Hedge Funds Demystified

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1. Background
2. What do they do?
3. How are they organised?
4. Risks & regulation
5. How important are they?
6. Why do people invest & who are they?
7. What are the returns?
8. Where do / will they fit in?

1. Background

1. When did they begin?
2. What are they?
   1. Alternative Investment Fund / Private Equity
   2. UCITS Fund
3. Size: global hedge fund assets estimated at $2.9trn, but are they systematically important?
4. What sort of things do they do?

2a Hedge funds are alternative investments

An **alternative investment** is an investment in asset classes other than stocks, bonds and cash. The term is a relatively loose one and includes tangible assets such as precious metals, art, wine, antiques, coins, or stamps and some financial assets such as a real estate fund, commodities, private equity, distressed securities, hedge funds, carbon credits, venture capital, film production and financial derivatives. Investments in real estate and forestry are also often termed alternative despite the ancient use of such real assets to enhance and preserve wealth.

2b. Alternative Investment Funds

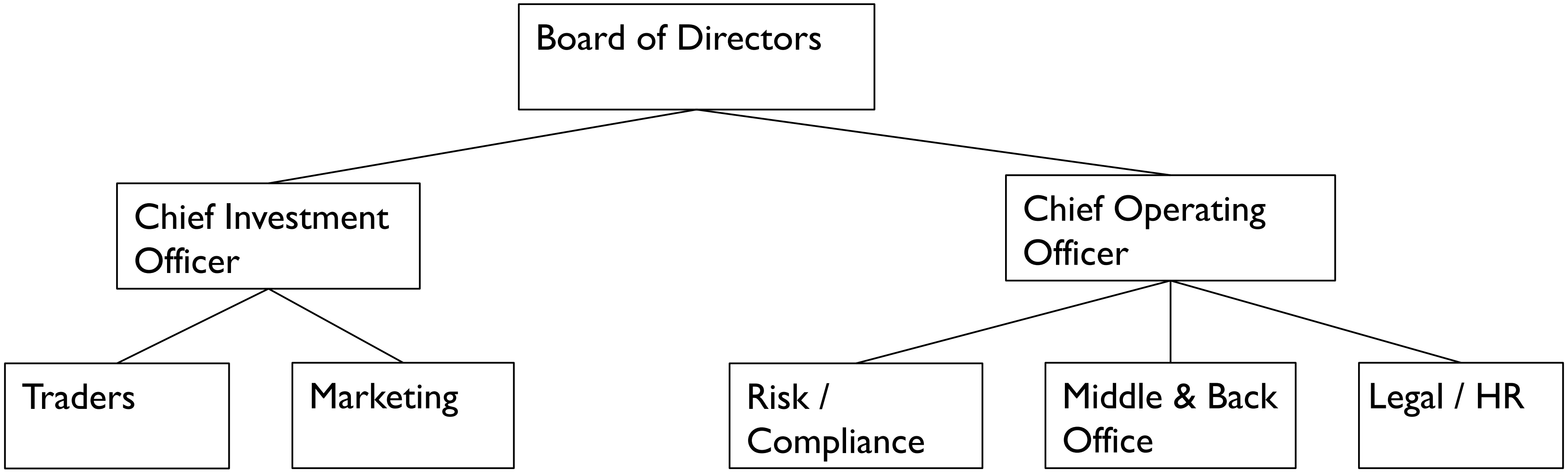
- Allow an investor to diversify their investment portfolio
- Low correlation with traditional financial investments such as stocks and bonds
- Some hard to value and illiquid assets (boat, art, film recepits, commodity, private equity investment)
- There may be limited historical risk and return data
- A high degree of analysis may be required before buying
- For qualified investors only

2c. Short selling? A hedge fund loss

- Traders seek to make money by betting on the share price of a company falling: traders agree to sell shares in a company (in this case VW) to a third party at a fixed price and by a certain date, then wait for the price to fall before buying the shares and handing them on to the third party.
- The difference between the agreed sale price and the price at which the trader buys the shares is profit. But if the share goes up, traders are exposed to potentially limitless losses.
- VW shares were being shorted by hedge funds, which led to oversupply, downward pressure on share price…but, unseen by hedge funds, Porsche had secretively been empire-building and acquiring VW shares, adding to its 42.6 per cent stake in VW by taking out options to buy VW shares owned by a number of German banks, having an option to buy 74% of VW!
- With the state of Lower Saxony owning another 20.1 per cent, this meant that just 5.8 per cent of VW shares were available to buy.
- But hedge fund managers had promised to sell to third parties a total of 12 per cent of VW's shares, and 12 into 5.8 doesn't go.

Result : Huge hedge fund losses!

3a. How organised – Swiss, smaller structure



3b Who is involved in the chain?

Custodian

Hedge fund

Exchange / Investment

Administrator

Hedge Fund Manager

Prime Broker / Broker

Investor

Distributor / Marketeer

4. Risks and regulation

1. History
2. Swiss comparison
3. Dodd Frank
4. AIFMD & CISA
5. Impact on management, custody and distribution or marketing of fund products to investors
6. Investor protection at three levels:
    1. Regulated Qualified investors – (e.g. banks, lowest protection)
    2. Unregulated Qualified Investors – (e.g. HNWI, medium protection)
    3. Unqualified Investors (i.e. the public – high levels of protection)

5. How important are they?

According to AIMA study:

1. 300’000 people employed directly or indirectly
    1. 240’000 in North America
    2. 50’000 Europe
    3. 10’000 Asia- Pacific
2. Annual tax contribution estimated at $4bn
3. Maybe 200-250 hedge fund management companies in Switzerland
    1. Range from bigger players to start-ups
    2. Many advisors / distributors

6a. What you need to believe in to invest

1. There are anomalies in the market (e.g. momentum)
2. There are managers who can take advantage of these
3. The returns outweigh the costs (e.g. 2% on AuM + 20% of performance over a benchmark)

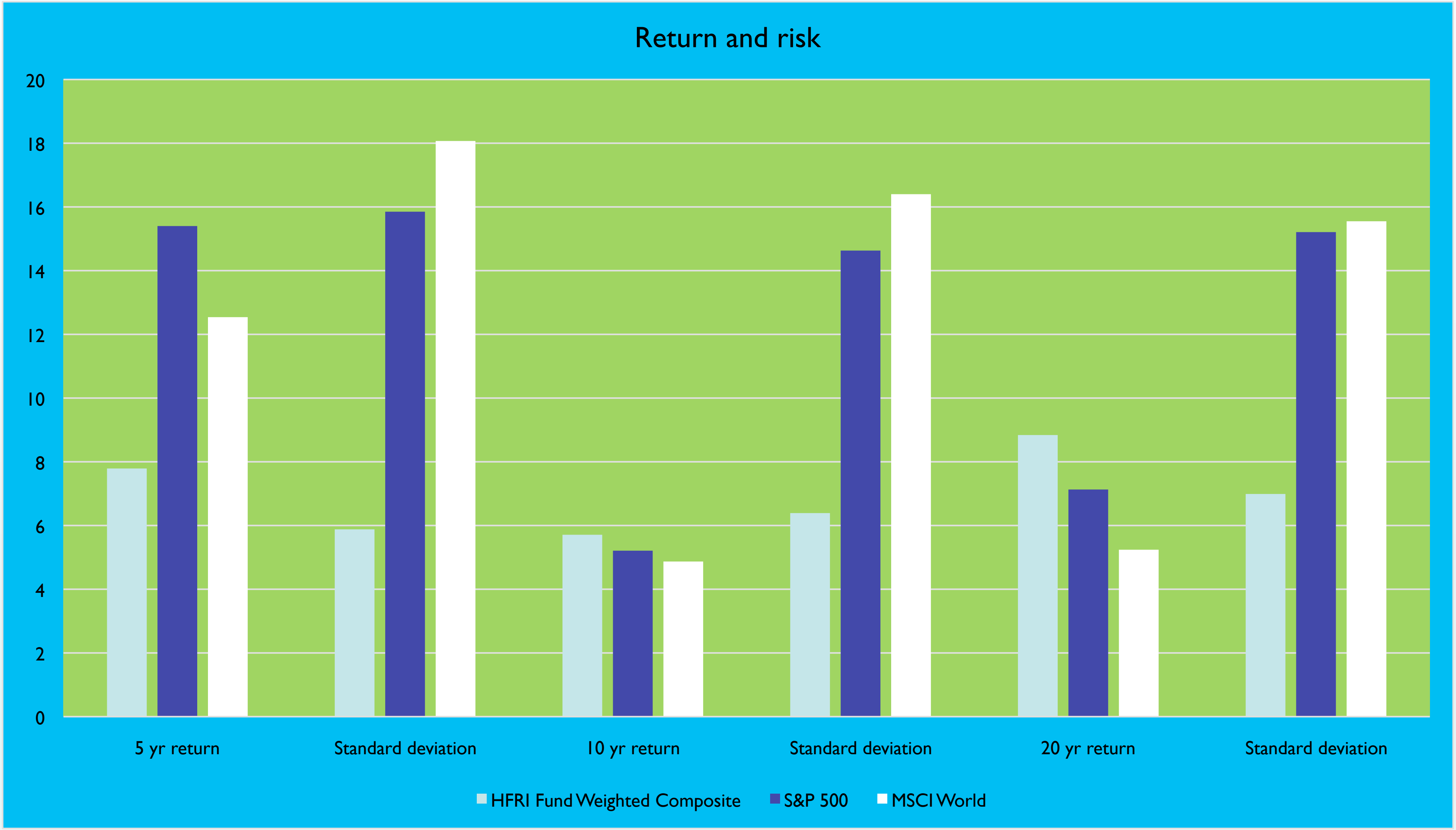
6b. Who actually invests?

1. Investors in collective investments

HNWI, Banks, Independent Asset Managers, Wealth managers including, Family Office, Trusts, Pension funds, professional organisations with their own treasury functions

1. Mutual funds
2. Exchange traded funds (ETFs or trackers)
3. Private Equity
4. Fund of funds
5. Hedge funds

7. Returns


Return and risk
20
18
16
14
12
10
8
6
4
2
0
5 yr return
Standard deviation
10 yr return
Standard deviation
20 yr return
Standard deviation
HFRI Fund Weighted Composite
S&P 500
MSCI World

8. Where do / will they fit in?

1. Part of asset management landscape
2. Still seeing start-ups
    1. What do you need to start?
    2. Where do you seek investors?
    3. The successful do very well…
3. Part of a balanced portfolio of investments
4. Outlook?

Q&A