SOUTH INDIAN Bank

# STUDENTS' ECONOMIC FORUM

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## Theme 192
## HEDGE FUNDS


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# Theme No. 192 : HEDGE FUNDS

## Introduction

The year was 1949, WW-II just ended, and the world was in a unified celebration. Alfred Winslow Jones, a sociologist, was working on an assignment for Fortune magazine investigating fundamental and technical research on forecasting the stock market. Jones was very much intrigued by a new class of stock market timers who adopted certain daring trading methods to achieve positive returns from the market operations. It was another Fortune magazine article, in 1966, which branded the market-neutral strategy that Jones identified in those funds as a "hedge fund". Hedge funds, some times referred to as 'hot money', have gained world wide notoriety for bringing the markets down. Be it a crash in the currency, stock or bond market, usually a hedge fund prominently figures somewhere in the picture. So, what's a hedge fund? How is it different from a mutual fund? Are hedge funds good for the markets or not? Should they be allowed to invest in India? This month we will explore the depths of hedge funds in an earnest way.

## Define Hedge funds

Although there is no exact definition for hedge funds, you can call it as a flexible investment company for a small number of large investors (usually the minimum investment is $1 million), which uses high-risk techniques such as short-selling and heavy leveraging. A similar version of the definition is "any unregistered, privately-offered, managed pool of capital for wealthy, financially sophisticated investors". The term "hedge fund" is loosely defined and does not always imply a hedging technique is being used. Hedge funds today employ all different types of strategies. In fact, contrary to the conventional meaning of the term 'hedge' which means 'to protect', these funds take a much higher risk than conventional mutual funds.

## If so, how can you identify them?

Although there is no proper definition for a hedge fund, these funds can be easily identified by some key characteristics like investment style, investment size, investment fees, leverage options etc. Hedge funds are for highly

sophisticated investors and not for general public. In reality hedge funds are loosely regulated private pool of money which invests in all kinds of "legal investments" to maximize the returns. It can be equities, futures, currencies, commodities, bonds, real estate and even they invest in "Weather Derivatives" (betting on weather conditions) or even seed capital start-up companies like private equity / venture capital funds.

**What are the prime strategies that hedge funds adopt?**

The strategies hedge funds utilize are not as easily accessible, especially as in case of other regulated entities, such as mutual funds. To achieve "absolute return", hedge fund managers have the flexibility to incorporate different strategies and techniques that may include short-selling, arbitrage and leveraging.

**What you mean by short selling or short positions?**

The sale of a borrowed security, commodity or currency with the expectation that the asset will fall in value is called short selling. For example, an investor who borrows shares of stock from a broker and sells them on the open market is said to have a short position in the stock. The investor must eventually return the borrowed stock by buying it back from the open market. If the stock falls in price, the investor buys it for less than he or she sold it, thus making a profit. Short sellers assume that they will be able to buy the stock at a lower amount than the price at which they sold short.

**Do you think there is something called long position?**

Why not? The buying of a security such as a stock, commodity or currency, with the expectation that the asset will rise in value is termed as long position . For example, an owner of shares in "South Indian Bank" is said to be "long South Indian Bank" or "has a long position in SIB".

**Can you mention what is arbitrage and leverage?**

Arbitrage is simultaneous buying and selling of a financial instrument in different markets to profit from the difference between the prices. Leveraging means borrowing money for investment purposes. The fund may collect, say, Rs.100 crore from investors, borrow Rs. 50 crore, and invest Rs. 150 crore.

**What kind of fees do most hedge funds charge?**

The majority of U.S. hedge funds charge the standard "one-and-twenty" ie. 1% of assets and 20% of profits annually (more precisely, the 1% fee is

usually charged in 0.25% increments quarterly in advance, while the 20% is usually charged annually). These are known as the “management fee” and “performance fee” respectively. There are many variations and exceptions. For instance, most funds observe a “high-water mark”. This simply means that if, in a given performance fee period, a fund loses part of its investor’s money; the investors will not be charged in later periods until the losses have been recovered. Another common variation is the “preferred return.” This means that a fund will not collect a performance fee until a certain return is achieved. Some funds have a “hurdle rate” alternative, which indicates the minimum investment return a fund must exceed before a performance allocation/incentive fee can be taken.

**What are the regulations on Hedge Funds?**

Although not strictly regulated, regulatory authorities have come up with a restriction that only wealthy / high net worth investors like accredited investors and family offices and institutional investors like private banks, pension funds, endowments, insurances etc can invest in hedge funds so as to protect the ordinary / small investors from loosing money investing in hedge funds. Hedge funds are prohibited from soliciting or advertising to a general audience through websites / internet, cold calling or other advertising media. So, hedge fund conferences, forums and seminars are popular as it provides networking opportunity for the managers and the investors. Event management companies are organizing more conferences every year due to the increasing demand. As hedge funds cannot advertise itself, their websites should be password protected and allow only qualified clients who fill up proper questionnaire. All the incoming and outgoing emails and all other electronic communications between the hedge fund firm’s employees and the investors must be stored in secured servers and are subjected to regulatory verifications if needed.

**What is the status of these funds in India?**

RBI has voiced its discomfort over allowing hedge funds to register like other FIIs in India. Other than the little disclosure and the high risk and complex trading strategies of these funds, regulators fear they could lend greater volatility to the market, and thereby hurt retail investors. In India, it is widely believed that hedge funds are already operating through subscribing to the Participatory Notes that the registered Foreign Institutional

Investors or their Sub-Accounts issue. SEBI, on October 25, had banned issuance of P-notes by sub-accounts of FIIs, and they have been asked to wind up their current position over a period of 18 months. SEBI has banned the issue of P-notes with underlying as derivatives and put a cap on notional value of P-Notes. As per the recent regulation, FIIs can issue P Notes only up to 40% of its Assets Under Custody (AUC) as on 30th Sept. 2007. However, AUC for this purpose will not include their positions in derivatives. As a result of these regulations, a good number of funds, including hedge funds are now registering with SEBI and the total number of FIIs registered with the regulator has increased to 1,170. This will at least bring in more transparency to the operations of hedge funds in the Indian markets.

SEBI expects these funds to come in directly as FIIs and get registered and regulated. However, it stipulates the same two key criteria as applicable in case of an FII viz., they must be registered with/regulated by the financial market regulator in their home country; and they must have at least a one-year track record. These funds will have to fulfil all the conditions that apply to foreign institutional investors. But hedge funds as we have discussed so far, are unregulated entities. In such case how does SEBI expect these hedge funds to be regulated in their home country is a topic for debate.

## Conclusion

Hedge funds were responsible for most of the recent fluctuations in the Indian market. A host of sharp volatilities in various markets, including India have been due to the unknown source of hot money through hedge funds. These tend to de-stabilise the markets, and can result in huge losses for long-term investors in such markets, who are not as smart as the hedge funds. Some, however, believe that hedge funds provide liquidity and momentum to the markets, and hence are good for the markets. In fact, sometimes they create markets for illiquid instruments and thus help other investors too. Since little is known about the operational strategies of the hedge funds, it is difficult to categorically say whether they are actually good or bad for the markets. And so, the debate continues as to whether these funds need strict regulations, even in the USA, where such funds have been operational for many years now. While, volatility cannot be wished away and sometimes it is good, one can have proper systems and procedures in place so as to safeguard the markets. Moreover, the systems and procedures, at least in the Indian equity markets are robust and world class.

## Hedge funds versus Mutual funds

| Hedge Funds | Mutual Funds |
|---|---|
| These involve a group of private investors, and minimal regulations. | These involve public money, and are highly regulated. |
| A limited number of investors. | A higher number of investors. |
| High minimum investment. | Low minimum investment. |
| Can be highly leveraged. | Can't be leveraged. |
| Highly flexible with their investment pattern. | Follow strict investment guidelines, hence are rigid. |
| High fees. | Low fees, usually fixed by the regulators. |
| Open only through private placement,usually offered to well-informed, high risk-appetite investors. | Open to the public. |
| Disclosure requirements are minimal. . | Disclosure requirements are high |

## FIIs & Sub Accounts

A Foreign Institutional Investor (FII) means an institution established or incorporated outside India, which proposes to make investment in India in Securities. The FIIs have to register with Securities and Exchange Board of India (SEBI) and they are permitted to trade in securities in primary as well as secondary markets. Sub-account includes those foreign corporations, foreign individuals, and institutions, funds or portfolios established or incorporated outside India on whose behalf investments are proposed to be made in India by a FII. P-notes are financial instruments issued by FIIs/Sub Accounts which are used by foreign investors not registered with SEBI to take an exposure to Indian companies. It is reported that, with the recent regulations on P-notes, forty six new FIIs opened their offices in India during November, which is the highest ever single month registration by foreign institutional investors.

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With Sibernet, you can now transfer funds to the SIB accounts of your kith and kin. Just log in to Sibernet and enter the amount and destination account. After getting your authorization and on the click of your mouse, funds get transferred. Your dear and near will get an instant SMS alert and they can withdraw the amount through the nearest ATM. With SIB, this is just a banking transaction, which is available even between 11 Pm and 3 Am, that too on a fine Diwali day.

Yes, we don't limit your expectations. We are open round the clock and you can manage your accounts from any nook and corner of this world. For details and A/c opening form, please visit our website.

***In Photo:*** *Dr. V A Joseph ,Chairman&CEO of the Bank inaugurating the enhanced Internet Banking facility. Mr. M Valsan ,Executive Director, Mr. Cheryan Varkey, General Manager Operations and Mr. Alex Mathew, General Manager, Administration are also seen.*