



AIMA

Hedge Funds Primer

January 2020

AIMA

THE ALTERNATIVE INVESTMENT
MANAGEMENT ASSOCIATION

“Hedge Funders”

The logo for the Association of Investment Management Administrators (AIMA). It consists of a dark blue square with the letters "AIMA" in white, positioned above a horizontal magenta bar.

Hedge Fund Manager

the investment management firm that makes the decisions on behalf of the hedge fund

Hedge Fund

the collective investment vehicle into which clients invest

Hedge Funds vs Traditional Funds

Traditional Funds

- invest in stocks and bonds on a “long only” basis
- have a tightly defined investment mandate
- typically focused on specific markets, e.g. European equities, US Government bonds
- usually daily liquidity for investors

Hedge Funds

- are “alternative” to traditional funds
- take both long and short positions
- have largely unconstrained investment mandates
- freely use leverage and derivatives
- come in many different styles and strategies
- commonly allow investors to get their money out with 3 months notice

Seeking Alpha

Traditional investment funds are mostly exposed to Beta – the direction of the markets they invest in

Hedge funds seek Alpha – the excess value not caused by market direction; the investment edge based on flexibility, skill and superior analysis

Getting paid for it - fees

Average fees are now closer to “1½ & 15”

1.5% of fund AUM and 15% of upside performance

Example

Initial fund size	\$250,000,000
2019 gross performance	+10%
1.5% of fund size	\$3,750,000
15% of performance	\$3,750,000
Total fees	\$7,500,000

Hedge Fund Strategies

- Long/Short Equity
- Merger Arbitrage
- Market neutral
- Systematic/Quant
- Event Driven
- Credit
- Fixed Income Arbitrage
- Global Macro
- Managed Futures/CTA
- Convertible and volatility arbitrage
- Multi-Strategy

Are hedge funds risky?

Performance Volatility

Stocks (S&P Index)	14%
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Bonds (10yr US Treasury)	4%
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Hedge Funds (HFR Index)	4%
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But surely leverage is risky?

Long 1,000,000 Tesco shares @ 255p
Cost: £2,550,000

Short 1,094,000 Sainsbury shares @ 233p
Proceeds: £2,549,000

- Market Neutral - a hedged position
- Gross position £5,099,000
- Prime brokerage margin 10% each side = £509,900
- Gross leverage = 10x

Long/Short - Scenario 1

Tesco +5%

Sainsbury -3%

Profit on Long Tesco:	£127,500
Profit on Short Sainsbury:	£76,470
Total Profit:	£203,970
Return on Equity (Margin)	40%

Long/Short - Scenario 2

Tesco +10%

Sainsbury +5%

Profit on Long Tesco:	£255,000
Loss on Short Sainsbury:	£127,450
Total Profit:	£127,550
Return on Equity (Margin)	25%

FTSE 100 Index – 2019 Best & Worst

Top 10		Bottom 10	
JD Sports	138%	Sainsbury	-5.5%
AVEVA	98.7%	Bunzl	-8.1%
London Stock Exchange	89.7%	TUI	-9.1%
Next	78.1%	Glencore	-9.8%
Barratt Developments	71.4%	BT	-11.8%
Halma	61.1%	Rolls-Royce	-11.9%
Ocado	58.6%	Imperial Brands	-13.5%
Taylor Wimpey	55.5%	Centrica	-26.1%
SEGRO	53.8%	Pearson	-28.5%
Melrose Industries	52.8%	NMC Health	-35.1%

S&P 500 Index – 2019 Best & Worst

Best

Advanced Micro Devices Inc.	150%
Lam Research Corp.	120%
KLA Corp.	104%
Target Corp.	102%
Chipotle Mexican Grill Inc.	94%
Xerox Holdings Corp.	93%
Qorvo Inc.	92%
Applied Materials Inc.	90%
Copart Inc.	90%

Worst

Abiomed Inc.	-48%
Macy's Inc.	-40%
Occidental Petroleum Corp.	-30%
DXC Technology Co.	-30%
Mylan NV	-28%
Gap Inc.	-27%
Mosaic Co.	-27%
L Brands Inc.	-25%
Alliance Data Systems Corp.	-25%

Who's who at a HF Manager?

Founder/CEO/Chief Investment Officer
Portfolio Manager/Analyst/Trader

Chief Operating Officer

Chief Financial Officer

General Counsel/Chief Legal Officer

Chief Compliance Officer

Chief Risk Officer

Chief Technology Officer

Head of Marketing & Investor Relations

What do they do? (i)

Founder(s)/Chief Investment Officer

- The owners/senior partners
- Portfolio management focused

CEO

- Most often the senior founder
- Sometimes an experienced professional brought in to lead the business (ex-portfolio management)

Portfolio Manager/Trader/Analyst

- Portfolio management team reporting to CIO/Founder
- Varying degrees of autonomy

COO

- In absence of CEO this is the senior person who manages the non-investment side of the business
- Runs the middle and back office
- Will have operations team to process trading activities of investment team
- Interface with Prime Brokers, Administrators
- Collateral management
- Main point of contact for investor Operational Due Diligence

What do they do? (ii)

CFO

- Can often also be the COO
- Responsible for fund accounting, corporate accounting & tax
- Interface with auditor, accountant and administrator

GC/Chief Legal Officer

- Responsible for fund structuring and documentation
- Negotiates counterparty service and trading agreements
- Assesses and monitors regulations applicable to the funds and the firm
- Oversight of regulatory enquiries and investigations
- Provides input on portfolio investments requiring legal advice
- Interface with law firms

Chief Compliance Officer

- Registration, filing and reporting with applicable regulators
- Performs regular compliance reviews
- Designs and maintains compliance manual
- Monitors trades and activity for regulatory compliance
- Often reports to Chief Legal Officer
- Interface with law firms

What do they do? (iii)

Chief Risk Officer

- Should be independent of investment functions
- Oversees risk management for the investment portfolio
- Creates reports identifying risks and exposures that might cause loss to the portfolio
- Uses quantitative risk analytics
- Analyses counterparty risk, liquidity risk as well as market risk
- Provides input to portfolio management team to optimise their return on risk

Chief Technology Officer

- Develops and maintains firm IT infrastructure
- Creates and monitors firm cyber security policy
- Builds or buys key firm systems - operational, compliance, reporting, risk management
- In quant firms can oversee a large team of developers
- Data storage
- Interface with technology service providers

Head of Marketing & Investor Relations

- Responsible for capital raising and managing client relationships
- Creates marketing materials
- Regularly out meeting with clients and prospects
- Maintains firm CRM
- Responsible for client onboarding and assisting with their due diligence
- Provides investor reports and updates
- Interface with primer broker capital introduction teams for new leads and meetings

The Service Providers

The logo for AIMA (Association of Investment Managers and Administrators) is located in the top right corner. It consists of a dark blue square with the letters "AIMA" in white, and a magenta horizontal bar at the bottom.

Prime Brokers

Executing Brokers

Fund Administrators

Law Firms

Auditors & Accountants

Independent Fund Directors

Technology Firms

Consultants

What do they do? (i)

Prime Brokers

- Provide leverage by lending money based on the collateral of the portfolio (e.g. can buy \$100 of shares with only \$20 down payment) - like a mortgage
- Lend stocks and bonds to meet delivery requirements for short positions
- Provide clearing and settlement for transactions in the fund
- Act as custodian for holdings in the fund

Executing Brokers

- Provide access to the market place for hedge funds to transact in stocks, bonds, foreign exchange, commodities, futures and derivatives
- Earn commission or a “spread” if acting as a risk-taking market maker
- Historically provided research as part of the package (no longer under MiFID II)

Fund Administrators

- Keep record of a fund’s assets
- Calculate Net Asset Value per share in fund
- Shareholder services - register/subscriptions/redemptions
- Anti-money laundering checks
- Financial Reporting
- Back office services

What do they do? (ii)

Law Firms

- Fund structuring & formation
- Prospectus/Offering Memorandum documentation
- Registration & Compliance advice
- Investor and Counterparty negotiations

Auditors & Accountants

- Audit the accounting practices of the hedge fund and management company
- Reviews fund's valuation methodology
- Reviews fund's account statements and performance
- Works with administrator who prepares the financial statements
- Provides tax advice

Independent Fund Directors

- Independent of the management company and its executives
- Governance oversight of the fund
- Acts in the interests of investors (fiduciary duty)
- Ensures investment manager is managing fund according to its mandate and prospectus
- Guards against fraud and other malpractice

What do they do? (iii)

Technology Firms

Wide range of firms providing technology solutions:

- IT infrastructure
- Transaction processing
- Accounting software
- Order management systems
- Portfolio and risk management systems
- Cloud storage
- Data warehouse
- Cyber security
- CRM

Consultants

- Regulator registration
- Service provider selection
- Risk assessments
- Compliance
- Technology

Who invests in Hedge Funds?

Investors

- Founders
- Pension Funds
- Sovereign Wealth Funds
- Fund of Funds
- Foundations/Charities
- Endowments
- Insurance Companies
- Private Banks/Wealth Managers
- High Net Worth Individuals

Industry overview (as of Q3 2019)

AIMA

5,949

number of
investors

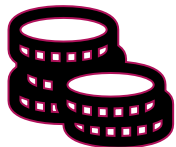
6,088

number of
fund
managers

16,364

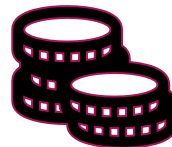
number of
funds

3,572



**AUM (\$bn) as at
Q3 2019**

-34.4



**Q3 2019
Asset Flow (\$bn)**

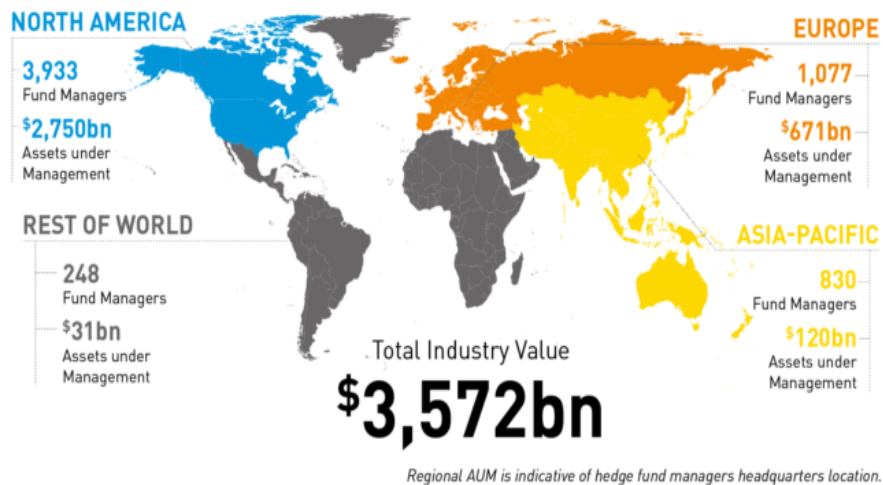
-0.28%



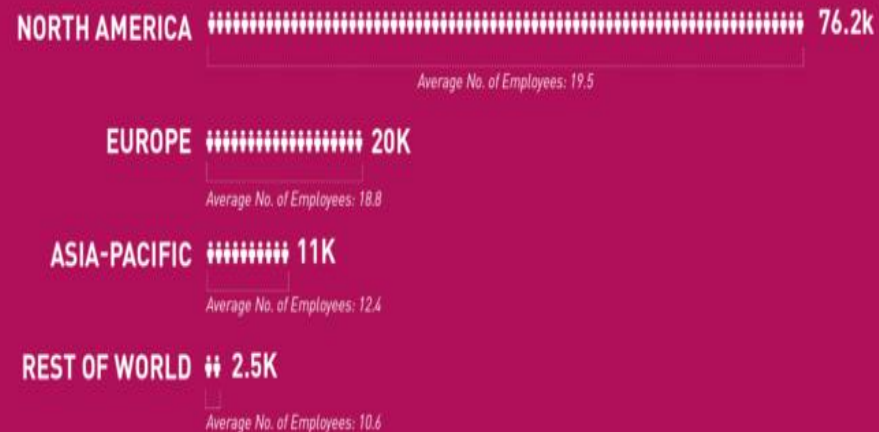
**Q3 2019
Hedge Funds
Performance**

Fund Manager Headquarters

Number of Hedge Funds and AUM by Fund Manager Headquarters



Number of Direct Hedge Fund Manager Employees by Fund Manager Headquarters



Investors by Region

Number of Institutional Investors that Allocate to Hedge Funds, by Region

