

# Hedge-linked Notes as a Means to Hedge Fund Investing: Does it Justify the Hype?

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*This article will examine recent trends in the use of structured notes as a means to hedge fund investing and will attempt to identify the risks inherent in these structures.*

Although recent events may make the performance of the financial markets of the 1990s seem like ancient history, the tremendous returns of the 1990s took hedge fund investing to an altogether new level. Hedge funds grew in popularity as the top-performing equity managers were able to launch new funds with ample access to new capital. Investors paid hefty management fees largely without objection, so long as managers succeeded in producing returns far exceeding industry benchmarks.

The weak equity markets of recent years do not seem to have negatively affected the alternative investment industry. If anything, investors have turned to hedge funds in increasing numbers in the present environment as, in contrast to traditional asset managers, hedge fund managers do not attempt to outperform specific markets. Rather, hedge funds are concerned with generating positive absolute returns regardless of overall market direction.

Not only have the returns of the hedge fund industry exceeded those of the overall equity markets over the past several years, but managers have often been able to achieve those positive returns while marketing products with risk profiles more like bonds than equities. Thus, investors have been able to improve the risk-return characteristics of their overall investment portfolios and to obtain positive returns even in periods when equities or bonds show negative returns.

In an effort to further reduce risk, investors have also increasingly diversified their portfolio of alternative investments from single-manager funds to multi-manager strategies and funds of funds. Concentration in only one or a few hedge funds can be very risky. Over the last few years, several hedge funds have wound down their activities or have gone into liquidation following poor performance. Other hedge funds have been victimised by fraud.

For these reasons, funds of funds have increased in popularity. Investing through a fund of funds enables investors to gain access to an increased number of managers. However, hedge funds of funds may be inaccessible to the majority of investors due to their unregulated status, adverse tax treatment, relatively high fees, limited liquidity, or legal prohibitions in the investor's country of origin.

Today, more investors throughout the world are seeking access to the world of alternative investing. At the same time, professional managers, distributors and sponsors of alternative investments are aggressively searching for new investors in an increasingly competitive environment. Indeed, the competitive pressure to raise capital for the approximately 6,000 hedge fund managers has resulted in an increasing 'mutualisation' of the hedge fund industry as it moves towards lower minimums, and more regulated and structured products in which the retail investor can participate.

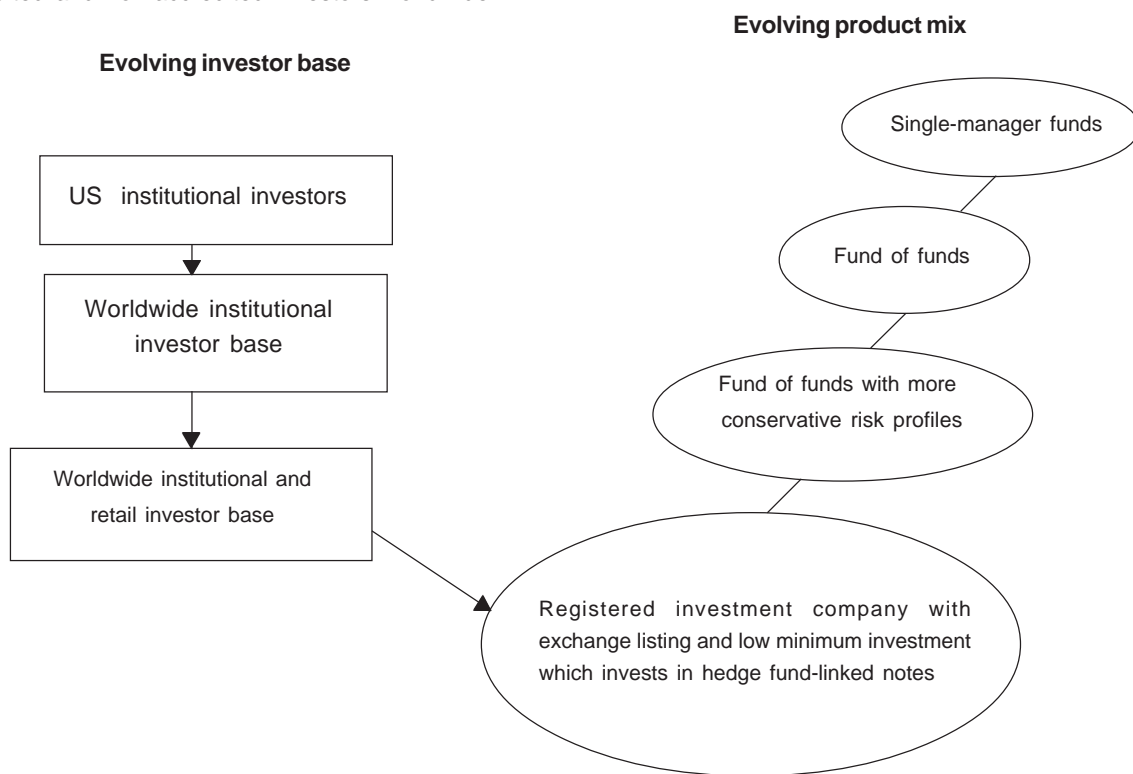
## Alternative IQ

While retail investors are increasingly interested in participating in hedge funds, and institutional investors desire to allocate more of their portfolios to hedge funds and alternative investments, institutional and other investors are looking for ways to obtain positive returns while keeping within conservative investment parameters. Products which feature structured notes or principal-protected notes linked to hedge funds have recently offered institutional investors a way to allocate investments of their fixed income portfolio to the alternative investment world, and have offered some retail investors access to an investment that for various legal and regulatory reasons was previously unavailable. These products have also allowed banks to become significant participants in the hedge fund industry, by providing the guarantee involved in many of the structured products which have capital protection features. The following chart shows a continuous evolution of the investor base to institutional and retail (both accredited and non-accredited) investors and an evolving product mix in the alternative investment area designed to appeal to both accredited and non-accredited investors worldwide.

## History of Structured Notes

Although structured notes have been in existence for many years, their emergence as a product in the hedge fund arena is quite recent.

The first structured products linked to alternative investment funds were created in the 1980s. Utilising these structures, zero coupon government bonds were purchased to guarantee somewhat less than the invested amount. The remainder was then invested with hedge fund managers and/or commodity trading advisers. These structures offered no leverage, however, and thus returns were quite low. Only a small percentage of total capital was invested for the purpose of attempting to achieve the high rates of return of alternative investments. Low returns, when combined with the relatively high fees charged by banks for products without significant real value added, made these products difficult to sell to investors.



The advent of option strategies to replace actual investments in hedge funds or with commodities trading advisers has led to a wide variety of structured products with embedded options, options on equities and other indices that are used with increasing frequency as the so-called 'alpha generator' for funds featuring structured products. Although investors could invest in a multi-manager fund or fund of funds which directly or indirectly employ such strategies, it has become increasingly common for a variety of regulatory and some economic reasons, to invest in a note which, through its redemption mechanism, provides the investor the return derived from the underlying strategy. Thus, the notes are often structured with a redemption price linked to the rise in the net asset value per share of a hedge fund, a futures fund or a fund of funds.

A fairly typical deal would involve an issuer, who in some cases may also be responsible for the distribution of the deal, an investment manager and a guarantor, typically a bank or another large financial institution with a credit rating sufficient to support the guarantee (assuming that the product is a structured note which is capital protected). The principal amount of the investment is then divided into two components, the at-risk portion and the portion reserved against the guarantee obligation. The percentage allocation depends in large part on the interest rate environment, but it would not be uncommon to see approximately 40% of the net asset value used for trading and 60% used to purchase zero coupon bonds or other similar investments.

The traded portion is typically invested using an option methodology which provides the leverage necessary to make the upside return on the note resemble that of the underlying fund into which the banks, as guarantors, will invest their own funds. To value options on what is usually a composite index of hedge funds, the banks which offer them have developed proprietary pricing models that take into account the past performance and volatility of the funds. The banks face a difficult task in hedging the risks implicit in these positions.

The issuer and/or guarantor that sells a fund-linked structure hedges its exposure as though it had sold any other option-based structure. This hedging takes the form of investments by the bank in the underlying funds.

The bank funds these investments out of its own capital. Thus, the purchaser of the option indirectly benefits from the good rating of the bank, since the funding cost of the hedge is one of the parameters which affects the price of the option. For the bank, not only are they able to use their credit rating for the guarantee component without really altering what their investment strategy for the funds would be in any event, but the mere existence of the guarantee makes it much easier for the bank and for the issuer to embed fees throughout the structure without as much concern about the nature of the disclosure. This is the case since the investor has been assured that it is receiving the greater of its investment or the performance of an index as its return and therefore is less concerned about the fees which are being charged at various points of the structure.

### **Risks of Structured Notes**

While the appeal of investing in structured notes seems obvious — that is, the potential to obtain hedge fund returns with minimal or no risk to the principal investment — in fact, hedge fund-linked notes do present certain risks as well as limitations which must be carefully considered. For notes featuring principal protection, the bank guarantee usually requires that managers adhere to certain limitations, including a stop-loss point at which hedge fund investments are cashed out and moved into zero coupon bonds. Thus, the investment does indeed capture the hedge fund's upside — but only as long as the fund's value never drops below the stop-loss point.

When hedge funds suffer downturns, a direct investor has the option of staying in or getting out, whichever they prefer. However, investors in hedge fund-linked notes do not generally have this option, and may be forced to cash out during downturns and then to wait for their return of the principal without realising any additional income on the investment. With interest rates as low as they currently are, investments in structured notes may produce higher yields than an investor's current fixed income portfolio. On the flip side, however, the zero coupon bonds may consume a substantial chunk of available cash over an extended period of time, leaving less cash available for alternative investments.

## Alternative IQ

Tax treatments and risks are a major focus for potential investors in hedge fund-linked notes. The returns on these notes are generally treated as taxable interest income. An investment through notes for tax purposes can turn all profits on the underlying hedge fund into interest income. This, of course, may not be significant where the fund's investments do not generate long-term capital gain, but where they do, the note structure will place an investor at a disadvantage over a direct investor. A direct investor's income will have the same character as recognised by the fund. Where most income is long-term capital gains, investors at least in the US and in other countries where long-term capital gains are taxed preferentially, will be disadvantaged by an investment in structured notes where the income is considered to be interest income.

Other risk factors of structured note programmes include that the circumstances could change, forcing an investor to sell their investments prior to the end of the investment period. Unlike a direct investment in a fund or fund of funds, an investor in a programme of hedge-linked notes really does have limited liquidity. In the event that an investor faces a need to sell, it may be difficult to dispose of the underlying notes. This has made some of the newer product offerings in the form of registered investment companies more popular with investors, since these products provide liquidity for investors in the secondary market. A recent product sponsored and distributed by Deutsche Bank, Xavex Hedge First (XHF), is an example of the products which major banks are currently sponsoring which bring hedge fund investments to the retail investor and provide for liquidity in the secondary market. Although it does not provide any minimum or, for that matter, maximum redemption payment, it allows the investor, for an investment of as little as US\$7,000, access to the universe of hedge funds. The investor purchases shares in a registered investment company which owns a portfolio of index-linked notes issued by a minimum of five separate issuers, all of which track the upside and downside performance of the Hedge First Index (a proprietary index developed by Deutsche Bank to track a portfolio of hedge funds).

However, if the investment is not in the form of a purchase of shares in a registered investment company, and there is no listing of the shares on any exchange, there may not

be a viable secondary market and any price obtainable in the secondary market may not reflect the net asset value of the company at all times. Investors should be aware that any liquidity may be of a limited nature and that selling an investment prior to the expiration of the investment period could result in a return less than the initial capital investment.

Where there is an investment of index-linked notes and one or more of the issuers become insolvent, or its credit rating is downgraded, the net assets of the company would be adversely affected; hence, returns to investors can be diminished in the case where there is no principal guarantee. Or if the guarantor becomes insolvent, even where there is a principal guarantee, returns to investors can be diminished or non-existent. Usually in a programme of index-linked notes, the sponsor may seek to sell notes of an issuer whose credit has been downgraded to third-party purchasers, rather than continue to hold such notes and to reinvest the proceeds in the purchase of notes of another issuer.

Investors may also be exposed to currency risks with an investment in a structured note product. If the hedge-linked note index is a US dollar-based index, and no foreign exchange cover is provided, the value of the investment will be exposed to fluctuations in the US dollar.

Ultimately, however, the major risk of these investments is one which an investor will face with any hedge fund investment — the performance of the hedge funds themselves which underlie the index. The notes will expose the investor to the upside and downside performance of the index. If the hedge funds underlying the index do not perform, the value of the index may fall to zero. If the value of the index falls to zero, the trading portion of the investment will be lost.

## Conclusion

It does appear that structured note programmes will continue to proliferate for a variety of regulatory and economic reasons. Some of the principal reasons why we will continue to see new product offerings utilising structured notes are the embedded options structures which can add leverage while controlling risk, and the

low interest rate environments in which these products can compete effectively with other offerings, especially fixed income alternatives, by creatively structuring around tax and regulatory hurdles, thereby allowing sponsors and promoters access to the retail investors. However, investors should understand what is really being offered by structured notes and the risks associated with such investments.

*Mr. Zimmermann's practice is concentrated in the areas of investment management and regulatory proceedings. Christine Woodhouse and Marc Cozzolino, associates with the firm, assisted in the preparation of this article.*

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