

# OVER THE HEDGE

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## PURPOSE OF THE SESSION

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- Barriers between traditional asset management and alternative investments increasingly blurred
- Adoption of new strategies into the 'retail' market requires enhanced due diligence
- Investors often treat hedge funds as a generic asset class
- Our aim is to flag questions for consideration in determining how best to meet your clients' needs

## AGENDA

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- What is a hedge fund
- The hedge fund market place
- When is a hedge fund not a hedge fund
- Hedge fund strategies for UK investors
- Q&A

# HOW WE THINK ABOUT FUNDS

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## → Index relative

- Incremental outperformance vs benchmark
- Tight risk framework

## → Unconstrained (alpha range)

- Significant outperformance over a cycle
- Risk aware, not risk constrained

## → Absolute return

- Absolute return year-in, year-out
- Low correlation to equity market
- Strong risk management
  - Low absolute drawdown
  - Target asymmetric returns

## WHAT IS A HEDGE FUND?

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- No legal definition – there are key characteristics which collectively usually identify a hedge fund

A hedge fund, sometimes called an “absolute return fund”, uses all financial instruments, including derivatives, to take positions in the markets to achieve an absolute investment performance.

## WHAT IS A HEDGE FUND NOT?

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Hedge funds are **not** an asset class – they are simply a tool for accessing investments.

# INVESTMENT SOLUTIONS

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## Attractions

- Higher returns and/or lower volatility
- Potential low correlation with other portfolios
- Greater flexibility
- Top quality fund managers
- Managers' personal interests

## Problems

- Opacity
- Liquidity
- Regulation
- Fee structure
- Key employee concentration
- Survivorship bias

## THE HEDGE FUND MARKET PLACE

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- Gained the attention of private and institutional investors in recent years
- UK and France are the largest markets in Europe
- UK dominates hedge fund management in Europe – 60% of all new funds in 2007 managed in UK\*
- HNW clients were biggest market for European asset managers, but institutional investors demand is increasing – expected to become half of all inflows during 2008 – becoming dominant investor thereafter
- Hedge funds are among most highly demanded alternative investments by HNW clients
- European market is forecast to be one of the fastest growing areas of the financial services over next five years
- Rapid growth expected – in three years, institutional market will be biggest customer base for hedge funds
- Regulatory issues are key challenge

## DRIVERS FOR HEDGE FUND DEMAND

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→ Pressure from obligations

- Aging population leading to longer pension liabilities
- Rising costs of healthcare

→ Market considerations

- Maturation of G7 Economies leading to lower equity returns
- Reduction of inflation in last 20 years resulting in comparable decreases in fixed income returns

→ Pressure to enhance nominal returns amongst major investor groups

- Endowments, foundations, HNW
- Pensions, insurance, banks, governments

## NEW OPPORTUNITIES – OLD VS NEW WORLD IN REGULATED FUNDS

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- UCITS III – The “New World” – these rules allow investment processes where:
- Futures, swaps, options, OTC derivatives, fund of funds are allowed;
  - Short exposure can be achieved through OTC derivatives (swaps);
  - OTC/derivatives instruments allowed up to 100% of NAV, i.e. leveraged portfolios possible;
  - ‘Regulatory Arbitrage’ – Regulators across Europe have the capacity for interpretation (despite the best efforts of CESR) – creates opportunities for Product Providers; and
  - NURS.

## UCITS III NEW OPPORTUNITIES – OTHER RESTRICTIONS

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### Allowed

- Futures – on equities, interest rates, currencies and related indices. Both cash and physically settled futures
- Swaps – including equity swaps
- Options – on equities, interest rates, currencies, indices and futures. Cash and physically settled options are allowed
- OTC derivative contracts
- Money market products and Funds (i.e. funds of funds etc.)

### Not Allowed in UCITS

- Direct investments in:
  - Non-regulated funds (hedge funds)
  - Precious metals
  - Commodities
  - Property
  - (Allowed in NURS)

## UCITS III NEW OPPORTUNITIES

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- UCITS III
- Funds able to utilise listed and OTC derivatives products other than for hedging or portfolio management purposes
- Ability to take outright positions in these instruments
- Execute additional alpha-type strategies e.g. 130/30
- Unable to short explicitly
- Robust risk management and valuation tools:
  - Monitor market risk
  - Valuation of positions
  - Publish accurate NAV
- Adequate middle/back office systems and staff to manage and settle these products
- Monitor OTC derivatives exposure per counterpart, as a percentage of a funds NAV

## UCITS III NEW OPPORTUNITIES

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- Short Selling
- A fund is **NOT** allowed to sell securities short or to enter derivative contracts equivalent to short sales (i.e. obliging the fund to deliver the underlying securities at expiry)\*. **BUT** they can achieve synthetic exposure equivalent to a short position.
- Swaps are allowed as they are cash settled OTC derivatives
- A fund is allowed to:
  - Buy a put option
  - Sell a covered call option

\*Note: Irish Regulator has recently authorised a UCITS which includes 'real' shorting much to the consternation of CESR. IFSA has now suspended authorisation of such products pending further discussion...

## UCITS III – FIRST MOVERS, BABY STEPS

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- Some retail funds have launched with wider powers (“high alpha”, “concentrated” etc)
- But this is a material minority, and has often come from houses that have in-house hedge fund capabilities anyway
- Key issues in the market:
  - Meaningful middle and back office problems exist for pure long-only fund managers, e.g. carrying a negative balance on holdings;
  - Meaningful skill set deficiencies exist e.g. shorting;
  - Some trustee/custodian concerns exist – especially over the use of derivatives;
  - BUT momentum is real: fund management houses see the fee opportunity; fund managers see the alpha opportunity; marketers see the inflow opportunity; and
  - FOR NOW, there is a lot of talking; some movement to address existing issues; and, in rare cases, a move to launch.

## RECENT CHANGES IN THE UCITS LANDSCAPE FOR HEDGE FUND INDICES

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- The Level 3 Guidelines were released by CESR after a rigorous consultation of the market was conducted to determine whether exposure to hedge fund indices is deemed suitable for UCITS investors
- This ruling concludes that hedge fund indices are indeed considered financial indices for the purposes of the UCITS Directive
- As a result, hedge fund indices and hedge fund index derivatives are an eligible investment for a UCITS fund
- For investors in UCITS regulated products this will expand the range of eligible underlying assets and permit them to participate in the performance of the expanding alternative investments universe

## FAITH IN FAIF – THE FSA CONSULTATION

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- Annual 'carrot dangling' (Wider-Range Retail Investment Products, June 2005: Wider-Range Retail Investment Products, March 2006)
- The 'Great Leap, umm, somewhere' (Funds of Alternative Investment Funds, March 2007)
- Momentum building on a pan-European basis e.g. Germany, Spain, Ireland, Luxembourg and Italy
- Keen to progress but not at any price:
  - Consumer protection is key
  - Treating Customers Fairly a Constant
  - Due Diligence hurdle
  - Practicalities of delivery e.g. pricing, liquidity etc

## LISTED SOLUTIONS

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- Classical Solution – Listed Special Purpose Entity
  - Investment Trust offering exposure to hedge fund strategy
  - Highly liquid as traded on recognised exchange
  - Price of shares reflects market price as opposed to underlying asset price i.e. may trade at premium or discount to NAV
    - Mechanism for controlling discount is key
  - Potentially tax efficient as is considered a listed security i.e. falls within CGT regime
  - Need to consider fees and cost of trading

## FAITH IN THE FUTURE

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- Why invest in a fund of hedge funds?
- Do you really need a hedge fund solution?
- Is active hedge fund selection needed?
- Who's the target client base?
- Do you need sector specific i.e. merger arbitrage, long/short etc?
- Distributors obligations?
- Fit to sell?
- Performance fees<sup>2</sup>?

## NAVIGATING THE MINEFIELD

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**When genius failed: The rise and fall of Long-Term Capital Management**

**End of the road for \$6bn-loser Amaranth**

**Cautious Bear falls foul of hedge fund trap**

**Regulator sues Wood River hedge manager**

## THE NEED FOR ADVICE

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- Huge choice of funds
- Lack of publicly available information
- Huge dispersion of returns between;
  - Managers
  - Strategies
- Merging with hedge fund, UCITS and NURS solutions

## SELECTING A HEDGE FUND

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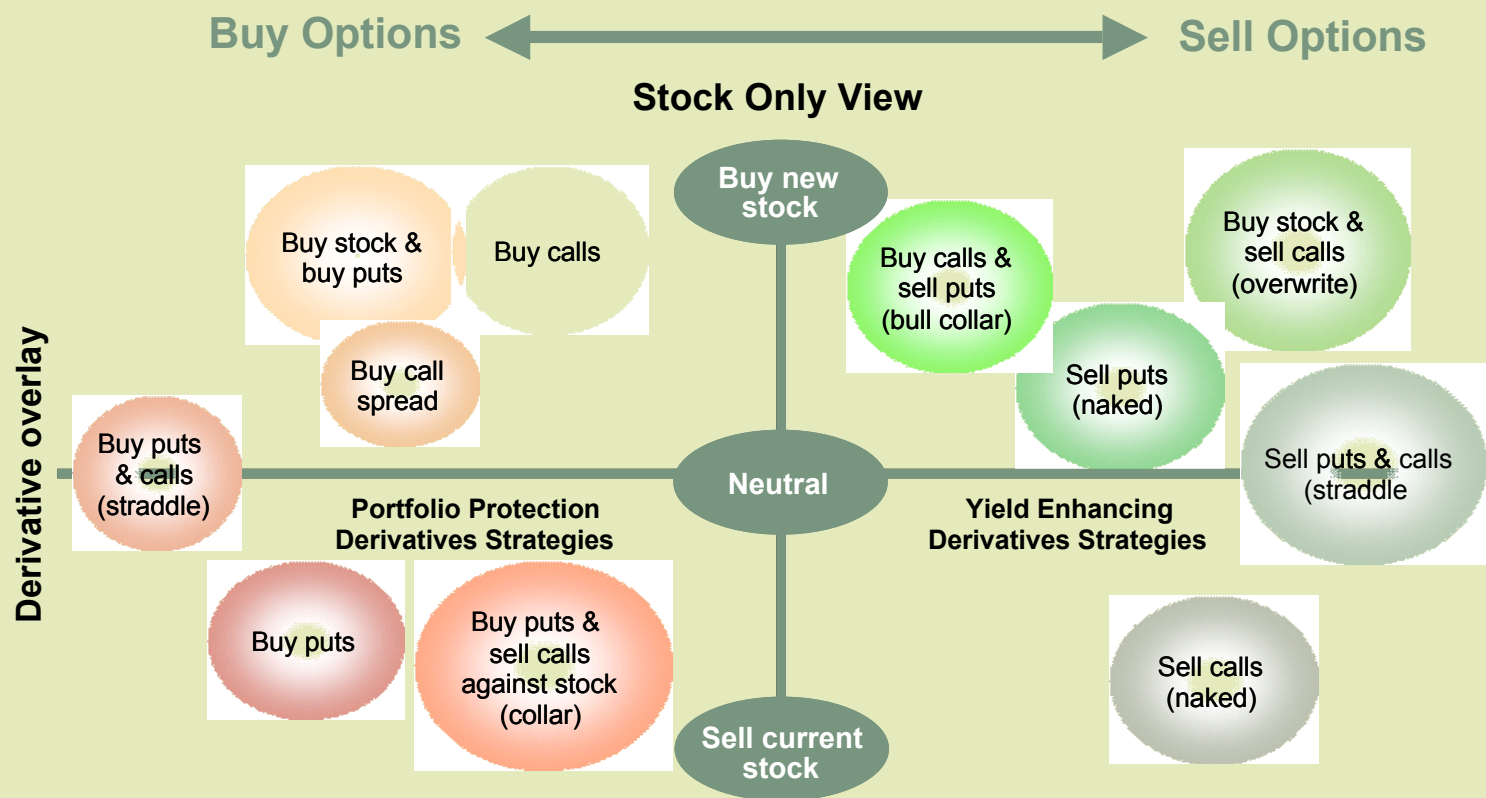
## APPENDICES

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- UCITS III New opportunities - derivative strategies
- Trip up on the tax trap
- Martin Currie hedge fund range
- Biography

# UCITS III NEW OPPORTUNITIES – DERIVATIVE STRATEGIES

- Whereas stock investors can express bullish / neutral / bearish views through their weightings in certain names, options investors have wider opportunities available:



## TRIP UP ON THE TAX TRAP

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→ Hedge funds must be 'offshore'

- By their nature hedge funds have difficulty securing 'distributor status'
- Current position (theory):
  - UK domiciled fund of offshore domiciled hedge funds
  - Fund subject to corporation tax on dividend receipts and capital gains
  - Investor subject to income tax on both income and gains
  - Better off buying an offshore fund of hedge funds in the first place!!
- Proposed position (discussion)
  - UK domiciled fund of offshore domiciled hedge funds
  - Fund 'deemed transparent' i.e. no tax at FoHF level
  - Investor subject to income tax on both income and gains
  - Equivalent to buying an offshore fund of hedge funds in the first place!!

## MARTIN CURRIE HEDGE FUND RANGE

	Launch date	Strategy size* (US\$m)	Annualised return %	Annualised volatility %	Sharpe ratio	Share class
Asia	18-Jul-02	339.8	14.32	10.12	1.05	US\$
China	06-Dec-02	224.4	18.22	16.25	0.88	US\$
European	01-Jun-04	89.5	11.35	12.06	0.48	£
Global Energy†	01-Mar-07	86.8	4.48	n/a	n/a	US\$
Global Financials †	01-Jun-06	6.0	6.14	n/a	n/a	US\$
Global Resources	01-Oct-03	928.8	16.05	9.55	1.25	US\$
Japan	30-Jun-00	242.9	7.10	7.50	0.91	US\$
UK (market neutral)	01-Jan-05	25.0	11.75	5.58	1.10	£
Omnium †	27-Mar-08	17.2	0.97	n/a	n/a	US\$

- An established and diverse range of proven products
- Eight equity long/short funds
- One fund of hedge funds
- Multi-regional, multi-sector and multi-cap

## BIOGRAPHY

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### **Toby Hogbin**

#### **Head of product development**

Toby ensures our product range is structured to meet the needs of clients around the world. He joined Martin Currie from Credit Suisse Asset Management, where he was director of products, investment solutions and marketing, and a member of the Credit Suisse Asset Management Funds (UK) Limited board. He was involved in the launch of the first SIF in Luxembourg, the first Oeic-Oeic integration in the UK, and the introduction of UCITS III and NURS funds. Toby also worked with SLC Asset Management as head of product management, before its takeover by Credit Suisse. Before that he was at Equitable Life Assurance for almost 10 years, latterly as their product development manager.

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Investment in the securities of smaller and unquoted companies can involve greater risk than is customarily associated with investment in larger, more established, companies. In particular, smaller companies often have limited product lines, markets or financial resources and their management may be dependent on a smaller number of key individuals. In addition, the market for stock in smaller companies is often less liquid than that for stock in larger companies, bringing with it potential difficulties in acquiring, valuing and disposing of such stock. Proper information for determining their value, or the risks to which they are exposed, may not be available.

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Many emerging markets, and the companies quoted on their stock exchanges, are exposed to the risks of political, social and religious instability, expropriation of assets or nationalisation, rapid rates of inflation, high interest rates, currency depreciation and fluctuations and changes in taxation which may affect the income and the value of its investments.

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