



Hedge Funds: Trends And Challenges

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History

Hedge funds have been in existence since the early 1960s, but changes in the economic landscape over the last forty years have caused an increased interest in hedge funds, which has resulted in rapid growth over the last ten to fifteen years. This industry has traditionally focused on the high net worth individual, with some hedge fund managers seeking only those clients with \$1-5 million to invest. Today this \$1 trillion industry consists of over 8,000 hedge funds, accessing a multiple number of strategies.

What Factors Contribute to Recent Growth?

The accelerated interest in hedge funds is the result of the convergence of several different factors. First of all, hedge funds managers are well known for their hard work, expertise, analytical skills and flexibility. They keep a close watch on developing trends and are therefore able to respond quickly to trends much before mainstream investors. Secondly, the industry has been especially attractive since it has, up until now, been unregulated. Next, the “dot-com” revolution spawned overnight millionaires with an appetite for investments. From 1987-1999 the stock market index increased manyfold. There are simply many more high net worth individuals today, a situation which has also impacted the recent popularity of hedge funds. Another contributing factor is that some managers are now working with a new category of clients who have a base as low as \$250,000 or \$500,000 to invest - which is a departure from the more exclusive high net worth client that was the original profile for a hedge fund manager. Another contributing factor is that the return from hedge funds is much greater than any profits realized from mutual funds. Many investors are no longer satisfied with a 2-3% return and they are showing an increased willingness for risk and reward. Lastly, pension fund managers, despite their fiduciary responsibility to their investors, have begun to broaden, expand and diversify by appropriating a portion of their money into hedge funds.

Trend to Regulation

While previously unregulated, this industry’s escalating growth has drawn the attention of the U.S. government, and the apprehension is based on several concerns. The first is that the hedge funds managers may now be taking too much risk. Secondly, there is some apprehension that the managers have begun to behave less cautiously, and that financial products – such as derivatives and SWAPs – can be too easy to access, without enough regulations to control the activity taking place. Lastly, many of the managers may not be Registered Investment Advisors (RIAs).

The government is under no obligation to “bail out” individual investors, but nonetheless has a responsibility to ensure that the financial market stays strong and viable and does not collapse.

With that in mind, hedge funds managers with a minimum number of accounts or a minimum amount of dollars under management will have to register with the Securities and Exchange Commission (SEC). This will enable the SEC to better monitor performance and track the industry.

Expansion Contributes to Growth

While most popular in the United States, hedge funds are also developing a strong toe hold in Western Europe and Asia. London is the primary base for financial services, but it has spread to France, Germany, Luxembourg and beyond as well as to Japan, China, Singapore and other countries.

Some funds exist in a side-by-side arrangement, domestic funds for United States investors, and offshore funds for foreign investors as well as for tax exempt investors who do not want to be taxed on leveraged income. Others have a master feeder structure, which is a master fund with separate feeder entities – on shore and off shore.

Hedge funds managers continue to work to capture new investors, and in doing so, have expanded into a world market as well as using a greater range of options, includ-

ing fixed income tools, such as convertible bonds and junk bonds..

Hedge Fund versus Mutual Funds

Hedge funds are flexible in their investment options, utilizing financial instruments that are beyond the scope of mutual funds. This pliability is built on the knowledge that encourages a “hedging” – using a variety of strategies in order to protect the investments from any downside risks.

While the mutual funds have a significantly larger base, the number of hedge funds has grown quickly and the growth of hedge fund assets has been even more rapid. Hedge funds managers enjoy a management fee of 1% of the capital invested and 20% of the profits generated by the funds. This is very lucrative, compared to mutual fund managers who do not receive any percent of the profits and gain but only a few basis points as management fees. Managers of both mutual funds and hedge funds are responsible for the implementation of their clients’ investment strategies. The current fear is that, without regulations, the hedge funds managers can become ever more aggressive and willing to take risks in anticipation of increasing the yield and benefiting from exploding growth and profits.

Conclusion

Understanding the differences between investment choices as well as the importance of government regulations is one important step toward making wise and educated choices. It is equally important for the astute investor to seek out funds managers that have developed a reputation for success and reliability, avoid inconsistency and volatility and exhibit a high degree of knowledge and experience. ■

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