What Are Hedge Funds And Who Are They For?

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YOUR MONEY MATTERS

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With the near-collapse of **Long-Term Capital Management** LP making headlines, many people may be wondering how smart investors wind up in something so apparently risky as a hedge fund. Others probably want to know how to get in.

Hedge funds are largely unregulated investment pools open to only the wealthiest investors. They have grown in popularity in recent years, both because of their outsized returns and their aura of exclusivity.

> **Levitt's Concerns**
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> SEC Chairman Arthur Levitt said the Long-Term Capital problem is an aberration, but said he is still concerned about risks for small investors. Meanwhile, Chase Manhattan becomes the first big bank to break out its exposure to the hedge-fund industry. Articles on page C17.

But some investors have moved into hedge funds for the wrong reasons or without understanding the potential downside, financial advisers say.

"Some people invest in hedge funds either because it's cocktail-party talk or because they're pursuing returns without looking at the risks," says Robert Elliott, senior executive vice president at **Bessemer Trust** Co., where about 30% of the clients have some hedge-fund exposure. "There's a role for hedge funds, but it has to be done very carefully."

Although attention is now focused on the riskiness of Long-Term Capital's gambles, the term "hedge fund" encompasses a broad range of investment funds that employ a wide variety of strategies. Estimates of the total number of hedge funds range from 2,200 to 4,000.

Most are far smaller than Long-Term Capital. "The typical hedge fund has under $500 million in assets," says E. Lee Hennessee, president of Hennessee Hedge Fund Advisory Group in New York. "There are many hedge funds that don't have $10 million."

Many hedge funds use short-positions, or bets that prices will fall, to offset their securities holdings. Some bet on mergers and acquisitions, convertible securities or foreign currencies. They frequently use borrowed money in an effort to boost returns, though to a far smaller extent than the huge size of Long-Term Capital's leveraged bets might suggest.

> **Hedging Your Bet**
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> Questions an investor should ask before putting money into a hedge fund:
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> - How does the investment strategy work?
> - What are the risks?
> - What market conditions favor the manager's strategy — and which ones work against it?
> - What is the manager's experience and track record?
> - How long before I can withdraw my money?
> - How are the manager and the consultant helping select the hedge fund compensated?

"If you step back, in the aggregate there are 20 different hedge-fund styles," says James Hedges IV, managing director of LJH Global Investments LLC, a Naples, Fla., firm that advises wealthy investors and institutions.

Because of the risks, securities laws limit participation in hedge funds to individuals with incomes of at least $200,000 in each of the two most recent years ($300,000 per couple) or net worth of $1 million. Until recently, hedge funds were limited to no more than 100 investors. But a 1996 law expanded participation to up to 500 investors, provided each has an investment portfolio valued at $5 million or more.

Traditionally, most hedge-fund clients

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