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HEDGING ONE'S BETS: Increasing Access to Hedge Funds

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The term "hedge fund" refers to a diverse class of private investment pools. These pools actively trade securities and are not subject to the full range of disclosure obligations and limitations on investment activities that federal securities law imposes on other types of investments. Hedge funds have rapidly grown in number and size in recent years to become major players in the financial markets, managing nearly $2.5 trillion globally.[1] In the United States, unlike in several other advanced economies such as Ireland and Hong Kong, the law requires individuals to be wealthy (e.g., earning $200,000 in income if single) to be qualified to invest in hedge funds. Although this regulation is intended to protect investors, limiting hedge funds only to the wealthy prevents financially sophisticated yet non-wealthy investors from using the funds to minimize losses to their investment portfolios.

DEFINING CHARACTERISTICS

Many of the defining characteristics of hedge funds stand in sharp contrast to those of publicly registered mutual funds, which many Americans use for their personal savings and retirement accounts.

First, hedge funds are nominally "private." They do not raise capital using any form of widespread advertising or solicitation; rather, they only accept funds from wealthy individuals or large institutions, and they cap their number of investors to fewer than 500. In so doing, hedge funds are not subject to the detailed and wide-ranging regime of registration and periodic disclosure requirements imposed upon public companies by the Securities Act of 1933 and the Securities and Exchange Act of 1934. For the same reasons, hedge funds are able to use nontraditional investment strategies because they are not subject to restrictions on their investment activities by the Investment Company Act of 1940, which imposes substantial costs on investment funds that engage in anything but traditional buy-and-hold investment strategies.

Second, hedge funds are unique in that they are typically organized as a limited partnership or a limited liability company. This structure prevents the company from being taxed at the entity level (as are public corporations) and gives fund managers total control in managing the fund's portfolio. The hedge fund management company or individual managers usually invest a substantial amount of capital in the funds they manage to align incentives with investors. The hedge fund manager is compensated by charging a management fee and a performance-based fee, which are typically about 2 percent and 20 percent, respectively. Hedge funds also limit the ability of investors to withdraw capital to a periodic basis (e.g., only at the end of the month) and institute a "lock-up," which requires the fund to hold capital contributions for a period ranging from one quarter to two years. These practices differ markedly from those of mutual funds, which the law prohibits from charging a performance fee and requires to redeem shares to investors daily if the investor so chooses.

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Third, hedge funds employ a wide variety of investment techniques that differ from mutual funds' traditional approach to investing, which consists of purchasing stock, bonds, and other securities with the expectation of later selling at a higher price and/or collecting interest and dividend payments while the investment is held. In addition to traditional buy-and-hold strategies, hedge funds engage in short-selling and derivatives trading. Selling a security short means to borrow a security from another investor, sell it, and then repurchase and return the security to the lender. A short seller has the expectation that the price will drop between the time the security is sold and the time it is repurchased, thus netting a profit to the short-seller. Derivatives are securities, the price of which is derived from the value of some other underlying asset. Employee stock options, for example, are derivatives because the price of the option is dependent upon the price of a company's stock. Hedge funds use short-sales and derivatives to manage risk and earn positive returns when the overall market is performing well or poorly, the latter of which is an option not available to mutual funds through buy-and-hold investing. In addition, hedge funds often use leverage (such as borrowing funds) to magnify returns. However, leverage also has the potential consequence of magnifying losses.

ABSOLUTE RETURNS

By combining short-sales, derivatives, and leverage with investments in all manner of assets ranging from stocks, bonds, and real estate to foreign exchange, commodities, and derivatives, hedge funds implement numerous unique investment strategies. The most popular hedge fund strategy is long/short equity, which seeks to gain from price increases in stocks it purchases and from price decreases in stocks it sells short. Other strategies use arbitrage, which is a technique that creates profits by making trades on temporary price differentials among securities. Regardless of the particular strategy employed, hedge funds aim to and are generally successful in achieving "absolute returns"—positive returns regardless of the direction of the overall market.

Hedge funds' pursuit of absolute returns means that the funds should help diversify a traditional investment portfolio consisting primarily of stocks and bonds. Given that the industry has only achieved its prominence in recent years, reliable industry-wide data does not exist prior to the mid-1990s. Nonetheless, the relatively recent performance of hedge funds suggests that by earning returns that are less dependent on overall market trends than traditional investments, hedge funds do help insulate an investor's portfolio from market fluctuations and therefore diversify the risks to which an investor is exposed. Figure 1 shows that hedge funds, on average, have been successful in obtaining positive returns throughout various market conditions. Using two different measures of hedge fund returns from 1996 to 2003, Figure 1 compares the average annual return from hedge funds with those of the general market, as measured by returns to the S&P 500 Index.

As Figure 1 illustrates, while hedge fund returns do not always beat market returns, they almost always produce annual gains

Figure 1

HEDGE FUND MEAN ANNUAL RETURNS COMPARED TO MARKET ANNUAL RETURNS

regardless of the direction of the general market. During the bear market of 2000 to 2002, the S&P 500 had an average annual loss of 15.5 percent. The NASDAQ Composite Index likewise lost 10.6 percent annually while the average annual return for hedge funds was a gain of approximately 2.5 percent.[2] More recently, in 2007, while the S&P 500 returned 5.49 percent after struggling through the credit crisis that began in the subprime mortgage market, various hedge fund data providers show that the funds' returns substantially outperformed the market, with estimates ranging from 10.36 percent to as high as 14.13 percent.[3] Although past performance is no guarantee of future performance, and certain hedge funds have suffered massive losses, the funds have generally made their investors better off when included as part of their portfolios.

WEALTH-BASED QUALIFICATIONS TO INVEST IN HEDGE FUNDS

The benefits of investing in hedge funds to help diversify an investment portfolio are reserved almost exclusively for wealthy individuals and large institutions. Although U.S. securities laws do not directly prohibit non-wealthy individual investors—so-called "retail investors"—from investing in hedge funds, the funds must limit their investor base almost exclusively to wealthy investors in order to qualify for exemptions from certain mandatory disclosure rules and other laws restricting investment activities.

To be able to invest in a hedge fund, an individual is required to have a net worth (or joint net worth with a spouse) exceeding $1,000,000 or an annual income for the last two years of $200,000 ($300,000 in joint income if married).[4] As a result, only about 8.5 percent of U.S. households are qualified to invest in hedge funds.[5] By contrast, Australia, Switzerland, Hong Kong, Singapore, and Ireland have successfully permitted retail investors to invest in hedge funds, and other foreign jurisdictions, such as the United Kingdom, are in the process of expanding access.

THE IMPACT OF WEALTH-BASED QUALIFICATIONS

Permitting only wealthy investors to invest in hedge funds is intended to further the goal of investor protection. Under federal securities law, wealthy investors are deemed able to make informed choices about hedge funds because even if they are not, in fact, financially sophisticated, wealthy investors are able either to hire the services of someone with sufficient financial acumen or at least to bear the losses from poor investment choices.

However, a retail investor seeking to invest in hedge funds likely has, either alone or with the assistance of a financial adviser, enough financial sophistication to make an informed choice about using hedge funds to diversify a portfolio. Unsophisticated retail investors would be very unlikely to express any desire for and undertake the steps necessary to invest in hedge funds as they tend to invest in companies with which they are familiar. Even if unsophisticated investors purchased hedge fund shares, there is no evidence that the funds are more prone to fraud or investor abuse than registered investment funds.[6] Furthermore, hedge funds are not more complicated or risky than a wide range of investments available to all retail investors, such as mutual funds, synthetic hedge funds that mimic genuine hedge funds, or exchange traded funds that have prices tied to the value of commodities or foreign currencies. Additionally, low-cost online trading platforms now enable anyone to engage any manner of complicated and risky trading on their own, without the guidance of a broker or adviser.

Wealth-based qualifications do not protect retail investors from bearing the risks associated with hedge funds and do not prevent investors from undertaking investments that may be too complicated for their levels of financial sophistication. Rather, the true impact of wealth-based qualifications is to prevent retail investors who have a sufficient understanding of hedge funds from reducing risk and maximizing their investment returns.

EXPANDING ACCESS TO HEDGE FUNDS

Although the Securities and Exchange Commission (SEC) and other financial market regulators are generally content with preserving wealth-based criteria for qualifying to invest in hedge funds, the SEC has at times expressed a desire to increase access to hedge funds while maintaining investor protection.[7] Different general approaches to reform could further that goal while simultaneously ensuring that the business of providing retail hedge funds is profitable to would-be retail hedge fund providers.[8]

One general approach would be to decrease or eliminate the hurdles currently placed upon registered investment companies seeking to engage in hedge fund trading strategies. Another approach would be to permit retail investors to invest in unregistered investment companies. Regardless of the specific approach to reform taken, the SEC should eliminate prohibitions on general solicitation and advertising to increase the amount of information available about the funds to the public.

With these reforms, retail investors would have the opportunity to benefit from the latest advances in finance and protect themselves from the risks of investing in an increasingly interconnected global financial marketplace.

ENDNOTES

1. "Global Hedge Fund Assets Surge 19% to $2.48 Trillion" (press release, HedgeFund Intelligence, Oct. 1, 2007), http://www.hedgefundintelligence.com/images/590/55595/Global%20hedge%20fund%20assets%20$2.48trillion.pdf.
2. Burton G. Malkiel and Atanu Saha, "Hedge Funds: Risk and Return," Financial Analysts Journal 61, no.6 (2005), 80-83; William Fung, David Hsieh, Narayan Naik, Tarun Ranadarai, "Hedge Funds: Performance, Risk and Capital Formation," (Paper presented at the AFA 2007 Chicago Meetings): 2–3, 25.
3. Dane Hamilton, "Big Winners, Losers for Hedge funds in 2007," *Reuters* (Jan. 10, 2008); "Hedge funds in Morningstar database return 14.13%," *Pensions and Investments* (Jan.17, 2008). This conclusion is the same even if these hedge fund 2007 return figures suffer from the highest estimated survivorship bias of 3 percent. See François-Serge Lhabitant, *Handbook on Hedge Funds* (New York: John Wiley and Sons, Inc. 2006), 482-84.
4. *Code of Federal Regulations*, title 17, sec. 230.501(a)(5) (2005); *Code of Federal Regulations*, title 17, sec. 230.501(a)(6) (2005).
5. Securities and Exchange Commission, "Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles," *Federal Register* 72 (proposed December 27, 2006), 406.
6. Securities and Exchange Commission, "Implications of the Growth of Hedge Funds, Staff Report to the United States Securities and Exchange Commission," (Sept. 29, 2003), 73; Patrick J. McCarty, General Counsel of the Commodity Futures Trading Commission, testimony before the U.S. Senate Committee on Banking, Housing and Urban Affairs (July 15, 2004), http://banking.senate.gov/_files/mccarty.pdf.
7. Securities and Exchange Commission, "Implications of the Growth of Hedge Funds, Staff Report to the United States Securities and Exchange Commission," (Sept. 29, 2003), 103–4; *The Long and Short of Hedge Funds: Effects of Strategies for Managing Market Risk*, Hearing Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Comm. on Financial Services, 108th Cong. 16 (2003) (statement of William H. Donaldson, Chairman, U.S. Securities and Exchange Commission).
8. To decrease the time and costs involved with investing in hedge funds and accepting capital from numerous individual investors, a retail hedge fund would most likely take the form of a fund of hedge funds, which is an investment pool that invests in a portfolio of hedge funds.

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