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Alternative investment Funds- The Rising Dominance of Hedge Funds

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ABSTRACT

The hedge fund industry has reshaped the investment landscape for its participants. Hedge funds- commonly categorized as Alternative Investment Funds(AIF)- are an exciting innovation to the range of professionally managed investment vehicles and have strongly confronted the traditional fund sector. Owing to the private nature of the fund, data on the industry is very scarce. There is extant literature on the hedge fund industry, in the international context, however there is dearth of literature and understanding of the attributes, evaluation and performance measurement of hedge funds in India. This paper proposes to bridge that gap by critically analyzing the dynamics of hedge funds and the parameters to be considered in the evaluation of a hedge fund. In the Indian context, Alternative Investment Funds remained a lucrative yet un-regulated sector. In 2011, Securities Exchange Board of India (SEBI), released a concept paper along with draft regulations on AIFs. The new regulation- SEBI (Alternative Investment Funds) Regulations 2012 , was released in 2012, aiming at creating greater transparency and visibility to Alternative funds and alternative investments. This study has also examined the provisions of the above-mentioned regulations and their impact to the Indian Hedge Fund Industry.

KEYWORDS :

Introduction:

Hedge funds are, an actively managed, pooled investment vehicle that are open to only limited group of investors whose performance can be measured in absolute return units. To "hedge" is to lower overall risk by taking on an asset position that offsets an existing source of risk. The investment strategies, the degrees of freedom of the hedge fund industry are very different from the others. Hedge funds- depending on the investment strategy- can sell short a security, leverage, arbitrage, integrate derivatives into the investment strategy, link managers' compensation to fund performance and employ various other techniques to increase shareholder wealth. Finance literature also reveals that hedge fund managers trade in different markets and at different frequencies, which allows them to engage in dynamic strategies for shareholder wealth creation. Extant hedge fund research has attempted to study the actual performance of Hedge funds, its impact on the market and shareholder wealth, its attributes and its relation to market volatility. However there is dearth of research in the Indian context as Hedge fund is an emerging industry in India. This paper proposes to study the background of hedge funds, its investments strategies, its performance and the impact of SEBI regulations on its functioning in India.

Back - ground of the Study:

The Securities Exchange Commission (SEC) of the United States was established by the Securities Exchange Actof 1934 and regulation of funds originated. In 1949, Alfred Jones, started and structured the first hedge fund to be exempt from SEC regulations, thus enabling the use of varied investment techniques for its success. By mid 80s the hedge fund gained popularity, revealed impressive returns and gained acceptance for their profitability. By the 90s Hedge funds were largely benefitting from and contributing to stock market volatility. By the end of the century, there was an explosive growth in the hedge fund industry coupled with losses and collapse of some hedge funds in the US. In the Indian context, with the onset of SEBI (Mutual Fund) Regulations 1993, private sector in the asset management business came into existence. Hedge funds came into the Indian markets only recently when the Indian capital markets opened up to newer investment opportunities. However SEBI (Foreign Institutional Investors) Regulations, 1995, had laid down several checks and balances in permitting the entry of hedge funds into the Indian markets. Hedge funds seeking registration as FIIs was subject to plethora of policy regulations. However, Hedge funds were increasingly considered as an important segment of the asset management industry, the asset under management was rapidly growing, it was increasingly understood that hedge funds need not necessarily be speculative in nature and that if considered as an alternative investment pool in the Indian markets, it would serve as a source of additional liquidity and would help in diversifying the pool of foreign investments in India. It is in this context that SEBI (Alternative Investment Funds) Regulations 2012 assumes significant importance and proposes to provide a regulated hedge fund structure and greater acceptance.

Research Methodology:

Objectives of the Paper:

The objectives of the paper are as follows (a) to critically analyse the characteristics of hedge fundas an alternative investment fund (b) to study the important factors in evaluating a hedge fund (c) to critically analyse the impact of SEBI (Alternative Investment Funds) Regulations 2012 on the hedge fund industry

Methodology

This paper is a descriptive study and is purely based on facts, figures and data, collected from various research articles from journals, magazines and websites especially from top corporates and accounting associations engaged in Hedge fund research. Further latest contributions of various experts on the subject have also been referred.

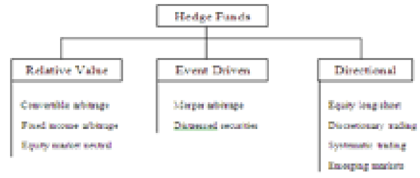
Scope of the Study

This study extends to Hedge funds alone as an alternative Investment fund. Other Alternative Investment funds such as Social Venture funds, Infrastructure funds, Real Estate funds etc., have not been considered for the study.

The Dynamics of Hedge Funds

Hedge funds are primarily organized as private partnerships to provide maximum flexibility in constructing a portfolio. They make concentrated investments, utilize leverage, enjoy a wide variety of investments including futures, PIPEs, real estate, art etc., and invest in many markets. Due to the private nature of Hedge funds, there are fewer restrictions on the use of leverage, short selling than more regulated vehicles like mutual funds. This allows for significantly different investment strategies followed by hedge funds than the traditional non - leveraged, long-only strategies. However the classification of a hedge fund remains a difficult proposition owing to its nature. Any classification would be subjective, inconsistent with some hedge fund data and incomplete. However, ambiguously, they may be classified as below:

Fig. 1



Hedge funds advocate asymmetric returns that is investment opportunities where, risk/ reward relationship is asymmetric.An asymmetric risk/return profile suggests having a high probability of financial success and survival with a low probability of the opposite. These profiles are not a function of randomness or market forces but a function of seeking new investment opportunities while actively managing risk, whereby risk is measured in absolute terms.Hedge funds follow an absolute return model in comparison to other funds, which follow relative return model. The return objective of a relative return fund is determined by a benchmark. The aim is to replicate or beat the benchmark. However the goal of a hedge fund is to achieve absolute returns by exploiting investment opportunities. The chart below clearly highlights the difference between a relative returns model and an absolute return model.

Fig. 2
Difference between relative return and absolute return model

Difference between relative return and absolute return model

	Relative – return models (Indexing)		Absolute return models — Benchmarking
		Relative returns	Absolute returns
Return objective General idea is to	Replicate benchmark	Beat benchmark	Exploit investment opportunity
		Tracking risk	Total risk
Risk management General idea is to	Replicate benchmark	Beat benchmark	Preserve capital

Source: Ineichen (2001)

Not all risks in a hedge fund are hedged, hedge funds do take risk in absolute terms and is actively controlled. Hence the risk to an investor is not from a market or benchmark, it is an absolute risk. An active management of the fund by a fund manager is a pre-requisiteto success. In investment management, alpha and beta are two sources of return that managers aspire for. Beta is referred to as the return attributed to market dynamics or capturing a risk premium, while alpha is the return typically associated with a manager's skill. All hedge funds aspire to achieve this alpha and that is possible because of an important dynamic of managing hedge funds that is, a hedge fund manager's interests and that of the investors are perfectly aligned since predominantly, hedge fund managers commit a portion of their wealth to the hedge fund.

Evaluation of a Hedge Fund

Hedge funds are undisputedly a new investment avenue, the working of which has not been comprehensively understood by most participants. Highlighted below are a few basic parameters imperative in evaluating a hedge fund:

1. Target Returns: Returns would be the top parameter in evaluating any investment including a hedge fund. The level of absolute returns a strategy can generate over the investment period over which those returns can be expected would be important.
2. Risk: Analyzing the risk in hedge fund strategies helps evaluating a fund better. Hedge funds often make investments with asymmetric payoffs, hence analyzing the risk involved with quantitative or systematic managers and fundamental managers is a pre-requisite.
3. Leverage: A leveraged strategy may lead to a capital loss greater than that deployed, hence understanding the leverage of the fund in question and striking an effective balance is required. An uncalculated leverage to scale up returns could be damaging.
4. Risk adjusted Returns: Sharpe ratio – the average annual return divided by the average annual risk- is a good measure of hedge fund performance. Most hedge funds rely on Sharpe ratio in evaluating returns while new measures of risk- adjusted returns are emerging too.
5. Beta and Correlation to existing asset classes: The beta and the correlation of the strategy to its existing asset class is required to evaluate if the hedge fund is following the right strategy and the kind of hidden risks it could be exposed to.
6. Liquidity: Hedge funds deal in varied and exotic asset classes. An understanding of the nature, liquidity and trading costs of these instruments is required in evaluating a hedge fund. These asset classes need to be liquid enough to exit without impacting the portfolio.
7. Tail Risk: Tail risk is the risk of a strategy losing large sums of money when an extremely unexpected event happens. The probability of the loss could be very low but the magnitude is usually very high. Tail risk analysis as an important tool in evaluating a hedge fund is of recent origin however has proved to be important and inevitable.
8. Experience: Ultimately the best way of evaluating a hedge fund would be to rely on the experience of the manager running the fund. Experience would help the manager to focus on measuring risks correctly, projecting realistic returns and protecting from tail risk. Hence a mangers experience becomes inevitable in evaluating a hedge fund.

SEBI (Alternative Investment Funds) Regulations 2012 – Implications on Hedge funds

General:

- The AIF regulations have widened the scope of Investments by including debt and other complex financial products
- This is a comprehensive regulation to create and regularize all unregulated funds, requiring mandatory registration of private pooled investment vehicles. The aim of SEBI in creating this regulation, however continues to be, to encourage early stage funding for entrepreneurs.

Scope:

- Scope of the regulation extends to (a) Funds established in India and investing in India and/or abroad (b) Funds established abroad and investing in India.

Registration and Incorporation:

- An AIF to compulsorily hold certificate of registration from SEBI-implies that all hedge funds should necessarily register to operate thus bringing it under regulation and scrutiny
- Registrations to be granted by SEBI category wise and Hedge funds classified as an AIF under category III and would need to seek registration under the same category
- An AIF can be incorporated as a Limited Liability Partnership (LLP) and can invest in a LLP too, making it an easy vehicle of investment. As LLP is popular in India, hedge funds can now be established as a LLP.

Eligibility:

- The sponsor or manager is required to have a continuing interest in the hedge fund of five percent or ten crores whichever is lesser and such interest shall not be through waiver of management fees
- Funds to be raised on private placement basis alone from residents, non residents and foreign investors
- Each scheme of AIF to have a corpus of atleast 20 crores.

Procedure:

- Funds to be raised by issue of Information Memorandum(IM)/ Placement Memorandum (PM)- this has been made mandatory and hedge funds will have to abide by this provision. IM will contain the investment objectives of the hedge fund also.
- IM/ PM to be filed with SEBI 30 days before the launch of the scheme

Sustainability:

- Hedge Funds may be open ended or close ended. Close - ended funds may apply for listing while open ended may buy back the units issued.
- Hedge funds may invest in securities of companies incorporated outside India but are not permitted to invest more than 10% of the corpus in one investee company
- Un-invested portion of the corpus may be invested in liquid assets of higher quality till deployment of funds as per Investment objective stated in IM

Disclosure:

- Hedge funds to disclose the "disciplinary history" of the fund, its sponsor, manager, director, partners, promoters and associates in the placement memorandum.

- Further disclosure on pending and past cases of litigations, criminal or civil prosecution, disputes etc to be made mandatorily

Reporting:

- Existing, Daily exposure reporting norms have been relaxed. Hedge funds shall report to the custodian the amount of leverage of each day by the end of the next working day, thus making the reporting easy and foolproof.

Conclusion:

The hedge fund industry has reshaped the investment landscape for its participants. They are an exciting innovation to the range of professionally managed investment vehicles. The distinct characteristic of these funds is that they attempt to outperform the market average by innovative trading strategies. Hedge funds not only provide greater flexibility in investment decisions for investors, but also provide excellent incentives to managers for strong performance. Hedge funds have strongly confronted the traditional fund sector. Owing to the private nature of the fund, data on the industry is very scarce, however, unofficial records suggest that the global hedge fund industry has grown from $500 billion in 2000 to $2.1 trillion by the end of 2012 and is predicted that hedge fund assets could reach $5trillion in the next five years. In the Indian context, Alternative Investment Funds (AIF) remained a lucrative yet un-regulated sector. However, with the new regulation- SEBI (Alternative Investment Funds) Regulations 2012, greater transparency and visibility has been created toAlternative funds and alternative investments. The AIF regulation will extend the scope to all unregulated funds with a view to providing stability, market efficiency, new capital formation and consumer protection.

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