



MARTIAL CAPITAL
www.martialcapital.com

MARTIAL CAPITAL WHITEPAPER:
WHAT IS A HEDGE FUND?

Hedge funds are defined by their structure and intent, not by any specific investment method. Hedge funds are pooled investments of private equity set up as limited partnerships or other vehicles. Their investors must certify that they are “accredited” or “sophisticated” so that the hedge fund can rely on an exemption from full registration by the securities regulators – the SEC in the US, the FSA in the UK etc. In practice, this means that investors must certify that they meet net worth and income tests.

Since hedge funds are almost uniformly unregulated, they are not allowed to advertise or solicit customers. Customers must come to them either by word of mouth, by their own independent research, or by recommendation from an investment advisor.

The term ‘hedge fund’ is today a misnomer, an artifact from the early days of hedge funds. “Hedge” means to prevent the complete loss of a bet by betting an additional amount against the original bet, so that no matter how it turns out, you’ll win something. Not all hedge funds are hedged. Some strive for absolute returns while others seek to maximize returns with no constraints on risk at all. Some manage the risk of their investments in other ways, by diversification, for example.

One of the strengths, for an investor, of the hedge fund market is the wide varieties of strategies available for an investor to choose from. A typical mutual fund prohibits the portfolio manager from engaging in certain strategies while the hedge fund manager is typically given greater freedom to seek out performance. Some funds increase their returns with leverage, derivatives, or arbitrage. Some funds, however, simply invest in long positions of listed securities. Some hedge funds make their investment decisions on personal judgment, like traditional investment managers, others use quantitative models. Some funds trade every minute in search of a few basis points per trade; others much more slowly in search of bigger gains per trade.

There is no exact definition of “hedge fund”. It is not defined anywhere in US law. It is commonly used

HOW DOES OUR MODEL WORK?



to mean an unregulated fund open only to accredited investors who attempt to achieve results generally unavailable with traditional fully regulated products.

One of the characteristics of a hedge fund is that the fund managers – the ones who make the investment decisions – have a very high incentive for the fund to make money. They are expected to be significant investors in the fund themselves and the vast majority of their compensation is based on the profits of the fund. A hedge fund manager will typically receive 2% of the assets of the fund per year plus 20% of the profits. Thus their interests and the investors' interests are highly aligned.

There are over 9,000 hedge funds in the U.S. today. These US hedge funds manage more than \$1.3 trillion in assets. There are even more hedge funds outside the US; there are hedge funds based in almost every country.

A US hedge fund will report to the IRS the taxable income of each investor; a UK based hedge fund will do the same to HM Revenue & Customs. Not surprisingly, only US taxpayers tend to invest in US hedge funds. Only Canadians invest in Canadian hedge funds. As a result, there are also a large number of hedge funds “offshore”.

Some offshore funds have set up special vehicles called “feeder funds”, which are based in the US, Canada or other tax-reporting jurisdictions. Feeder funds report tax information to the local taxing authority. Those offshore funds that have set up feeders will require that taxable investors from those countries invest through their feeder funds.

The benefits of investing in a hedge fund are higher returns as well as access to investment strategies not available to the general public. Investors also prefer to invest in hedge funds because the fund managers are compensated largely on how well they perform and in many cases the fund manager is also one of the key investors in the fund. These are two very strong incentives for the fund manager and one reason why many hedge funds achieve better results than other investment vehicles.

On the other hand, hedge funds are not regulated and not subject to the same disclosure requirements or oversight that registered investments are. As a result, they are restricted to sophisticated investors.