

The Rothschild Report

The Dance of The Seven Veils (or seven questions you should ask to make sure you know what you are getting into with hedge funds)

Summary

Hedge funds have been a feature of the US landscape for many years. Europe has also boomed as a market with an appetite for hedge funds in the past five years.

In Australia we are seeing growing interest from both retail and wholesale customers. Not surprisingly, there has been a boom in product offerings recently. Most of these are calling themselves hedge funds. These products are not familiar to investors; there are no rating services and no performance surveys to rely on when making investment decisions.

The purpose of this paper is to provide investors with a list of questions to ask themselves when looking at new offers.

The paper maintains that investors should look at the following issues:

Do investors understand the investment benefits of the product they are considering?

Are investors sure they know how much they are paying; what they are paying for; and, if they are investing in a fund of fund managers, who exactly are they paying?

Do investors understand the legal structure of the fund?

Do they understand the tax consequences?

Is the investment manager licensed?

Past performance is not necessarily a guarantee of success, so what does the manager's claimed performance mean?

What is the experience of the proposed managers?

If investors are satisfied with the answers, the potential rewards of hedge funds are well worth the effort.

NB Rothschild Australia Asset Management has launched on the Australian market a domestic fund of hedge funds, the Rothschild Total Return Fund. Rothschild has also formed an alliance with the oldest fund of hedge fund managers in the US, Chicago-based Grosvenor Capital Management. As a result of this alliance, Rothschild is planning to launch a global fund of hedge funds product in Australia.

The prospectus for the Rothschild Global Return Fund will be available later in the year.



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Veil 1 — Understand the investment benefit

‘Just because it is called a hedge fund does not mean it is one, are you paying hedge fund fees for something that is really an equity trust?’

Alternative investments are certainly very popular at the moment and can offer some very useful investment benefits to investors. The risk is that opportunistic vendors will try to charge the higher fees normally associated with hedge funds by calling a product a hedge fund when it is not. This presents two big problems to the investor. First, they may be paying fees of up to 10% for a product that should otherwise have a Management Expense Ratio (MER) of 2%. Second, and worse, the investor may have bought the investment as a hedge against a fall in equity markets only to find that they have actually bought just another equity product.

Ask yourself what is the investment benefit of a product. Compare this benefit to other products you probably already invest in. For example, if a product invests mainly by buying shares it is probably a lot like an equity unit trust. In this way you can compare fees. If you can’t understand the investment benefit, don’t invest.

Veil 2 — Understand what you are paying for

‘How much am I paying, what am I paying for and who am I paying it to?’

Know how much you are paying

Read the offer document and identify all the fees. In many alternative investment products fees are a combination of flat fee and performance fee. Don’t rely on the statement about the MER. In some offer documents the manager will state the MER based on the management fee alone. The management fee

is not the only fee you are paying, so look for a statement about maximum fees.

A common fee structure is 1% management fee plus 10% performance fee for performance in excess of 10%. A manager might state their MER is 1.25% (management fee of 1% plus expense recovery).

However, if the fund returned 20%, the fee would be 2%, that is, 1% management fee + 10% of (20% - 10%) performance fee.

Know what you are paying for

Let’s talk more about performance fees. When well constructed they serve to align the interest of the investor and the investment manager. As long as the investor understands the maximum fee level, this alignment interest should be of comfort. However, poorly constructed performance fees are to be avoided.

Performance fees have four components.

The rate

A performance component of 20% of return is not uncommon in individual hedge funds. In funds of funds, however, one would expect to see a flat fee - or a much lower performance fee. A performance fee of more than 10% on a multi manager product that also charges a management fee is too much.

The hurdle rate

This is the level of return over which the performance fee is charged - it is like a benchmark in some ways. The hurdle rate should match the type of investment. Hedge fund type products typically offer the investor the promise of ‘absolute returns’ in all market conditions. Thus the most appropriate hurdle rate is the cash rate. Good hedge fund performance fees will use a cash rate as the hurdle. This also means that performance fees are only paid on positive performance.



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A traditional equity fund that uses a cash hurdle rate is an example of a potentially bad performance fee. Imagine if shares rose 50% in a year and the cash rate was only 5%. The investor could pay up to 20% of the 45% difference as a performance fee. This is 9%.

Are losses carried forward?

A good performance fee is only charged on profits. If the manager suffers losses, these losses must be recovered before performance fees are accrued. Suppose that in the first month the manager loses 10%. The Net Asset Value (NAV) sinks from 100 to 90. In the next month the manager makes 10%. The NAV rises from 90 to 99. The manager should not take any performance fee for this second month even though they have made 10%. This is because the gain was not enough to offset the loss from the previous period.

The timing of the payment of the performance fee

If the manager takes their performance fees more frequently than annually, look for a clawback provision.

	March Q	June Q	Sept Q	Dec Q
Opening				
NAV = 100	-10%	-10%	-10%	+30%
Progressive				
NAV	90	81	73	95

A manager who did not have to recover losses before paying themselves a performance fee could look at the last quarter and say that they have made \$22 (95 – 73) and pay themselves a performance fee even though the investor has lost money over the year.

Know who is paying who

Investors should look for a statement that outlines the relationship between any fund of fund manager and the underlying managers. Where fund of fund managers negotiate 'fee deals' with underlying managers, investors should look for a statement that these deals benefit the investor and not the fund of funds manager.

Veil 3 — Understand the investment structure

Investment performance is almost always quoted on a pre tax basis. Unfortunately, investors do have to pay tax so the impact on after tax returns of the investment structure is important. There are two common types of investment vehicle and investors should at least know what they are buying and the implications.

The two vehicles are the unit trust and the unlisted investment company.

Investment companies pay income tax on investment earnings at the company tax rate (currently 34%). The benefit of such tax payments is not available to investors until payment of franked dividends to investors. If dividends are not paid regularly, the company pays tax but no franking credit is available to investors until a later date, compromising returns to investors.

On the other hand, unit trusts are flow-through vehicles for tax purposes. Income tax is not payable by the unit trust, instead income tax is payable by investors at each investor's marginal tax rate on trust distributions. Investors in unit trusts enjoy the cash flow advantage of receiving earnings in cash prior to payment of taxes on such amounts.



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The recent introduction of the Capital Gains Tax discount is also important. This is because capital gains realised on investments held by unit trusts retain their character and qualify for concessional tax rates in the hands of unit trust investors. By contrast the Capital Gains Tax discount is not available for investments held by unlisted investment companies.

Another feature of the investment product that is not always obvious is liquidity. We are all used to unit trusts that are priced daily and allow us to enter and exit with ease. Alternative investments are generally not like this, often for good reasons. Investors, however, need to understand how they exit. Ask the simple question, ‘How do I get my money out?’ If there is no clear answer, then don’t invest.

An example is where the investment vehicle is an unlisted investment company. You need to ask who will buy your shares from you, as this is required to provide the investor with an exit mechanism.

Veil 4 — Understand the tax consequences

Many hedge fund products are domiciled overseas. This brings Foreign Investment Fund (FIF) tax into play.

Investments in foreign hedge funds are generally treated as Foreign Investment Funds (FIFs) for tax purposes, and are subject to taxation on an accruals basis. In summary, this means that investors are taxed each year on either the increase in market value of their investment or on the basis of a deemed rate of return (currently 9.86%) applied to their investment.

The FIF tax liability applies regardless of whether or not the investor receives any distributions. Therefore investors, who are subject to the FIF rules, are often faced with a tax liability and receive no cash with which to pay the tax.

Investors should know that they are investing in a FIF and what the financial impact is.

Veil 5 — Is the investment manager licensed?

Not all investment managers need to be regulated. However, most serious managers will seek registration under some form of regulator. It reflects a certain level of commitment and shows that a certain level of due diligence has already been done by the regulator. It is by no means a guarantee, but it does provide some comfort. Look for the investment adviser to be regulated by a recognised party, like ASIC in Australia, or the SEC in the USA, or IMRO in the UK. There are others, but most product here will come from one of these three jurisdictions.

Veil 6 — Don’t buy on past performance

‘You can’t buy historical performance’

Performance records are particularly difficult in the alternative investment universe. An investor should look at a ‘new product’ that boasts a five year track record with a degree of scepticism. Investors should ask to see the connection between the historical record that is shown in the offer document and the product that they are going to buy.

Imagine there is a new fund of hedge funds established. Let’s say the fund of funds has 20 managers. It puts a performance record of the 20 managers over the past five years in its



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offer document. This begs two questions. (1) How much did they allocate to each manager and (2) would those 20 managers have been the ones they chose five years ago?

There is no need to answer these questions; the truth is that the performance record is meaningless.

Veil 7 — Have the managers done this before?

Most offer documents will contain information about the people in the firm. It is important to match the experience of the people to the strategies they offer. Ask a simple question, 'have you done this before?'

Look at the number of people in the firm. Make sure they are still there when you invest as much can happen between the time an offer document is printed and the time you invest. Ask yourself if it is credible that the number of people in the firm can manufacture the product. A 'one man' firm is not a good bet.



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Conclusion

Hedge funds can be an excellent addition to a portfolio. They can diversify the source of risk in the portfolio and may indeed lead to higher return at lower risk.

However, one needs to be very careful what one is buying. Just because it is called a hedge fund does not mean it is.

If you are buying the product for a particular benefit (say diversification) then make sure the product is constructed to deliver that benefit. The risk is that you end up paying more in fees to deliver the same benefit that you get from another product. You lose twice, more fees and perhaps no protection when you need it most.

The maxim “Caveat emptor” - buyer beware - is appropriate to remember.



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