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Hedge Fund Risks – The Real, the Perceived, and the Ephemeral

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People view hedge funds as "riskier" than their registered counterparts as a truism. It is true that investing in hedge funds presents risks to its investors. However, it is also true that all investments present some level of risk and that different financial instruments have risks that are unique onto themselves. So why are hedge funds viewed as "riskier" and is that view fair?

In order to address these questions, within the confines of a short article, the discussion below will, out of necessity, be very general and gloss over or omit many meaningful details. That is not to say that the details are not important, they are. However, to prevent getting lost in the weeds, I will present the information generically and at a high level.

There are two key concepts that need to be addressed upfront. What does it mean to be registered and what is risk?

What does it mean to be registered? Generally, a registered investment company (e.g., mutual fund[1]) has its securities (shares) registered under the Securities Act of 1933 ("Securities Act"), the "fund" itself, is registered under the Investment Company Act of 1940 ("Investment Company Act"), and the mutual fund's investment adviser is registered under the Investment Advisers Act of 1940 ("Advisers Act"). In order to become registered, the officers/directors of the fund file required disclosures that include financial, operational, and investment strategy information in a standardized form to the staff of the Securities and Exchange Commission ("SEC"). There is an emphasis on disclosing to the SEC and the public all "material risks" of the registered investment company. Further, a staff member of the SEC reviews the submission, provides comments that are generally incorporated into the disclosure. Once registered, the mutual fund is subject to the provisions of the Securities Act and the Investment Company Act. Likewise, the investment adviser is subject to the provisions of the Advisers Act.

Even a brief summary of these provisions would be beyond the scope of this article. For purposes of just this article, the sum total of these provisions is that the mutual fund is obligated to disclose certain information to the public (including the obligation to update the information on, effectively, an annual basis), every investor in a mutual fund must be provided the same standardized disclosure, the registered investment company is limited to engaging in only certain types of transactions and prohibited from entering into other types of transactions, and the investment company is subject to the oversight of the SEC and a board of directors, a majority of whom are independent (e.g., not economically tied to the investment adviser).

Hedge funds are not registered either under the Securities Act or the Investment Company Act and thus are not subject to the restrictions or disclosure obligations under those acts. So where a mutual fund is defined in how it is limited in the actions that it can take, a hedge fund is defined in how little it is limited from taking action. It is important to note that the investment adviser to the hedge fund may be required to register under the Advisers Act (or a state regulatory authority).

What is risk? Risk means different things to different people. To some, risk is the probability of a negative effect happening. To others, risk is the unknown. In discussing hedge fund risks, the staff of the SEC stated that:

[mutual funds] generally have less flexibility to change their investment objectives than do most hedge funds. As a result, [mutual funds] provide their advisers with a diminished ability to take alternative approaches when market conditions change.[2]

For example, let us consider the following scenario:

There are two funds: a hedge fund and a mutual fund, both of whom pursue a fixed income strategy. A mutual fund will have to follow its investment objective and investment strategy as disclosed in the mutual fund's prospectus, which will include a majority (if not at least 80%) of its assets in fixed income securities. A hedge fund, on the other hand, will have more flexibility in what it can invest in, and most hedge fund offering memoranda reserve the right to invest in almost any instrument.

Assume interest rates increase. What happens? The mutual fund will likely

lose money. It has to because of its investment strategy and the limitations imposed on it by the securities acts. The amount of the loss may vary among managers, but the consequences will be the same. The consequences for the hedge fund, in contrast, are less well predicted. The hedge fund, like the mutual fund, may lose money; the investment adviser may have adequately hedged the interest rate risk and, thus, the change in interest rates had no effect on the hedge fund's performance; or the adviser may have capitalized on the change in interest rates and increased the hedge fund's performance.

Based on the above scenario, which fund is "riskier"? The answer is that it depends on your perspective. To some, the mutual fund is less risky, because the consequences are known. Interests rates go up, the fund's returns goes down. The consequences are known, and can be planned for. These same people would look at the hedge fund and say that the consequences of an increase in interest rates on the hedge fund are less well defined – the hedge funds returns can be down, neutral, or up.

Others will look at the same scenario and say that the mutual fund is riskier. If interest rates go up, one of three things can happen and only one of those three consequences is negative for a hedge fund; compared to 100% of the consequences in the mutual fund scenario are negative. There is the problem. Different people, (e.g., investors) define, view and measure risks differently.[3]

This difference in the perception of risk also goes further than just performance. It goes into the operation of a mutual fund and a hedge fund. What are the non-investment risks in the operation of a hedge fund?

Economists, in order to simplify an analysis, will often assume away an inconvenient fact or unknown issue. For example, an economist may assume that there is no inflation in order to simplify an analysis. Borrowing from the economist's tool box, I will assume the following: 1) the investment adviser to a hedge fund (like the investment adviser to a mutual fund) is registered under the Advisers Act and 2) the risk of non-compliance with the Advisers Act is the same for both an investment adviser to a mutual fund and to a hedge fund. Thus, for purposes of this article, we will assume that the probability that an investment adviser engages in some level of "wrongful activity" is the same for mutual fund and hedge fund investment advisers.

The risks of how a mutual fund or a hedge fund operate, the "terms of the investment deal" as it were, fall under the issue of the known and unknown. Although a gross over simplification, I sometimes compare the difference between mutual funds and hedge funds as being in the same vein as the difference between a "Mac" and a "PC". I like Macs. I take it out of the box, I turn it on, and it works. I do not need to think about it too much or worry, as much, about viruses. My son, by contrast, prefers PCs. He is knowledgeable about computers and how they work. He enjoys swapping out components, increasing or decreasing certain capabilities and he likes being able to customize his experience. To him, the Mac is too rigid and does not provide him with the ability to use the computer the way he wants to use it.

A particular mutual fund is a known quantity. With a mutual fund, you know the strategy because it is disclosed in its prospectus, you can predict how it will react under certain market conditions, and you can plan accordingly. Further, certain things are guaranteed. Under the Securities Act and the Investment Company Act, the mutual fund is required to provide you with certain disclosures about the fund's performance, strategy, risks, holdings, financial condition, etc. This disclosure is in a standardized format and it is current. There are regulatory limits on the use of derivatives and the use of leverage. There are regulatory restrictions on what the assets of the mutual fund can be used for and regulatory requirements regarding redemptions.

Mutual funds are, relatively, simple and you know what terms you are subject to. To illustrate this example, let's take the examples of fees and liquidity.

- A mutual fund's fees are disclosed in its prospectus. Further, the total expense ratio is required to be disclosed. Generally, each investor is charged the same fees. While there may be different classes of shares, with different administration fees or distribution fees, investors within those classes are all charged the same fees and the management/adviser's fee is the same across all classes. Generally, an individual investor does not have to worry about whether another investor is getting a better deal.

- Regarding liquidity. A mutual fund investor is, generally, able to liquidate some or all of his/her/its investment the same business day and receive his/her/its money within a few days.

In contrast, a particular hedge fund is an unknown quantity. Hedge funds are all different. There are no

regulatory requirements for minimum disclosure. The investment adviser to a hedge fund may or may not be registered under the Advisers Act. There are no regulatory restrictions on leverage. Depending on certain factors, including the investment adviser's status with respect to the CFTC, the hedge fund's investment adviser may, or may not, be limited in the amount of derivatives it can use. The investment terms are delineated in the offering document and the corporate documents (limited partnership agreement, limited liability company agreement, etc.). However, the terms (for example, transparency, fees, liquidity, etc.) may be negotiated and revised, through side letters, for certain investors, but not all. An investor's ability to negotiate these terms will vary, based on how much they invest. Further, because of the wide flexibility provided to the investment advisers to invest in any instrument and their ability to leverage their portfolios, hedge fund advisers can make large profits. However, that same flexibility also provides for the risk of large losses.

Hedge funds are not simple. They require a lot more work, due diligence and an understanding of what is in, and what is missing from, the offering documents in order to understand what terms you are getting. Using the examples of fees and liquidity.

- The hedge fund's offering documents generally disclose the fees that an investor pays to the adviser and its affiliates. However, unlike in a mutual fund, there is no requirement that a total expense ratio be provided. It may be requested, but there is no requirement to provide it. Further, an investor in a hedge fund may negotiate to pay a lower fee than other investors.
- Hedge funds are less liquid. They generally require advanced notice of an intent to redeem. The amount of notice varies from hedge fund to hedge fund. Further, it could take weeks, months or even years, before an investor receives her/his/its money back.

With all this unknown, some may view the hedge funds as "riskier" and they would be right. Others may view this unknown as an opportunity to increase their investment returns, regardless of which way the market goes, and to customize their investment experience. They would be right as well.

In conclusion, hedge funds have risks. Some of these risks are real. Other risks are based on perception. At the end of the day, hedge funds provide their investment advisers with a great deal of discretion. Many hedge fund investors have benefitted from that discretion. Others have paid a steep price for that discretion. As a result, hedge funds require more work and more due diligence in order to understand the terms of the investment. However, in examining the risks of investing in hedge funds versus mutual funds, I believe that hedge fund risks are similar to financial risks overall:

[t]he term "risk" is usually associated with downside or bad outcomes, but when trying to understand financial risk [hedge fund risk], limiting the analysis to just downside would be a mistake. Managing financial risk [hedge fund risk] is as much about exploiting opportunities for gain as it is about avoiding downside.[4]

[1] Although there are many different types of registered investment companies, for this article we will focus on the open-ended, registered management investment company, referred to as a "mutual fund."

[2] SEC staff report "Implications of the Growth of Hedge Funds" (September 2003).

[3] For an interesting discussion regarding people's abilities to perceive and quantify risks see "Thinking Fast and Slow" by Daniel Kahneman (October 25, 2011).

[4] Thomas S. Coleman, A Practical Guide to Risk Management, Research Foundation of CFA Institute (July 8, 2011) [paraphrasing included in brackets]. ■

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