



Gaining the Hedge

Hedge funds are generally not very well understood by UK investors who perceive them to be extremely high risk investments. This public perception dates back to the economic crises of the 1990's such as the UK's exit from the European exchange rate mechanism in 1992 and the Asian currency crisis of 1997.

Whilst it is true that some hedge fund strategies, such as global macro economic funds, can achieve spectacular gains (and losses), many other funds have achieved steady, consistent performance with little or no correlation to market movements. As such, the name "hedge fund" has little meaning as a generic badge as it is used to describe investments across the full spectrum of risk, from fundamentally conservative to highly speculative, and all points in between.

The term "to hedge" can be defined as "taking measures against an undesired effect". The long term aim of most hedge fund managers is to achieve consistent absolute returns with low risk as opposed to the more traditional investment philosophy of achieving relative performance to a stated benchmark.

Most hedge funds invest either directly or via derivative instruments in liquid securities such as bonds and, more often, shares. However, there is an increasing trend for hedge funds to be employed in more oblique financial situations, such as proxy finance companies to provide asset based lending.

Equity hedge funds managers employ alternative investment strategies to benefit from anticipated share price movements in an attempt to achieve long term returns. Hedge funds follow the premise that markets are fundamentally inefficient and can create opportunities allowing investors to exploit mispriced securities without incurring excessive levels of risk.

Hedge funds use a range of assets and techniques as well as leverage (also known as gearing - the ability to borrow and invest the proceeds) and derivatives to achieve these aims.

There are many diverse hedge fund strategies and this number increase each year. The majority are based in the United States and are denominated in US dollars. For many investors, the best way to access these alternative investments is via a fund of hedge funds. These are collective investments which aim to dilute risk by diversification between a wide selection of proven hedge funds and strategies.

Held individually, hedge funds are unregulated offshore collective investment schemes and are normally subject to tax according to the regime in which they are based. Many funds are based in offshore centres such the Cayman Islands where funds are not taxed. For U.K. investors, gains tend to be rolled up into the share price and treated as income. Funds of hedge funds tend to be set up as offshore closed ended investment companies with gains chargeable to Capital Gains Tax on redemption.



There are strict rules for the marketing of hedge funds in the UK which can only be discussed with appropriate clients, often categorised as sophisticated investors, who will appreciate the various risks involved with investments of this type.

These alternative investment strategies continue to gain in popularity as they become better understood by investors. Many UK investors have become more “sophisticated” following the downturn in equity markets at the beginning of the decade; and the movement towards more diversified portfolios, that can hopefully better withstand any future volatility, continues. Some hedge funds can play an important part in this but it is important to take a view of one’s portfolio as a whole and to seek the advice of an experienced adviser.

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