Nucleus
ADVISORS
UNWIND
HEDGE FUNDS
2020

What are Hedge Funds?

Someone asked the famous hedge fund investor, Ray Dalio, "What is a hedge fund?" He sarcastically replied, "I also don't know what hedge fund means!"

He further explained that "It is a structure within which an investor can do anything. It allows you to invest without any restrictions. The investor has the freedom to invest anywhere. They can go long as well as short. There is no bad or good times or cycles as such."

In definitive terms, hedge funds are a type of Alternative Investment Funds (AIFs), which uses pooled funds and aims at generating active returns or alpha for their investors by employing different kinds of strategies. Hedge funds generally, opt for an aggressive approach to generate a return. It uses complex techniques like derivatives, short selling, and leverage, in both the domestic as well as the international market with a goal to generate higher returns. The accessibility of hedge fund services are only limited to some accredited investors like the HNIs, banks, insurance companies, and endowments & pension funds.

The major difference between a hedge fund and a mutual fund is the number of regulations as a hedge fund is less regulated in comparison to any other fund. Hedge funds also differ from Private Equity, Angel Networks, Venture Capital Firms or other any other similar close-ended funds since they trade in liquid assets, thereby providing their investors an option to withdraw funds periodically on the basis of NAV (Net Asset Value).

The fund manager who manages the investment is generally paid a management fee on the basis of the "Two And Twenty Fee" arrangement. This is the standard arrangement in the hedge fund industry. This includes both the management as well as the performance fee. Two refers to the charges related to annual management fees, calculated as 2% of the Assets Under Management (AUM) and twenty refers to the 20% incentive fees which is paid to the manager whenever the profits cross a certain hurdle rate.

History of Hedge Funds

Alfred Winslow Jones is known as the father of Hedge Fund. He had been a spy, a sociologist, a magazine writer, and a communist before starting a hedge fund. He is also a Harvard and Columbia alumnus. He launched his first fund with USD 100,000. His two strategies are still used by a lot of investors which are known as leverage and short selling. He also invented the two and twenty rule of charging fees, which is still a crucial part of the industry today.

In the 1960s, nearly 140 new hedge funds were launched as the new method of investing and managing money was getting popular. They were attracted by greater flexibility and hefty compensations. However, most of the hedge funds showed a downfall in the 1970 bear market. It was because most of the hedge funds did not use the two tools namely leverage and short selling in the same manner as used by Alfred. Instead of hedging, only leverage was used to enhance returns, ignoring the short-selling aspect that Jones employed. This decision exposed most of the hedge funds and some hedge funds dropped in value by more than 70%. This lead to a lot of investors turning away from hedge funds market.

The market scenario started changing as hedge funds entered the 1980s, with inflation coming under control and the opening of the global market. This bullish trend resulted in the rise in prices of both the US stocks and the global market. In the late 1980s, various hedge fund managers including George Soros, Michael Steinhart, and Julian Robertson also contributed to changing the industry dynamics. As time passed, more complex instruments like derivatives and currency trading helped hedge fund managers to earn a good return again. By the late 1990s, there were over 500 hedge funds worldwide with assets of about USD 38 billion.

Currently, hedge funds represent one of the largest segments of the investment management industry. At present, it is estimated that there are over 10,000 hedge funds in existence and the industry's estimated worth to be at USD 3.2 trillion.

Alfred Winslow Jones

George Soros

Julian Robertson

How does a Hedge Fund work?

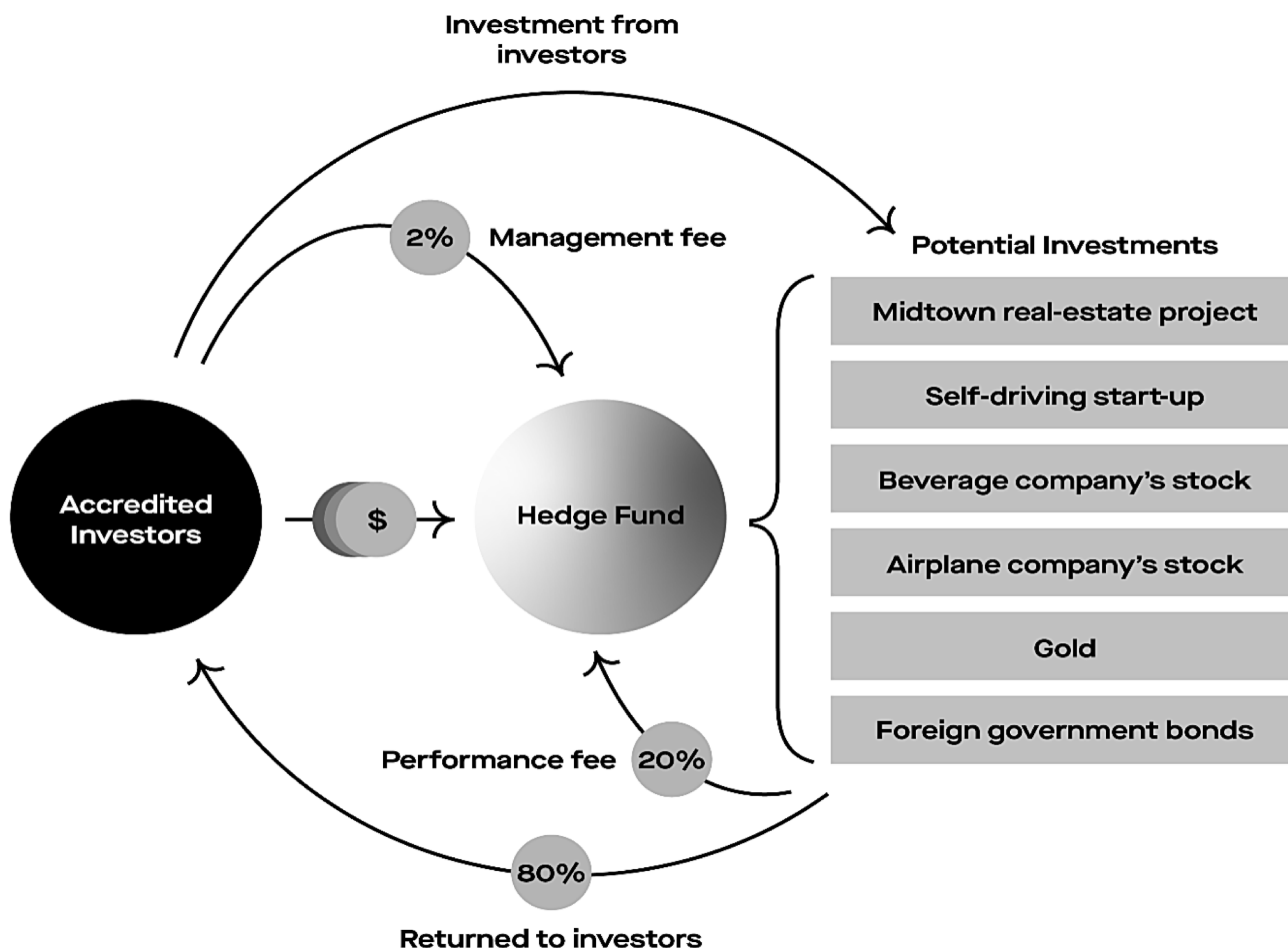
The structure of the hedge fund follows the partnership model which is similar to Venture Capital (VC) firms. There are two kinds of partners-

General Partner

General Partners are the founders and the fund managers who manage the hedge fund on the basis of fund strategy and objectives. They are responsible for the day to day operations of the fund. They not only form the fund but also control the investment according to their strategies. General Partners generally assume unlimited liabilities towards the fund.

Limited Partner

Limited partners are the investors who invest in the fund. Only qualified or accredited investors are allowed to invest which mainly consists of banks, insurance companies, pension & endowments funds, HNIs, and ultra HNIs. The minimum ticket size for investors investing in these funds is generally INR 1 cr. Limited Partners generally have limited liability.



Strategies Applied by Hedge Fund Managers

Long/Short Equity

This is one of the most famous fundamental equity strategies used by hedge fund managers. In this strategy, managers buy the stock of companies that are expected to outperform and sell stocks of companies that are expected to underperform.

If the share of ICICI Bank is cheaper in comparison to HDFC Bank, the trader may buy Rs.1,00,000 of ICICI Bank and short HDFC for an equal amount. If ICICI Bank outperforms, the trader will make a profit no matter what will be the prevailing market conditions.

Suppose ICICI Bank rises 15% and HDFC bank rises by 10%, trader will sell ICICI Bank share for Rs.1,15,000 and cover the short of HDFC bank of Rs. 1,10,000 and earns a profit of Rs. 5,000. If ICICI Bank falls 10% and HDFC bank falls by 15%, trader will sell ICICI Bank share for Rs.90,000 and will short of HDFC bank of Rs. 85000 and earns a profit of Rs. 5,000. In case ICICI Bank fails to outperform HDFC Bank traders will make losses.

Market Neutral

In the market neutral strategy, the hedge funds longs and short for equal market value to attain zero market exposure. The returns, in this case, are entirely based upon the selection of stock. This strategy is considered as less risky from long/short equity but in turn, comes with lower expected returns.

The fund manager may go long in the 10 biotech stocks that are expected to outperform and short the 10 biotech stocks that may underperform. Therefore, in such a case the gains and losses will offset each other despite how the actual market does. So even if the sector moves in any direction the gain on the long stock is offset by a loss on the short.

Capital Structure Arbitrage

In capital structure arbitrage, the firm's undervalued security is brought and overvalued security is sold. The strategy is used by many directional, quantitative, and market neutral credit hedge funds. This strategy aims to earn profit from inefficient pricing in the firm's capital structure.

For example, if there is news that a particular company is performing badly. The prices of bonds and shares both will fall but as equities are subject to more risk, prices of equity will fall comparatively faster than bonds. Even bonds will continue to earn a fixed rate of interest and carries an obligation for the company to be paid as a liability. The trader in such a case will long for bonds and short equities of the same company to balance his risk and return profile.

Merger Arbitrage Strategy

In the merger arbitrage strategy, stocks of two merging entities are brought and sold to earn a profit. This strategy plays upon the uncertainty that the merger deal will not close on time. When an entity combines its price hikes, the hike is usually between the current prices and acquisition price decided for merging entities. Therefore, the hedge fund will purchase the stock at lower prices and will, later on, sell it at the acquisition price which will be higher than his purchase price.

ABC Co. is trading at Rs.40 per share when XYZ Co. comes along and bids Rs.40 per share which is a 25% premium. The stock of ABC will jump up, but will soon settle at some price which is higher than Rs.40 and less than Rs.50 until the takeover deal is closed. Let's say the price prevailing in the market is Rs.45. The trader will purchase a large number of shares at Rs.46 per share and will hold it till the merger and later on will sell it at an acquisition price of Rs. 50 once the merger is done.

Convertible Arbitrage Strategy

Convertible Arbitrage strategy, includes a combination of convertible bonds and equity options. This strategy takes benefits from mispricing between the convertible bond and underlying security. If the convertible bond is cheap or if it is undervalued relative to the underlying stock, the arbitrageur will take a long position in the convertible bond and a short position in the stock. If the convertible bond is overpriced relative to the underlying stock, the arbitrageur will take a short position in the convertible bond and a long position in the stock.

If the trader longs for the convertible 1-year bond that has a 5% coupon rate that has a par value of Rs.1000 and holding it till maturity will earn interest of Rs.50. The bond is convertible to 50 common shares whenever the bondholder desires to get them converted. The stock price at that time was Rs.20.If the stock price rises to Rs.25 the trader will exercise the conversion and will own 50 equity shares worth Rs.1250 in lieu of bonds worth Rs.1000. Even if the trader wants to sell the bond he can sell it for Rs.1250 in the market.

Fixed Income Arbitrage Strategy

In fixed-income arbitrage strategy, profit is made from arbitrage opportunities in interest rate securities. The most common type of fixed-income arbitrage is swap-spread arbitrage. In swap spread arbitrage, long and short positions are taken in a swap and a treasury bond. This particular type of hedging earns small return and exposes to a high risk of loss.

A trader takes long for 1000 2 years municipal bond at Rs.100 with a payout interest rate of 6%. The interest income that will be earned by the trader will be Rs.12000 in 2 years. In order to mitigate the risk of default in interest payment, a strategy is to take short on interest rate swaps of companies that pay interest of 6% and are taxed at 5%. Total interest payout in 2 years will be Rs.11400 (Rs10000*6%*2*95%).
Income made by hedging will be Rs600 (Rs.12000-Rs11400).

Event Driven Strategy

Event-driven strategies seek to exploit inflation and deflation that occurs in response to specific corporate events. These events can include mergers and takeovers, reorganizations, restructuring, asset sales, spin-offs, bankruptcy, and other events creating inefficient stock pricing. Event-driven strategies require expertise in fundamental modeling and analysis of corporate events.

For example, the Fund manager buys the debt at lower rates available in markets of the company which has filed bankruptcy and whom he expects will be able to payback or fund manager may short the equity of the company who has not yet filed bankruptcy, expecting that the share price of the company will fall once bankruptcy will be declared.

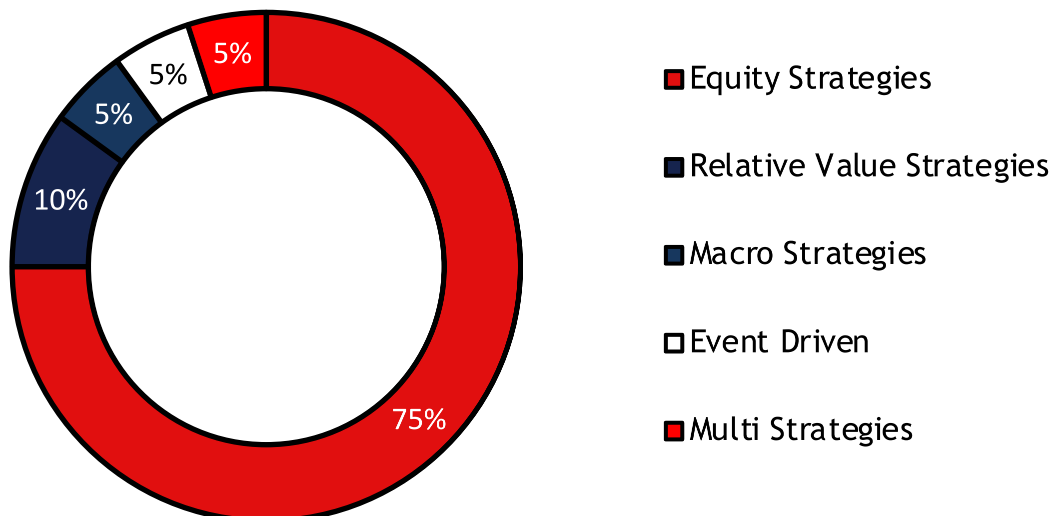
Global Macro Strategy

Global macro funds are not confined to any specific investment vehicle or asset class. They can include investments in equity, debt, commodities, futures, currencies, real estate, and other assets in various countries. The strategy involves making decisions based on broad political and economic outlooks of various countries. The global macro strategy involves directional analysis, which seeks to predict the rise or decline of a country's economy, as well as relative analysis, evaluating economic trends relative to each other.

For example, the Fund manager will take a short position in the currency of the country with a diminishing economy and long for the currency of the country with improving or growing economy.

Multi Strategy

Multi-strategy funds have the discretion to use a variety of investment strategies to achieve positive returns regardless of overall market performance. They are not married to a single investment strategy or objective. Multi-strategy funds tend to have a low-risk tolerance and maintain a high priority on capital preservation.



Source: www.ai-cio.com

World's Prominent Hedge Fund Managers

Ray Dalio
Co-Chief Investment Officer
Bridgewater Associates

Kenneth C. Griffin
CEO
Citadel LLC

David Seigal
Co-Founder
Two Sigma Investments

Christopher Hohn
Founder and Manager
TCI Management

John Overdeck
Co-Founder
Two Sigma Investments

Jim Simons
Founder
Renaissance Technologies

Hedge Funds Industry in India

What are Alternative Investment Funds (AIF)?

AIFs are defined under Regulation 2(1)(B) of SEBI Regulations Act 2012.

It means any fund established or incorporated in India in the form of a trust or a company or a limited liability partnership or a body corporate which is a privately pooled investment vehicle which collects funds from investors, whether India or foreign, for investing it in accordance with a defined investment policy for the benefit of its investors and is also not covered under the Securities and Exchange Board of India (Mutual Fund) Regulations 1996, Securities and Exchange Board of India (Collective Investment Schemes) Regulations, 1999 or any other regulations of the Board to regulate fund management activities.

AIF Regulations has further segregated it into three categories:

Category 1

Category I AIFs are funds with strategies to invest in start-up or early-stage ventures or social ventures or SMEs or infrastructure or other sectors or areas which the government or regulators consider as socially or economically desirable. These funds are subcategorized as venture capital funds, SME funds, social venture funds, infrastructure funds and such other AIFs as may be specified. The Government promotes investment in these projects because of its multiplier effect on the Economy and Job Creation.

Category 2

Category II AIFs are funds that cannot be categorized as Category I AIFs or Category III AIFs. It includes private equity funds or debt funds for which no specific incentives or concessions are given by the Government of India or any other regulator are included in the Category II AIF classification. These funds also do not undertake leverage or borrowing other than to meet day-to-day operational requirements.

Category 3

Category III AIFs are funds which employ complex or diverse trading strategies and may employ leverage through investment in listed or unlisted derivatives. AIFs such as hedge funds or funds which trade with a view to make short term returns or such other funds which are open-ended and for which no specific incentives or concessions are given by the Government of India or any other regulator are included in the Category III AIF classification.

Category 1

Venture Capital Funds

Infrastructure Funds

Angel Funds

Social Venture Funds

Category 2

Private Equity Funds

Debt Funds

Fund Of Funds

Category 3

Hedge Funds

Private Investment In Public Equity Funds (Pipe)

In India, AIFs started its journey and operations in 2012. Since then, commitments raised under Category III AIFs have reached Rs.48,410 crore as of June 30, 2020. The number of funds raised stood at Rs.42,025 crore and investments made stood at Rs.36,507 crore.

Commitments raised under Category III AIFs are the second-highest among all three categories. It accounts for 15% of commitments raised under all three categories.

Cumulative net figures as at the end of June 30, 2020
(All figures in INR Crores)

Category	Commitments raised	Funds raised	Investments made
Category I			
Infrastructure Fund	12,090	8,027	6,974
Social Venture Fund	1,994	1,373	1,009
Venture Capital Fund	25,997	10,419	7,924
SME Fund	522	101	46
Category I Total	**40,603**	**19,920**	**15,953**
Category II	**2,96,384**	**1,27,661**	**1,06,375**
Category III	**48,410**	**42,025**	**36,507**
Grand Total	**3,85,397**	**1,89,606**	**1,58,835**

Note: The above report is compiled on the basis of quarterly / monthly information submitted to SEBI by registered Alternative Investment Funds.

India's Prominent Hedge Fund Managers

Vaibhav Sanghavi
Co-CEO, Avendus Capital Public Markets
Alternate Strategies LLP

Nalin Moniz
Chief Investment Officer, Alternate Equity
Edelweiss Asset Management Limited

Nikhil Kamath
Co-Founder & Chief Investment Officer
True Beacon

Andrew Holland
CEO
Avendus Capital Alternate Strategies

Piyush Shah
Managing Director, Avendus Capital Public
Markets Alternate Strategies LLP

Tarun Kewalramani
Director, Avendus Capital Public Markets
Alternate Strategies LLP

Why Hedge Funds are not so Popular in India?

Category iii of AIF (Hedge Funds) is still not given pass-through status as per the tax structure. This means that income generated from these funds is taxable at the investment fund level and not through the investors end. Hence, the tax obligation will not pass through to the unit-holders. This is a major disadvantage for the overall industry as they can't compare themselves with the fund houses and mutual funds on the same level. Investors who invest in mutual funds are taxed whenever they redeem units or receive any dividends.

Whatever the rational basis of those fears, the regulator's efforts to set up from scratch a domestic industry in alternative assets are being torpedoed by the taxman. "They may be unwittingly about to kill off the onshore hedge fund industry that SEBI created, even before it has begun to crawl," Vijay Krishna-Kumar, head of IDFC Asset Management's liquid alternatives investment.

High tax rates, non-allowance regarding setting off the tax against any other business losses and other tough regulatory compliances have acted as a negative sign for the overall hedge fund industry in India. All factors have ended up giving lessor returns to the investors.

The Securities and Exchange Board of India (SEBI) has always been suspicious regarding the source of capital for hedge funds investing in India from countries like Singapore or Hong Kong. It believes dirty and black money – proceeds of crime, corruption, or tax evasion – comes back home from offshore and foreign financial centers after being laundered.

The Category III AIF will be taxed at the maximum marginal rate (highest slab rate with surcharge and cess) on whatever type of income it earns. Thus if the income is classified as business income or interest income, it would be 42.74%. However, in the case of capital gains on shares, it will be 15% or 10% depending on the holding period, along with surcharge and cess. Dividends will also be taxed at 35.88%, and not 42.74%," said Gautam Nayak, Partner, CNK and Associates LLP. "This is not the TDS rate, it is the tax payable at the fund level. Even if the investor himself is taxable at a lower rate, he cannot claim a refund of the tax paid by the trust. However, the money paid to the investor after tax paid by the trust will not again be taxable in the investor's hands," he added.

Future of Hedge Funds in India

- As per the global industry view, the hedge fund industry is expected to grow by 31% in the next three years, reaching USD 4.7 trillion in 2023.
- Financial experts believes that India has tremendous potential for attracting global investments in hedge funds. The early entrants into the Indian markets have recorded amazing returns which in turn attracted other hedge fund players to step in.
- Renaissance Technologies, Vikram Pandit-founded Old Lane, DE Shaw, Och-Ziff Capital Management are some examples of International hedge funds firms in India.
- Despite of having huge potential to attract global investments hedge funds has faced great growth setback owing to the tough tax regime for hedge fund investors in India. This means that income generated from these funds is taxable at the investment fund level and not in the hands of investor. Hence, the tax obligation will not pass through to the unit-holders. Hedge fund managers here in India are expecting a dark future of hedge funds.
- The higher tax is hurting prospects for growth in the industry, which is already tiny as alternative-fund holdings comprise only about 0.1 per cent of total equity assets in India. Domestic hedge-fund assets dropped 6 per cent to USD 4.6 billion last year from 2018, according to annual data from Eureka hedge, a database for such funds. This is the biggest decline since 2011.
- Apart from the reason of tax regime the another reason due to which hedge fund industry is not outshining in India is shortage of derivatives. Long and short strategy is one of the most popular hedging strategy followed by hedge fund managers. Shortage of derivatives owes to a few option left with hedge fund manager to take short position in security to mitigate the risk and earn returns. Derivatives are available for less than 5 per cent of India's listed companies which also hampers Indian fund managers as they have limited options for taking short or long positions on individual stocks finding them as mis priced.

About Us

Nucleus AAR Advisors LLP is a business consulting firm providing specialized services in the field of Investment Banking, Deal Transaction Advisory, Corporate Advisory, International Taxation, Audit & Assurance. We partner entrepreneurs in their critical decision making by providing them various analysis customized as per their requirement. We also help in the effective implementation of decisions and its subsequent monitoring as well.

Team Nucleus is comprised of people from Big4s and reputed consulting firms with combined experience of 30+ years.

Team is distinguished by their functional and technical expertise combined with their hands-on experience, thereby ensuring that our clients receive the most professional