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What's the Hedge funds and how do they generate money

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Synopsis

In simple terms, Hedge Funds pool money from high-net-worth individuals and large companies to generate higher return and diversify risk. The funds are managed by professional fund managers who follow a wide range of strategies to invest in traditional or non-traditional assets, to earn above-average investment returns.

The investments are often considered high-risk a and usually done by high net worth individuals.

'Money' has been to humanity what mitochondria are to a cell, a 'powerhouse.' Humanity has evolved around money; we have moved places, fought wars, and become civilized and globalized due to our motivation for money. We all strive for the 'biblical money printing machine,' a source for unlimited money and subsequent 'power. But what if there are a selected few who have access to this 'mythical machine,' not the Mafia or the Federal bank, but rather a set of entities that have been formed in the last 70 years, which have completely transformed the world of Finance: Hedge Funds.

What's Hedge Fund?

'In Securities and Exchange Board of India (Sebi's) words, “Hedge funds, including fund of funds, are unregistered private investment partnerships, funds or pools that may invest and trade in many different markets, strategies and instruments (including securities, non-securities and derivatives) and are not subject to the same regulatory requirements as mutual funds.”

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What is the typical hedge fund fee structure?

'Hedge funds charge an asset management fee based on the fund's net assets, along with a performance-based fee. The asset management fee is generally between 1 per cent and 2 per cent of the fund's net assets, and is charged on a monthly or quarterly basis. The performance fee can range between 10 per cent and 15 per cent of each investor's net profits for each calendar year. The fee may go up 20 per cent.

So, if an investment of Rs 10 lakh increases to Rs 12 lakh in one year, Rs 40,000 is the fee owed to the fund.

Who can invest in Hedge Fund?

Only qualified or accredited investors can invest in hedge funds. They are mainly high net worth individuals (HNIs). The minimum size for investing in these funds is Rs 1 crore per investor and an entire fund needs to have a minimum corpus of Rs 20 crore.

History and understanding about hedge funds

The brainchild of A.W Jones, the first Hedge Fund, came about in 1952. Hedge Funds were primarily built around two main factors: proprietary investment strategies and access to money. As more people entered the market, they formed their own strategies and, subsequently, their own funds. With roaring economic success in the early 60s, money flowed in too. But the success was short-lived; with the economic downturn at the turn of the decade, hedge funds caught in the fire as well. By 1975, assets under the Management of Hedge funds declined by 70%. They needed new ideas, and a mathematician bought one.

Jim Simmons, with his army of math professors, revolutionized the Hedge Fund industry. He understood that the rest of the Hedge Funds are making a futile attempt to predict the market movements in the long term; it is not possible with the dangers of market crashes always present. Instead, market movements could be understood for a very short time period, and this is where Renaissance Technology would make their money. Hedge Funds have only strengthened from there.

From unabated speculation by George Soros in the 1990s to the role of Hedge Funds in the 2008 Financial crisis, the role of Hedge Funds came under the serious gaze. So much so that a bunch of Redditors collaborated to destroy Melvin Capital as revenge for the role of Hedge Fund in the 2008 crisis by buying into Gamestop Stock, which Melvin was short on. Melvin had to close the shop this year. A bunch of Davids brought down the proverbial Goliath.

Melvin was not the only one. A bunch of other Hedge Funds, too, were forced to close due to unabated losses in the market. Market drawdowns, very high risk, and low due diligence for investments made a perfect recipe for disaster. It has increasingly been believed with the recession starting in the short-term that Hedge Funds need new inspiration. Like in the 1980s, the time is ripe for the rise of new ideas!

What if idea of taking positions based on short-term market movements is combined with robust risk management?
Further if trends based on historical data and real-time sentiment analysis is added to this analytics, this can create a powerful tool. Some hedge funds like Secvolt use Quant-based analytics to generate higher returns that are unaffected with the market fluctuations.