

# CRISIL YOUNG THOUGHT LEADER 2007

A DISSERTATION ON

**“Hedge funds vs traditional banks.  
Which is better?”**

By

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**EXECUTIVE SUMMARY**

This paper shall examine the entities – The hedge funds, and analyze their risk-return profiles especially in the present context. The sub-prime crisis reemphasizes the need to examine their financial offerings and their suitability of entering the Indian Markets. The paper examines status of hedge funds, especially in India, the regulations and their impact on the market. It also examines the role of traditional banks and whether the regulations inhibit innovation in the banking sector. Looking at the current needs of the market, the changing profile of the hedge funds, certain recommendations have been provided for the entry and regulations for the hedge funds entry into India.

**Introduction – An Overview**

Hedge Funds have no universal definition though they are certain characteristics that are typical of these entities. (Refer Appendix A)

According to SEBI, Hedge funds are unregistered private investment partnerships, funds/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

Hedge funds employ various strategies to reduce volatility and risk while attempting to preserve capital and deliver positive returns under all market conditions. However, today the term primarily refers to their status as private and unregistered investment pools.

**Why are Hedge funds so Attractive to investors?**

In this section we will explore the reasons for the increased interest in Hedge funds, especially from the investors’ perspective

Advantages:-

- **Provide portfolio diversification** due to the low correlation with the tradition asset classes such as Equities or Mutual Funds as shown in Table 1
- **Provide lower volatility** usually but depends on the managers skill
- **Provides positive returns** even in a downside market by appropriate strategies unlike mutual funds that strive to give better returns than the market or limits the risk of losses in a downturn.

Table 1 – Correlation between Hedge Funds and Equity Index

Monthly correlation Apr '96 - Mar '01	S&P 500 Index	Lehman Bros Aggregate	SSB World Govt Bond Index	MSCI EAFE wNet Dividends	HFR Short Selling	Barclays CTA Index	HFR Market Timing	HFR Macro	HFR Fixed Inc. Convert. Bond	HFR Distressed Securities	HFR Convert Arb	HFR Equity Market Neutral	HFR Fixed Income: Arb	HFR Merger Arb	HFR Relative Value Arb	HFR Event-Driven
S&P 500 Index	1.00	0.20	0.11	0.75	-0.65	0.01	0.65	0.47	0.68	0.49	0.34	0.15	-0.14	0.49	0.50	0.63
Lehman Bros Aggregate	0.20	1.00	0.47	0.02	-0.03	0.34	0.15	0.20	-0.03	-0.13	-0.08	0.21	-0.13	-0.15	-0.06	-0.04
SSB World Govt Bond Index	0.11	0.47	1.00	0.24	-0.11	0.06	0.17	-0.13	-0.10	-0.26	-0.35	0.09	-0.37	-0.01	-0.22	-0.10
MSCI EAFE wNet Dividends	0.75	0.02	0.24	1.00	-0.66	-0.04	0.69	0.49	0.61	0.53	0.30	0.16	-0.02	0.48	0.39	0.62
HFR Short Selling	-0.65	-0.03	-0.11	-0.66	1.00	0.06	-0.72	-0.68	-0.76	-0.59	-0.38	-0.18	0.05	-0.41	-0.47	-0.72
Barclays CTA Index	0.01	0.34	0.06	-0.04	0.06	1.00	0.12	0.46	-0.11	-0.20	-0.23	0.09	0.00	-0.21	-0.27	-0.07
HFR Market Timing	0.65	0.15	0.17	0.69	-0.72	0.12	1.00	0.57	0.56	0.39	0.27	0.13	-0.06	0.30	0.24	0.52
HFR Macro	0.47	0.20	-0.13	0.49	-0.58	0.46	0.57	1.00	0.55	0.54	0.39	0.30	0.23	0.23	0.41	0.67
HFR Fixed Inc. Convert. B	0.68	-0.03	-0.10	0.61	-0.75	-0.11	0.55	0.55	1.00	0.71	0.60	-0.02	0.06	0.44	0.62	0.79
HFR Distressed Securities	0.49	-0.13	-0.26	0.53	-0.59	-0.20	0.39	0.54	0.71	1.00	0.78	0.16	0.39	0.53	0.82	0.87
HFR Convert Arb	0.34	-0.08	-0.35	0.30	-0.38	-0.23	0.27	0.39	0.60	0.78	1.00	0.17	0.34	0.44	0.81	0.69
HFR Equity Market Neutral	0.15	0.21	0.09	0.16	-0.16	0.09	0.13	0.30	-0.02	0.16	0.17	1.00	0.18	0.28	0.23	0.25
HFR Fixed Income: Arb	-0.14	-0.13	-0.37	-0.02	0.05	0.00	-0.06	0.23	0.06	0.39	0.34	0.18	1.00	-0.01	0.26	0.23
HFR Merger Arb	0.49	-0.15	-0.01	0.48	-0.41	-0.21	0.30	0.23	0.44	0.53	0.44	0.28	-0.01	1.00	0.65	0.65
HFR Relative Value Arb	0.50	-0.06	-0.22	0.39	-0.47	-0.27	0.24	0.41	0.62	0.62	0.61	0.23	0.26	0.65	1.00	0.78
HFR Event-Driven	0.63	-0.04	-0.10	0.62	-0.72	-0.07	0.52	0.67	0.79	0.67	0.69	0.25	0.23	0.65	0.78	1.00

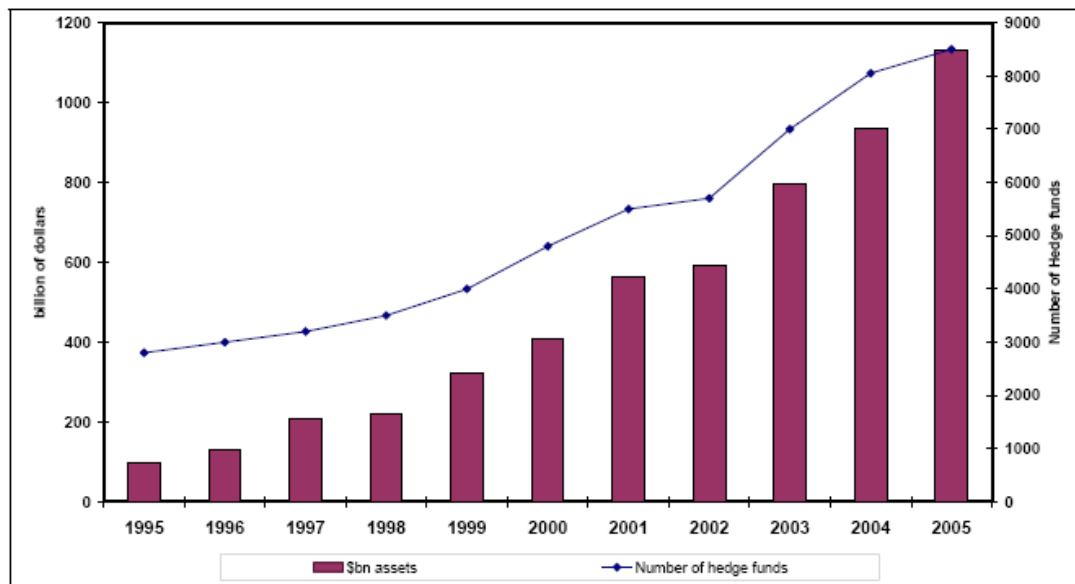
Disadvantages:-

- **Longer Lock-ups** of the invested capital upto atleast one year or more unlike mutual funds where it can be easily withdrawn
- **Limited accessibility and customizability** as huge invested capital minimizes the other investment options available to the investor increasing the risk of concentration in one hedge fund.
- **Lack of transparency** as hedge funds are usually not registered and hence unregulated. They provide limited information about their market exposure, the instruments used, the leverage amounts etc. Moreover, not all funds are published in the databases, disabling the investors from choosing the correct fund
- **Performance based fees** – The performance based component of the fee structure makes it expensive to invest in these entities. To prevent the managers from taking undue risk to get higher returns and hence higher fees, the concept of ‘high water marks’ is used.

### The Current status of Hedge Funds

The global hedge fund market grew by 19% to almost \$2.500 bn <sup>[1]</sup> in July.

*The global hedge fund industry*



Source: Hennessee Group LLC; IFSL estimates for 2005.

Most of these funds are based in the western nations but the investment is increasing in Asia now.<sup>a</sup> India has become a favoured destination though investment is possible only through PNs issued by SEBI-registered Foreign Institutional Investors (FIIs).

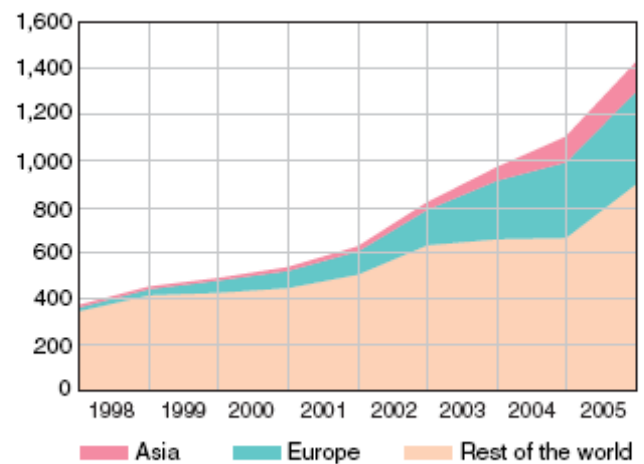
As per official data, the PNs account for 35 per cent of FII inflows while Market estimates say its more than 40 per cent. No official data on hedge funds' contribution to PNs is available.

Boyson and Mooradian<sup>[3]</sup> find strong evidence that hedge fund activists improve both short-term stock performance and long-term operating performance of their targets.

The research by Brave, Partnoy and Thomas<sup>[4]</sup> finds that hedge funds' efforts to improve companies they hold big stakes in have spillover benefits for all shareholders: a quick 5% to 7% jump in stock prices.

Since 2001, the HFN Emerging Markets Average has produced a cumulative return of 245% (average annual return of 23%), while the cumulative return for the S&P 500 total return index during this same time frame was 19%.<sup>[2]</sup> Overall, the equity indices usually trail the funds indices.

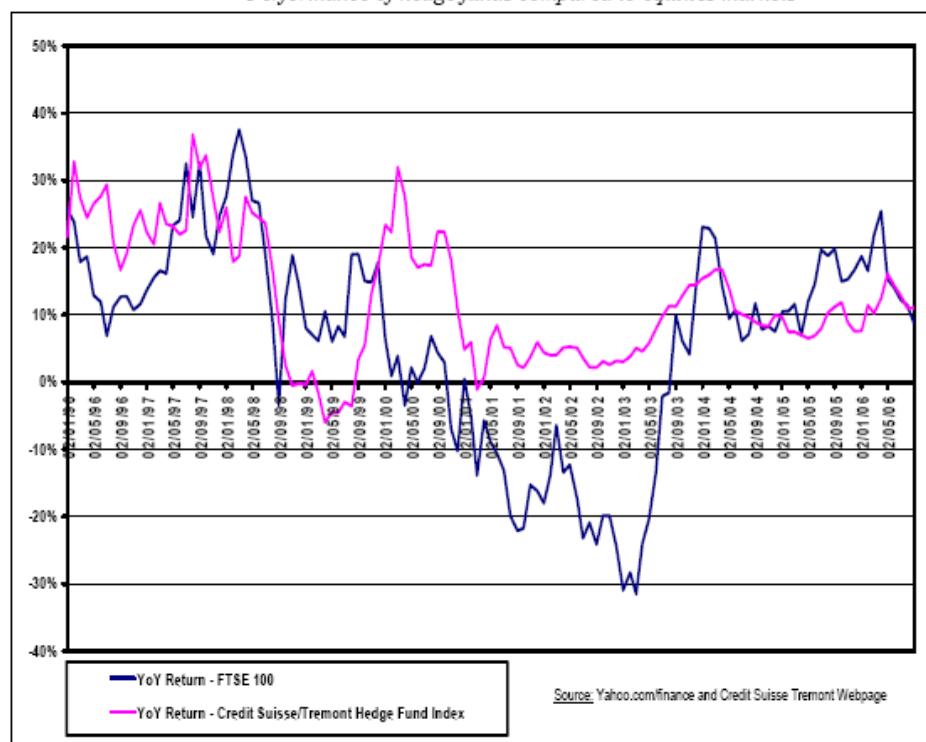
**Hedge fund assets under management by region**  
(USD billions)



Sources: EurekaHedge, EuroHedge, Factiva, HFR.

<sup>a</sup> The total assets in hedge funds concentrating on emerging markets have increased by more than 330% (2003 to 2006)

Performance of hedge funds compared to equities markets



Source - ECMI Policy Brief No. 5/April 2007

Latest statistics also show the higher returns compared to the global benchmarks.<sup>b</sup>

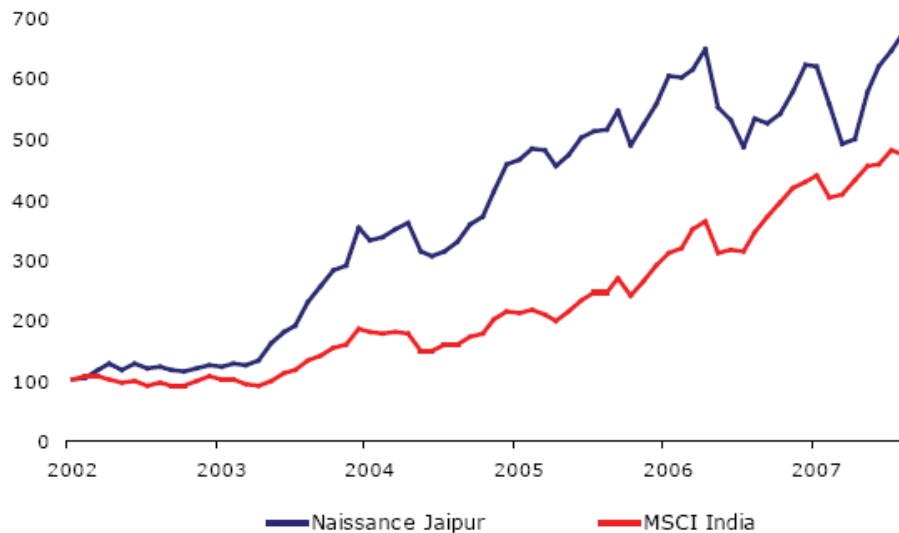
	TOTAL RETURN					3 Yr Annualized		5 Yr Annualized	
	7-Aug	7-Jul	YTD	3Month	1YEAR	CAR	STD	CAR	STD
Global Hedge Fund Index	-1.40%	0.40%	6.80%	0.10%	12.40%	11.50%	4.10%	11.00%	4.20%
Comparative Benchmark									
Lehman Brothers Aggregate Bond	1.20%	0.80%	3.10%	1.80%	5.30%	3.70%	2.80%	4.30%	3.70%
S&P 500	1.50%	-3.10%	5.20%	-3.30%	15.10%	12.20%	7.40%	12.00%	11.10%
MSCI World Equity Index	-0.30%	-2.30%	5.30%	-3.40%	14.90%	14.90%	7.70%	13.50%	11.10%
FTSE 100	-0.90%	-3.80%	1.30%	-4.80%	6.70%	12.20%	7.40%	8.30%	11.7

For the Indian scenario, we can look at the performance of an India focussed hedge fund called Naissance Jaipur against MSCI India.<sup>c</sup>

<sup>b</sup> Source - <http://www.greenwichai.com/>

<sup>c</sup> <http://www.naissancecapital.com/EN/funds/fund/NJFactSheet.pdf>

### Monthly Return



Current regulations permit foreign investors relatively free access to the equity and equity derivative markets, a very limited access to the fixed income market and practically no access to other segments of the Indian securities markets. Given this, the hedge funds investing into India are primarily equity focused.

### **Origins in India and the Rules & Regulation**

The current status does not permit the hedge funds to directly invest in India.

However most funds route their investments through registered investment banks, which buy securities and sell synthetic products based on them to the funds. Among these are "participatory notes" or P-notes, which track the performance of a pool of securities. The investment banks own and trade the underlying securities on their books, making the whole set-up look above-board.

Market regulator Securities and Exchange Board of India (SEBI) has had reservations about permitting hedge fund investment in India. To minimize the impact of these indirect trades, SEBI has issued several guidelines for FIIs such as P-Notes fortnightly disclosures.

To increase transparency and decrease transaction costs for investors, SEBI agreed to allow foreign individuals, corporates and other investors such as hedge funds to register directly as foreign institutional investors (FII)<sup>d</sup>

It is in the process of deciding on allowing short-selling by both domestic and foreign institutional investors.

### **Is The Indian Market Ready – The Associated Risks**

SEBI has been wary of hedge funds for many reasons.

Traditionally hedge funds are seen as risky ventures due to the higher degree of leverages and their exotic investment strategies. However, these fears are unfounded in India since RBI regulations do not allow the offshore funds to invest in India through the FII route if they are extremely leveraged

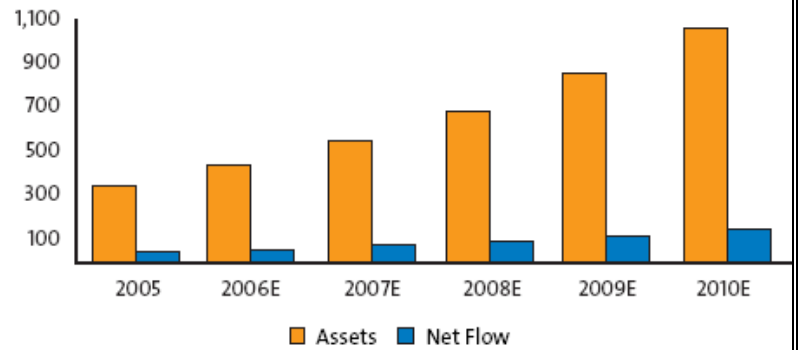
Another concern is regarding flight of capital. India has limited account convertibility but we are now moving towards greater convertibility. RBI's monetary policy for 2007-2008 has helped bring hedge funds within reach of the Indian market by increasing the present limit for individuals for any permitted current or capital account transaction from \$50,000 to \$100,000 per financial year. The limited avenues available make the hedge funds in India not as risky as postulated.

Another fact that must be taken into account is the likely impact these funds will have on other institutional investors in the market. It may force them to realign their investment style to a shorter duration to book regular profits due to the fear of a sudden withdrawal by hedge funds. Moreover, they may resort to riskier strategies to play against the high returns promised by the hedge funds, inspite of lack of expertise in these strategies. The combined effect will be increase in speculative trading and riskier markets. However, no evidence of this has been found and these fears are unfounded.

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<sup>d</sup> On 30<sup>th</sup> July, 2007,

The hedge funds seek significant investment from retail investors and institutional investors like pension funds, endowment funds etc. According to estimates, the global institutional investment in hedge funds will exceed \$1 trillion by



Source: The Bank of New York and Casey, Quirk & Associates analysis

2010. Similar trend will be seen in India too. Moreover, the lack of enforcement of caps now lets individuals with a lower net worth to invest in these funds.

**Projected Global Institutional Hedge Fund Assets and Flows (\$ billions)**  
Source - BNYHedgeFundWhitePaper2006

The major form of risk is not so much market related (as other equity investments) but related to the strategies employed and manager's skill. The managers may not have the competence or the processes and controls to adequately manage the fund and explain this clearly to his investors. SEBI's proposed guidelines address this.

Critics argue that hedge funds play with complex-esoteric derivatives which are even illiquid at times and not listed on the exchange, and hence the hedge funds may not be able to price them properly.

Proponents of hedge fund say that if FIIs are allowed, so should be hedge funds. Hedge funds offer variety and tend to be contrarian, hence being less correlated to the market. This can lower the volatility of the markets.

In light of the above reasons and as hedge funds provide liquidity to the market and enhance the price discovery mechanisms, they should be allowed to enter India via a direct route but SEBI should set guidelines to moderate their impact on the market.<sup>e</sup>

<sup>e</sup> However as pointed out by RBI in its recent quarter review of the annual monetary policy for 2007-08, "With greater risk aversion going forward, with credit quality deteriorating and with the widening of credit

### **The Traditional Banking Sector and Innovation**

The traditional Banking system stemmed from the need to provide intermediation to money lenders and borrowers. However, with the deregulation of interest rates, the opening up of the Indian financial sector and the surge in alternate investment opportunities, the traditional banks have evolved into broader entities encompassing various roles and emerging as Universal Banks.

The growing need of customization demanded by customers and the varied customer classes (both on the basis of income and risk appetite) has compelled the banks towards being universalized. Though the basic aim of these institutions has been to stabilize the economy and provide financial support for fueling the growth, these factors have led to increased innovation in products, services and operations.

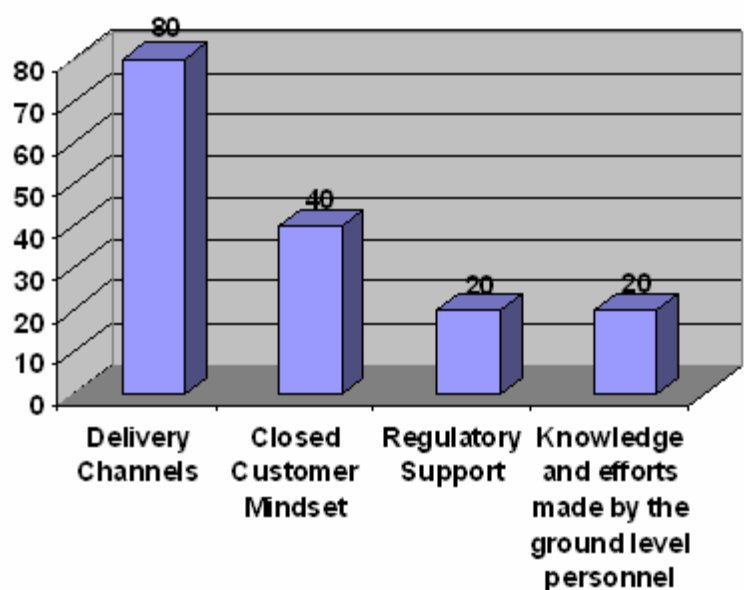
To compete with alternate means of investment, banks also provide customized and structured products and indulge in off-balance sheet activities. They strive to provide complete financial solutions<sup>f</sup>

Besides just innovative products, innovative delivery systems such as E-banking, Mobile banking etc

However, these varied services further increase the banks risk exposure and regulations such as Basel II Guidelines go a long way in preserving the interest of the middle class investor with lower risk appetite. These regulations also safeguard this sector from exogenous

spreads, the potential fragility of hedge funds to the prospects for financing and growth in tl<sup>f</sup> these span from spheres such as health insur. Travel Cards. commodity derivatives, private banking, forex services, investment advisory services in bonds, mutual funds, investment in "Pure Gold" , Senior Citizens Savings Schemes etc.

**Hindrances Faced During Introduction of New Products**



shocks that often wreak the financial markets, such as the recent sub-prime mess or the Asian crisis.

The Annual Survey (2006) carried out by FICCI<sup>[5]</sup> highlights that regulatory support was not a major hindrance towards innovation.

On an average an Indian bank sells 1.4 products to every customer compared to other countries (1.8 Spain, 2.6 UK, 2.7 Norway, 3 France). This figure is improving steadily.

However to facilitate further innovation, we must usher in a culture of systematic and institutionalized innovation with clearer organizational processes such as the stage-gate system (where ideas pass through stages to verify their feasibility) to foster innovation, a system of higher incentives and rewards, a more customer-oriented approach, data mining techniques and efficient use of technology. Creative partnering with competitors and other financial entities can also foster growth and improve operating efficiencies. (Ex: Franklin Templeton tie-up with Central Bank of India)

### **Hedge Funds - The Way Forward for SEBI**

Though hedge funds are not regulated, they are subject to market abuse laws and anti-money laundering procedures.

The existing regulations regarding FII's and sub-accounts already set in certain safeguards (Refer Appendix C). Moreover, FII cannot invest in currency or commodities which limits currency trading or investment in commodity related financial products as options for any hedge funds under the present FII Regulations

SEBI itself has proposed certain guidelines such as minimum 20% contribution into the fund by institutional investors, minimum experience limit for fund manager etc. (Refer Appendix D)

I would recommend that initially, the amount of investments made by these funds can be restricted (in terms of total market exposure) so as to minimize the impact of a

withdrawal if any. Eventually these restrictions will also have to be done away with to align the markets to the global markets

Another way to make hedge funds safer for retail investors is to allow mutual funds to invest in funds of funds. These funds of funds are listed and traded on stock exchanges and are subject to regulations.

There should also be guidelines for the marketing of these products to ensure that the investors get complete information about the risks associated and also of the various options available to them

Also, eventually we would need a database for the hedge funds in India for information on their performances etc. There are some databases such as HedgeFundIntelligence, HFR, TASS database etc none provide detailed information on the Indian scenario

### **Which is better? Hedge fund or banks?**

To compare the two, we have to consider various perspectives, that of the investor, the market and the country.

From an investors perspective, the choice of investing in hedge funds or banks (via the banks products or investing in the banking sector via stock market) would be contingent on the risk profile of the investor.

The risks associated with the banks are primarily the credit risks, market risks and the operational risks. Due to the various regulations and the conformance to the Basel framework, investing with banks is definitely a less risky proposition.

For a risk averse investor the banks offer lesser returns but at a lower risk. The hedge funds do not fare very well in terms of Sharpe ratio, kurtosis and skewness<sup>g</sup>. Hence, hedge funds may not be all that desirable due to the higher returns

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<sup>g</sup> The hedge fund universe exhibit lower standard deviation than equities but also undesirably high kurtosis and considerable negative skewness.

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**Descriptive Statistics for Various Hedge Fund Categories, 1995–2003**


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Fund Type	Annual		Monthly		Sharpe Ratio	Skewness	Kurtosis
	Return	Standard Deviation	Return	Standard Deviation			
Convertible arbitrage	11.42%	15.56%	0.86%	1.40%	0.46	-0.50	6.61
Dedicated short bias	-0.01	23.82	0.25	5.75	-0.18	0.65	4.15
Emerging markets	14.19	44.09	0.71	5.06	0.23	-0.66	5.11
Equity market neutral	5.56	13.08	0.57	0.93	0.10	-0.62	4.22
Event driven	9.71	17.73	0.83	1.58	0.31	-1.50	10.61
Fixed-income arbitrage	7.04	17.70	0.58	1.08	0.16	-2.03	9.16
Fund of funds	6.67	15.97	0.51	1.79	0.15	-0.13	6.43
Global macro	6.79	24.15	0.38	2.03	0.11	0.09	3.00
Long-short equity hedge	10.33	29.91	1.01	2.89	0.20	-0.09	4.34
Managed futures	7.68	23.22	0.51	2.49	0.15	0.09	2.87
Other	11.42	29.71	0.75	1.79	0.24	-1.28	8.57
Hedge fund universe	8.82	9.21	0.70	1.99	0.50	-0.25	2.51
CSFB	13.41	10.36	1.05	2.45	0.89	0.07	1.90
S&P 500	12.38	21.69	0.93	4.70	0.38	-0.64	0.28
U.S. T-bill	4.20	1.78	0.34	0.14	0.00	-0.89	-0.80

Source <sup>h</sup>

In a country like India, most investors are risk averse (unlike in countries like US) and hence for the larger majority, traditional banks are a better option.

From the markets perspective, the traditional banks are very important from the point of view of financing and maintaining stability. The hedge funds may result in instability if they pull out in large numbers or incur very high leverages. Especially in events such as the sub-prime crisis, hedge funds may pull out from the Indian markets where they have got good returns to send funds back to their countries. However, the exclusion of hedge funds would be inhibiting the markets from achieving a natural progression to more evolved strategies. Moreover they help achieve pricing efficiencies and liquidity. However, for systemic stability, SEBI should enforce certain guidelines to ensure that the Indian markets are not affected adversely and these can be eased gradually to help the Indian markets adjust.

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<sup>h</sup> Hedge Funds: Risk and Return - Burton G. Malkiel and Atanu Saha

Also, hedge funds are regulated by SEBI while banks are regulated by RBI. Both these entities have different guidelines that will impact the future of the investment opportunities.

### **Conclusion**

With the pace of globalization and the increasing linkages between the various markets and the instruments, it is imperative to allow hedge funds in India. However, keeping in mind the nascent stage of the Indian market and the increasing investment by institutional investors in these funds, these have to be regulated by SEBI to gradually introduce these funds in the market through legitimate routes. For the systemic stability of India, the role of banks cannot be downplayed and for a risk averse investor, banks offer a better investment opportunity. Keeping the increasing risk appetites in India also, hedge funds will turn out to be important investment opportunities.

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## **APPENDIX**

### **Appendix A – Common characteristics of hedge funds**

The common characteristics of Hedge Funds are:-

- Their Objective is to get “absolute” returns and are often not benchmarked against any index, unlike Mutual Funds or other equity related investments
- Are organized as limited partnerships, an offshore fund, or a specialized kind of separate account.
- Use wide array of strategies (Briefly mentioned in the appendix)
- These are usually smaller firms
- Have fewer restrictions/regulations governing their investment styles but limit their marketing as they cannot target all investors
- Asset based fees and a higher percentage of Performance Based Fees
- Are Pass Through entities that limits the taxation to investor level, bypassing the fund

Mutual Funds, Private Equity funds, Commodity pools and Venture capital funds are often said to be similar to hedge funds. They do share varied similarities with hedge Funds but differ on some account or the other. Ex:- The investment concentration in commodity futures distinguishes commodity pools from hedge funds.

### **Appendix B - A Brief Overview of the Strategies Employed by Hedge Funds**

The hedge funds represent a distinctive investment style and employ an array of investment techniques. These strategies make the funds vary in terms of their *investment returns, volatility, and risk*. The major strategies comprise:-

(Source : [http://en.wikipedia.org/wiki/Hedge\\_funds](http://en.wikipedia.org/wiki/Hedge_funds))

**Global macro** – seeking assets that are mispriced relative to global alternatives.

**Arbitrage** – seeking related assets that have deviated from some anticipated relationship.

- Convertible arbitrage – between a convertible bond and equity.
- Fixed income arbitrage – between related bonds.
- Risk arbitrage – between securities whose prices appear to imply different probabilities for an event.
- Statistical arbitrage (or 'StatArb') – between securities that have deviated from some statistically estimated relationship.
- Derivative arbitrage – between a derivative security and the underlying security.

**Long / short equity** – generic term covering all hedged investment in equities.

- Short bias – emphasizing or investing solely short.
- Equity market neutral – maintaining a close balance between long and short positions.

**Event driven** – specialized in the analysis of a particular kind of event

- Distressed securities – companies that are or may become bankrupt
- Regulation D – distressed companies issuing securities
- Merger arbitrage - between an acquiring public company and a target public company

### **Appendix C -Relevant Provisions of FII Regulations:**

Though hedge funds are not an excluded category of foreign institutional investors under the SEBI (FII) Regulations, 1995 they are, however, by virtue of not being regulated by securities regulators in their place of incorporation or operations, cannot come as FII under the present provisions of SEBI (FII) Regulations. Regulation 6 (i) (b) of the FII Regulations require an FII applicant to be a regulated entity in its place of incorporation or operations.

The FII Regulations allow sub-accounts sponsored by registered FIIs to invest in India. Regulation 2 (k) defines “sub-account” which “includes foreign corporates or foreign individuals and those institutions, established or incorporated outside India and those funds, or portfolios, established outside India, whether incorporated or not, on whose

behalf investments 38 are proposed to be made in India by a foreign institutional investor”.

Further, provisions of the regulation 13 lay down the conditions and procedure for granting registration to a sub-account of an FII. Hedge Funds of almost all variations can meet the requirements of sub-accounts if they are ‘fit and proper’ persons. However, based on (an internal administrative decision) if an applicant indicates in the application that it is a hedge fund, the consideration of the application is withheld. Since granting of registration to FII/sub-accounts is based on the disclosure of details and on the undertaking given by the applicant in the application form, it could be possible that a few entities who described their activities in the application form in terms other than hedge funds could have already got registration as sub- accounts. However, it must be remembered that all sub-accounts have to be sponsored by registered FIIs who are required to be regulated entities by the relevant regulators in their home countries.

Chapter II of the SEBI (Foreign Institutional Investors) Regulations, 1995 inter alia list out the instruments in which an FII/sub-account can invest. The regulation does not include currency or commodities as eligible instruments for investment for the FIIs. Therefore, currency trading or investment in commodity related financial products will not be an option for any hedge funds under the present FII Regulations

#### **Appendix D – Proposed guidelines by SEBI**

SEBI itself has proposed certain guidelines for hedge funds in India that includes the following clauses:-

1. The investment adviser to the hedge funds should be a regulated investment advisor under the relevant Investor Advisor Act or the fund is registered under Collective Investment Fund Regulations or Investment Companies Act .
2. At least 20% of the corpus of the fund should be contributed by the investors such as pension funds, university funds, charitable trusts or societies, endowments,

banks and insurance companies. The presence of institutional investors in the fund is expected to ensure better governance on the part of the fund manager and fund administrators and help fund managers to take a long term perspective of the market.

3. The fund should be a broad based fund in terms of the SEBI (Foreign Institutional Investors) Regulations
4. The fund manager or investment adviser must have experience of at least 3 years of managing funds with similar investment strategy that the applicant fund has adopted. This provision is expected to allow well managed funds to access our market and protect it from adverse effects of 'trial and errors' by uninitiated rookies.