The growing interest in alternative investments in general and hedge funds in particular may have reached a defining point with the AIC Global Hedge Fund Congress held in Sydney in February this year. This conference may have been a defining point because it is one of the rare major events willing to use the term "hedge fund", hitherto something of a taboo.

More to the point, a "who’s who" of leading institutions chose to address a conference that was specifically labelled a “hedge fund” conference. This in itself should not be taken as an endorsement of the hedge fund industry by these institutions; it does however represent a relaxation of the concerns that have previously characterised responses to questions about hedge funds.

However, while investment houses, consulting firms and a handful of emerging local hedge fund managers are becoming more comfortable with the term, the broader client market is still unsure. Comments like “hedge funds are bad” or “it is hard to sell hedge funds to my trustees” are still common. It is to be hoped that in time investors will look past the name and recognise that while hedge funds have associated risks (as indeed do the unit trusts we are all familiar with) they also have unique benefits that could be very attractive to clients of all types.

So what is in a name? What is a hedge fund? Where do terms like “skill-based investing” and “absolute returns funds” come from and what do they mean? More to the point, what do they mean in the Australian context?

**HEDGE FUNDS**

The term “hedge fund” has typically referred to an investment structure in the same way the term mutual fund or unit trust refer to an investment structure. In the US, hedge funds typically refer to an unregistered investment adviser, one not subject to SEC regulation. Investments are typically offered through limited partnership (LP) or limited liability companies (LLC) and the investment strategies employed include the use of short selling, gearing and more extensive use of derivatives.

Because hedge fund managers want to avoid the compliance burden that goes with SEC oversight, they use an exemption to the 1933 Securities Act requirement that public offerings of securities must be registered. The requirements to meet the exemption include the absence of public solicitation and meeting of certain net worth levels.

Protecting investors from rapacious hedge fund managers is a little like SOCOG deciding that people with certain postcodes could not afford premium tickets to the Sydney Olympics.

The term hedge fund itself provides no guidance as to the investment risks contained in the investment. For example, one can buy a mutual fund that invests in cash or a mutual fund that invests in emerging market shares. The term mutual fund itself does not give any indication of the risk involved in the investment. Yet
people want the term hedge fund to carry some universal definition. This is not the case. What it does is describe an investment structure and indicate the potential use of certain investment strategies not found in traditional mutual fund business.

FROM HEDGED TO HEDGE
A.W. Jones is credited with offering the first “hedged” fund. Jones arrived in the US from Melbourne at the age of four. He graduated from Harvard in 1923 and after a period as purser on a steamship he served as vice-consul in the US embassy in Berlin in the 1930s. In 1941 he completed a doctorate at Columbia University. His thesis, “Life, Liberty and Property”, has become a standard sociology text. In the 1940s Jones was an associate editor at Fortune.

Soon after, he established his first investment partnership in which he fused the investment techniques of short-selling and the use of leverage. Jones believed it was necessary to maintain a basket of shorted stock to act as a hedge against a drop in the overall market. Once he had this mechanism for controlling market risk he was free to amplify his stock-selection skill by the use of leverage.

By 1966 the hedged fund industry was still in its infancy with a handful of “Jones” model managers. In April of that year Fortune published a story titled “The Jones Nobody Keeps Up With”. In the following three years there was a flurry of new managers launching hedged funds, including George Soros.

In the bull market conditions of the mid-1960s short-selling proved time-consuming, difficult and not very profitable. Needless to say, the grinding bear market up to 1974 identified those who were hedged and those who were not. The hedge fund industry took a breather until interest was revived in the mid-1980s when the outstanding results of Julian Robertson’s Tiger fund were made public. By this time the universe of hedge funds had become very diverse, with few looking like the Jones equity-hedged fund model. One could say the industry had moved from the Jones-style “hedged fund” to “edge” fund management.

WHAT IS SKILL-BASED INVESTING?
The term “skill-based investing” has become widely used to describe hedge fund investment strategies. While some hedge fund practitioners like to argue that all the skillful professionals are moving from long-only investment businesses to the hedge fund arena, skill is most certainly not limited to hedge fund managers.

What is true, however, is that returns from hedge fund managers should be dominated by security-based investment decisions, unlike a traditional equity mutual fund where the market accounts for at least 80% of the return. The diagram shows how the source of returns (market versus security specific) differs between skill-based managers and more traditional long-only investment managers.

One expects the return on a market-linked investment product to be dominated by the market return. In contrast, a skill-based investment manager is attempting to remove the impact of market risk by using hedging strategies and leaving security-selection decisions (skill) as the dominant source of return.

“Skill-based investment” is a usefully descriptive term. It immediately alerts the investor to the fact that the manager’s skill in security selection and hedging techniques is critical. It also provides an indication of the investment strategies one would expect to see (eg, short-selling, gearing, extensive use of derivatives) in order to make security selection the dominant source of return.

Skill-based strategies aim to isolate and maximise alpha (security-specific source of return) and minimise beta/duration (systemic source of return). They do this by exploiting pricing inefficiencies between related securities, buying cheap or relatively cheap assets and hedging this exposure by short-selling expensive or relative expensive assets and using long and short positions to control systemic risk.

The result is that the returns from skill-based investment strategies are not dependent on rising equity or fixed-income markets and thus should be consistent over time. The returns are, however, completely dependent on the manager’s skill. If the manager has “bad” skill, the results should be consistently bad. If the manager has a random style, one would expect the results to be random as well.

ABSOLUTE RETURN FUNDS
This term refers to funds that seek to produce positive returns over relatively short periods regardless of what is happening in traditional asset markets such as shares and bonds. If the manager is investing in risky securities such as shares and bonds, the only way to generate positive returns regardless of market conditions is to shift the expected source of return away from market risk to security-specific risk. For absolute return funds with skill-based investment strategies, security selection and relative valuation decisions will dominate their return.

SUMMARY
Established investment houses, researchers, consultants and emerging specialist hedge fund managers seem to have become comfortable with the term hedge fund. However, some investors appear to have residual concerns.

If they can look past the bad press hedge funds have received they will see that some investment strategies classed as hedge funds are actually risk-averse. Further, these investment strategies have the potential to deliver real benefits to investors. They are worthy of consideration regardless of what they are called.