

What do you want to know about hedge funds? Here are answers to some Frequently Asked Questions; you can learn more in *Hedge Funds for Dummies*.

How do you define hedge funds?

A hedge fund is an investment partnership with relatively little regulatory oversight that can invest in a wide range of assets and follow a wide range of aggressive strategies. I think people get confused by the word “fund” and think of mutual funds, which are heavily regulated public companies that can’t invest in some assets or pursue some trading strategies.

To a big extent, a hedge fund is a business model: the money manager charges an asset management fee and a performance fee, the investor agrees to give up certain forms of regulatory oversight, and both parties agree on an investment strategy. This may work out great for investors who have a lot of money and who need the risk and return benefits that hedge funds offer, but the fees and the lack of oversight may prove too expensive for everyone else. No type of investment has a lock on performance, although hedge funds get the headlines.

What about funds of funds?

A funds of funds collects money from investors, then puts it into several different hedge funds. The idea is to give investors access to a diversified portfolio of the “best of the best”, and it might be the only way that smaller investors can get into the best hedge funds. In the U.K, the Financial Services Authority proposes to open funds of funds to individual investors. However, the fund of fund manager is going to charge a fee for his or her services on top of the fee that the hedge fund charges, sometimes as much as 1% of assets and 10% of profits. It’s really hard to overcome that handicap. Many investors can get the same risk and return benefits after fees from traditional investments.

What is alpha?

Alpha is a term drawn from the Capital Assets Pricing Model, which is an academic theory of how securities are valued. Under that, alpha is performance added from the portfolio manager’s skills. It’s the performance that the manager adds or subtracts from her intellectual ability, her ability to time the market and make decisions, and her ability to come up with new investing strategies. Each hedge fund has its own way of achieving alpha, and fund managers love to talk about it whether or not they have any interest in the Capital Assets Pricing Model.

But in theory, alpha is zero. The market is huge and efficient – not perfectly efficient, but pretty close, especially over the long haul. That means that no investor can get a consistent advantage over the market. If alpha does exist, it can be positive or negative — in other words, the fund manager could be subtracting value from the fund. Positive alpha isn’t as common as most hedge fund investors would like to think. I’m not saying it doesn’t exist, or that some fund managers haven’t figured out a way to beat the market consistently. Just remember: Anyone who has really figured alpha out isn’t getting up and going to work every day.

As much as hedge fund managers and investors want to believe that alpha can be achieved, thrive, and generate consistent profits, the success is probably a short-term opportunity. Good fund managers know this and adapt to changing markets.

What kind of risk do hedge fund have?

It depends. How's that for an answer? Historically, hedge funds were designed to hedge – to reduce risk for a given amount of return. Some managers still run funds this way, using what are called absolute return strategies. These funds are set up to generate returns within a narrow band, say 7 percent to 9 percent per year, with very little variation, by eliminating market risk.

The first fund, set up by Alfred Winslow Jones, was a private partnership that charged a management fee and a 20-percent bonus paid out of performance. It also hedged risk by buying securities it expected to go up and selling short shares it expected to go down. In other words, Jones had a unique business structure and a unique investment strategy in his hedge fund. Nowadays, investment partnerships that call themselves “hedge funds” keep the business structure but not necessarily the hedging strategy. The result is that some hedge funds have enormous risk and some have very little. You don't know until you talk to the manager, learn about the strategy, and analyze past returns.

What kind of performance do hedge funds have?

No one knows, but many investors want to get into hedge funds because they think they can make big bucks. Many money managers want to start hedge funds for the same reason. The idea of a flexible investment policy that can profit from markets, whether they go up or down, is mighty appealing to investors who want returns and fund managers who want to collect annual bonuses.

The stark truth: many hedge funds don't perform well. You don't hear about these funds, because hedge funds don't have to report their results. (A lot of fund managers and their investors like that, because that lets them stay under the radar.) And when a fund does perform well, the fund manager's cut of the profits may bring the returns down to the same levels that mutual fund investors receive. In 2006, the average hedge fund in the Credit Suisse/Tremont Hedge Fund Index returned 13.86% after fees, while the S&P 500 returned 13.62%. Yes, the hedge fund investors made more money, but not much more. And you can bet that funds that didn't do well didn't give their data to Credit Suisse/Tremont.

Hedge funds are like any other type of investment — some do well, and some don't. The label has nothing to do with its performance.