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The Hedge Fund

An Ideal Investment Vehicle for Muslim Investors

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ABSTRACT

Hedge funds are privately managed investment partnerships that use alternative investment styles to perform well in bull and (especially) bear markets. They are similar to mutual funds in some ways but differ in investment strategies, overhead, and target market. Because hedge funds are exempt from certain financial regulations, they can use more investment tools and incentives to manage risk and return, are specially designed, and focus on high-net-worth and institutional investors. The Platinum USA Fund, a *Shari'ah*-based growth fund whose highest priority is risk management, lets Muslims invest in equities in a *halal* manner. While *Shari'ah* restrictions bar short selling and taking a call option on the index, two common hedging tools, the limited regulations on hedge funds give Muslims freedom to run them according to the *Shari'ah*. The absence of an appropriate benchmark hinders the development and acceptability of *Shari'ah*-based hedge funds.

I. INTRODUCTION TO HEDGE FUNDS

A. Definition and Scope

Hedge funds are investment partnerships, which are not regulated by the U.S. Securities and Exchange Commission. They are privately-managed investment vehicles and acquired their name in the early 1960s because of the practice of managers who bought stocks and sold them short to hedge their risks. This technique is presently known as "market neutral" strategy. However, the term "hedge fund" today refers to investment vehicles using alternative investment styles, some of which may not hedge risks.

For the last few years, hedge funds have been very much in vogue, both as investment vehicles for investors seeking higher returns as well as corporate pedestals for bright and ambitious money managers to launch their independent careers.

In terms of their intrinsic characteristics, hedge funds are very similar to mutual funds, since both are investment vehicles focused primarily on equity markets and seek to ensure maximum returns to investors.

B. Size and Market Share

The number of hedge funds is estimated to be between 3000 to 5000. Their numbers have risen by about 20% per year for the last seven years, with an even greater rate of growth in the size of the assets, which exceed $300 billion. While hedge-fund assets have grown quickly, they amount to less than 10% of the mutual-fund industry's $3.5 trillion in assets.

C. Legal Framework and Regulatory Environment

Hedge funds are established as limited partnerships after claiming and qualifying for exemptions from the Investment Companies Act of 1940 and the Securities Act of 1933, which outline rules for the issuance of securities in the primary market.

It is both expensive and cumbersome to operate as an investment company under the Investment Company Act. Because hedge funds primarily invest in securities, they would invariably fall within the definition of an "investment company" and thus be subjected to a greater degree of scrutiny, control, and disclosure requirements. To save costs and to preserve the freedom to use alternative investment styles, hedge funds are therefore structured to qualify for and claim exemptions from this Act.

Exemptions from the 1940 Act were initially available to companies that had 99 or fewer investors. This number was subsequently increased to 499 by the National Securities Market Act of 1996.

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The exemption is available to companies only if they are not making a public offering of securities. The second exemption from the 1940 Act is only for funds that are held exclusively by "qualified purchasers."

Similarly, hedge funds are exempt from the Securities Act of 1933 only if limited partnership interests are sold through a private offering rather than a public offering. While "private offering" is not defined in the 1933 Act, Regulation D has been enacted to facilitate the making of a private offering. An offering made pursuant to Rule 506 of Section D, will be deemed a private offering. Rule 506 also limits hedge funds from "general solicitation or general advertising" to attract investors. Furthermore, offerings should only be made to "accredited investors." An accredited hedge fund investor must have a net worth of at least $1 million (including any homes) or an income in the past consecutive two years of at least $200,000 if single, $300,000 if married.

D. Reasons for the Popularity of Hedge Funds

The primary reason behind the tremendous popularity of hedge funds is their ability to consistently perform well, in both bull and bear markets, by using investment techniques such as short selling, margin trading, and exercising call options on indices. Despite the tactical leeway they enjoy and the exotic instruments they can deploy, hedge fund managers usually try to control risk rather than simply to maximize returns. They are sharply focussed on investment strategies such as short selling, risk arbitrage, or dealing in equities in both long and short positions. The overriding goal of hedge funds is to perform whether the market goes up or down—this contributed to their success.

Another reason for hedge funds' popularity has been proposed by Fortune magazine: investors are realizing that abnormally large annual increases in the value of the stock market, on the order of 20% and 30% per year, can not be sustained, and that the market return should decline to its long-term average of 10%. Other press reports echo the theme that the hedge funds have much room to grow.

II. Hedge Funds versus Mutual Funds

As investment vehicles, hedge funds and mutual funds have many basic similarities. Both are companies whose primary role is to mobilize funds from investors and to invest those funds in various financial assets with a view to making profit for mutual gain. However, there are several major differences between the two types of funds. They include differences in the applicable laws, investment styles, overhead, intended market, and historical performance.

A. Legal Framework and Regulatory Environment

Mutual funds operate as open-ended investment companies incorporated under the Investment Companies Act of 1940, while hedge funds are limited partnerships with the fund manager as general partner. There is a quid pro quo. Mutual funds have stringent disclosure requirements and regulatory controls to which they must strictly conform. As a result, they are allowed full freedom to advertise and draw investment from a larger group of potential customers. Hedge funds, on the other hand, are allowed greater flexibility in management style and in deploying investment strategies, but they can approach only so-called "accredited investors" because only these informed people, who have a higher tolerance for risk, ought to be allowed to invest in hedge funds.

There is a general misconception that hedge funds are totally unregulated. This is not entirely true. While hedge funds operate in a looser regulatory environment and have greater flexibility than mutual funds, they are nevertheless required to make available a detailed disclosure document at the time of the private offering, outlining the full and complete details. These include the possible risks, the composition of the portfolio, strengths and weaknesses, and so on. Any deviation from the stated strategies and policies obviously puts hedge funds in a vulnerable situation respecting their clients. Moreover, hedge funds must meet the requirements of the state securities boards in the respective states in which they are based. They are required to submit periodic returns.

B. Differences in Investment Style

The most vital and basic difference between hedge funds and mutual funds arguably lies in what hedge funds can do with the assets the manage and mutual funds cannot. Hedge funds, because of the very nature of their charters, have the freedom and flexibility to employ virtually all the techniques of modern-day investment, which mutual funds are barred from. Hedge funds can sell short, trade in derivatives, buy

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and sell options, deal in futures and commodities, and leverage their portfolios through margin trading. They are therefore known as funds having "alternative investment styles."

C. Loads and Costs

Hedge funds owe their growing popularity among high-net-worth individuals and institutional investors to their cost and remuneration structures. Hedge funds do not charge any front-end or back-end loads and have no sales charge. They usually charge a management fee of 1% to 2% of the net asset value and share their profits with investors only if they have a positive performance. Usually this is 20% of the profit. Consequently, hedge-fund managers have an incentive to do well: they will be paid only when they make money for their investors. If the hedge fund loses money, its manager is not paid the performance fee. This also acts as an incentive to manage and minimize risk.

By contrast, mutual funds have a front-end load, back-end load, or a sales charge, ranging from 5% to 9% and deducted from the assets mobilized. The front-end load is deducted up-front. However, there are a growing number of no-load mutual funds. They apply what is known as a 12-b-1 charge.

D. Markets for Hedge Funds and Mutual Funds

In view of their regulatory environment, hedge funds are specially designed and inclined to focus on the upper end of the investment market. The minimum investment that an average hedge fund accepts is $250,000. Many accept less than that: there are some whose minimum is as high as $10 million. Mutual funds will take investments of a few hundred dollars. Hedge funds therefore focus their marketing on high-net-worth and institutional investors. These two groups form its typical client base.

Hedge funds are more exclusive than their high levels of minimum investment would warrant. Even if an investor agrees to the requirement to invest $250,000, his entry is not automatic. Hedge funds do not advertise and selectively accept investments, usually once every quarter. This is sometimes done to ensure that the cash flow of new investors does not dilute the returns of senior investors. Some accounting issues are involved as well. Conversely, mutual funds are open to almost all investors.

E. Performance of Hedge funds

According to a study of more than 1600 hedge funds for the five years ending December 1995, conducted by Van Hedge Fund Advisors Inc., global hedge funds have achieved higher returns than mutual funds with a lower risk of loss, when risk is measured similarly for both types of funds. In that 5-year period, almost all hedge-fund investment styles earned significant excess returns compared to mutual funds. However, the result of this and other such studies only point out the general trend; specific performance results require specific comparisons.

Hedge funds have, in the past, been especially effective in sudden bear markets. In 1987, the year the Dow Jones Industrial Average crashed in October, the S&P 500 rose 5.24%, growth mutual funds only 1.02%, and hedge funds 14.49%. In 1990, a time of uncertainty due to Iraq's invasion of Kuwait, the S&P 500 and growth mutual funds returned 3.11% and 3.82%, respectively, while hedge funds finished the year up 10.97%.

Hedge funds have a better risk and reward profile than mutual funds. Prospective investors are advised to compare the Sharpe ratio (a measure of risk-adjusted return) of the two types of funds. According to Morningstar, a major independent source of information on mutual funds, the typical growth mutual fund's Sharpe ratio for the past three years is 1.54%. A hedge fund's Sharpe ratio should generally be higher than this; otherwise, its manager must explain with a good reason. The two funds' beta coefficients and standard deviations are other important measures to watch.

F. Advantages and Disadvantages of Investing through Hedge Funds

Hedge funds benefit from professional management. The brightest minds in the financial industry work in this area. They also offer no-load investing, consistent with their lean nature and focus on profit and performance. Hedge funds charge performance fees only when they show good results for their investor. Since they deal with a small number of large customers, they provide efficient, client-focused, customized, and state-of-the-art services to their clients.

Other aspects of their structure also benefit investors. As hedge funds are limited partnerships, the liability of an investor is limited to the extent of his or her investment in the partnership. Double taxation is avoided, since the Internal Revenue Service, America's tax-collection arm, recognizes limited partnerships

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as pass-through entities that are not subject to the corporate income tax. Partners' profits are reported through K-1 and 1065 forms, similar to mutual funds'.

Finally, investments in hedge funds are not liquid investments. Most investments are accepted with a clear understanding of their horizon or maturity period. While the preferred investment horizon in stock market is three years, hedge funds usually accept investments for at least one year. A notice of 30 to 60 days is generally required prior to redemption. On the other hand, it is much easier and quicker to sell investments in a mutual fund. Consequently, investments in hedge funds have the characteristic of illiquidity. The customers of hedge funds generally support this because they tend to have surplus funds to invest.

III. THE PLATINUM USA FUND

The Platinum USA Fund is a *Shari'ah*-based fund, established to abide by both the letter and the spirit of the *Shari'ah*. It provides Muslim high-net-worth individuals and institutional investors with a window, through a corporate vehicle, to the equity markets of the world, particularly the U.S. equity markets. The Platinum USA Fund is a domestic equity fund, managed by Platinum Asset Management Inc. acting as its General Partner. Platinum Asset Management Inc is registered with the State Security Board as a Registered Investment Advisor.

It is a growth fund, having the S&P 400 as its benchmark. The Fund's philosophy is to invest primarily in mid-cap securities. While there is no clear-cut definition as to what constitutes "small cap," "mid cap," or "large cap," it is generally presumed that companies having a market capitalization of between $1 billion and $5 billion are considered mid-cap. Some components of the fund contain small-cap and large-cap securities.

Despite their flexibility to invest in any security and in any market, hedge funds in general and the Platinum USA Fund in particular are professionally and prudently managed. Risk management remains the Fund's highest priority, and toward this end the following strategies are employed to ensure better risk management:

1. well diversified portfolio of 40 to 45 securities;
2. primary portfolio in equities of companies having market capitalization of over $1 billion;
3. not more than 5% of the portfolio is invested in any one company, and this proportion will decrease as the size of the fund increases;
4. diversification among various market and industry sectors;
5. no leveraging or margin trading;
6. no investment in derivatives; and
7. nothing exotic.

Hedge funds tend to be lean organizations that keep a strict check on their cost structures. The salaries and wages of employees are not paid out of the fund. The only remuneration is the performance/incentive fee, payable once every year, if positive performance is shown. In addition, the Platinum USA Fund charges a management fee of 0.75% every quarter. To keep costs down without compromising quality of service, the Fund uses the services of some of the best names in the United States.

IV. *SHARI'AH* INVESTMENT PRODUCT

A. *Shari'ah* Filters

The Platinum USA Fund is dedicated to providing an investment vehicle by upholding the tenets of the *Shari'ah*. Consequently, it makes no investments in any *riba*-based products such as Treasury bills, Treasury bonds, intermediate bonds, municipal bonds, and Fannie Mae securities. It also avoids preferred stocks, corporate bonds, and convertible bonds and makes no investment in the equities of banks, insurance companies, entertainment firms, gambling-related businesses, casinos, and brewers/winemakers. The *Shari'ah* also prevents the Fund from engaging in margin trading and dealing with futures, options, companies in which interest-based debt exceeds 30% of total debt, and companies that derive more than 15% of total income from interest.

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B. Hedge Funds: The most suitable investment vehicles for the Muslim investor.

There are no regulatory or statutory restrictions imposed on hedge funds that may impede adherence to the *Shari'ah*. Hedge funds are transparent entities and by far the only investment vehicle that can be fully customized to meet the *Shari'ah*'s requirements, without violating the letter or spirit of the applicable laws of the land. Furthermore, even the various interpretations of *fiqh* can be incorporated in the management philosophy of hedge funds because of the sheer size and depth of the equities available in the market. Anything contrary to the fund manager's faith and beliefs can easily be omitted. The stipulations of the *Shari'ah* guidelines can be clearly stated in the disclosure documents at the time of offering. This gives the hedge fund the freedom to incorporate all the strategies permissible under the *Shari'ah*, and screen out whatever is not allowed. In view of the flexibility it affords, a hedge fund is probably the most suitable investment vehicle for Muslim institutional and high-net-worth investors.

C. Problems and Difficulties

Hedge funds are known, theoretically at least, to perform well in both bull and bear markets. Their good performance in a bear market is attributable to the various hedging techniques they employ, such as short selling and taking a call option on the index, and the absence of an appropriate benchmark and index. However, since short selling requires the borrowing of securities and entails *riba*, and since *Shari'ah* scholars rule that options are inadmissible, the Platinum USA Fund is short of two commonly used hedging tools.

The absence of a comparable index or an appropriate benchmark is a major drawback in the development and acceptability of *Shari'ah*-compliant hedge funds. The use of existing benchmarks to compare the performance of *Shari'ah*-based investment vehicles is not financially appropriate; there is a need to develop at least 7 to 10 indices corresponding to the existing benchmarks being used by the hedge-fund industry in America. The benchmarks should be as close to the existing benchmarks as the weighting would permit. For example, the S&P 500 has a significant component of the conventional financial sector, which is a prohibited area for Muslim investors. That sector may be replaced with more of its remaining constituents. The *Shari'ah*-based indices must have international recognition, particularly on Wall Street.

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