HEDGE FUNDS

Broadening the investor base for hedge funds

Once the preserve of the wealthy investor, hedge funds have come a long way since they began as unregulated offshore funds. Now retail investors can access the real returns available from these investments explains David Stuff, head of UK retail structured products at Barclays Capital

Hedge funds, once the preserve of the very wealthy are becoming increasingly accessible to a wide range of retail investors through the creation and marketing of structured products linked to these unfettered vehicles.

Hedge funds have been in the vanguard of the modern trend towards absolute return benchmarks. The extremely affluent investors who provided the capital for the first funds were not interested in investing in a fund that aimed to beat the FTSE or Standard & Poor's.

These investors were solely interested in making more money than they had before. The benchmark for them was not an equity index that could go up or down, but instead was the interest that they could earn if their money was on deposit. Equity and balanced benchmarked funds were unattractive because of the risk of a significant decline in the benchmark. What was the point of investing in a fund that beats its benchmark by a few per cent if the benchmark falls by 10 per cent or more? These investors just demanded that their managers turn their cash into even more cash than they had before.

NEW STYLE

So with a new group of investors demanding a new style of investment, money managers had to develop new styles of managing money. It was no longer sufficient to buy an asset that was cheap, since cheap meant nothing if it became cheaper still. Value needed to be verified by comparison against an asset that was expensive, and then this value gap realised through buying the cheap asset and selling the expensive one.

Now managers were insulated against swings in the overall level of asset prices, and were able to profit from a narrowing of the gap between the assets that they owned, and the assets that they had sold short (that is the assets that they have sold, although never owned in the first place). Provided that this gap closed up, the manager would make money.

FINDING VALUE

Managers started to look for value across the financial markets. They exploited differences between the value of a company being bid for, and the value of the bid.

Convertible bonds offered chances to identify both cheap volatility that could be hedged with listed and over-the-counter options, and credit that could be hedged into the rapidly expanding market for credit derivatives. Non-voting shares traded at a discount to their voting cousins, investment trusts traded at a discount to the assets that they held, holding companies could be bought for less than the price of the assets that they represented. ADRs did not always trade in line with the base share. In the fixed income markets lumps and bumps in the yield curve offered managers the opportunities to profit from a smoothing in forward interest rates.

Establishing these positions, and profiting from the differences in valuations, required managers to utilise sophisticated investment techniques. Managers made extensive use of derivatives and leverage. They 'borrowed' the stock that they have sold but never owned. The techniques required to exploit these opportunities were outside the scope of conventional regulated collective investment schemes and so these managers moved offshore and established funds in unregulated markets that allowed them the freedom to use the techniques and tools that they wanted to use. And with this move the hedge fund was born.

The managers of these funds also raised the bar when it came to the fees that they demanded for their services, and the commitment that they required from investors. In addition to a percentage annual fee, managers would also charge 20 per cent or more of any gains made (above a set level). The ability of investors to put money into these funds and to take money out was also much more restricted than with conventional funds. The ability to invest will typically be restricted, particularly when the manager feels that too much cash will swamp the opportunity that they are trying to exploit. Once into a fund, it was common for investors to see withdrawals restricted to monthly or quarterly. Some of the most successful funds will restrict liquidity even more, and may even require that investors remain invested for years before being able to redeem their investment.

So, hedge funds are illiquid unregulated collective investment vehicles that pursue unorthodox investment strategies using myriad techniques including derivatives and leverage. Minimum investment levels can be set so that they are prohibitive to all but the very rich and having got in, your ability to get out can be very restricted. In addition, the management companies can be very small and unregulated as well. So investors face risks that can come from operational errors, fraud, incompetence and all of the other wrongdoings that are possible without the normal safety net that a regulated business enjoys.

INVESTOR PROTECTION

It is no surprise that the regulators have been reluctant to allow these funds to be marketed to retail investors. It can be difficult enough for professional investors to conduct sufficient due diligence on these funds. It would be impossible for retail investors to ever get enough information to make a sensible decision and to invest directly into these funds.

At the same time that hedge funds were developing, and maturing, so the market for structured products was also developing. From humble beginnings, structured products have flourished. The vanilla, capital-protected, FTSE-linked product remains as popular as ever, appealing simultaneously to the fear and greed of many investors. The asymmetric return profile of the protected product fits neatly into the asymmetric utility profile that most of us have to making and losing money. Consider for a moment how much more unhappy you are when you lose money on an investment to the benefit that you get from making a similar amount. But the market now offers so much more.

Product structures at Barclays Capital are now able to offer products linked to credit, interest rates, FX, commodities, equities, and of course funds and hedge funds. The type of return offered has also developed significantly as well, with a raft of dynamic allocation techniques being developed to augment the now bewildering array of option and derivative structures.

The dynamic structures include a range of techniques that fall under the label constant proportion portfolio insurance (CPPI). The technique requires that the exposure to the underlying asset is adjusted regularly according to the difference between the product value at the time, and the value of the protection that is being offered.

CPPI has been particularly attractive when used with funds and hedge funds. It is a technique that allows investors to access fund performance but with the assurance of a protected minimum return. The technique is used to create products that offer a minimum value at a future date, and also for products that provide an immediate sub-par protection that can rise with the value of the investment.

To put some flesh on the bones, what this means is that a product may offer investors the assurance of a 100 per cent minimum return on the seventh anniversary of the investment date, and up to 200 per cent exposure to a fund. An alternative product could offer investors exposure to a fund, but with the comfort of knowing that there is a protected price that is 80 per cent of the highest ever net asset value of the product.

Barclays Capital has been at the forefront of product development in this area, and we have one of the largest fund-linked derivatives teams in the world. The coming together of new structuring techniques, with a growing maturity in the hedge fund market has created the conditions where structured hedge fund products are proliferating. The regulator is also re-examining its approach to the marketing of hedge fund-linked products, and seem to be softening its view, particularly when the products offer investors additional protection.

Investors in Barclays Capital hedge fund-linked products will not only benefit from the protection that may be built into the structure, but are also able to access these returns with much smaller investments. Barclays Capital has created hedge fund-linked products that are much more readily marketable into the UK.

Our products have been bought by fund managers, discretionary managers of private client funds, advisory managers, and even by retail investors through their IFAs. Investors can take comfort from the fact that Barclays has conducted detailed due diligence on the underlying funds. We examine the administration and custody arrangements, and make sure that there is sufficient separation in the execution of the key control functions. While not able to eliminate the possibility of something going wrong, our checking makes any non-investment risk a much more remote possibility.