

## FACT SHEET:

## HEDGE FUNDS VERSUS MUTUAL FUNDS

**Hedge Funds vs. Mutual Funds**

It is very important that investors understand the differences between hedge funds and mutual funds. Generally, hedge funds are referred to as private placement vehicles, usually with fewer than 100 investors, that may invest in any asset class as well as derivative securities, use long and short positions, and use leverage. With typically low correlation to ordinary securities strategies, hedge funds can add greater diversification and a wider range of return opportunities. This fact sheet attempts to briefly outline some of the major differences between hedge funds and mutual funds, and highlight some of the potential advantages of hedge fund investing.

**Regulations & Structure:** The primary difference between hedge funds and mutual funds is the legal and regulatory structure that hedge funds operate under. Hedge funds are largely unregulated, whereas mutual funds are very highly regulated. Given that, hedge funds have greater flexibility and are allowed to engage in activities that mutual funds cannot. Hedge funds are typically structured as Limited Partnerships. This structure allows for either monthly or quarterly liquidation.

**Marketing:** Hedge funds are restricted from advertising, thus making them extremely difficult to find, research and analyze. In addition, hedge funds marketed in the U.S. can only be sold to "accredited investors" per SEC rules. To be "accredited", an investor must have a net worth in excess of \$1,000,000 or have an income of at least \$200,000 (\$300,000 joint with spouse) for the current and preceding years.

**Compensation:** Hedge fund managers are compensated based on the performance of the fund. Managers typically make a 2% management fee and a 20% incentive fee. Mutual fund managers are generally compensated directly by the fund management company in the form of salary and bonuses.

**Size:** Because hedge fund managers have an incentive to perform while mutual fund managers have an incentive to raise assets, hedge funds are typically much smaller than mutual funds. This allows hedge funds to be more nimble and dynamic in their trading strategies than traditional equity-based investments.

*...hedge funds these days, small is beautiful.*

*["Hedge Funds Are Hot Again", Business Week (February 26, 2001), p. 83.]*

**Talent:** Due to the compensation and flexibility issues, hedge funds today are attracting some of the best talent, in many cases away from mutual funds.

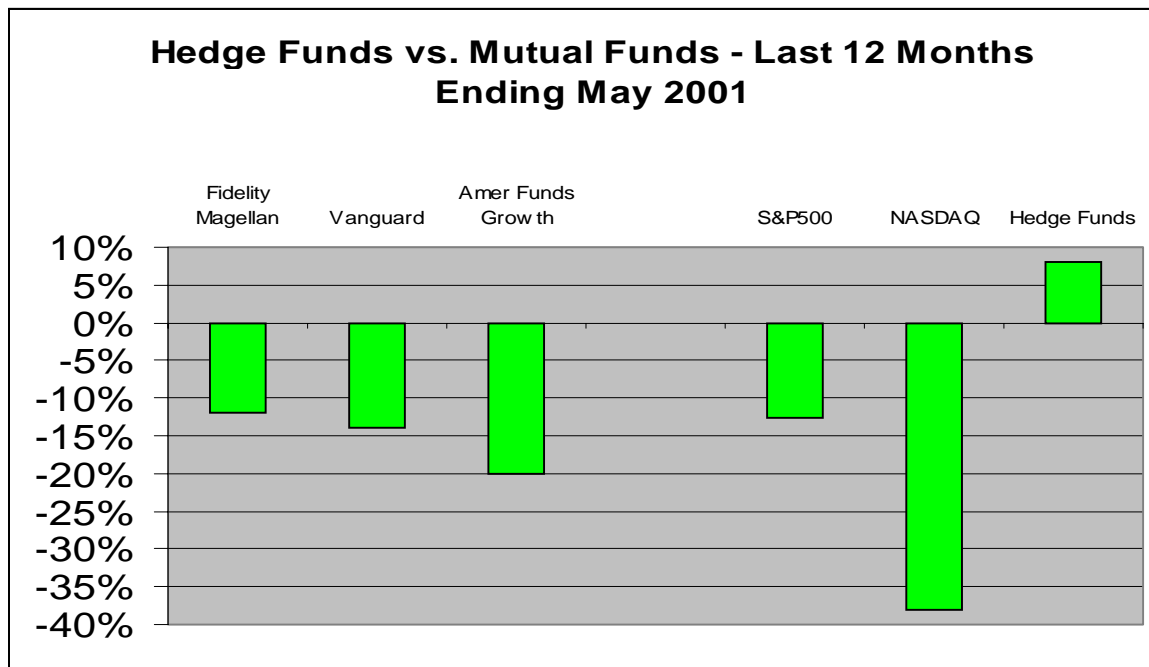
*...more and more mutual fund managers have jumped ship to start hedge funds on their own or at their existing firms. Jeffrey Vinik, the former Fidelity Magellan manager, opened his own hedge fund in late 1996 and racked up triple-digit returns through the end of 2000.*

*["Hedge Funds Are Hot Again", Business Week (February 26, 2001), p. 84.]*

**Manager Participation:** Unlike mutual funds, hedge fund managers are usually heavily invested in a portion of the funds they manage and thus share in the same risks and rewards as investors.

**Performance:** The performance of mutual funds is dependent on the direction of the equity markets. They are measured on relative performance, meaning that their performance is compared to a relevant index, such as the S&P 500, or to other mutual funds in their sector. Hedge funds aim to deliver absolute returns, meaning they attempt to deliver positive returns under all market conditions.

## Hedge Funds vs. Mutual Funds – Last 12 Months Ending May 2001



### Hedge Funds vs. Mutual Funds Comparison

#### **Hedge Funds**

- Private Investment Partnership limited
- 99 investors number of investors
- Ability to utilize short selling
- Ability to use leverage
- Ability to use derivatives
- Large minimum investment
- Prohibited from advertising or promotion
- Offered by private placement memorandum
- Manager compensated on performance
- Manager invests own capital
- Flexibility in investment strategies
- Liquidity varies from monthly to annually
- Usually aim for absolute returns

#### **Mutual Funds**

- SEC Registered investment fund with unlimited to
- Limitation to 30% of profits from short selling
- Limited use of leverage
- May not use derivatives
  - Small minimum investment
- May freely use advertising and promotion
  - Offered by prospectus
- Manager receives compensation from fund management company
- Manager typically does not invest own capital
- Relatively inflexible to change in strategy
- Daily liquidity and redemption
- Aim to outperform market benchmarks

Today, there are an estimated 4000 - 5000 hedge funds. However, because of their restrictions on advertising individual performance, they are very difficult to find. Given the information gap between hedge funds and mutual funds, it is critical to perform an in-depth evaluation on hedge funds.

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PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS. FUTURE TRADING IS SPECULATIVE AND INVOLVES RISK OF SUBSTANTIAL LOSS.