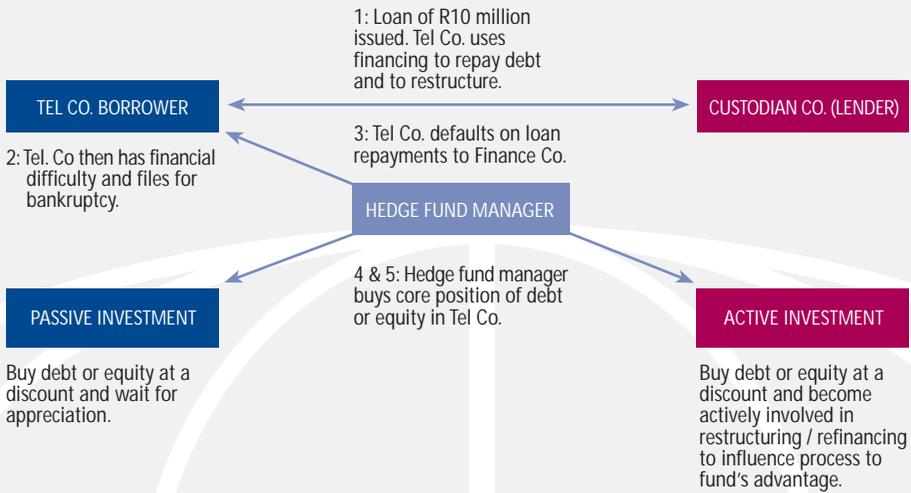
*(a) A financial institution (Finance Co.) makes a loan to a borrower (Tel Co.). Tel Co. uses the funds to restructure the company and/or repay some debt.*

*(b) Tel Co. then finds itself in financial difficulty, resulting in bankruptcy or near-bankruptcy.*

*(c) Tel Co. defaults on its debt, resulting in a decrease in the value of the loan.*

*(d) A Distressed Debt specialist analyses the situation for possible investment, either in the debt or equity of the company considering the following questions:*

- Does the business have long-term value?
- Is the company in trouble because of problems, such as over-leveraging, that can be rectified?
- Are the company's operating metrics declining?
- What class of debt will have the most power in the restructuring?



### 3.3 Opportunistic Strategies (Directional)

Opportunistic strategies generally include any hedge fund where the manager's investment approach changes over time to take advantage of current market conditions and investment opportunities. Opportunistic strategies may have higher risk than relative value and event-driven strategies, as they have higher directional exposure.

Managers will base the investment decision on their view of the degree by which individual securities are under or over valued relative to current market prices. These strategies are heavily reliant on the skill of the manager in discerning the value of a security. The manager may use quantitative tools; however the final investment decision is usually a subjective one.

Strategies often combine long and short positions thereby reducing or eliminating (in the case of market neutral strategies) directional market risk, and generating returns based on the price movements in securities. This may involve borrowing securities that the manager considers to be overvalued, and

then selling them on the market in the expectation that the price will be lower when the fund has to buy back the securities to be able to return them to the brokers.

These funds take positions along the whole risk-return spectrum and try to distinguish their performance from that of the asset class as a whole. Returns will, therefore, deviate substantially from the underlying market return. Portfolios will also tend to be more concentrated than those of traditional long-only managers.

#### 3.3.1 Long/ Short Equity

Managers employing this strategy will hold both long and short positions with usually a net long, or net short exposure. The objective is not necessarily to be market neutral. This category excludes long only portfolios. To be considered a hedge fund, the manager's strategy must include short positions while maintaining an absolute return objective. Managers have the ability to shift from value to growth, and

from small to medium to large capitalisation stocks. Managers may use futures and options to hedge. The focus may be regional, such as long/ short US or European equity, or sector specific, such as long and short technology or healthcare stocks.

### Long Bias Example:

The manager will take both long and short positions, depending on their market outlook. Portfolios may shift between, large cap and small cap, and across sectors within a particular market. The following example below highlights some typical trades that may be present in a portfolio that trades within and across sectors. The portfolio will usually consist of many more trades than displayed here.

*Long Bias Example: The portfolio has a net long position of 60% with 40% held in short positions.*

INDUSTRY SECTOR	EXPECTED PRICE CHANGE	POSITION	STOCK	STOCK
BANKING	UP	LONG	BANK 1	15%
	DOWN	SHORT	BANK 2	13%
	UP	LONG	BANK 3	16%
TECHNOLOGY	UP	LONG	TECH.CO.1	14%
	DOWN	SHORT	TECH.CO.2	16%
CONSUMER DISCRETIONARY	UP	LONG	DEPARTMENT STORE 1	15%
	DOWN	SHORT	DEPARTMENT STORE 2	13%
				60%
TOTAL LONG POSITIONS IN PORTFOLIO				42%
TOTAL LONG POSITIONS IN PORTFOLIO				18% LONG
NET PORTFOLIO EXPOSURE				

### Dedicated Short-Bias Example:

The following portfolio is an illustration of the characteristics of a net short hedge fund. The manager has taken a larger bet on the short positions, as indicated by both the number of short versus long positions and the total portfolio value of short positions versus the value of long positions.

Number of Short Positions	32
Total Value of Short Positions	R400,000
Number of Long Positions	4
Long Total Value of Positions	R20,000
Portfolio Bias: Net short	R380,000

### 3.3.2 Dedicated Short-Bias

In employing this strategy, a hedge fund manager will maintain a net short bias against the market. Managers look for securities that they perceive to be overvalued and short those stocks or use derivatives to profit from a declining share price. They may achieve better results in bearish markets.

### 3.4 Global Macro

A global macro strategy involves opportunistically allocating capital among a wide variety of strategies and asset classes. Strategies or themes may be directional or non-directional. Global macro is the most flexible of investment strategies, with the manager often taking a top-down thematic approach



and investing on an opportunistic basis, moving between countries, markets and instruments based on the manager's forecasts of changes in factors such as interest rates, exchange rates and liquidity. A variety of trading strategies are used depending on the opportunities identified. Most funds invest globally in both developed and emerging markets.

### Global Macro Example:

A manager will attempt to exploit global trends and market movements by entering into leveraged, directional positions. If for example a manager expects interest rate spreads between South Africa and the USA to widen as a result of interest rates rising in South Africa, positions may be taken in interest rates or currencies of the two countries.

The fund manager takes a position to buy the South African Rand (ZAR) and sell the US Dollar (USD), with the expectation that the Rand will rise against the USD following an increase in South African interest rates. The risk in this strategy is that the ZAR may depreciate against the USD.

### 3.5 Emerging Markets

Broadly defined, an emerging market is a country making an effort to change and improve its economy with the goal of raising its performance to that of the world's more advanced nations. The World Bank classifies economies with a Gross National Income per capita of \$9,266 and above as high-income countries. Emerging markets however are not necessarily small or poor. China, for example, is considered an emerging market even though it has vast resources, has launched satellites into space and a population of more than a billion people.

The emerging markets strategy used by hedge funds involves equity or fixed income investing in emerging markets around the world. Because some

emerging markets do not allow short selling, nor offer viable futures or other derivative products with which to hedge, emerging market investing more frequently involves long-only strategies. As the currency of many emerging markets cannot be properly hedged through the use of derivatives, an investment in an emerging market can result in exposure to the movements in currency of the underlying country.

### 3.6 Managed Futures

A managed futures strategy is based on speculation of the direction in market prices of currencies, commodities, equities and fixed interest and on spot or futures markets across the globe. The managers are usually referred to as Commodity Trading Advisors, or CTAs. Trading disciplines are generally systematic or discretionary.

Systematic traders tend to use price and market specific information (often technical) to follow trends, while discretionary managers use a less quantitative approach relying on both fundamental and technical analysis.

#### 3.6.1 Systematic Trading

Proprietary, quantitative models are typically used to identify market opportunities and establish positions, including the size of positions and the risk control. As a group, these managers are trend followers. They seek to identify a trend or pattern and position themselves to stay invested as long as it persists. Systematic trading differs from statistical arbitrage in that each position is essentially an independent directional trade that is intended to produce a profit, not a relative position.

#### 3.6.2 Discretionary Trading

A manager will use fundamental analysis or computer systems or a combination of the two to

identify profitable trades. In general, this tends to be the highest risk and highest return strategy within the universe of hedge funds, with concentrated positions held for very short periods of time. The main difference between these strategies and systematic trading is that the investment decision is not automated. The manager will make the final investment decision.

Typical Trades of Managed Futures strategies include:

- *Trend following using technical analysis with stop-losses in place. Instruments used include currency futures, forwards, exchange traded and over-the-counter options and warrants.*
- *Long-term directional trading based on market fundamentals.*
- *Short-term spot trading based on flow information.*

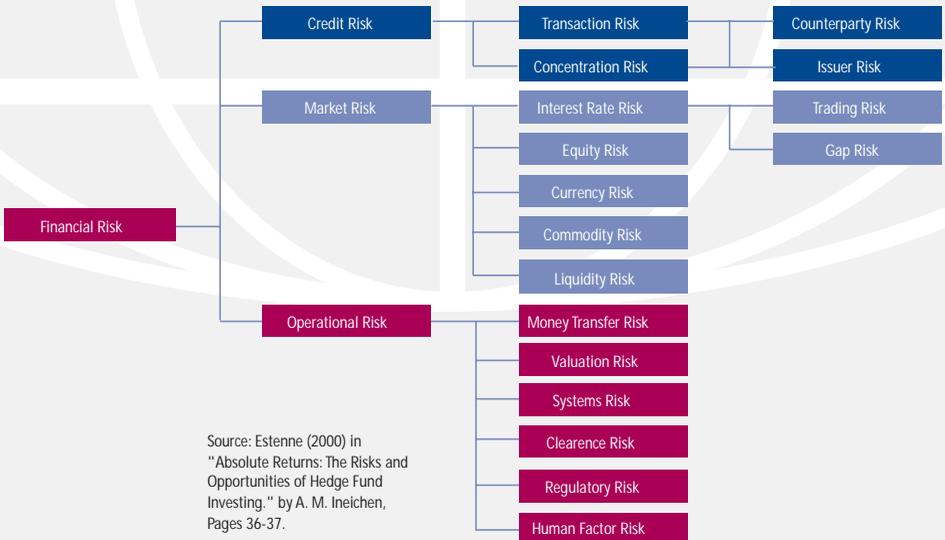
#### 4.0 HEDGE FUND RISK / RETURN DRIVERS

An important measure for an investor to consider

is the degree of exposure to the broad movements of the market and the impact on the fund's risk and return. Funds are generally constructed with specific targets and strategies, such that the investor knows to anticipate a certain risk/ return profile. In general, the higher the degree of "directionality" or investing in market direction, the higher will be the potential return and volatility.

For hedge funds with absolute return objectives, it is more meaningful to measure correlations and risk which evaluate both the upside and downside deviations relative to each fund's specific objective, rather than performance relative to an index or peer group. It is important to note that while an absolute return objective implies a positive return over the long term, short-term volatility can result in negative monthly returns for hedge fund strategies through the market cycle. The risks associated with each strategy will depend on the type of strategy and the degree to which it is exposed to market factors.

The most common risks associated with each strategy are detailed in the table below:



Source: Estenne (2000) in "Absolute Returns: The Risks and Opportunities of Hedge Fund Investing," by A. M. Ineichen, Pages 36-37.



HEDGE FUND CATEGORY	TYPICAL RISK EXPOSURES BY STRATEGY
1. Relative Value	1. Convertible Arbitrage: Interest rate risk, credit risk, equity volatility risk
	2. Fixed-income Arbitrage: Interest rate risk, credit risk, model risk
	3. Equity Market-neutral: Individual Equity risk, model risk
2. Event Driven	1. Merger Arbitrage: Dealrisk/corporate event risk, equity volatility risk
	2. Distressed/High-yield Securities: Corporate event risk, credit risk, equity volatility risk, interest rate risk, liquidity risk
3. Opportunistic	1. Equity Hedge: Equity Market Risk, equity volatility risk
	2. Global Macro: Equity market risk, interest rate risk, currency risk, model risk
	3. Managed Futures: Commodity market risk, interest rate risk, currency risk, model risk.
	4. Emerging Markets: Equity market risk, interest rate risk, political risk, credit risk, currency risk, liquidity risk

Other risks of investing in hedge funds are non-quantifiable risks, specifically inclusive of liquidity issues, transparency, key person risk, fraud and leverage. These risks are more pronounced in hedge funds due to the fact that hedge funds are based on the skill of the manager more than the market return of an asset class.

## 5.0 INVESTING IN HEDGE FUNDS

### 5.1 Why Invest in Hedge Funds?

As noted in Section 1, the types of investors who are attracted to hedge funds varies from institutional funds to retail investors. Throughout a market cycle, there will be periods during which equity and bond markets will offer both attractive and unattractive investment opportunities. The difficulty with investing in any market is identifying when these opportunities will occur and positioning

an investor's portfolio to take advantage of favourable market conditions. An equity market bull-run can be followed by a bear market with lower returns from market based strategies, price/earnings contraction and the delivery of lower returns by traditional managers. However, it is difficult to predict the duration and extent of a bull or bear market.

Therefore, hedge funds present an attractive opportunity for inclusion in an investor's diversified portfolio due to the possibility of enhanced risk adjusted returns and the low correlation of returns that many hedge funds have to traditional asset classes. A lower correlation between asset classes within an investor's portfolio will result in a reduction in the overall level of risk within the portfolio. The correlation of returns that some hedge fund strategies exhibit with those of traditional equity markets is shown in Table 5.1.

**TABLE 5.1: CORRELATION OF HEDGE FUND INDICES WITH US EQUITY AND WORLD EQUITY MARKETS**

<b>Correlations from Jan 1994 to Dec 2005</b>	<b>S&amp;P 500</b>	<b>MSCI World \$</b>
S&P500	1	0.80
MSCI World \$	0.83	1
Convertible Arbitrage	0.44	0.29
Equity Market Neutral	0.11	0.16
Event Driven	0.60	0.62
Fixed Income Arbitrage	-0.10	-0.04
Global Macro	0.32	0.38
Dedicated Short Bias	-0.70	-0.71
Long Short Equity	0.65	0.76
Managed Futures	-0.21	-0.19

*Source: CSFB/ Tremont Index*

The lowest correlation of returns occurs with dedicated short bias and managed futures strategies where these strategies are based on taking profit as a result of opposite movements in the price of securities from that of the broad equity market. Those strategies that are implemented through investment in equities demonstrate the highest correlation of returns with equity markets, notably event driven (0.60 correlation to S&P 500) and long/short equity (0.65 correlation to S&P 500) strategies. However the correlation in returns of these strategies with the US market (S&P 500) and the global market (MSCI World \$) is significantly lower than the correlations these markets exhibit with each other (0.80). Correlations will however change over time and may rise in certain market conditions.

The question has emerged as to whether hedge funds should be treated as a separate asset class, in a similar way to equities or bonds. Support for the case that hedge funds belong to a separate asset class is primarily based upon the non-correlated return profile generated by hedge funds when compared to traditional asset classes. To be considered a separate asset class, the securities within an asset class need to be more highly

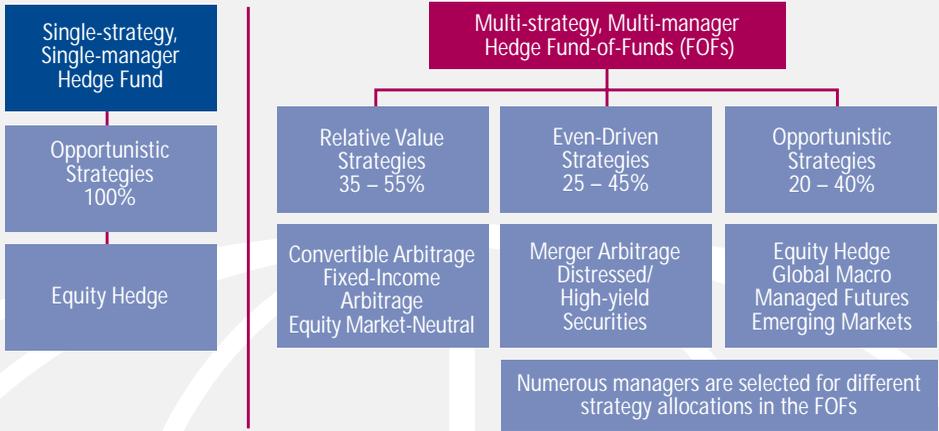
correlated with each other than with assets outside this class, which is not the case for hedge funds.

This belief comes from the diverse nature of hedge fund strategies and consequently low correlation with each other. Cottier: Hedge Funds and Managed Futures, Performance, Risks, Strategies and use in investment portfolios, 2000

## 5.2 Single Strategy Funds and Funds of Hedge Funds

An investor has several options for accessing hedge funds. One is to directly invest in one or several hedge funds. Another is to purchase an interest in a fund of hedge funds, also known as a multi-manager fund. The investment manager of a fund of hedge funds selects and invests in multiple hedge funds, numbering anywhere from 5 to over 40, often through an offshore corporation or similar privately placed vehicle.

A single strategy manager will focus on a particular asset class or trading strategy to generate returns. A fund of hedge funds manager will combine various strategies and seek out the “best of breed” hedge fund managers to diversify across strategies and managers.



A fund of hedge funds incorporates single strategies that are broadly available. Several long-term investors may gain broad exposure through a fund of hedge fund and seek to add single hedge funds to their portfolio. Observations indicate that a sophisticated investor may be able to compile their own fund of hedge funds.

Using a single manager will result in lower fees than a fund of hedge funds vehicle, where the investment selection and monitoring fees of the fund of hedge funds manager are additional to the fees of the underlying hedge fund manager. If the investor is successful in selecting a strategy and manager, the potential return generation can be greater than a fund of hedge funds albeit with a more concentrated level of risk by only investing in one strategy with one manager.

For a fund of hedge funds, the return to the investor is a combination of the performance of the underlying funds minus applicable fees. Using advanced financial engineering techniques and optimisation analysis to achieve targeted asset and risk combinations, the fund of hedge funds manager creates a new product that seeks to maximise the advantages and minimise the disadvantages of the

underlying holdings.

In an analysis of more than 1000 randomly generated hedge fund portfolios, Morgan Stanley Dean Witter concluded that portfolios with as few as 20 hedge funds typically preserve the desirable properties of the indexes that cover the entire hedge fund universe. (Why Hedge Funds Make Sense, Morgan Stanley Dean Witter, Nov 2000). Investors should be aware that the South African landscape offers fewer strategies than the global opportunity set, and a smaller number of funds e.g. 5 - 15 could be expected to adequately cover the investment opportunities without diminishing returns in the name of diversification.

### 5.3 What Portion of an Investor's Portfolio Should be Allocated to Hedge Funds?

An investor's portfolio will exhibit certain return and risk characteristics based on their investment objective, time horizon and overall "comfort" with short-term return volatility. There are many questions and debates as to the appropriate amount an investor should allocate to hedge funds. Even if a fixed allocation of say "10%" is used as a starting point, which assets should be redeemed to

accommodate this investment? Hedge funds are not necessarily a separate asset class that is as easily definable as equities, fixed interest or cash as the risk/ return profile of a hedge fund will vary according to the strategy used, the assets invested and the geography.

However, a hedge fund investing in equity markets or fixed income markets will not necessarily take on the characteristics of that particular market. As an example, within the equity based category of hedge fund strategies a long/ short equity portfolio or an equity market neutral portfolio or a short bias portfolio may deliver risk/ return characteristics over time that are quite different to those of broader equity markets and therefore cannot always be considered an appropriate replacement for equities.

When using portfolio modelling (such as mean-variance optimisation) to make asset allocation decisions, it is best to use the expected risk/ return characteristics of different asset classes that are based on market factors and not a particular manager's ability to add value over the market. Given manager capability is removed from all other asset class returns (namely equity, property, fixed interest and cash) it is not appropriate to use manager based hedge fund benchmarks as proxies for the return of all hedge funds. These benchmarks provide an indication of the average manager skill available rather than passive (market based) returns available from this form of investing. However, there is no data available to forecast hedge fund returns given there is no passive benchmark. There are limitations to portfolio modelling of hedge funds, and this form of analysis should be used only as a tool, not a driver of the decision.

The question of allocating a portion of a client's portfolio to hedge funds therefore becomes one of a market specialisation within the portfolio. Market specialisation categories include active

versus passive, value versus growth, large cap versus small cap and now market based versus skill based strategies. One could therefore argue that the choice of investing in hedge funds (skill-based strategies) is part of the active versus passive manager selection decision, rather than part of the traditional asset allocation decision.

## 5.4 Factors to Consider Before Investing

*The decisions of whether to invest in hedge funds and how much of the investor's portfolio to allocate require consideration of the following factors:*

- *The investor's investment objective, incorporating their return objective and risk tolerance. This will necessarily consider whether the investor's aim is to improve the return profile or reduce the risk profile of their existing portfolio position. As demonstrated above in general terms, where an investor aims to substantially improve the return profile of their portfolio, an allocation from fixed interest to a fund of fund hedge fund may be appropriate. As an improvement to the return expectation implies taking on additional risk, the opposite case applies for a reduction in the return expectation.*
- *Which asset class to allocate funds from, for investment in hedge funds, will depend on the return/ risk objective of the hedge fund being considered.*
- *Whether the investor has the time and knowledge to research individual hedge fund managers offering single strategies to bring together their own "fund of hedge funds".*
- *The time frame to invest, considering any lock up period the hedge fund manager may impose.*

- *Funds of Hedge Funds offerings may be more suited to conservative investors in improving the return profile at a slightly lower risk.*

- *An appropriate allocation to a single manager will depend on whether the hedge fund has fixed interest or equity like characteristics.*

- *An investor's income and taxation position should be considered. Generally income distributions from hedge funds will be treated as ordinary income with very little or no capital gains or dividend imputation. This is a result of frequent trading employed by most hedge funds. However, the tax treatment of distributions, gains and deemed gains may vary depending on the legal structure of the hedge fund and the nature of the investors' participation.*

- *The need for professional guidance in manager/fund selection and the appropriate allocation within an investor's portfolio.*

## 6.0 GLOSSARY

**Accredited Investors:** An institution or high-net-worth individual that meets criteria set by national regulations on a country-by-country basis, e.g. the USA: under Rule 506 of Regulation D of the Securities Act of 1933: Net worth higher than \$1 million (for individuals or married couples). Annual income greater than \$200,000 for individuals or \$300,000 for married couples in each of the last two years, as well as a reasonable expectation for such earnings in the current year. Employed as an officer or general partner of the fund. A bank, licensed broker-dealer, employee-benefit plan, trust or endowment with assets of \$5 million or more that exists for a purpose other than investing in the fund.

**Active Risk (Tracking Error):** See Risk.

**Alpha:** A numerical value indicating a manager's risk-adjusted excess rate of return relative to a benchmark. Measures a manager's "value-added" in selecting individual securities, independent of the effect of overall market movements.

**Arbitrage:** This strategy exploits the mis-pricing between two related assets by investing long in assets perceived to be undervalued and shorting assets to be overvalued. A profit is achieved when, and if, the prices of the two assets converge. Earning returns that far exceed the risk incurred.

**Benchmark:** A reference (security or index) against which a comparison and evaluation of performance of an investment portfolio can be made.

**Beta:** Beta of a portfolio is the portfolio's sensitivity to market movements. It represents the change in the portfolio's return for every 1% change in the market return. The sign of the beta (+/-) indicates whether, on average, the portfolio's returns move in line with the market (+) or in the opposite direction (-).  
If  $B = 1.0$ , returns tend to mirror the market  
If  $B = 2.0$ , returns tend to be twice those of the market  
If  $B = -0.5$ , returns tend to be half that of the market.

**Beta Neutral:** Describes a fund with no sensitivity to broad market movements. Therefore, the fund's beta is close to zero.

**Closed-End Fund:** A fund with a fixed number of shares outstanding that are publicly traded at a premium or discount to the fund's net asset value. Not to be confused with a closed fund.

**Commodity Trading Adviser (CTA) or Managed Futures Manager**  
The manager or adviser of a managed futures fund, as defined by the US National Futures Association and the CFTC. The term reflects the fact that early futures markets were commodities-based and were set up to enable manufacturers, shippers and buyers to protect themselves against possible advisers' price movements in the underlying asset.

**Correlation (R-Squared):** Correlation is a measure of the interdependence or strength of the relationship between two investments. It tells us something about the degree to which the variations of returns from their respective means move together. If two investments are positively correlated, when one performs above its mean return, it is likely that the other will also perform above its own mean return. If two investments are negatively correlated, when one performs above its mean return, it is likely that the other will perform below its mean return. Note that correlation says nothing about the mean returns themselves: they could both be up, or both down, or one could be up and one down. To measure the strength of the relationship, we use the correlation coefficient.

**Correlation Coefficient:** A statistical measure of the interdependence of two or more random variables. Fundamentally, the value indicates how much of a change in one variable is explained by a change in another. Used in portfolio analysis and modelling. The correlation coefficient  $r$  is a measure of how nearly a scatter-plot falls on a straight line. The correlation coefficient is always between -1 (perfect negative correlation) and +1 (perfect positive correlation).

**Credit Risk:** See Risk.

**Derivative:** A financial instrument traded on or off an exchange, the price of which is directly dependent upon (i.e., "derived from") the



value of one or more underlying securities, equity indices, debt instruments, commodities, other derivative instruments, or any agreed upon pricing index or arrangement (e.g., the movement over time of the Consumer Price Index or freight rates). Derivatives involve the trading of rights or obligations based on the underlying product, but do not directly transfer property. They are used to hedge risk or to exchange a floating rate of return for a fixed rate of return. Derivatives include futures, options, and swaps. For example, futures contracts are derivatives of the physical contract and options on futures are derivatives of futures contracts.

**Diversification:** Generally refers to the variety of investments in a fund's portfolio. Risk-averse fund managers seek to combine investments that are unlikely to all move in the same direction at the same time.

**Drawdown:** The percentage loss that a fund incurs from its peak net asset value to its lowest value. The maximum drawdown over a significant period is sometimes employed as a means of measuring the risk of a vehicle. Usually expressed as a percentage decline in net asset value. The period between the peak level and the trough is called the length of the drawdown, and the period between the trough and the recapturing of the peak is called the recovery. The worst or maximum drawdown represents the greatest peak to trough decline over the life of an investment.

**Efficient Frontier:** The combination of securities that maximizes the expected return for any level of expected risk, or that minimizes expected risk for any level of expected return.

**Equity Long/ Short (Market Driven Strategies):** Long/short strategies represent an evolution of traditional long-only equity investment. As with long-only strategies, managers aim to buy undervalued securities, profiting when their prices rise. However, in long/short strategies, they also aim to sell short overvalued securities. Long/short managers differ further from buy-and-hold investors by having the flexibility to use leverage as well as derivatives, such as futures and options. By combining long and short positions, long/short equity hedge funds can reduce market risk as well as producing returns

from falling stock prices.

**Equity Market Neutral:** Equity Market Neutral funds take long and short positions in such a way that the impact of the overall market is minimized. Market neutral can imply dollar neutral, beta neutral or both. A dollar neutral strategy has zero net investment (i.e. equal dollar amounts in long and short positions). A beta neutral strategy targets a zero total portfolio beta (i.e. the beta of the long side equals the beta of the short side). While dollar neutrality has the virtue of simplicity, beta neutrality better defines a strategy that is uncorrelated with the market return. Many practitioners of market-neutral long/short equity trading balance their longs and shorts in the same sector or industry. By being sector neutral, they avoid the risk of market swings affecting some industries or sectors differently than others. Equity market neutral is a relative value strategy.

**Event Driven:** Event Driven funds tend to take advantage of pricing anomalies resulting from corporate transactions and special situations. The success of Event Driven funds depends on their ability to assess the probability of failure / success of such corporate events.

**Exposure:** The extent to which a hedge fund is vulnerable to changes in a given financial market. Exposure can be measured on a net or gross basis. Gross Exposure is calculated by adding the percentage of the fund's equity invested in short sales to the percentage of its equity used for long positions. In both cases, the exposures often exceed 100% because they do not account for the use of leverage. Net Exposure takes into account the benefits of offsetting long and short positions and is calculated by subtracting the percentage of the fund's equity capital invested in short sales from the percentage of its equity capital used for long positions. For example, if a fund is 125% long and 50% short, its net exposure would be 75%.

**Forward:** A private, over-the-counter (OTC) derivative instrument that requires one party to sell and another party to buy a specific security or commodity at a pre-set price on an agreed-upon date in the future. Similar to a futures contract, which is traded on an exchange.

**Fund of Funds:** Funds of Funds are portfolios of hedge funds offering

investors exposure to a wide range of alternative investment styles and strategies. Funds of funds generally allocate capital to 15-30 hedge funds to achieve efficient risk diversification. Nevertheless a smaller number of funds may be used to concentrate capital on a particular strategy. Such funds of hedge funds aim to post high returns and are more concerned by manager and event risks. Conversely, a larger number of funds may be used to control for extreme risks. Most funds of funds invest in portfolios diversified by manager and strategy which enable them to produce consistent absolute returns with low levels of risk.

**Futures Contract:** A future is an exchange-traded derivative instrument that involves a contract to buy or sell an asset (stock index, commodity, currency, fixed income or other security) for delivery at a future date at a specific price. Futures can be traded on an exchange until they expire. The exchange acts as the buyers' or sellers' counterparty. This implies that there is no counterparty risk and that since the exchange acts as the counterparty, it is possible to buy a contract from one person and sell a contract to another.

**General Partner:** The individual or firm that organizes and manages a limited partnership, such as a hedge fund. The general partner assumes unlimited legal responsibility for the liabilities of a partnership.

**Global Macro:** Global Macro funds aim to profit from changes in global economies, typically brought about by shifts in government policy that impact interest rates, in turn affecting currency, stock, and bond markets. They participate in all major markets – equities, bonds, currencies and commodities – though not always at the same time. Global Macro funds use leverage and derivatives to accentuate the impact of market moves. They also utilize hedging, but the leveraged directional investments tend to have the largest impact on performance. Some funds may focus their efforts on a reduced number of positions. Most global macro funds follow a top/down type management process. As a result, the importance of stock picking is reduced in comparison with the asset allocation process (both strategic and tactical). Due to a large exposure to stock, bond, currency and other markets, Global Macro is regarded as a Multi-

Directional strategy.

**Gross Exposure:** See Exposure.

**Hedge Fund Manager:** With there being no standard international/legal definition for a hedge fund manager, they are managers who run funds which may have all or some of the following characteristics:

- May use some form of short asset exposure (see short selling in terms);
- May use derivatives an/or more diverse risks or complex underlying products are involved;
- May use some form of leverage, measured by gross exposure of underlying assets exceeding the amount of capital in the fund;
- Funds charge a fee based on the performance of the fund relative to an absolute return benchmark as well as a management fee;
- Investors are typically permitted to redeem their interest only periodically, e.g. quarterly or semi-annually;
- Often the manager is a significant investor alongside the other fund investors.

**Hedging:** The process of protecting the value of an investment from the risk of loss, in the case of an adverse price movement.

**High Water Mark:** The existence of the high water mark ensures that a fund only takes performance-related fees on new profits. For example, assume a \$1,000,000 investment is made and that the fund declines by 20% in year 1, leaving \$800,000 in the fund. In year 2, the fund returns 25%, bringing the investment value back to \$1,000,000. If the fund employs a high water mark, it will not take incentive fees on the return in year 2, since the investment has never really grown, i.e. the fund did not make any new profits. The fund will only take incentive fees if the investment grows above the level of \$1,000,000.

**Hurdle Rate:** The minimum return necessary for a fund manager to start collecting incentive fees. The hurdle is usually tied to a benchmark



rate such as Libor or the one-year Treasury bill rate plus a spread. If, for example, the manager sets a hurdle rate equal to 5%, and the fund returns 15%, incentive fees would only apply to the 10% above the hurdle rate.

**Leverage/ Gearing:** The borrowed money that an investor employs to increase buying power and increase its exposure to an investment. Users of leverage seek to increase their overall invested amounts in hopes that the returns on their positions will exceed their borrowing costs. The extent of a fund's leverage is stated either as a debt-to-equity ratio or as a percentage of the fund's total assets that are funded by debt. Example: If a fund has \$1 million of equity capital and it borrows another \$2 million to bring its total assets to \$3 million, its leverage can be stated as "two times equity" or as 67% (\$2 million divided by \$3 million).

**Limited Partnership:** Many hedge funds are structured as limited partnerships, which are business organizations managed by one or more general partners who are liable for the fund's debts and obligations. The investors in such a structure are limited partners who do not participate in day-to-day operations and are liable only to the extent of their investments.

**Long Position:** Holding a positive amount of an asset.

**Managed Account:** A vehicle in which investors give a manager or broker discretion to buy and sell securities, futures or other instruments on their behalf, either unconditionally or with restrictions.

**Market Neutral:** Denotes an approach to investment where the emphasis is on the value of securities relative to each other and the use of arbitrage techniques, rather than market direction forecasting. By emphasizing the relative value of securities and the exploitation of pricing anomalies between related securities, practitioners of market neutral approaches aim to generate profits regardless of the overall direction of broad market prices. Market neutrality is generally achieved by offsetting long and short positions or maintaining balanced exposure to the market. The term market neutral can be applied with some justification to the majority of alternative investment

styles because of their ability to capitalize on both upward and downward price moves or to profit in a wide range of market environments.

**Merger Arbitrage:** Merger Arbitrage funds invest in companies involved in a merger or acquisition process. They typically go long the targeted company, and sell short the stock of the acquiring company. This strategy aims to capture the price spread (i.e. Merger Spread) between the current market price of the targeted company and the price offered by the acquiring firm. The performance of Merger Arbitrage funds depends on their ability to assess the probability of success / failure of the corporate transactions. The exposure of Merger Arbitrage funds to market risk depends on the transactions arrangement. Merger Arbitrage strategies are generally characterized by a relatively high return and a significant correlation with major stock indexes.

**Multi-Strategy:** An investment style that combines several different strategy approaches. The term often applies to funds of funds and hedge funds that allocate capital to a diverse group of hedge funds.

**Net Asset Value (NAV):** The market value of a fund's total assets, minus its liabilities and intangible assets, divided by the number of its shares outstanding. The measure is used to determine prices available to investors for redemptions and subscriptions. Hedge funds typically calculate their NAVs at the end of every business day, but report them to investors on a monthly basis. Mutual funds report their NAVs daily.

**Net Exposure:** See Exposure.

**Option:** An option is the right (but not the obligation) to trade a particular amount of a specific good on or before a set day at an agreed ("strike" or "exercise") price. The right to buy is known as a "call" option and the right to sell a "put" option. Since options give one party the opportunity to benefit when it is advantageous to them, but gives them no obligation to trade when it is not, they must pay for it. One party buys the option and pays the option

“premium” to the option “writer” who must honour the contract.

**Over-The-Counter (OTC):** The trading of commodities, contracts, or other instruments not listed on any exchange. OTC transactions can occur electronically or over the telephone. Also referred to as Off-Exchange.

**Pair Trading:** A relative value approach that seeks to identify similar companies in a given sector, whose securities are trading or are anticipated to trade at a wide differential. The manager of such a fund would assume a short position in the overvalued security, while taking a long position in the undervalued one.

**Prime Broker:** A large bank or securities firm that provides various administrative, back-office and financing services to hedge funds and other professional investors. Prime brokers can provide a wide variety of services, including trade reconciliation (clearing and settlement), custody services, risk management, margin financing, securities lending for the purpose of carrying out short sales, recordkeeping, and investor reporting. A prime brokerage relationship does not preclude hedge funds from carrying out trades with other brokers, or even employing others as prime brokers.

**Pro-Forma:** A representation of a track record (see ‘Track Record’) that is developed to show the effect on actual performance of intended or potential adjustments for different fee structures, portfolio allocations or other variations in the investment structure upon which the original track record is based. It is important to note that a pro-forma is based on actual trading results and differs from a simulation, which models the hypothetical performance of a portfolio or investment approach that has yet to be applied or implemented in actual trading.

**Risk: Active Risk**

Also known as Tracking Error. Refers to the variation between a fund’s returns and a benchmark’s returns. A large tracking error indicates a large variation from the benchmark, and implies a high level of manager risk.

**Credit Risk:** Credit risk is the risk that another party may fail to honour an agreement. The archetypal example would be the issuer of a bond defaulting on its obligation to pay back its debt. Agencies such as Standard and Poors (S&P) and Moody’s grade debt-issuers according to their credit-worthiness. If a party is perceived to become less credit-worthy, the market price of its debt is likely to fall as a buyer would need to be compensated for the increased credit sensitivity and higher risk of default. Increasingly, it is possible to use credit derivatives to insure against the risk of default.

**Downside Risk:** Downside risk is a similar measure to Volatility, except that this statistic calculates an average return for only the periods where return was lower than zero (or another benchmark rate) and then measures the variation of only these “losing” periods around the calculated average. In other words, this statistic measures the volatility of the downside performance.

**Event Risk:** The likelihood that an investment’s value will change as the result of unexpected events, such as corporate restructurings, a takeover, regulatory shifts or disasters.

**Liquidity Risk:** The potential that an investor will be unable to convert its holdings into cash quickly and in large quantities without having to accept a substantial discount. The term also refers to the potential that a securities buyer will not have enough money to pay for the purchase.

**Market Risk:** See ‘Systematic Risk’.

**Operational Risk:** Measures the probability that investment losses will result from factors other than credit risk, market risk or liquidity risk, such as employee fraud or misconduct, errors in cashflow models, incorrect or incomplete documentation of trades or man-made disasters.

**Systematic Risk:** Systematic risk is the level of risk that is faced by a well-diversified portfolio. It is sometimes known as “market risk” as it is the risk of the market as a whole - that is, risk factors that impact on all stocks in the economy - for example changes in interest



rates or the state of the economy. It is said to be undiversifiable risk because adding more investments to a diversified portfolio will not decrease the level of this type of risk. Beta is a measure of systematic risk taken on by a portfolio.

**Unsystematic Risk/ Unique Risk:** Unsystematic risk is the potential variability in the returns offered by a security as a result of factors specific to its issuer. For company shares, for example, the quality of its management affects its specific risk. This type of risk is diversifiable because the specific risks of different securities will not all be highly correlated with each other - hence combining them in a portfolio reduces its unsystematic risk.

**Value at Risk (VaR):** A measure of the potential change in value that a fund's portfolio may experience during that vehicle's holding period. It is usually expressed as a percentage, which is referred to as a confidence level.

**Sharpe Ratio:** A measure of risk-adjusted performance (how well a fund is rewarded for the risk it incurs). The higher the ratio, the better the return per unit of risk taken. It is calculated by subtracting the risk-free rate from the fund's annualized average return, and dividing the result by the fund's annualized standard deviation. A Sharpe ratio of 1:1 indicates that the rate of return is proportional to the risk assumed in seeking that reward. A measure of more than 1 (by the manager) means he/she is skilled at extracting extra returns without too much more risk. (Developed by Prof. William R. Sharpe of Stanford University.)

**Short Selling:** Short Selling funds sell securities short in anticipation of being able to buy them back in the future at a lower price. The manager estimates that the securities, or the market, are overvalued or anticipates earnings disappointments, often due to accounting irregularities, new competition, change of management, etc. Short Selling funds are often used as a hedge to offset long-only portfolios and by those who feel that the market is approaching a bearish cycle. Short Selling funds are by nature strongly exposed to extreme risks since their short positions present infinite loss potential. As a result, short selling is strictly regulated and should be regarded with

caution. Short Selling is a Directional strategy generally characterized by relatively volatile returns and a significant correlation with major stock indexes.

**Sortino Ratio:** A measure of risk-adjusted performance that indicates the level of excess return per unit of downside risk. It differs from the Sharpe ratio (see Sharpe ratio) in that it recognises investors' greater tolerance for volatility in profitable periods ('good volatility') compared with their tolerance for volatility in periods of negative performance ('bad volatility'), and uses a measure of 'bad volatility' as provided by semi-deviation - the annualised standard deviation of the returns that fall below a target return. Also called the "upside potential ratio".

**Standard Deviation:** For an investment portfolio, it measures the variation of returns around the portfolio's mean-average return. In other words, it expresses an investment's historical volatility. The further the variation from the average return, the higher the standard deviation.

**Statistical Arbitrage:** A Market-Neutral investment strategy that seeks to simultaneously profit and limit risk by exploiting pricing inefficiencies identified by mathematical model designed on the assumption that prices will trend toward their historical norms. The strategy often involves high velocity and high volume trading of short-term positions

**Style:** A generic investment approach - such as equity hedge and long/short, event driven, arbitrage, global macro, or fund of funds - that has developed as a result of numerous managers aiming to exploit a particular type of market inefficiency, sharing a broadly similar conceptual understanding of that inefficiency, and employing a broadly similar investment methodology in order to extract value. Practitioners of a particular style will have their own investment process or strategy with unique distinguishing features and techniques.

**Survivorship Bias:** An over-estimation of historic returns for the hedge fund industry that results from the tendency of poor-performing hedge funds to drop out of an index while strong performers continue

to be tracked. The result is a sample of current funds that includes those that have been successful in the past, while many funds that underperformed are not included.

**Systematic Trading:** Systematic Trading strategies use rule-based trading models implemented in a systematic fashion to identify and execute trading opportunities with limited manager intervention.

**Systemic Risk:** The risk that a default by one market participant will have repercussions on other participants due to the interlocking nature of financial markets. For example, Customer A's default in X market may affect Intermediary B's ability to fulfil its obligations in Markets X, Y, and Z.

**Track Record:** The actual performance of an investment since inception, usually represented by audited monthly returns, net of fees.

**Unsystematic Risk/ Unique Risk:** See Risk.

**Volatility:** A statistical measurement of the rate of price change of a futures contract, security, or other instrument underlying an option. See Standard Deviation.

**Warrant:** A contract that gives an investor the rights to purchase a security at a specific price (usually above the current price) on a future date. It is usually issued with a bond or preferred stock to provide additional incentive to the buyer. Warrants are similar to options contracts, but unlike options, they can stay in effect for a period ranging from a few years to eternity.

**Yield:** The return earned on an investment with the annual income and present capital value taken into account.

**Yield curve:** A graphic representation of market yield for a fixed income security plotted against the maturity of the security.

*Courtesy of AIMA's Glossary of Hedge Fund Industry  
Terms and Definitions*



## APPENDIX I : REFERENCES, ADDITIONAL READING, AND WEBSITES

### REFERENCES & ADDITIONAL READING:

- BARRA RogersCasey: "An Introduction to Hedge Funds. The first in the BRC Hedge Fund Series"; BARRA RogersCasey; 2001
- Fraser E: "Hedge Funds 101: Trustee Education"; January 2004.
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- Lowenstein R: "When Genius Failed: The Rise and Fall of Long Term Capital Management"; Fourth Estate; 2002.
- Rahl L: "Hedge Fund Risk Transparency: Unravelling the Complex and Controversial Debate"
- Schneeweis T: "Dealing with Myths of Hedge Fund Investment": The Journal of Alternative Investments, Winter 1998.

### WEBSITES:

AIMA	<a href="http://www.aima.org">http://www.aima.org</a>
Financial Services Board	<a href="http://www.fsb.co.za">http://www.fsb.co.za</a>
HedgeWorld	<a href="http://www.hedgeworld.com">http://www.hedgeworld.com</a>
Hedge Fund Research, Inc.	<a href="http://www.hedgefundresearch.com">http://www.hedgefundresearch.com</a>
InvestHedge	<a href="http://www.hedgefundintelligence.com/ih/index.htm">http://www.hedgefundintelligence.com/ih/index.htm</a>
Van Hedge Fund Advisors	<a href="http://www.hedgefund.com">http://www.hedgefund.com</a>



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