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Accessing the Hedge Fund Market

Investment objectives should determine which vehicle investors select.

Over the last five years, investments in absolute return strategies, or hedge funds, have increased dramatically. As this market grows, it is important for investors to familiarize themselves with the pros and cons of these strategies, including relevant legal and regulatory concerns.

The most common vehicles used to access this market are managed accounts, pooled funds and derivatives or structured notes. Managed accounts are a relatively straightforward means of gaining access to the expertise of a hedge fund manager. These accounts enable a manager to invest on behalf of investors in accordance with the terms of an investment management agreement between the parties.

Managed accounts do have some drawbacks, though. A manager may call for a large investment, increasing the amount required to implement particular trading strategies. In fact, due to the additional administrative and disclosure requirements associated with a managed account, some managers may not offer managed accounts at all. In addition, given the use of short selling, derivatives, and leverage by many hedge funds, a managed account may expose investors to liabilities that exceed the initial investment. Accordingly, investors may need to consider using limited recourse trading accounts or imposing special purpose vehicles to manage risk.

LIMITED PARTNERSHIPS

The most common method of gaining access to a particular manager's absolute return strategies is to purchase units from that manager's pooled fund. Canadian funds are typically set up using one of two investment vehicles: limited partnership or trusts. As the name suggests, limited partnerships involve a partnership with at least one limited partner and one general partner. Investors or limited partners are liable only for the amount of money invested in the partnership while the general partner or manager has unlimited liability. Partnerships are effective conduits for tax purposes and, as a result, they pass on both gains and losses to investors.

Trusts, on the other hand, are a declaration of trust in which investors become beneficiaries. While uncertainties in trust law may expose investors to liability for an amount greater than their original investment, simple structural changes to the trust can help reduce and even eliminate this potential risk.

Investors can also use a broad range of derivative products or structured notes to access hedge fund returns. Derivatives offer similar economic returns such as owning a unit in the underlying fund without requiring investors to own the actual units of that fund. Derivatives have many other advantages as well, such as lower credit risk and a degree of familiarity. Another advantage is additional due diligence with respect to the underlying hedge fund that a counter party to a derivative transaction may require because of its involvement in the transaction.

Once again, the benefits of this particular vehicle need to be weighed against the potential costs associated with them. Structured notes provide investors with a familiar vehicle to access the returns of the hedge fund market by passing on the total return of a particular fund. In addition, they may also provide a guarantee of the return of an investor's principal upon the maturity of that note.

As the hedge fund market continues to grow, more financial instruments will emerge allowing investors to enjoy the performance returns of absolute return strategies. However, given the complexities of this asset class, investors need to articulate their overall investment objectives and then determine the particular vehicle that best serves their goals. ■