

Mode of operation and potential risks of hedge funds



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Introduction

Hedge fund refers to the financial futures and financial options and other financial derivatives financial funds to high risk and speculation as a means to profit for the purpose of combination and the financial organization. hedge funds are the latest investment theories and extremely complex financial market operation skill based, full use of various financial derivatives products lever effectiveness, high risk, high return investment model.

The traditional sense of the hedge is a kind of behavior or strategy aimed at reducing the risk of. Hedging often takes the form of a transaction in a market or assets, to hedge risk, another market or assets of a company for example, buy a foreign exchange option risk to its business to hedge the spot exchange rate fluctuations. Fund of hedge funds is to give the basic idea to obtain high profits through the use of various financial derivatives of the private equity fund.

Hedge funds through the shortselling and leverage operations, in the market with less capital will have the probability to obtain high returns. Several well-known Tremont Group Holdings Inc have a combined annual income of up to 40% to 50% of the rate. But it is worth mentioning that the hedge fund investment strategy is a high risk investment, hedge funds may bring high return but also bring inestimable loss to hedge funds. The largest hedge funds could not change unpredictably in the financial market in an invincible position forever. The Tiger Fund in the cause of the peak appeared unable to

get up after a fall position error, in this paper, will discuss the potential risk and the mode of operation of the hedge fund.

Literature Review

In the The future of hedge fund investing, the author based on the situation of Australian hedge fund manager for the acceptance of new products as well as the survey of Australian hedge fund market, expressed on the future development of hedge funds. The author is a direct expression of the hedge fund will become one of the main mode of future development, but the future rate of return will tend to rational. Hedge funds can provide very good nontraditional investment projects and investment philosophy, thus breaking the traditional sense of the financial system of the absolute, such as stock and futures market.

Investors must not simply from the stock rise in profits or profit from the good development of economy, but also can benefit from the various possibilities by hedge funds. This model to overthrow the traditional investment concept. The ability to hedge funds over risk-free money market assets is easy to verify comparable hedge fund performance and the main stock index reveals mixed results. Hedge fund should consider contains only they can provide diversification benefits not drag the whole income portfolio rate in the diversified portfolio.

Hedge funds have been trying to move beyond monetary market agents, suggesting that, on average, investors should be better in the currency market investment. Australian investors, from the bank bill yields than hedge fund returns do not bear any risk in this period. (Ali, 2004).

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In the Hedge fund reporting challenged, the author suggested to hedge funds, one of the main potential risks. Hedge fund investors in understanding the initial investment hedge fund manager, whether this distribution have a positive return or not interested. In the past the investment rate of return information that is of particular interest, is the prospect of information in the profit or loss of the future. Hedge fund report can be a tense relationship between investors and hedge funds origin.

The report is the main concern for investors data prior to disclosure the past rate of return on investment, but investors rarely take the initiative to care about the obtained before changes in the objective market high returns and the international financial system environment. This is the number of big hedge fund in successive years of high returns, one of the potential risk of sudden trouble. When investors and hedge fund managers at the same time the face of this report, the mentality is different each other. Investors want to obtain information from the hedge fund report, see the foundation in the future may be and the same as before to obtain a high rate of return on investment, while for the hedge fund managers, they would prefer to adopt a perfect report to obtain higher investment amount, and then through the financial derivatives to move more high leverage to demand higher interest. (Schröder, (2009))

In the article the Banking & Financial Services Policy Report, the author points out a series of questions of hedge funds since the. This article uses a lot of data to illustrate the operation mode of hedge fund will make these funds will eventually go blind profit and ignore the regulation of the abyss. In this paper, the author will provide potential agency problems associated with <https://assignbuster.com/mode-of-operation-and-potential-risks-of-hedge-funds/>

the management of the hedge fund, the relevant reasons to increase or decrease in the regulation of hedge funds, and discuss the international differences in the regulation of hedge funds. At the same time, the author also points out the necessity and possibility of the development of hedge funds to do supervision and the future development in this trend.

This paper points out that the Agency Problems in Hedge Fund Management¼Potential Conflicts Arising from Investor Base¼Potential Conflicts Arising from Fees and Proprietary Investment by Hedge Fund Managers¼Potential Conflicts Arising from Lack of Regulatory Oversight Potential Conflicts Arising from Lack of Transparency, Potential Conflicts Arising from Lack of Transparency, Liquidity, Independent Valuation, and Pricing¼Potential Conflicts Arising from Strategies and Leverage and International Differences in Hedge Fund Regulation are the major problems of hedge fund.

The author cites a large number of problems in depth later, found the cause of the problem, and put forward a relative dialectical argument in the solution to the problem cause, is about the supervision of strict degree. The use of innovative investment strategies of hedge fund of hedge fund. On the one hand, to provide a variety of welfare hedge fund strategies these innovation, financial system involved, including the market liquidity and provide vital, limit price distortions and abnormal through arbitrage, and the tools and the risk of the market, because they can quickly change the portfolio. At the same time regulation can avoid more human or human operational errors based on the market tends to be more rational and restrained.

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However, people also hold clear opposing views concerning the draconian regulation, such as regulation is going to cause the market too friendly, hedge fund managers may face administrative regulation more trivial on trifles and unable to better respond to market changes, the hedge fund manager will relocate to more lax regulation of less jurisdiction. At the same time, for more regulation will involve taking self regulatory function from hedge fund participants, which may encourage the investment decision and risk management of relaxation. And finally the author puts forward the problem now is not how to regulate the industry, but where to draw the line in and excessive regulation. If it is assumed that all hedge fund manager to complete freedom to do what they do best, then any additional regulation would lose their favorable position in market failure in the market self adjustment ability, but it is easier to make the fund managers do not health more cross line led to the development of the market, is not conducive to the long development. (Cumming, (2008).)

In an annual report from Deutsche Bank, the hedge fund's derivatives business has been affected by the financial tsunami's biggest business. Performance data of bad, caused the final quarter of the year in many hedge fund strategies 2008, investors' Redemption requests boom. Deutsche Bank is one of those still in the market. Keep away from new business, it continues to thousands of products, so that the two grade market, has been in the restructuring of the damaged hedge fund positions are very active, and has developed a new hedge funds, exchange traded funds to investors liquidity. The bank also help clients to fund investment in hedge funds and funds.

Deutsche bank restructuring process of more than \$2000000000 of products for more than a year. In some cases, other dealers structure it help investors hedge fund products supplier credit risk or involved in the transaction. This structural adjustment as a means of coping with the crisis, operation method and the new popular form in more of the financial system. According to Deutsche Bank in a report, it is not difficult to see that the structural problems brought about by solving hedge fund existing products has become a main direction of major financial institutions, at the same time, the bank also gives a better solution is to avoid speculation concept, simple game on the existing basis, derivatives more market more transparent, provide financial tsunami hedge fund after a good operation platform.

“ It is groundbreaking because, for the first time, investors can access a diversified pool of hedge funds, which is Ucits Illcompliant, transparent, over-collateralised and developed into a package that is as liquid as foreign exchange,” says Farouze. “ Everybody is going to ask how we are providing intra-day liquidity and not taking big risks because the underlying managers are not liquid, but it is a fundamental misunderstanding that managers are illiquid.”

Deutsche Bank report a future development direction, but this is not the only direction. In fact, the financial system is with the development of science and technology and the process of globalization. While similar to the hedge fund this fund molding for just a few decades, and only in the last ten years of substantial growth, occupy a space for one person in financial institutions. It is not difficult to see, the future development is diversity, hedge fund

concept will be with the development of financial system and complete change. This will later in the paper mentioned. (BANK, 2010)

Research Questions

In this report, will be around 2 main research. First, the operation mode and the hedging strategy of hedge fund. Second, hedge funds will face what risks and how to avoid these risks.

Operation mode about hedge funds will choose more common and easily understood model analysis, through analysis, a direction to try to explain why hedge funds as institutional investors are willing to invest, and position fully understand why financial derivatives play in different market operation.

About the risk hedge funds face, will be analyzed from different aspects, first of all will be based on several reasons the literature has been mentioned analysis will be between hedge fund managers and investors have problems and explore why hedge fund risk management must be very strict, and will use examples of why once large hedge fund be unable to get up after a fall in the market changes, exit the market stage, finally according to the international economic environment and puts forward some assumptions and analysis of hedge funds will be how to face these difficulties, and puts forward the solution or the method of risk aversion.

the operation mode and the hedging strategy of hedge fund

Hedge funds have a lot of investment strategy, the investment strategy, academic classification is roughly four, arbitrage, event driven, directional and global macro. And the four way investment, should be said that the four

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main thinking pattern, they can coexist also can invest strategy according to one or more of them adjustment. It is also a reflection of the hedge fund freely. In the paper, classification will be analyzed, and give examples.

Arbitrage

The basic idea is to arbitrage fund assets to buy shares, part of the assets of the short selling of shares. Multiple assets amount to buy stocks by the B coefficient (coefficient a measure of stock and market relevance) adjusted to form a long position, short asset amount of the short selling of stocks by the B coefficient adjustment after the formation of short positions, long positions and short positions of the difference between the formation of the assets of the fund market position. The market position for long, short or is zero, thereby regulating funds face market risk. When the market position to zero, long / short strategy to become the market neutral strategy, the fluctuation of return and market fund completely unrelated. Through adjusting the market positions, types or further adjustment of portfolio stock, can adjust the portfolio risk degree and the risk types. Hedge is a double-edged sword. When the fund market risk faced by hour, value-added potential of the fund can enjoy the stock market long-term upward trend has also reduced. In addition to hedge market risk, we can also be other risk funds to hedge funds, such as exchange rate risk, interest rate risk, the industry risk etc.. Whenever a risk is hedged, there is no possibility of fund managers use the risk factors for the fund value. In theory, a perfect hedge fund returns should be the risk-free rate minus the transaction cost. Therefore, in practice, the fund manager will not take all the risk factors for hedge funds, but their risk

factors cannot grasp the hedged risk factors, leaving his grasp, make investment decisions in these risk factors to obtain excess returns.

Stock index futures

Stock index futures is not reasonable price the stock index futures market, at the same time to participate in the stock index futures and spot market transactions, or simultaneously in different period, different (but similar) category stock index contracts, to earn post behavior. Stock index futures arbitrage sub - now hedge, hedging, hedging and cross city, cross species hedge.

Commodity futures

Similar to stock index futures, commodity futures also exists in the hedge strategy, to buy or sell a futures contract at the same time, selling or buying another contract related, and in a time of the two kinds of contracts.

Transactions in the form it and hedging some similar, but hedging is to buy on the spot market (or sell) real goods, selling in the futures market at the same time (or buy) futures arbitrage; and only in the futures market sale and purchase agreement, does not involve the spot transaction. Commodity futures arbitrage are now hedge, hedging, cross market arbitrage and cross species arbitrage.

Option hedging

Option is also called the right to choose, is a kind of derivative financial instruments in the future on the basis of. From its essence, option is essentially in the financial sector to the rights and obligations of separate

pricing, the right of the transferee within the specified time on whether to trade to exercise its rights and obligations must be fulfilled. In options trading, purchase option is termed the buyer, and the sale of options side is called the seller; the buyer is the right of the assignee, and the seller must fulfill the buyer to exercise the right obligation.

Option has the advantages of unlimited income and risk of loss is limited, so in many cases, the option to replace the futures, short hedge trading, will risk arbitrage has smaller and higher rate of return than the futures.