HEDGE FUNDS

Fall 2002

How they are different from Mutual Funds

- **Often off shore (i.e., registered in the Caymans)**
- **Usually wider array of securities including derivatives**
- **Often leveraged**
- **More dramatic changes in their composition**
- **Pure ones are market neutral**
- **Usually compensated as percentage of profits**
- **Limited partnership**

Normal Compensation

1. Annual fee of 1% to 2% of assets.

2. Incentive fee of 5% to 25% of assets benchmarked to zero or treasury rate.

3. Usually prior thresholds that are not met are added to current threshold.

How Differ from Normal

Hedge Fund Investments Are Dynamic:

- **Rarely Buy-and-Hold**
- **Fees Reflect *Active* Management**
- **Information-Driven Trading**
- **Sensitive To Economic and Market Conditions**
- **Effects Are Generally Nonlinear**
- **Static Risk Analytics Are Not Appropriate**

Difficult to Measure Performance

Example: Capital Decimation Partners, L.P.

- **Market Neutral Equity Hedge Fund**
- **Established January 1992**
- **Initial Assets: $10M**
- **8-Year Track Record (96 Months)**

Trading Strategy Is A Synthetic Option!

- Delta-Hedging Strategy (Black-Scholes Formula)

- Replicates Short European Put On:
  - -10,000,000 Shares of XYZ
  - -Strike: $25
  - -Time To Maturity: 2 Years
  - -Borrowing Rate: 5%

- Put Options Worth Only $14,693

- Profitable *Most* of the Time