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Institutional characteristics of hedge funds

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INSTITUTIONAL CHARACTERISTICS OF HEDGE FUNDS

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Abstract: This article reviews the institutional characteristics of hedge funds based on their comparison with traditional collective investment schemes and investment funds. The study arrives at the conclusion that hedge funds are highly leveraged boutique investment funds of a quasi-open nature that apply active portfolio management in order to obtain high absolute yield regardless of the behaviour of financial markets when conducting their activity in an environment of little transparency and legislative and institutional regulation.

Key words: hedge funds, collective investment schemes.

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Hedge funds are some of the most popular financial institutions in the large family of collective investment schemes. They are predominantly ill-reputed within the financial and economic community. Their investment activity is often associated with creating crises¹ on individual national financial markets or with infusing tension into the entire global financial market. Furthermore, there are notable examples in history when the activity of hedge funds posed unsolvable problems to well established global financial institutions.² The great economic power of hedge funds and

¹ Such an event was the failure of the Long Term Capital Management hedge fund in 1998.

² The author refers to the 1992 attack against the British pound by a hedge fund controlled by George Soros. The attack resulted in the devaluation of the pound sterling and rendered it impossible for the Bank of England to further include the British currency in the European Exchange Rate Mechanism.

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their immense impact upon the processes in financial markets have determined the growing interest among the academic community abroad in studying various aspects of their activity. Therefore, all related issues have been studied extensively and explained in detail.³ On the other hand, the research conducted by Y. Yordanov⁴, S. Dimov⁵, D. Minkova⁶ and K. Georgiev⁷ only provide some general outlines of the emergence and the activity of hedge funds. We may therefore conclude that hedge funds have been insufficiently studied and the topic is not particularly popular in specialist financial literature in Bulgaria. Consequently, hedge funds as financial institutions are the subject of research in this article, while the main objective is to identify their characteristics as institutions.

³ For further details, see: Lavinio, S. *The Hedge Fund Handbook: A Definitive Guide for Analyzing and Evaluating Alternative Investments*. McGraw-Hill Professional, 1999; Gregoriou, G. N., Karavas, V. N., Rouah, F. *Hedge Funds: Strategies, Risk Assessment, and Returns*. Beard Books, 2003; McCrary, S. A. *Hedge Fund Course*. John Wiley & Sons, 2004; Nicholas, J.G. *Investing In Hedge Funds*. John Wiley & Sons, 2005; Anson, M. J. P. *Handbook of Alternative Assets*. John Wiley & Sons, 2006; Lhabitant, F. *Handbook of Hedge Funds*. John Wiley & Sons, 2006; Guizot, A. *The Hedge Fund Compliance and Risk Management Guide*. John Wiley & Sons, 2007; Jones, C. *Hedge Funds Of Funds: A Guide for Investors*. John Wiley & Sons, 2008; Scharfman, J. A. *Hedge Fund Operational Due Diligence: Understanding the Risks*. John Wiley & Sons, 2008; Longo, J. M. *Hedge Fund Alpha: A Framework for Generating and Understanding Investment Performance*. World Scientific, 2009; Rittereiser, C. M., Kochard, L. E. *Top Hedge Fund Investors: Stories, Strategies, and Advice*. John Wiley & Sons, 2010; Strachman, D. A. *Getting Started in Hedge Funds: From Launching a Hedge Fund to New Regulation, the Use of Leverage, and Top Manager Profiles*. John Wiley & Sons, 2011; Wilson, R. C. *The Hedge Fund Book: A Training Manual for Professionals and Capital-Raising Executives*. John Wiley and Sons, 2011.

⁴ See: Yordanov, Y. *Investitsionni fondove – struktura, menidzhmant, otsenka*. Varna, ET Peevi, 2002.

⁵ See: Dimov, S. *Hedzh fondovete – edna ot novite i moderni tendentsii na finansovite pazari*. // *Biznes possoki, Tsentar po ikonomicheski i upravlenski nauki – Burgaski svoboden universitet*, No. 1, 2007, p. 20-35.

⁶ See: Minkova, D. *Alternativni strategii pri upravlениeto na portfelli*. // *Ikonomicheski alternativi*, 2009, p. 63-78.

⁷ See: Georgiev, K. *Evolutsionni karakteristiki na kolektivnite shemi za investitsii v tsenni knizha*. // *Narodnostopanski arhiv*, kn. 1, 2009, p. 82-96.

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As an element of the financial system, hedge funds certainly belong to the institutions engaged in organising collective investment in financial, liquid and exchange-traded real assets. Therefore, their primary definition as an institution should always include the awareness that they are in essence investment funds which manage a collective financial resource in order to obtain positive economic effects as a result of investment operations. A similar definition, however, is far from adequate to describe hedge funds as institutions. Even a brief analysis of their historical development reveals that their characteristics distinguish them from classic collective investment schemes, while the objective behind their emergence and evolution was to do away with the restrictions of traditional ways of organising collective investment. The major factor that hinders the analysis of the institutional characteristics of hedge funds is that they constitute a rather inhomogeneous set. That is exactly why foreign economic literature does not provide a single definition of their nature. There is no such definition of hedge funds in global investment practice, either. Therefore, in order to gain an awareness of the nature of hedge funds, it is necessary to analyse all aspects of their activity as well as what distinguishes them from traditional investment funds by applying diverse criteria which describe various aspects of the existence of any collective investment scheme, such as:

- The characteristics of their portfolio management;
- Profitability and investment risk;
- Risk profile;
- Employment of financial leverage;
- Classification of individual varieties;
- Factors affecting investment results;
- Characteristics of clients (investors);
- Scale of activity/value of managed assets;
- Mode of entry or exit of an investment in/from a fund/liquidity;
- Form of legal organisation;
- Economic nature of owners' involvement;

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- The way the institution is maintained;
- Regulations and institutional oversight;
- Degree of transparency of the activity;
- Organisational structure.

The first major characteristic of hedge funds and, at the same time, that which distinguishes them from regular collective investment schemes, relates to the nature of the portfolio management employed. In managing their portfolios, conventional investment funds employ the instruments, provisions, and models designed by contemporary portfolio theory. A large number of them are based on a series of assumptions about the behaviour of investors and capital markets, which renders them relatively simple and easy to employ. A major element of contemporary portfolio theory⁸ is the assumption that capital markets are efficient. Therefore, based on the relation between yield and risk, it would be easy to construct an investment portfolio with optimal characteristics according to investors' risk preferences. Furthermore, an important theorem for portfolio managers employing the provisions of contemporary portfolio theory is that unsystematic risk can be reduced and eliminated. Thus the only relevant issue for them seems to remain systematic risk and the sensitivity of the investment portfolio to that risk over a longer period of time. As a result, portfolio management of classical investment funds may be defined as being long-term oriented and predominantly passive. Its major objective is to achieve higher yields compared to that of a particular benchmark which may be a competitive fund or a market index. Things are different for hedge funds portfolio managers. The underlying assumption of classical hedge fund strategies⁹ is that over a different period of time there will be some assets which are not properly estimated by the market (i.e. they are either overestimated or underestimated). By applying complex quantitative analysis and specific investment strategies, overestimated and

⁸ For further details on the nature of contemporary portfolio theory, see: Patev, Pl., Kanaryan, N. Upravlenie na portfeila. V. Tarnovo, Abagar, 2008.

⁹ For further details on the investment strategies of hedge funds, see Ganchev, A. Hedzh fondovete – alternativnen instrument za investitsii na finansovite pazari. Al Tsenov, 2012, p. 92-124.

underestimated assets are included in an investment portfolio which will produce very high absolute (positive) returns regardless of the general condition of capital markets. Therefore we may say that portfolio managers of hedge funds like unsystematic risk. What is more, they consciously seek it and are likely to take that risk in their effort to obtain very good investment results. In order to minimize its potential adverse manifestations however, portfolio managers employ extremely dynamic portfolio management. Translated in terms of contemporary portfolio theory, this means that the optimal risk-return ratio is not an issue with hedge funds. Rather, the only objective is to obtain a positive alpha coefficient of the portfolio at zero sensitivity to the systematic risk factor. Therefore, the major characteristic of hedge funds portfolio management is that it is markedly active and of an extremely short-term nature compared to the portfolio management employed for traditional investment funds.

Low risk	Funds of funds investing on the money market Money markets index based funds Money market funds Funds of funds investing in bonds Bond-markets index based funds Bond funds
Moderate risk	Funds of funds investing in stocks and bonds Growth and income funds Assets allocation funds Balanced funds
High risk	Funds of funds investing in stocks Stock-markets index funds Stocks and income funds International funds Growth funds Aggressive growth funds

Figure 1. Types of traditional collective investment schemes according to their risk profile

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Due to the employment of strategies aimed at achieving a high alpha coefficient, the risk profile of hedge funds may definitely be classified as high-risk. In contrast with traditional investment funds, there are institutions with low-risk, balanced, and high-risk profiles. It should be noted though, that the high investment risk of hedge funds does not imply that they a priori entail a higher risk than that of conventional investment funds. This is due to the fact that the risk entailed by both types of collective investment schemes is of different origin. The risk entailed by regular collective investment schemes arises from systematic factors, while the risk entailed by hedge funds arises from its unsystematic components. It is therefore theoretically possible to have a very high risk exposure of a traditional investment fund to systematic factors, which may render it even riskier than a hedge fund managing appropriately its unsystematic risk.

The risk profile is also essential when classifying hedge funds and regular collective investment schemes into different types. Figure 1 presents the classification of traditional investment funds according to their risk profile. Obviously, equity securities entail the highest risk and the highest returns. They are followed by funds investing in mixed portfolios of debt and equity securities. The least risky funds are those investing only in debt securities or financial market instruments. The situation with hedge funds is different, as their classification is not based on their risk profile, but on the primary investment strategy employed. Hedge funds are therefore classified as employing the strategies long/short equity; dedicated short bias; equity market neutral; event driven; convertible arbitrage; fixed income arbitrage; global macro; emerging markets; managed futures and multi-strategy.¹⁰

A large part of the unsystematic risk related to hedge funds arises from applying leverage in the investment strategies designed. Leverage has been an essential element ever since the first modern-type hedge fund¹¹ was established as it is a catalyst enhancing the effect of the investment strategy employed. Whether leverage is a function of funds

¹⁰ See further: <http://www.hedgeindex.com/hedgeindex/en/indexoverview.aspx?indexname=SECT&cy=USD>

¹¹ This is the A. W. Jones & Co. Hedge Fund established by Alfred Jones in 1949.

obtained through short sales, margin trading, the employment of financial derivatives, repurchase agreements, or directly borrowed resources, its ratio in hedge funds is always significant. A typical example is the Long Term Capital Management Fund which, at the time of its bankruptcy in 1998, was operating at a leverage ratio of 28:1, which is comparable to the levels of financial leverage employed by major investment banks at the time.¹² Regular investment funds do not face similar problems since the strict oversight by regulatory authorities does not allow them similar financial freedom.

Research conducted by Jaeger in 2003¹³ focuses on another aspect of the activity of hedge funds which directly relates to and stems from all issues commented on above, that is, the sources (factors) of their yield and risk. While with standard investment funds these could be the market conditions, the investment strategy employed and the skills of investment managers, with hedge funds these factors include only the investment strategy and the skills of portfolio managers. This is quite logical in terms of the objective of hedge funds to seek absolute returns regardless of market conditions. Therefore the ability of hedge fund managers to select the right investment vehicles and to incorporate them in strategies that allow the accomplishment of their primary objective is essential. Market conditions are not a key factor in this process, but a feature of the investment environment.

The freedom of their investment policy, which hedge funds have enjoyed ever since they first appeared, goes hand in hand with the need for less oversight and fewer regulations on their activity. This effect is partially achieved by setting specific requirements to the entities that may invest in them. According to USA legislation, these are the so-called accredited investors. Usually, they are financial sector companies; economic entities with total assets in excess of \$ 5 million; managing persons in investment companies'; and individual investors with a net worth of over \$ 1 million or

¹² For further details, see: Scalcione, R. *The Derivatives Revolution: A Trapped Innovation and a Blueprint for Regulatory Reform*. Kluwer Law International, 2011, p. 110.

¹³ See: Jaeger, R. A. *All About Hedge Funds: The Easy Way to Get Started*. McGraw-Hill, 2003, p. 5-6.

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natural persons whose earned annual income exceeds \$ 200,000 or \$ 300,000 together with a spouse.¹⁴

Hedge funds around the world have to observe similar principles, which suggest that there are economic, as well as legislative reasons behind this. The former relates directly to the scale of operations and the value of managed assets. Since their investment policy must be highly flexible, hedge funds operations are of a relatively small scale, compared to the activity of other financial institutions. This is due to the fact that too large an investment portfolio can hardly be managed without loss of efficiency. Another reason is that with hedge funds high returns may be obtained with a relatively small, yet highly leveraged investment portfolio. We can therefore conclude that, due to their investment policy, the economic objective behind hedge funds is neither to expand unlimitedly, nor to achieve economies of scale. In contrast to all elements of conventional collective schemes, a wide range of economic entities may be engaged in them, i.e. individual and institutional investors, regardless of their wealth or the value of the resources they provide to be managed through these funds. The above-stated clearly determines the scope of the activity of these institutions. Compared to hedge funds, that scope is enormous, since due to their predominantly passive portfolio management, economies of scale are deliberately sought.

Liquidity of investments is an issue important to all investors. In terms of being involved in a collective investment scheme, this is the question how an economic entity can invest in a particular fund and how the investment in that fund can then be terminated. Another relevant issue refers to potential constraints. With conventional investment funds, there is maximum liquidity of investments. These institutions are legally required to calculate and publish on a daily basis the issue price and the redemption price of their shares.¹⁵ It is through these that economic entities are able to

¹⁴ For further details, see: U. S. Securities Act. Rule 501, Regulation D, § 230.501, Definitions and terms used in Regulation D, 1933.

<http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&sid=441856d07884ed3f0111d84a92d9765f&rgn=div5&view=text&node=17:2.0.1.1.12&idno=17>.

¹⁵ In Bulgaria, the legal regulation in this field is provided through the Collective Investment Schemes and Other Undertakings for Collective Investments

open or terminate their investments in these funds. Naturally, there are sometimes certain constraints due to the fact that the opportunity to make or terminate an investment at any time may put conventional investment funds in a situation in which they need to pay more attention to redemption requests than to their portfolio management. Therefore, it is common practice to have at a single point of time an issue price per share higher than its redemption price. This guarantees that, for a minimum period of time, investors would be encouraged to keep their money with the investment fund. In other words, with conventional investment funds there are only economic barriers to postpone the moment of exiting these funds. Obviously, the presence of such barriers does not deprive these funds of liquidity, since an investment may be terminated as soon as it has been made, at a minimum loss though. In addition, the liquidity of investments in common collective investment schemes is also legally guaranteed. This is achieved through legislative regulations requiring that a certain percentage of managed assets must be kept in cash so as to consistently meet redemption requests.

Usually, an investment in a hedge fund may only be made on certain dates at an interval of one or three months. Similarly, investors are not allowed to randomly exit a hedge fund at any point of time. Investors are often obliged to keep the initially invested funds for a minimum period of time¹⁶, which may sometimes be as long as one calendar year. Furthermore, an investment can only be terminated on strictly fixed dates, usually at the end of each calendar quarter. In addition, should investors in a hedge fund be willing to redeem their shares, they are obliged to inform the fund about their decision in advance.¹⁷ All these facts render the liquidity of hedge funds as rather limited and definitely too low. This is mainly due to the scope of the institutions, investment purposes and the

Act, in particular, Art. 21, paragraph 1. For details, see through the Collective Investment Schemes and Other Undertakings for Collective Investments Act, promulgated in issue 77 of the State Gazette, last amended and supplemented in issue 27 from 2014.

¹⁶ This is the so-called lockup period. For further details regarding its nature and role, see: Tran, V. Q. *Evaluating Hedge Fund Performance*. John Wiley & Sons, 2006, p. 129.

¹⁷ This is the so-called prior notice.

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portfolio management applied. The longer the period of time during which investors are 'obliged' to stay with a hedge fund, the longer the period of time which portfolio managers have at their disposal to apply adequate investment strategies, to adapt current strategies and to deal with incurred losses. Furthermore, due to their relatively small scope, hedge funds have to utilise the assets they manage much more efficiently. Therefore, a high liquidity for investors would equal deteriorated investment results for hedge funds. Thus the constraint to redeem shares on strictly fixed dates only, the requirement to give prior notice and the investment lockup period make it possible to invest money which would otherwise be allocated as a buffer to meet redemption requests with standard investment funds. Hedge funds managers are therefore able to plan more accurately closing their positions in financial instruments so as to obtain maximum benefit with a minimum impact on all other investors in the fund.

Analysis of the legal entities as which conventional collective investment funds operate, indicates that nowadays they are predominantly operating as dependent economic entities.¹⁸ They are established and managed by specialist management companies¹⁹ which are usually joint stock companies. Certainly, regulations in the USA, Great Britain, and most EU member states also allow for the possibility that investment funds may be independent entities. These are trusts in the USA and Great Britain, while in EU member states they operate mainly as companies owned by shareholders.²⁰ Hedge funds, in turn, exist as various legal entities, in most cases as limited partnerships²¹. The main feature of establishing hedge funds as such legal entities is that their founders and managers have the status of unlimited liable partners, while investors' liability is limited to the amount of the capital that has been provided to be managed.

¹⁸ This conclusion is based on a review of different types of legal organisation of collective investment schemes around the world which are systematically described in ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT. Financial market trends, 78/March, 2001.

¹⁹ In Bulgaria, the equivalent of these investment companies is an asset management company.

²⁰ The Bulgarian equivalent is open and closed investment companies.

²¹ This is the term limited partnership.

In investment practice, there are two other varieties of hedge fund organisations. These are limited liability companies²², as well as the more popular off-shore investment companies (providing for certain tax benefits and reduced institutional control) which are usually registered as joint stock-companies. The opportunity to register hedge funds off-shore allows for two other models of doing business that are of special interest. These are so-called mirror hedge funds²³ and hedge funds of the 'master-feeder' type.²⁴ With the first type, two hedge funds which are absolutely identical in terms of investments, yet totally independent as legal entities, are owned and managed by the same economic entity. The main reason behind their establishment is the opportunity to attract both traditional investors as well as ones willing to obtain certain tax benefits. The major disadvantage of these type of structures is that virtually any problem related to the organisation, administration, reporting, or portfolio management of the two existing structures is doubled. Many of these shortcomings can be overcome by structuring a few hedge funds around the 'master-feeder' scheme. Under this scheme, there is a major fund which is usually registered in an off-shore zone and less frequently in a state with no tax relieves. The role of the major fund is to implement the overall investment policy and the investment operations of the hedge funds group. The rest of the hedge funds in the scheme have the same investment profile as that of the major fund, yet they are subordinate to it. Their only function is to attract clients and to invest in the major fund the financial resources they have attracted without conducting an independent investment policy.

The manner in which these two types of collective investments schemes are legally structured also determines the nature of the relations between the entities that organise them and their investors. By participating in a conventional investment fund, investors in fact entrust some of their wealth to be managed by the entity that has established that fund. That entity consequently becomes its manager. Therefore, despite some insignificant deviations, with conventional investments funds there is a classical relation between a principal and an agent. As a matter of fact,

²² This is the term limited liability company.

²³ This is the term mirror hedge fund.

²⁴ This is the term master-feeder.

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the fund manager may be an investor as well, although there is no such requirement. With hedge funds, regardless of the manner in which they are structured, the owner and the investors have the status of partners. In other words, the entity that organises the hedge fund is at the same time a manager and an investor, while the relationship between that entity and the investors evolves to one between partners (a partner-partner relationship).

One of the key differences between conventional investment funds and hedge funds relates to the charges accrued for the management of invested funds. With conventional investment funds, the management charge accrued is a percentage of the net value of the assets of the fund for a certain period.²⁵ That percentage and, above all, its maximum value are subject to legal regulation, the main concern being not to harm the interests of investors. An interesting consequence in this case is that the proportionate nature of forming the revenues of classical investment funds has become another reason why they seek a large scope for their activity, rather than positive investment results. Hedge funds also charge a management fee on the amount of the assets they manage,²⁶ yet it is smaller compared to that charged by conventional investment funds. As McCrary points out, it usually amounts to 1 or 2 per cent annually.²⁷ The role of the fee is to cover the operating costs of hedge funds, not to generate profit. Hedge funds revenues are mainly from the fees charged on the growth of the value of managed assets²⁸, i.e. on the profits made. When the first contemporary hedge funds were established, this fee, which is directly related to the performance of hedge funds, was fixed at 20 per cent²⁹ and has remained the same. The reason for charging this second

²⁵ The practice in Bulgaria allows for charging fees on the sale and redemption of shares. For details, see Art. 173 of the Collective Investment Schemes and Other Undertakings for Collective Investments Act, promulgated in issue 77 of the State Gazette, last amended and supplemented in issue 27 from 2014.

²⁶ This is the term management fee.

²⁷ See: McCrary, S. A. *How to Create & Manage a Hedge Fund: A Professional's Guide*. John Wiley & Sons, 2002, p. 13

²⁸ This is the term incentive fee.

²⁹ A publication by Papageorgiou, Hübner and Rouah in 2011 stated that more than 51 per cent of hedge funds around the world apply this amount in combination with a 1 to 2 per cent fee charged on the amount of managed assets. For further details, see: Papageorgiou, N., Hübner, G., Rouah, F. D. *Hedge Funds: Insi-*

fee is to make portfolio managers seek positive absolute returns at all costs. Otherwise they would only cover the operating costs of the hedge fund but would not realize a positive financial result for themselves. In order to boost that effect and to attract more qualified investors, some hedge funds accrue that fee only after a certain amount of positive returns³⁰ has been achieved or when their returns cover the losses incurred in previous periods.³¹ Due to the fact that conventional investment funds manage a significant volume of public financial resources that belong to individual or institutional investors, their activity is subject to enhanced control and supervision by specialised state bodies³² engaged in managing the processes on financial markets, which results in a higher transparency in their activities. Hedge funds represent the opposite extreme. They are subject to relatively weak institutional control while their activity is somewhat obscure and shrouded in mystery. Furthermore, despite the efforts of regulatory bodies in recent years to make the activity of hedge funds more transparent, such obscurity is deliberately sought. The reasons behind this are obvious. A greater publicity of hedge funds activity would unveil some of the secrets about the investment policy they employ, which would put an end to the opportunity to achieve positive returns. In addition, a combination of transparent activity and potential related problems may undoubtedly benefit their competitors. When the mechanisms of leverage are applied, this is very likely to lead to the bankruptcy of a particular hedge fund. We may therefore conclude that the lack of transparency of hedge funds is part of the investment policy they apply and at the same time a protection mechanism ensuring the survival of hedge funds in the hostile environment of financial markets.

Further differences between ordinary investment funds and hedge funds may be identified when reviewing the taxation regime applied to their activity. This, however, is an issue of a markedly legal character. What is more, rather diverse national tax laws and the existence of off-shore hedge

ghts in Performance Measurement, Risk Analysis, and Portfolio Allocation. John Wiley & Sons, 2011, p. 182.

³⁰ This is the so-called hurdle rate.

³¹ This is the so-called high water-mark.

³² In Bulgaria, this is the Financial Supervision Commission.

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funds render the scope of a similar problem too big and therefore require to be researched independently. Due to this, taxation of hedge funds has not been included in the focus of this research.

A review of the organizational structure of hedge funds adds some final, yet, indispensable touches to their institutional characteristics. Clearly, related features are in line with the comparisons made earlier in this article. With the management of conventional collective investment schemes, the structure of the institution which organises them totally matches the scope of their activity. It is markedly horizontal and includes many separate aspects whose functions serve portfolio management³³, investment analyses, accounting, marketing, etc. Hedge funds are the opposite extreme. Due to their different investment profile, the various legal regimes under which they operate, and due to the requirement for economic efficiency, hedge funds are small boutique financial institutions with highly simplified organizational structure. Over the last years, in an attempt to achieve greater flexibility, there has been a trend to delegate more and more aspects of their activity to external entities.³⁴ In other words, the term 'hedge fund' is no longer used to refer to a particular institution, but to a set of institutions whose services form and constitute that fund. Nevertheless, functional similarities in the activity of hedge funds across the world make it possible to highlight the major elements of their organizational structure which are presented in Figure 2. Clearly, such a presentation is highly provisional, yet it is sufficient to conclude that the organizational structure of hedge funds totally matches the scope of their activity and has a vertical, highly simplified character. The major elements of that organizational structure may be presented as follows:

³³ For further details regarding the horizontal character of the organizational structure upon the establishment and management of conventional investment funds, see: Investment Company Institute. 2009 Investment Company Fact Book. 49-th edition, 2009, p. 174, accessible at http://www.ici.org/pdf/2009_factbook.pdf

³⁴ This observation refers mainly to administrative and legal counseling activities.

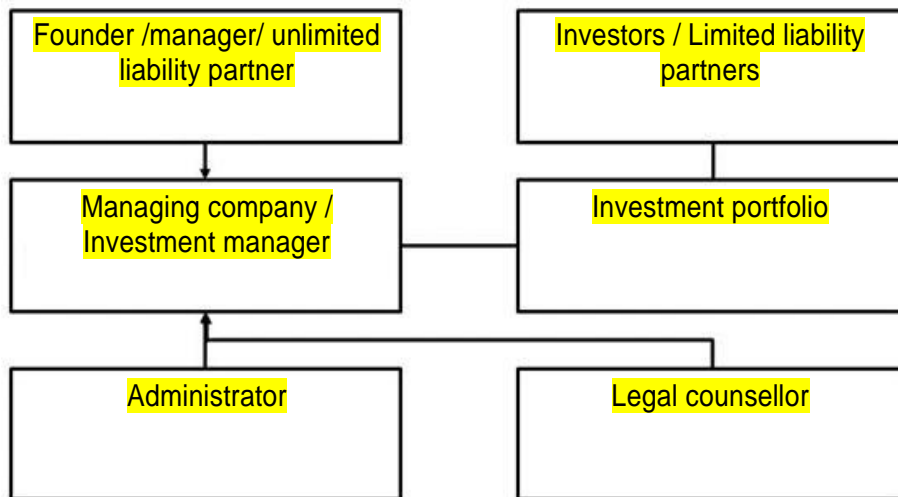


Figure 2. Theoretical organizational structure of a hedge fund

First, the founder. The figure of the founder is essential for the existence of any hedge fund. Specialist financial literature also refers to hedge fund founders as sponsors or managers.³⁵ This is the person who initiates the establishment of a hedge fund and determines its investment portfolio and policy. The history of hedge funds development indicates that sponsors are usually successful specialists on financial markets and investments who are well known in the investment community. The founder of a hedge fund is thus the business card of that fund and the major factor which helps attract clients. Practice shows that when a hedge fund begins to operate, the manager invests a large share of their personal wealth in that fund. This is a major indication to investors that the hedge fund is a long-term undertaking and its policy will be oriented towards increasing the wealth of its clients. From a legal perspective, the founder of the hedge fund is usually an unlimited liability partner or has the legal control over the institution, unless it is registered as a partnership. Unlike the founder,

³⁵ For further details, see: Strachman, D. A. *The Fundamentals of Hedge Fund Management*. John Wiley & Sons, 2012, p. 72-73.

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investors of hedge funds are only clients. Therefore they are usually limited liability partners who do not have any legal control over the hedge fund or any management functions in its organizational structure, although being part of that structure.

Second, the managing company/the investment manager. The function of investment managers is to conduct the investment policy of hedge funds by designing and managing their portfolios. This is usually done by a managing company which is fully owned or legally controlled by the founder of the hedge fund. In the USA, the managing company usually has the statute of an investment counsellor.³⁶ The managing company in fact organises the hedge fund, executes its operational management and takes care of attracting other companies.

Third, the administrator. The administrator is the last major functional unit in the management of a hedge fund. Their role relates to the technical aspects of the operation of the hedge fund, such as calculating the net worth of the assets; adjusting that value according to accrued management charges; preparing the financial statements, and communicating with tax authorities. Trends over recent decades indicate that hedge funds are increasingly relying on external entities for conducting various administrative activities. A survey conducted by eVestment, a company specialising in providing insight and intelligence to hedge funds, indicates that, as of the last quarter of the year 2011, an extremely large share of hedge funds across the globe were being run by leading investment banks or by companies which had been established precisely to deal with the administration of hedge funds.³⁷ Some of the reasons behind this may be the willingness to reduce operating costs, and above all, the requirements for greater transparency of their activity.

Fourth, the legal counsellor. Compared to the entities listed above, the legal counsellor has the smallest role, yet one that is essential for the operation of a hedge fund. A legal counsellor has to resolve any legal

³⁶ For further details, see: Williams, O. M. *Hedge Funds: Overview of Regulatory Oversight, Counterparty Risks, and Investment Challenges*. DIANE Publishing, 2009, p. 6-9

³⁷ For further details, see: eVestment|HFN. *Hedge Fund Administrator Survey*, sponsored by Advent Software. eVestment Alliance, 2012.

issues related to the existence of a hedge fund, such as the legal procedures for its establishment, legal communication with official authorities; dealing with taxation issues and providing legal expertise on specific investment transactions. As evident from the data of research company, Cogent Investment Research, the legal counsellors of hedge funds are usually leading law firms and consulting companies.³⁸

* * *

We may conclude the analyses made in this article result in the summary that hedge funds differ significantly from conventional investment funds in three major aspects: their legal organisation and organizational structure; the character of the investment policy they apply and issues related to it; as well as the regulatory and institutional control on their activity. The institutional characteristics of hedge funds and their distinctions from conventional investment funds provide a basis for defining their nature as institutions. Based on the analyses made in this paper, hedge funds may be defined as highly leveraged boutique investment funds of a quasi-open nature that apply active portfolio management in order to achieve high absolute returns regardless of financial markets behaviour while conducting their business under low transparency and weak legal and institutional regulation.

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³⁸ Вж. http://www.cogenthedge.com/admin/rank_providers.asp.

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