**Understanding Hedge Funds**

Definition: A fund, usually used by wealthy individuals and institutions, which is allowed to use aggressive strategies that are unavailable to mutual funds, including selling short, leverage, program trading, swaps, arbitrage, and derivatives. Hedge funds are exempt from many of the rules and regulations governing other mutual funds, which allow them to accomplish aggressive investing goals. In the U.S., they are restricted by law to no more than 100 investors per fund, and as a result most hedge funds set extremely high minimum investment amounts, ranging anywhere from $250,000 to over $1 million. As with traditional mutual funds, investors in hedge funds pay a management fee (usually 2% of assets); however, hedge funds also collect a percentage of the profits (usually 20%).

Today, hedge fund strategies fall into four open categories: absolute return, long/short equity, event driven, and global asset allocation. Absolute driven strategies are known as "market-neutral" funds, which seek to moderate the effects of overall market forces. Long/Short hedge funds, which represent about half of the assets in the hedge fund industry, seek to profit from underpricings by buying long, and overpricing through short selling. Event driven hedge funds benefit from corporate mispricings, typically through events such as mergers and acquisitions or bankruptcies. And investors in the final hedge fund strategy, global asset allocation, invest in currencies, commodities, equities and debt around the world.

There is no such thing as an average hedge fund. Because of different strategies, along with various management styles, there is an extremely wide array of hedge fund returns. Although they have potential for large profits, hedge funds are exposed to a number of risks. Factors such as leverage (borrowing), portfolio concentration, and liquidity may make hedge funds riskier than other investments like bonds or mutual funds. Although they have the ability to be extremely profitable, there are some disadvantages that can make hedge funds very vulnerable. When things go wrong with hedge funds, they go very wrong. Their use of leverage, can pose a great threat when the fund's investment strategies fail to deliver.

The first hedge fund dates back to 1949, when an American journalist, Alfred Winslow Jones, began taking off-setting positions in shares to hedge market risk. Winslow believed he had a better system for managing money, which in addition to selling short stock to protect against market risk also involved borrowing money (leveraging) to boost the potential return on assets. The success of his new idea caught on, and by 1966 there were nearly 200 hedge funds. Since that time, New York City and (more recently) a swathe of leafy suburbs radiating from Greenwich, Connecticut, have been the center of what became the hedge-fund world.

Hedge funds arrived in Britain much more recently, in the early 1990s. Since then London has emerged as the center of Europe's hedge-fund management industry (with the funds themselves being held offshore, in tax havens like the Cayman Islands).

New York City remains home to roughly double the number of hedge-fund managers as London (2006 data), but the two centers increasingly stand head and shoulders above the rest of the world. At the end of 2010, there were about 6,800 hedge funds in existence, according to industry tracker Hedge Fund Research. That's down from a little more than 7,600 at the industry's peak in 2007.

Hedge funds first disappointed investors en masse in 2008, when the average fund fell by 19%. Since then they have struggled to beat the market (see chart).



**California Hedge Fund Is Latest Europe Crisis Casualty**

**Bloomberg.com June 14, 2012**

Hedge-fund manager Paul Sinclair is the latest casualty of Europe’s sovereign-debt turmoil, almost six thousand miles away from the epicenter of the crisis. Sinclair, who is based in Los Angeles, is liquidating his $458 million health-care equities fund, Expo Capital Management LLC, after more than five years, as political decisions made on the other side of the globe have undermined his stock picks and spurred losses for a second year.

“I don’t have an edge on Greek elections, the Spanish banking system, what the European Central Bank, the International Monetary Fund, the Chinese government, Angela Merkel, or the U.S. Federal Reserve will do,” he said in a telephone interview yesterday.

Sinclair, 41, said that over the past year he’s found it increasingly difficult to make money because of the macroeconomic environment, and that investing in health care since 2004 has left him “physically and mentally exhausted.” He said he chose to return money to investors, which he plans to do by the end of the month, rather than hold cash and charge them fees. Sinclair’s Expo Health Sciences Fund lost about 6 percent this year through May, after falling 8.7 percent in 2011, the hedge fund’s first year of negative returns, he said in an e- mail. The fund has returned about 50 percent since its 2007 inception, net of fees.

Billionaire energy trader John Arnold, former Morgan Stanley co-president Zoe Cruz, and Duke Buchan III are among managers who have shuttered hedge funds in the past year as Europe’s sovereign-debt crisis has roiled global markets. The industry last month posted its biggest loss since September as stocks slumped on concern Greece may exit the euro and the global economy is weakening.

“It’s a confluence of tricky markets, super-cautious investors and a tough fundraising environment that’s making it a difficult time for hedge-fund managers,” said Steven Nadel, a partner at New York-based law firm Seward & Kissel LLP, which advises hedge funds.

Returning client money “is an unusual move but fair and would be welcomed by investors,” said Graziano Lusenti, founder of Nyon, Switzerland-based Lusenti Partners, which advises clients on investing. “Most hedge funds would try to hold onto the money for as long as they can.”

Hedge funds slumped 2.9 percent in May and 1.3 percent this year, according to data compiled by Bloomberg. They lost 5.8 percent last year and a record 19 percent in 2008, the data show.

**Liquidations Rise**

Liquidations in the hedge-fund industry rose to 775 last year, the most since 2009, according to Hedge Fund Research Inc., a Chicago-based research firm. At least three hedge funds run by former Moore Capital Management LLC traders have shuttered in the past seven months after losing client money. They are Salute Capital Management, run by Lev Mikheev, Avesta Capital Advisors LLC, founded by William Tung and Tim Leslie’s JCAM Global fund.

Fortress Investment Group LLC, based in New York, last month said it will liquidate its $500 million commodities fund run by William Callanan after losing almost 13 percent in the first four months of the year. Cruz, the former Morgan Stanley executive, is liquidating her $200 million hedge fund after losing 8 percent last year. Buchan, a New York-based hedge-fund manager, cited the European debt crisis as one of the reasons behind the closing of his equity hedge fund Hunter Global Investors LP.

“Markets seem to be driven more by the latest news out of Europe than by a company’s earnings prospects,” Buchan in a Dec. 8 investor letter. “We have not weathered the ensuing volatility well.”

**Market Correlation**

The turmoil in the global markets has spurred stocks across industries to rise and fall in tandem. The relationship between price fluctuations for health-care stocks and the rest of the market has tightened. The 30-day correlation coefficient between the MSCI World Index and its members in that industry is 0.92, compared with the average since 1995 of 0.73, according to data compiled by Bloomberg. Readings of 1 mean prices are moving in lockstep.