

## A Look Inside Hedge Funds:

Hi, my name is Patty Hearsh. I'm a senior editor at Market Place. Today I want to talk about hedge funds. The reason being, is because firstly hedge funds have been responsible - and in some cases, for a lot of the volatility we've seen in many of the markets recently. And secondly, because it's clear from a number of conversations and posting that people have made to the website that people don't really understand what a hedge fund is. So that's a goal at explaining that.

Alright, the name is obviously very helpful. We have hedge funds. The name tells you that it's a fund to start that gets involved in hedging.

So what is hedging? Well, hedging, just judging by the expression, to hedge your bets, means it's a way of offsetting risks in any trade or investment that you make.

So let's take our hedger. His name is Dennis. Dennis is an adventurous investor. And Dennis has got a number of means at his disposal in order to hedge his bets. If he invests in debt, for example, he might take out insurance in the form of a "credit default swap" (CDS). If he buys bonds or debt or stock, he could short that stuff – short selling. He might get involved in arbitrage. He might get involved in options. Put some goals that might help him deal with.. to help him offset his risks by making investments. I'm not going to go through all of these things – a number of them we have actually explained in other white-boarder explainers that you can find on the website.

But say that Dennis decides (that) after a short career in an investment banking to start his own hedge funds. Well the first thing he does is, he goes to see his uncle Sam. Well, it's the old uncle Sam here. A stern chap. And uncle Sam says, "So, what is it you're gonna be buying"? And Dennis says, "Well, I wanna buy everything, I wanna buy stock, I wanna buy bonds, I wanna buy loans, I wanna buy credit default swaps based on the government debt from Britan, I wanna buy race horses in Ireland, everything. Well, uncle Sam says well, in that case you're gonna be a hedge fund. If ya gonna be a hedge fund, there's some rules. "Ok", Dennis says, "So what are the rules"?"

"Well, the first thing", says uncle Sam, "Is 65% of your investors have to be accredited". Accredited investors. "And what does that mean?" says Dennis. It says it means that they have to be rich. And by rich I mean that they have to have more than a million dollars in assets, or last year they had to have made more than 200k, and next year they have the expectation of earning the same, or if it's a man and his wife, they have to earn more than 300k a year, last year and they are expected to earn the coming year. Now Dennis knows there are church mice in NY who earn 200k a year, and after they pay their mortgage, they can barely afford to shop at the farmer's market, so he's quite happy with that arrangement.

Alright, any other rules? Ok, says Dennis, so he decides to take 10% of the bonus he got paid when he left Wall Street, which was about 4 million dollars, and he invested in his own hedge fund. And he's gonna call that hedge fund "Buccaneer Capital". He thinks it sounds like a very sexy name, but he thinks he'll get a lot of attention in the press. And by the way, there was a hedge fund called Pirate Capital,

which this has nothing to do with, but you can read all about the adventures of Pirate Capital if you go to the website and check on some of the links we have there - fascinating reading.

Anyway, Dennis goes out and he decides to form Buccaneer Capital, and there's only one rule that uncle Sam has given him and it's about these accredited investors. So, he decides to make up a few of his own rules.

1. He first decides to do is to invest a large personal stake. His stake, of course, is 4 million dollars. And the reason he has that is because he thinks that if he has a large personal stake, then more people will have incentive to join in his fund.
2. The second thing he decides to do is to have high-minimum investments. Why does he want that? Well, he knows the more people that invest, the more fees he gets, but at the same time, large amounts are a lot easier to deal with than small amounts.

So, Ok, the minimum investment is going to be a million dollars. So, that's his high-minimum. So he goes out to a bunch of people and says, "Investors, invest your money with me. I've invested 4 million, I'm looking for 10 million, you know. I'll invest your money and make you 15 or 20% over the next 3 years. And people invest for various reasons. One might say, "Wow, Buccaneer Capital, that's a cool name. I'll give you 2 million dollars. Somebody else might say, "Wow, you're putting up 4 million dollars of your own money, you must really know what you're doing. I'll give you 2 million." And then, you know, he goes to another person – his auntie, and she says, "Oh, you've always been one of my favorite nephews; I'll give you 2 million. So people invest for all sorts of different reasons in these hedge funds, but eventually he ends up with the 10 million he's after-. 10 million in total.

But what he says to these investors is, "Thanks very much for the 2 million dollars, but you know I'm going to be doing some very creative investments that are gonna make you a lot of money, but one of my new rules is that I'm gonna lock you in for a year - first year lock in. You can't get your money back for a year. And when that first year is over, I'm gonna limit your redemption capacity. So, I'm gonna have infrequent redemptions, maybe once or twice every year, or once a quarter. So we have infrequent redemptions, as they're called. You only get your money out a couple a times a year, or maybe 4 times a year.

So he then goes out and looks for his investments. And they could be whatever he wants. He – like I say – can invest in race horses in Ireland. He can invest in CDS, you know.. backed by the Chinese government bonds... whatever he wants to do – absolutely anything. And he can use all these hedging techniques, so he has the use of hedging techniques. And he has a variety of investments. Some hedge funds may go and decide to invest in a certain number of things, maybe they'll only invest in bonds, or only invest in bank (?) or only invest in stock, and some of them will only use one or two techniques. There are classic types of hedge funds called long, short hedge funds which would only invest in stocks or bonds and they would go long on one side and short on the other to balance themselves out.

The next rule he has is he says, "You guys have invested all of this money, and that's great. I'm going to have to look after myself of course, and I'm gonna be guaranteeing you say 15-20% a year. What I'm

gonna do is I'm gonna take my 2/20, it's called. 2% of my initial investment and 20% of any gains down the road. 2/20, and gains for him, that's his income. Alright, so that's his structure.

Now, he's only got 10 million dollars. And he goes out and sees a lot of his compatriots, you know, Service Capital, you know these large hedge funds that are making all sorts of money and he gets a little bit jealous. So what he does then, is he goes to his bank. Goes to good 'ol Chase Manhattan Bank. And he says, "Guys, I've got 10 million dollars here". I've got some great ideas, resources in Ireland, I can make loads of money, how about giving me some more money, how about levering me up? They say, "Ok. We'll tell you what. We'll lend you 50 million dollars to give you a 60 million dollar fund. These guys give him 50 – 50 million. He's got 10 million, which means he has 5 to 1 leverage, or levered 5 times. So the last guy this guy's got in his fund is leverage.

So here's a list of all the things that hedge funds.. this is all the characteristics of a hedge fund. Firstly is the hard and fast rule: the accreditation. Secondly, most of them have ..put in large personal stakes. They have a high-minimum investment, often between 250 to 1 million dollars. Usually the first year is locked in and you can't get your money back. There are infrequent redemptions thereafter. These guys use all sorts of hedging techniques; the world is pretty much open to them. They have a variety of investments they can invest in, pretty much whatever they want. Most of them use this structure where they earn 2% on the initial investment, and then 20% on any earnings on the fund, and the majorities in the past have used leverage, although this is less common these days. Also the fee structure is coming down as well. So those are the main characteristics of the hedge fund.

The thing that we're worried about these days, and the reason the hedge funds are in the news so much is because of the infrequent redemptions, and the leverage. Ok, what's happened is, say you have a hedge fund that only has redemptions 4 times a year. Well, the hedge fund calls up its investors and says, "Redemption time is coming up. You need to let us know if you want your money back. And of course since the market is in the state that it is, and so many investors want to be in cash, and don't want to be involved in the market because it's sinking like a stone, they say, "We want our money back". And they're doing it by the hundreds of thousands. As a result, they find that there's a run on hedge funds essentially.

Hedge funds are finding that in order to make this money back, they have to sell almost everything they have in the fund. But of course, because they're leveraged up really, really high, as soon as they start selling hard, it means that they are in real danger of losing their principle, but they don't really have a choice because they're committed into giving these redemptions.

Well, when I say committed, of course there's one other rule, which is there really are no rules apart from this one (accreditation). So a hedge fund can always turn around to its investors and say, you know what, "We're gonna lock you in. And we're gonna say to you, 'You can't get your money back at all. We're gonna hold onto the fund. We're gonna allow no money to come out of the fund, until such time as the market has risen back up again, and we feel we can sell our assets at a reasonable price. Firstly, not drive the market down, and secondly, get a fair price for the assets so we can actually pay you back for when you want your redemptions." So they're locking people in until the market settles down. This is

necessary because if they don't lock in, then they're gonna have to make these sales, because with the leverage in the accounts, and the fact that people want their money back, they're having to sell things very, very quickly.

This is one of the reasons why we're seeing so much volatility in the market. Now, because the hedge funders realize that it has to give its money back, it's gotta sell everything in its portfolio, the price of which has already gone down, so once it starts to sell, and sell hard, it's driving the prices of things down further and further. And that's leaving everyone in the market with hedge funds and investors badly needing a trick.