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EMERGENCE OF HEDGE FUNDS: IMPLICATIONS ON THE INDIAN CAPITAL MARKET

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ABSTRACT

Hedge fund is an aggressively managed portfolio of investments that uses advanced investment strategies such as leverage, long, short and derivative positions in both domestic and international markets with the goal of generating high returns.The present study gives the working process of hedge funds and the concerning fees structure in hedge funds and Investment strategy for hedging and the risk management.

KEYWORDS

Hedge Funds, Mutual Funds, Capital Market

INTRODUCTION

A hedge fund can be defined as an actively managed, pooled investment vehicle that is open to only a limited group of investors and whose performance is measured in absolute return units. However, this simple definition excludes some hedge funds and includes some funds that are clearly not hedge funds. Hedge fund is an investment structure that manages a "private unregistered investment pool" and compensates the fund manager with an incentive-based fee based on a percentage of the profits earned by the fund. Legally, hedge funds are most often set up as private investment partnerships that are open to a limited number of investors and require a very large initial minimum investment. Investments in hedge funds are illiquid as they often require investors to keep their money in the fund for a minimum period of at least one year. They are typically organized as private partnerships and often located offshore, thus, saving on tax and regulatory issues. Also, the initial high investments and illiquid nature of funds keeps a check on the investment in hedge funds. Hedge funds, in general, are not registered. They have avoided registration by limiting the number of investors and requiring that their investors meet an income or a net worth standard. Furthermore, hedge funds are also prohibited from soliciting or advertising to the general audience. The primary aim of most hedge funds is to reduce volatility and risk while attempting to preserve capital, and deliver positive returns under all market conditions.

The present paper naming "Emergence of hedge funds: Implication on Indian capital market", gives the knowledge about various aspects of hedge funds .The initial part enlighten on the definitions of hedge funds given by the authors. Later on we have discussed about the history and the emergence of hedge funds, earlier its types during 1960 to 1990. The next part of paper gives the features, size and growth of hedge fund industry. The other section of study gives the definition of Indian Capital Market and the features of it with the implications of hedge funds on it. Last part gives the conclusion of all study related to the hedge funds and the references concerning to the various reviews**.**

FOR PRESENT PURPOSES, 3 MAIN CLASSES OF HEDGE FUNDS CAN BE IDENTIFIED

- **Macro Funds**, which take large unhedged positions in national markets based on top-down analysis of macroeconomic and financial conditions. These funds take position in either mature or key emerging markets. They spread their holdings across equities, bonds and currencies. Some long-established macro funds find it cheaper to use conventional forwards and futures to take positions ahead of the market moves they foresee.
- **Global Funds**, which also take positions worldwide, but employ bottom-up analysis, picking stocks on the basis of individual companies' prospects.
- **Relative Value Funds**, which take bets on the relative prices of closely related securities (treasury bills and bonds, for example). They limit their holdings to the mature markets, because their expertise is limited to those markets. Relative value funds are also inclined to use derivatives.

The nomenclature "hedge fund" provides insight into its original definition.To "hedge" is to lower overall risk by taking on an asset position that offsets an existing source of risk. For example, an investor holding a large position in foreign equities can hedge the portfolio's currency risk by going short currency futures. This classic definition of speculation also includes the careful research of undervalued securities for long-term gain – what is informally termed "investing". In informal contexts, the word speculation has acquired the implicit meaning of actions based on inconclusive evidence and the desire for short-term, high-risk profit. A hedge fund is a fund that can take both long and short positions, use arbitrage, buy and sell undervalued securities, trade options or bonds, and invest in almost any opportunity in any market where it foresees impressive gains at reduced risk.

This theoretical definition of a hedge fund also explains the "hedge "terminology. Suppose that the traditional actively-managed fund has been constructed so that its exposures to market-wide risks are kept the same as in the benchmark. Then the implied hedge fund has zero exposures to market wise risks, since the benchmark and active portfolio exposures cancel each other out, i.e., hedging.

The Emergence of Hedge Funds

The Origin of Hedge Funds

The year was 1949, World WarII just ended, and the world was in a unified celebration. Alfred Winslow Jones, a sociologist, was working on assignment for Fortune magazine investigating fundamental and technical research on forecasting the stock market. The article reported on a new class of stock market timers, in addition to unorthodox methods of investing, all to achieve positive returns and call the market. Jones was very intrigued by these trading methods and became absolutely consumed with his own concept of an investment fund.

The First Hedge Fund-In 1949, Alfred Winslow Jones started an investment partnership that is regarded as the first hedge fund. Remarkably many of the ideas that he introduced over fifty years ago remain fundamental to today's hedge fund industry. Jones structured his fund to be exempt from the SEC regulations described in the Investment Company Act of 1940. This enabled Jones' fund to use a wider variety of investment techniques, including short selling, leverage, and concentration (rather than diversification) of his portfolio. Jones committed his own money in the partnership and based his remuneration as a performance incentive fee, 20% of profits. Both practices encourage interest alignment between manager and outside investor and continue to be used today by most hedge funds.Jones pioneered combining shorting and leverage, techniques that generally increase risk, and used them to hedge against market movements and reduce his risk exposure. He considered himself to be an excellent stock picker, but a poor market timer, so he used a market-neutral strategy of having equal long and short positions. Jones' long-short strategy rewarded exceptional stock selection and created a portfolio that reacted less to vagaries of the overall market. He also used the capital made available from short selling as leverage make additional investments

Size and Growth of the Hedge Fund Industry-Since hedge funds are structured to avoid regulation, even disclosure of the existence of a hedge fund is not mandatory. There is no regulatory agency that maintains official hedge fund data. There are private firms that gather data that are voluntarily reported by the hedge funds themselves. This gives an obvious source of self-selection bias, since only successful funds may choose to report. Some databases combine hedge funds with commodity trading advisers (CTAs) and some separate them into two categories. Also, different hedge funds define leverage inconsistently, which affects the determination of assets under management (AUM), so aggregate hedge fund data are best viewed as estimates hedge fund. Clearly, AUM is not the whole story in understanding the "size" of a hedge fund, or of the hedge fund industry.

CHARACTERISTICS OF HEDGE FUNDS

Although financial service providers, regulators and the media commonly refer to "hedge funds," the term has no precise legal or universally accepted definition. The term generally identifies an entity that holds a pool of securities and perhaps other assets that does not register its securities offerings under the Securities Act and which is not registered as an investment company under the Investment Company Act. Hedge funds are also characterized by their fee structure, which compensates the adviser based upon a percentage of the hedge fund's capital gains and capital appreciation. Hedge fund advisory personnel often invest significant amounts of their own money into the hedge funds that they manage. Hedge funds typically engage one or more broker-dealers to provide a variety of services, including trade clearance and settlement, financing and custody services.

Following are some key characteristics of Hedge Fund

- Hedge funds utilize a variety of financial instruments to reduce risk, enhance returns and minimize the correlation with equity and bond markets. Many hedge funds are flexible in their investment options (can use short selling, leverage, derivatives such as puts, calls, options, futures, etc.
- Many hedge funds have the ability to deliver non-market correlated returns.
- Many hedge funds have as an objective consistency of returns and capital preservation rather than magnitude of returns.
- Most hedge funds are managed by experienced investment professionals who are generally disciplined and diligent.
- Pension funds, endowments, insurance companies, private banks and high net worth individuals and families invest in hedge funds to minimize overall portfolio volatility and enhance returns.
- Most hedge fund managers are highly specialized and trade only within their area of expertise and competitive advantage.
- Hedge funds benefit by heavily weighting hedge fund managers' remuneration towards performance incentives, thus attracting the best brains in the investment business. In addition, hedge fund managers usually have their own money invested in their fund.

Advantages of Hedge Fund Investing

- Aggressive investment strategies such as short-selling or using borrowed money to buy more assets (leverage buying) can legally be utilized.
- Huge gains in the millions are the potential reward for investing in hedge funds
- Many hedge fund strategies have the ability to generate positive returns in both rising and falling equity and bond markets.
- Inclusion of hedge funds in a balanced portfolio reduces overall portfolio risk and volatility and increases returns.
- Huge variety of hedge fund investment styles – many uncorrelated with each other – provides investors with a wide choice of hedge fund strategies to meet their investment objectives.
- Academic research proves hedge funds have higher returns and lower overall risk than traditional investment funds.
- Hedge funds provide an ideal long-term investment solution, eliminating the need to correctly time entry and exit from markets.
- Adding hedge funds to an investment portfolio provides diversification not otherwise available in traditional investing.

Limitations to Hedge Fund Investing

- Only the wealthiest individuals can participate in hedge funds.
- Hedge funds are extremely risky and millions of dollars can be lost in the blink of an eye.
- The performance fee for the investment manager may encourage them to take bigger risks with your money.
- There are very few government regulations overseeing hedge fund investments.

HEDGE FUNDS Vs. MUTUAL FUNDS

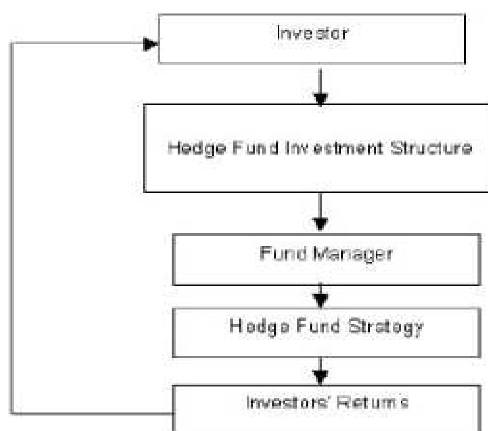
Hedge funds are institutional investors, just like mutual funds. However, this is where the similarity ends. Typically, only high net worth individuals and institutions invest in hedge funds, while mutual funds are the main investment vehicle of the small and retail investors. Additionally, mutual funds are highly regulated institutions that file a lot of information like inflows and outflows, breakup of investments and other statutory details with the regulatory authority.
Hedge funds took some heat from the credit crisis as liquidity and transparency became critical factors in investment decision-making. It's fair to say hedge funds continued to deliver decent returns to investors, but how do they compare to mutual funds if we focus on performance and risk alone ..

COMPARISON OF MUTUAL FUNDS AND HEDGE FUNDS

Feature	Mutual fund	Hedge fund
Number of Owners	Very large (in Thousands)	Few high net worth individuals or institutions
Regulations	Regulated strictly by capital market regulator	Minimum regulation
Transparency	Publishes annual reports and monthly information sheets that show investment and profit	Information given only to investors
Investment Style	Invests equity, debt and derivatives, but follow a long strategy	Follows many investment strategies, including going short on some securities
Management Fee	Fee not linked to performance. Usually a percentage of assets managed.	Fee linked to performance managers charge a high percentage of profit made
Management Ownership	Usually, find manager does not own a substantial portion of the find	The find manager owns a large part of find

HEDGE FUND STRUCTURE

To achieve pre-set returns target, these funds do not restrict themselves to their country of origin and operate on a global scale. Hedge fund managers typically seek absolute positive investment performance. This means that, the hedge funds target a specific range of performance, and attempt to produce targeted returns irrespective of the stock market trends. This is in contrast to investments by mutual funds, where success or failure is often measured in terms of performance in relation to a stock index, like the Sensex or Nifty in India.



THE HEDGE FUND STRUCTURE

The hedge fund structure helps the investor turn market opportunities into investment returns. The investor brings funds to the industry, these funds are pooled in investment structures called hedge funds, and this structure gives the investor access to hedge fund managers who provide investment expertise and use alternative investment strategies:

For investors, this structure –

- helps pool assets with those of other investors
- is a way to access talented hedge fund managers
- is a method to access the alternative investment strategies used by the manager

To achieve this "absolute return", hedge fund managers have the flexibility to incorporate different strategies and techniques that may include:

Short-selling: Sale of a security that you do not own, with the anticipation of purchasing it in the future, at a reduced cost.

Arbitrage: Simultaneous buying and selling of a financial instrument in different markets to profit from the difference between the prices

Hedging: Buying/selling a security to offset a potential loss on an investment.

Leverage: Borrowing money for investment purposes.

Hedge Fund Fee Structure

Performance-based Fees

Hedge fund managers are compensated by two types of fees: a management fee, usually a percentage of the size of the fund (measured by AUM), and a performance-based incentive fee, similar to the 20% of profit that Alfred Winslow Jones collected on the very first hedge fund. Fung and Hsieh (1999) determine that the median management fee is between 1-2% of AUM and the median incentive fee is 15-20% of profits. Ackermann et al. (1999) cite similar median figures: a management fee of 1% of assets and an incentive fee of 20% (a so-called "1 and 20 fund").The incentive fee is a crucial feature for the success of hedge funds. A pay-for profits compensation causes the manager's aim to be absolute returns, not merely beating a benchmark. To achieve absolute returns regularly, the hedge fund manager must pursue investment strategies that generate returns regardless of market conditions; that is, strategies with low correlation to the market. However, a hedge fund incentive fee is asymmetric; it rewards positive absolute returns without a corresponding penalty for negative returns. Empirical studies provide evidence for the effectiveness of incentive fees. Liang (1999) reports that a 1% increase in incentive fee is coupled with an average 1.3% increase in monthly return.

Hedge Fund Investment Strategies

Hedge funds do not constitute a homogeneous asset class. The bulk of hedge funds describe themselves as long / short equity, perhaps because this is the least specific of the available descriptions, but many different approaches are used taking different exposures, exploiting different market opportunities, using different techniques and different instruments.Although classification systems vary, hedge funds may generally be classified according to broad style and strategy categories, including:

Strategy Categories for Hedge Funds

Hedge funds do not constitute a homogeneous asset class. The bulk of hedge funds describe themselves as long / short equity, perhaps because this is the least specific of the available descriptions, but many different approaches are used taking different exposures, exploiting different market opportunities, using different techniques and different instruments: Hedge funds use a wide variety of investment styles and strategies. Even among hedge funds that claim to use the same investment strategy or invest within the same asset class, there is a wide range of investment activities, performance and risk levels. Because the investment activities of hedge funds are so diverse, the hedge funds assigned to a particular investment category are likely to exhibit less similarity than more traditional investment vehicles, such as registered investment companies. A hedge fund may pursue several strategies at the same time, internally allocating its assets proportionately across different strategies. Although classification systems vary, hedge funds may generally be classified according to broad style and strategy categories, including:

Market Trend (Directional/Tactical) Strategies

Macro

These funds may take positions in currencies (often unhedged) based on their opinion of various countries' macroeconomic fundamentals. For example, if a country's economic policies look inconsistent and its ability to sustain its exchange rate appears questionable, macro funds may take positions designed to profit from devaluation, usually by selling the currency short.

Long/Short

These funds try to exploit perceived anomalies in the prices of securities. For example, a hedge fund may buy bonds that it believes to be under priced and sell short bonds that it believes to be overpriced. No matter what happens to overall interest rates, as long as the spread between the two narrows, the fund profits. Conversely, if spreads widen, gains can turn quickly into losses. Long/short equity is the most frequently used strategy among hedge funds.

Long-short portfolios are rarely completely market-neutral. They typically exhibit either a long bias or short bias, and so have a corresponding market exposure (positive or negative). They are also likely to be exposed to other market-wide sources of risk, such as style or industry risk factors.

Event-Driven Strategies

Event-driven strategies exploit perceived mispricing of securities by anticipating events such as corporate mergers or bankruptcies, and their effects.

Merger (or risk) arbitrage is the investment in both companies (the acquirer and takeover candidate) after a merger has been announced. Until the merger is completed, there is usually a difference between the takeover bid price and the current price of the takeover candidate, which reflects uncertainty about whether the merger will actually happen. For instance, a fund manager may buy the takeover candidate, short stock of the acquirer, and expect the prices of the two companies to converge. In this case, there may be substantial risk that the merger will fail to occur.

Distressed Securities

These funds may take long and/or short positions to attempt to profit from pricing anomalies among securities issued by companies going through bankruptcy or reorganization.

Risk/Merger Arbitrage

These funds attempt to profit from pending merger transactions by, for example, taking a long position in the stock of the company to be acquired in a merger, leverage buyout or takeover and simultaneously taking a short position in the stock of the acquiring company.

Arbitrage Strategies

Convertible Arbitrage

This strategy involves taking long positions in a company's convertible bonds, preferred stock, or warrants that are deemed to be undervalued while taking short positions in the company's common stock.

Fixed Income Arbitrage

Hedge funds in this category seek to provide stable, positive returns by exploiting the relatively small pricing inefficiencies of fixed income instruments. For example, a newly issued ("on the run") 10-year Treasury bond may trade at a slightly higher price than a similar previously issued ("off-the-run") 10-year Treasury bond. A hedge fund may seek to profit from this disparity by purchasing off-the-run Treasuries and selling on-the-run Treasuries short.

Statistical Arbitrage

Funds in this category attempt to profit from pricing inefficiencies identified through the use of mathematical models. Statistical arbitrage attempts to profit from the likelihood that prices will trend toward a historical norm.

Relative Value

Relative value funds use market-neutral strategies that take advantage of perceived mispricing between related financial instruments. Fixed-income arbitrage may exploit short-term anomalies in bond attributes, such as the yield curve or the spread between Treasury and corporate bonds. Convertible arbitrage profits from situations where convertible bonds are undervalued compared to the theoretical value of the underlying equity and pure bond. In these cases, the hedge fund manager takes long positions on the convertible bond and shorts the underlying stock. Statistical arbitrage involves exploiting price differences between stocks, bonds, and derivatives (options or futures) while diversifying away all or most market-wide risks.

Situations for relative-value arbitrage often occur with illiquid assets, so there may be added liquidity risk. Gains on individual trades made be small, so leverage is often used with relative-value strategies to increase total returns.

RISK MANAGEMENT

Sources of Risk

The name "hedge funds" seems to imply risk reduction (since "hedging" is a risk reduction technique), but this need not be the case. It is better to think of hedge fund as a fund that hedges away any risk not related to its speculative strategy. The riskiness of a hedge fund therefore depends intimately upon its strategy. This contrasts with a traditional active fund where most of the risk comes from the benchmark, and a minority from the active portfolio strategy.Using our theoretical definition of a hedge fund as the "purely active "component of a traditional fund, total risk measurement of a hedge fund is theoretically equivalent to active risk measurement of a traditional active fund. To summaries, for a hedge fund, total risk measurement and active risk measurement are the same, and they are theoretically equivalent to active risk measurement of a traditional active fund. As mentioned above, hedge fund risk exposure is strongly dependent on the investment strategy chosen. In a well-run hedge fund, the only risks remaining in the portfolio are those that are intimately connected to the fund's speculative strategy, or those that it is impossible or too costly to hedge away. Some hedge funds incur liquidity risk, such as those specializing in emerging market equities or distressed assets, which target illiquid securities that maybe overlooked and mispriced by other analysts. Often, the profitable trading strategies of arbitrage-based hedge fund strategies include active positions insecurities with limited or uncertain liquidity. Hence liquidity risk is of particular importance in risk measurement for hedge funds. Hedge funds have two sources for credit risk. A hedge fund that specializes in distressed securities or fixed-income arbitrage is exposed to the default risk of debt securities that it owns. More significantly, most hedge funds use leverage, which subjects them to the other type of credit risk, the need to repay the financial institutions that extend hedge funds their credit. Under extremely adverse market conditions, a hedge fund may face both credit and liquidity crises simultaneously. In an emergency (such as margin calls), the hedge fund may not be able to obtain additional credit and may be forced to obtain cash quickly. Other hedge funds, and similarly positioned traders, may be facing similar circumstances. A large imbalance between willing buyers and desperate sellers needing cash may compel a hedge fund tosell its portfolio below "fair value".

Measuring Hedge Fund Risk

There are two standard approaches to measuring portfolio risk: the variance basedapproach and the value-at-risk approach. These two approaches are notincompatible, and many portfolio managers use both.The variance of a portfolio return is the expected squared deviation of thereturn from its mean. If the portfolio return has a normal distribution, thevariance of the return completely describes the riskiness of the return.Although normality is not necessary for application of the variance-basedapproach, the approach becomes less useful if returns differ very sharply froma normal distribution. Derivative securities and portfolios that includederivatives are notable for their lack of normality.

The variance-based approach is most powerful if returns have a linear factorstructure, so that the random return of each asset can be decomposed intolinear responses to a small number of market-wide factors plus an asset specificrisk. A linear factor model is a useful model for simple stock andbond portfolios, but not for portfolios that include derivatives. Derivativeshave a non-linear relationship to their underlying security, and so a portfolioincluding derivatives (except plain-vanilla futures contracts) cannot bemodeled with a linear factor model.

Because of the lack of normality and the inadequacy of factor models, variance-based approaches do not work well for portfolios that include derivatives. Most (but not all) hedge funds include derivatives. Some types of hedge fund strategies, for example, betting on currency or interest rate realignments, lead to highly non-normal portfolio returns and poor factor model fit even without any derivatives exposure. It is clear that some other approach instead of (or in addition to) the variance-based approach is needed to measure the risk of hedge funds.

In the aftermath of the LTCM collapse, the President's Working Group on Financial Markets (1999) recommended use of the value-at-risk (VaR) approach to monitor hedge fund risk and guard against extreme events. VaRis defined as the maximum loss to be sustained within a given time period fora given level of probability.

IMPLICATIONS TO INDIAN CAPITAL MARKET

Different Players in Indian Capital Market

Mutual Funds

Mutual fund is a form of collective investment that pools money from many investors and invests their money in stocks, bonds, dividends, short-term money market instruments, and/or other securities. In a mutual fund, the fund manager trades the fund's underlying securities, realizing capital gains or losses, and collects the dividend or interest income. The investment proceeds are then passed along to the individual investors. The value of a share of the mutual fund, known as the net asset value per share (NAV), is calculated daily based on the total value of the fund divided by the number of shares currently issued and outstanding.

Foreign Institutional Investor

Foreign Institutional Investor [FII]is used to denote an investor - mostly of the form of an institution or entity, which invests money in the financial markets of a country different from the one where in the institution or entity was originally incorporated. An investor or investment fund that is from or registered in a country outside of the one in which it is currently investing. Institutional investors include hedge funds, insurance companies, pension funds and mutual funds. The term is used most commonly in India to refer to outside companies investing in the financial markets of India. International institutional investors must

register with the Securities and Exchange Board of India to participate in the market. One of the major market regulations pertaining to FIIs involves placing limits on FII ownership in Indian companies.

Retail Investors

Retail investors according to SEBI rules are those investors whose investment corpus is not more than Rs. 1 lakh. In India, retail investors play a very small role in capital markets. This is mainly due to the risk aversion. The retail investors are mainly concentrated in four metros and Ahmadabad. Ahmadabad has major chunk of retail investors who are very much active in the stock investors.

But slowly this scenario is changing with the increase in the number of Demat accounts through which these investors mainly invest. Slowly the retail investors' confidence has increased in the Indian Stock markets. Their total share in the market capitalization is around 3%which is very much less compared to that of USA where it is around 20-25%. But with Indian capital markets gaining popularity, there is high scope that the participation of retail investors will gradually increase.

HEDGE FUND IN INDIA

With the notification of SEBI (Mutual Fund) Regulations 1993, the asset management business under private sector took its root in India. In the same year SEBI, also notified Regulations and Rules governing Portfolio Managers who pursuant to a contract or arrangement with clients, advise clients or undertake the management of portfolio of securities or funds of the client. We have however, no information about any hedge funds domiciled in India. Further, on account of limited convertibility, offshore hedge funds have yet to offer their products to Indian investors within India.

The fiscal year (2003-2004) has seen a spectacular increase in FII activities in Indian market. Till this report is filed FIIs have already invested US $ 10 bn. during this year alone which is a record. Robust economic fundamentals, strong corporate earnings and improvement in market micro structure are driving the FII interest in India. Investors all over the world are keen to come to Indian market. From informal discussions with institutional investors including some reputed and well established hedge funds, one could gauge the extent of interest they have about Indian markets. During the discussions they have requested whether India, like other Asian emerging markets, can provide a regulatory framework that will allow them to directly invest in Indian market in a transparent manner.

WHY HEDGE FUNDS ARE LOOKING AT INDIA

Unlike China, where stock markets are not well developed and company information is relatively opaque, experts note that India has much of the necessary institutional framework for hedging, including a regulatory regime and good information disclosure standards. "Investors look at multiple markets around the world," says Marti G. Subrahmanyam, a professor of finance at New York University's Stern School of Business. "There is a sense that the changes taking place in India are going to result in superior performance in the economy, and that the corporate sector will be a big beneficiary. Now, obviously the Chinese economy is larger, but the capital markets are better developed in India. If you look at the stock market, even if you were to include Hong Kong, the market cap in China relative to its GDP is lower. So if you're looking for investment opportunities where you won't suffer the consequences of illiquidity, India is the more attractive opportunity".

In addition, notes Subrahmanyam, India is the largest market for single stock futures in the world and has a well developed derivatives market in index futures and options. "This gives you hedging possibilities not available in other emerging markets," he says. There is also enough liquidity in the big stocks for [domestic] investors to sell short. Even though there are restrictions, these are less binding than in other emerging markets.

MARKET BENEFITS OF HEDGE FUNDS

Hedge funds can provide benefits to financial markets by contributing to market efficiency and enhance liquidity. Many hedge fund advisors take speculative trading positions on behalf of their managed hedge funds based extensive research about the true value or future value of a security. They may also use short term trading strategies to exploit perceived mis-pricings of securities. Because securities markets are dynamic, the result of such trading is that market prices of securities will move toward their true value. Trading on behalf of hedge funds can thus bring price information to the securities markets, which can translate into market price efficiency. Hedge funds also provide liquidity to the capital markets by participating in the market.Hedge funds can provide benefits to financial markets by contributing to market efficiency and enhancing liquidity. Many hedge fund advisers take speculative trading positions on behalf of their managed hedge funds based on extensive research about the true value or future value of a security. They may also use short-term trading strategies to exploit perceived mispricing of securities. Because securities markets are dynamic, the result of such trading is that market prices of securities will move toward their true value. Trading on behalf of hedge funds can thus bring price information to the securities markets, which can translate into market price efficiencies.Hedge funds also provide liquidity to the capital markets by participating in the market.Hedge funds play an important role in a financial system where various risks are distributed across a variety of innovative financial instruments. They often assume risks by serving as ready counter parties to entities that wish to hedge risks. For example, hedge funds are buyers and sellers of certain derivatives, such as securitized financial instruments, that provide a mechanism for banks and other creditors to un-bundle the risks involved in real economic activity. By actively participating in the secondary market for these instruments, hedge funds can help such entities to reduce or manage their own risks because a portion of the financial risks are shifted to investors in the form of these tradable financial instruments. By reallocating financial risks, this market activity provides the added benefit of lowering the financing costs shouldered by other sectors of the economy. The absence of hedge funds from these markets could lead to fewer risk management choices and a higher cost of capital. Hedge funds also can serve as an important risk management tool for investors by providing valuable portfolio diversification. Hedge fund investment strategies are typically designed to protect investment principal. Hedge funds frequently use financial instruments (e.g., derivatives) and techniques (e.g., short selling) to hedge against market risk and construct a conservative investment portfolio -- one designed to preserve wealth. In addition, hedge fund investment performance can exhibit low correlation to that of traditional investments in the equity and fixed-income markets. Institutional investors have used hedge funds to diversify their investments based on this historic low correlation with overall market activity.

In addition, hedge funds investment performance can exhibit low correlation to that of traditional investments in the equity and fixed income markets. Institutional investors have used hedge funds to diversify their investments based on this historic low correlation with overall market activity.

IMPLICATIONS OF HEDGE FUND

Impact of Hedge Funds on Indian Capital Market

Hedge funds are present in India in a large way through Participatory Notes i.e. sub accounts of FII's. Participatory note is just an instrument used by foreign funds and investors who are not registered with Securities & Exchange Board of India but are interested in taking exposure to Indian markets. Many people argue that a hedge fund has a short investment horizon and that its investments would be volatile — hot money — while the regulated FII has a longer horizon and its investments would be less volatile. However, as finance theory teaches us, correlations are usually more important than volatility. Investments by regulated FIIs tend to be highly correlated because they face common redemption pressures and common home country regulatory environments. Hedge funds by contrast tend to be contrarian and their strategies are less correlated with each other and with regulated FIIs. In other words, hedge funds are less subject to herding behavior than regulated FIIs.

The Hot Money that the hedge funds have brought into Indian markets has brought more liquidity in the market. Due to their investments though volatility has increased but it has negated the herding mentality of most FIIs. For example during the recent slump in the world and Indian markets in Feb and March is attributed to the herding mentality of FIIs. But this was largely negated due to the investments by Hedge funds in the Indian markets. Consider this fact during the month of March, 2007 Japanese FIIs were net sellers in Indian markets to a tune of $2 billion in a couple of days because of the Yuan Carry of Trade. Due to this the benchmark index has lost around 10% in a couple of days. But this was negated due to the inflow of Hedge funds and these hedge funds brought some relief by pumping their money into the market because of which the Index again surged back to comfortable levels.

Following are the areas of Hedge Fund Implication:-

1. On Investors
2. Corporate
3. The sell side- Brokers and Financial Institutions

INVESTORS

One would expect India to be considered as a destination for hedge fund investment, rather than a market for raising corpus. With RBI's monetary policy 2007-2008 announced on April 24, hedge funds have come within reach of the Indian market. The RBI announced that it has increased the present limit for individuals for any permitted current or capital account transaction from $50,000 to $100,000 per financial year. Though one would believe that the hedge funds are still not accessible; a closer look at the hedge fund industry would reveal that with increasing number of fund of funds the minimum investment cap is well within the $100,000 mark. Moreover, SEC the regulator in US is no more stringent regarding the maximum cap of 100 investors in a Hedge Fund. Given this, HNIs have an altogether new Risk-Return matrix before them. The bigger question that arises is should RBI be monitoring the flow. Supporters of Hedge Funds claim the investors in these funds are HNIs and Institutional Investors who are well awareof the market scenario, unlike the retail investor. They argue Caveat Emptor or Buyers beware. Though, this would have worked in US, in the Indian scenario one is yet to find mature investing. The wealth being created was the result of investors riding the wave. Thankfully the wave has been in its favour during the last 5 years. One has to understand that, though the Indices are surging, Indian market is still not mature enough. Thus investing in an asset class without virtually any regulation, transparency and disclosure might not be the best step at this stage. Given that, even SEC is not clear of its policy towards Hedge Funds its Indian counter part should put in a lot of groundwork before hedge funds are marketed freely in India. SEBI should design appropriate framework, paying particular attention to the marketing of these products to ensure that investors are adequately apprised of the associated risks.

CORPORATE

Hedge funds are an important set of investors for a corporate (especially ones with poor fundamentals and pronounced asymmetries) because of their risk appetite. However, corporations are always in a quandary when issuing capital to these funds. The prime reason being the volatility they bring with them. Private equity investors usually invest with a lock-in period and have a strategic motive behind their investment, while Hedge funds investment in distressed companies have no such restrictions (though investment in hedge funds come with a lock-in period). Private Equity invests to avail normal returns, returns from organic growth of the organization in sales, profits etc. On the other hand Hedge funds look for abnormal returns, asset mis-pricings and purchase with an intension to sell immediately.

THE SELL SIDE- BROKERS AND FINANCIAL INSTITUTIONS

The LTCM debacle exposed the vulnerability of brokerage houses and financial institutions to the hedge fund strategies. In their pursuit of larger market share, brokers and banks often underscore how hedge fund activities can harm them and markets. As a consequence to the losses on leveraged positions, liquidity shortages come into play, which further aggravate the situation. With excessive leverage, even a moderate price swing could force hedge funds to liquidate their leveraged positions to meet margin calls, potentially leading to ripple effects across a number of markets. Thus, leveraged market risk can, if not supported by adequate liquidity reserves or borrowing capacity, force a fund to default on its obligations to prime brokers and other financial institutions. If the fund's size is large, the spill-over effect on markets could be grave. In an environment where the default rate of hedge funds across the globe is 10%, such instances are not difficult to find. The recent example on Sub-prime crisis in US is an apt example. The short term approach of hedge funds is questioned many a times by the regulators and the retail investors. An inquisitive reasoning would highlight that such strategies are harmful not only for the funds themselves, but also to other financial institutions. With the entry of these fast-moving funds into the market, other institutional players might be forced to realign their investment style to a shorter duration, in order to remain competitive. They would book profits regularly due to the fear of a sudden sell-off by hedge funds. This, in turn, will further boost speculative trading. Every investor/investor class has his/its own risk appetite. For instance, risk taking capability of a mutual fund would be higher than a pension fund. Given an environment, where the market could rise and fall at the will and fancy of the hedge funds, they would not be motivated to remain invested for a long period, which defeats the larger purpose of Investment.

CONCLUSION

Hedge funds are an exciting innovation to the range of professionally managed investment vehicles. Hedge funds concentrate almost exclusively on the speculative role of investment management, that is, the attempt to outperform the market average by superior security valuation and successful trading strategies. Hedge funds are in a sense the opposite of index tracking funds, which simply try to earn the market average return with minimal management cost. Theoretically, one can view a traditionally managed active fund as a combination of a hedge fund and an index tracking fund. The index tracking fund is the "purely passive" component and the hedge fund is the "purely active" component of the traditional active fund.

Hedge funds offer very strong incentives for the portfolio manager by linking the manager's compensation tightly to the realized return of the fund. Hedge funds minimize information leakage and maximize flexibility by avoiding full disclosure and granting the manager very wide latitude in strategy and trading decisions. These policies differ from those of the traditional fund, which must meet regulatory guidelines intended for protection of the investment public. Hedge funds restrict access to exempt investors only, in order to avoid these regulatory constraints.

Hedge funds confront the traditional fund sector with a strong challenge. They have attracted more attention and media interest than the traditional sector, they have drawn heavily on the pool of talented fund managers due to their lucrative compensation packages, and they have attracted a very strong (but still proportionately small) flow of capital. There is also some evidence that hedge funds have outperformed on average in terms of their risk-reward profile, although this evidence is not yet conclusive.

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