DECEMBER 2003 ISSUE 16
PWM
PROFESSIONAL WEALTH MANAGEMENT
SOLUTIONS FOR EUROPEAN DISTRIBUTORS

HEDGE FUNDS

PROPER TOOLS NEEDED TO WORK A COMPLEX INVESTMENT STRATEGY

As they tend to use more complicated and more aggressive strategies than traditional funds, and are highly dependent on the fund manager's judgement, hedge funds attract a higher level of volatility. For successful investment, risk limits must be carefully set and correctly monitored

Hedge funds strategies deserve consideration as many of them offer the opportunity to generate returns independent of the movements of the broad capital markets.

Furthermore, many of these strategies have demonstrated the ability to generate attractive risk-adjusted returns over time.

However, as with any type of investment strategy, there are specific risks associated with hedge funds strategies that must be clearly understood by any potential investor.

IN THEORY

The term hedge fund refers to a universe of various investment strategies, falling into four major hedge fund sectors. (See Chart 1.) Each sector has a specific investment focus:

- **Relative value:** These funds seek to capitalise on pricing inefficiencies among individual securities, focusing on the value of one security relative to another. One example of such a strategy might be convertible arbitrage, which seeks to profit from mispricing of the embedded option in a convertible bond. Other relative value strategies include statistical arbitrage as well as other fixed income related products.
- **Event driven:** These funds typically invest based on the anticipated outcomes of company-specific or transaction-specific situations, such as a merger, acquisition or emergence from bankruptcy. Merger arbitrage, which is probably the most well known of these strategies, seeks to exploit the change in price of a firm's securities as a result of a takeover or merger. Typically, the manager will take long positions in the securities of the target firm and short positions in the securities of the acquiring firm.
- **Global macro:** These strategies seek to profit from changes in global financial markets and take positions to exploit changes in interest rates, exchange rates, liquidity and other macroeconomic factors. Strategies typically use moderate amounts of leverage.
- **Equity long/short:** The manager will take long and short positions in equity securities. The resulting portfolio may be either long- or short-biased, market neutral or opportunistic. Results are achieved primarily through superior security selection.

IN REALITY

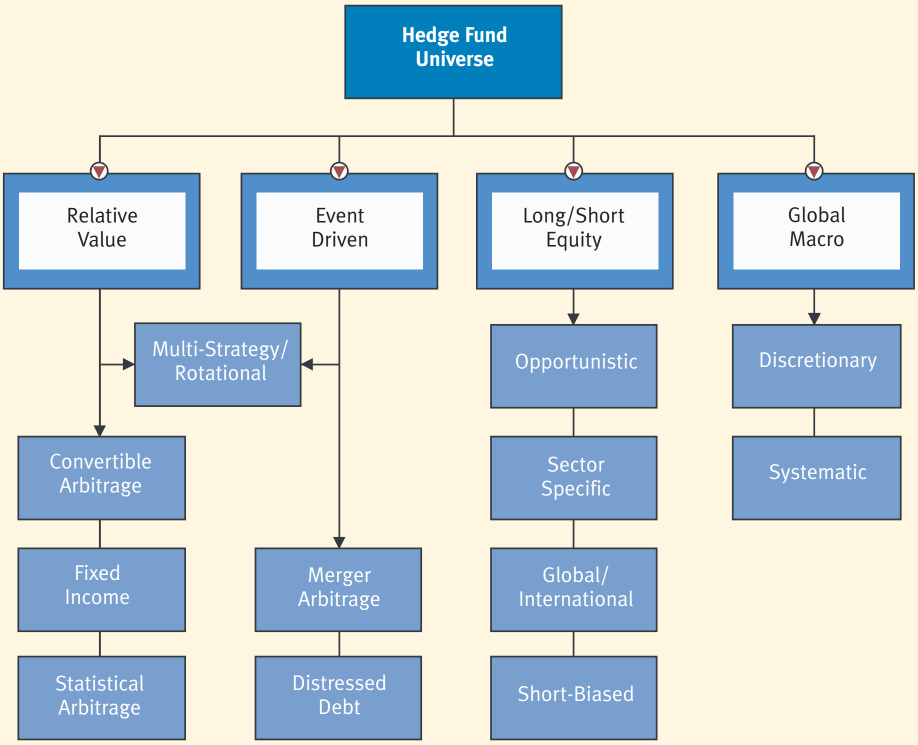
To demonstrate how hedge funds work in reality, let us look at an example – a market neutral long/short equity fund.

The investment process for such a hedge fund is built

'History has shown that one rogue fund can impair the overall performance of the hedge funds sector and generate very adverse publicity'
Thomas Richter, DWS

1

The four major hedge fund sectors



Source: DB Absolute Return Strategies

on two pillars: firstly bottom-up stock picking and, secondly, factor analysis to control risk. The long and short positions are selected on a fundamental basis through straight bottom-up stock picking. Long positions are generally undervalued stocks with an intrinsic value significantly higher than today's market price.

Long positions will include stocks with expected value drivers such as sales growth or operating profit margins not yet fully recognised by the market.

VALUE DRIVERS

On the other hand, overvalued stocks are shorted if the value drivers implied in today's market price far exceed expectations. Close contact with the management of the companies held in the hedge fund's portfolio enables the manager to understand price and volume trends, cost and investment (in)efficiencies and other value drivers.

Such a strategy will typically target between 20 to 40 names on the long side, and 20 to 40 names on the short side. Each individual position ranges between 1 and 5 per cent of the portfolio. Leverage, i.e. the ratio of total assets to equity capital, will tend to be in the range of 1 to 1.5.

Strict limits on single holdings, sectors, countries, currencies and emerging markets will ensure that the hedge fund does not exceed its target volatility, which might be, say, 6 to 8 per cent. Single positions will be cut if the loss exceeds a certain limit, for example 10 per cent.

TODAY'S RISKS

History has shown that one rogue fund can impair the overall performance of the hedge funds sector and generate very adverse publicity. Well known examples of hedge fund implosions include the Manhattan Funds and Long Term Capital Management. But what are the risks to investors today?

- **Manager risk:** In traditional mutual funds, the risk of a broad market decline is an investor's single biggest worry. In hedge funds, however, the poor performance of an individual manager is the most serious potential problem. Hedge funds may use more aggressive investment strategies than a traditional fund and therefore may be subject to a higher level of risk.
- **Lack of transparency:** Generally, hedge funds are unregulated investment pools. As such, they are typically not subject to detailed disclosure requirements. Some of today's funds, however, are more transparent. Some European countries, such as Germany, have tight transparency rules for the hedge funds industry.
- **Less liquidity:** Hedge funds tend to be less liquid than

traditional asset classes. Most hedge funds specify a lock-up period ranging from six months to five years. After this initial lock-up period, the fund becomes subject to standard liquidity provisions. Certain funds of funds, however, can provide greater liquidity.

- **Operative risk:** Due to the complexity of hedge fund strategies, the requirements regarding operative work flows and IT infrastructure are especially important.
- **Style drift:** Consistent perpetuation of the chosen strategy is key to a successful management of hedge fund.

MANAGEMENT

Risk management is affected by such issues as the complexity of the investment strategy, limitations of transparency, liquidity, operational risk and manager risk.

Hence, hedge funds have to provide an extensive set of risk management tools:

- Strict risk limits must be specified
- Measurement of regional, sector and asset class exposure
- Value at Risk (VaR)
- Daily monitoring of these limits
- Monitoring of daily profit/loss positions
- Monitoring of investment strategy and the fund manager

Running hedge funds involves tremendous effort, but if done well, it pays off.

Thomas Richter, head of corporate communication, DWS

CORPORATE STATEMENT

DWS is the leading German mutual fund manager with a market share of 25 per cent. Managing assets of €120bn in more than 300 mutual funds, DWS-Group is also the leading European mutual fund company. DWS has received numerous awards by independent experts for its superior performance record. Among these is the prestigious Standard & Poor's Fund Award as best mutual fund company in Austria, France, Germany, Spain and Switzerland.

Contact:

- Thomas Richter, head of corporate communication
  Tel: +49 69 71909 4195; Fax: +49 69 719 09 4165
  E-mail: thomas-g.richter@dws.com