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Hedge Funds verses Mutual Funds: A Review

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Abstract

When it comes to shaping the economy, mutual funds have contributed significantly. The Indian financial market had witnessed a great rise in the early eighties and nineties. Money markets and the Government securities market have also been benefitted from the increased mutual fund investments. However, the limited availability of short-selling and derivatives transactions in emerging markets drew attention towards new investment options in emerging economies like, India. An eighty year old product 'hedge funds' were allowed in India with the permission of Securities Exchange Board of India in the year 2012. The hedge fund tries to hedge risks to investor's capital against market volatility by employing alternative investment approaches. Nevertheless, both mutual funds and hedge funds have persisted to be well established investment alternatives in recent years. It is a lingering debate on the actual purpose of what mutual funds serve and what hedge funds serve. This paper tries to explore the key similarities and differences between the both. The paper further tries to study the applicability of both the funds in different market conditions through a thorough literature review.

Keywords: *Mutual Funds; Hedge Funds, Differences, Similarities.*

Introduction

The new trends in the personal finance focus on the popular issue of wealth allocation across different assets classes and alternative investments. Among these, mutual funds are the investment vehicles which pool the securities like, stocks, bonds, money market instruments and much more (Prather, et. al., 2004). Hedge funds are the actively managed portfolios of investments that use advanced investment strategies like, leverage, short selling and derivative positions in domestic and international markets with the objective of high returns (Fung and Hseih, 1999). Mutual funds and hedge funds have differences in their fees, leveraging, pricing strategies, regulatory frameworks and liquidity practices they employ. Usually, there characteristics differ with the different types of investors involved in them. Mutual funds are the most strictly regulated financial products and are subjected to multiple requirements to ensure they operate in the best interests of their shareholders. Hedge funds are private investment pools subjected to far less regulatory oversight (https://www.ici.org/files/faqs_hedge).

Mutual funds have not been subjected to harsh criticism because various regulatory norms confine them from investing into derivatives and taking extreme leveraging positions in the market. However, several mutual funds have been accused for charging high fees in the financial markets as well (Daniel, et. al., 2005). Whereas, hedge funds because of their loose oversight in activities and lesser disclosure requirements, have been criticized in the financial markets. However, tremendous growth of hedge funds in recent years has made them widely popular among the wealthy set of investors because of their high risk high return profiles (Engelhard, 2012). The performance of hedge funds was measured in absolute terms. Comparing mutual funds with that of hedge funds, it was found that during bad years, the biggest mutual funds winners were the ones who

held the most cash, since mutual funds did not go short, that is, sell shares that they did not own in hopes of buying them back at a lower price whereas in sharp contrast, hedge funds were less constrained than typical mutual funds. Hedge funds were not limited to investing in or trading any particular asset. They dealt in currencies, commodities, bonds and stocks also. Also they could be short or long anything they traded in as their default option was not cash. As a result of less constraints and high level of volatility in many of the commodity markets along with the leveraged access to trade those markets, hedge fund managers made extra ordinarily high returns (Totala, et. al., 2014).

Rationale

A sound knowledge of investing into financial markets into any economy gives the optimum returns to an investor. To make the most of their participation in the stock market, all investors should have at least an elementary understanding of the types of investment options available and how these options can help grow their asset portfolio. Hedge funds and mutual funds are two such alternative options in asset classes. Although often confused with one another, these funds are distinct vehicles designed to interact with the stock market in unique ways (http://online.pointpark.edu/business/hedge-fund-vs-mutual-fund/). Mutual funds and hedge funds both invest in variety of stocks and bonds and aim to make money for their investors. The operations and the potential upsides and the downsides of both the asset classes are necessary to understand (https://budgeting.thenest.com/mutual-funds-vs-hedge-funds-3913.html). Many investors are obsessed with hedge funds and look upon the mutual funds as disregards. There is a need to layout the basics of both hedge funds and mutual funds and to know what makes them similar and what makes them different. Hence, the rationale of the study is to clearly portray the exact utilities of mutual funds and hedge funds so that the investors can attain the desired returns with their individual risk profiles in the prevalent fragile financial markets by proper selection of investment vehicle and tools inter alia.

Objectives

To study the similarities between mutual funds and hedge funds.

To study the differences between mutual funds and hedge funds.

To study the applicability of mutual funds and hedge funds in different market conditions.

Research Methodology

The research study carried out is exploratory/descriptive and qualitative in nature. It is based on secondary data. The secondary data used in the study has been sourced from various journals, websites, SEBI, literature survey, summary of different souvenirs, and other publications in the public domain.

Review of Literature

Mutual Funds Basics

A mutual fund is an investment scheme that is professionally-managed and run by an asset management company which brings a group of people together and invests their money in stocks, bonds and other securities. Mutual funds are like baskets that hold certain types of stocks, bonds or a blend of stocks and bonds to combine for one mutual fund portfolio (https://www.printfriendly.com/print?customCSSURL=&disableClickToDel=0&disableEmail=0&disablePDF=0&disablePrint=0&headerImageUrl=&h). A mutual fund offers an opportunity to make diversified and professional investments at comparatively a lower cost (https://keydifferences.com/difference-between-hedge-fund-and-mutual-fund.html).

Hedge Funds Basics

Hedge fund is a private investment partnership and funds pool which uses variety of complex proprietary strategies and invests or trades in complex products, like listed and unlisted derivatives. A hedge fund is a pool of money that takes both short and long positions, buys and sells equities, initiates arbitrage, and trades bonds,

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currencies, convertible securities, commodities and derivative products to generate returns at reduced risk. Hedge fund tries to hedge risks to investor's capital against market volatility by employing different alternative investment approaches (https://www.printfriendly.com/print?customCSSURL=&disableClickToDel=0&disableEmail=0&disablePDF=0&disablePrint=0&headerImageUrl=&h).

However, these are unregistered private investments that use diverse range of techniques for trading and invest in diversified and risky securities (https://keydifferences.com/difference-between-hedge-fund-and-mutual-fund.html).

Evolution

The inception of Unit Trust of India in the year 1963 marked the evolution of the Indian mutual fund industry with the basic objective to attract the small investors or retail investors for investment which was made possible through the combined efforts of the Government of India and the Reserve Bank of India (http://shodhganga.inflibnet.ac.in/bitstream/10603/36578/3/03_abstract.pdf).

The hedge fund term originated in an article by Carol Loomis in 1966 with the title 'The Jones Nobody Keeps Up With' published in Fortune, Loomis' article shocked the investment communities by describing something called a 'hedge fund' run by an unknown sociologist named Alfred Jones (Fortune, 1966). SEBI in May, 2012 issued The Securities and Exchange Board of India (Alternative Investment Funds) Regulations 2012 popularly called as AIF Regulations to govern the establishment as well as the operation of various types of alternative funds in India. The AIF Regulations were introduced and category III AIFs is hedge funds. This was the time when hedge funds officially entered Indian financial market (www.sebi.gov.in).

Organizational Structure

Mutual funds usually involve sponsors like banking institutions, insurance companies, broking firms, etc. Investors of mutual funds may also purchase them without any intermediary. Independent directors manage mutual funds and are generally the investment advisors and charge some fees. There are money managers for these funds who usually are responsible for executing transactions (Engelhard, 2012). Hedge funds are organized as private partnerships and incorporated offshore for tax reasons and are limited to 500 investors. A private pool of investment capital is organized into a limited partnership to invest in a portfolio made up of a variety of securities (Ballew, et. al., 2002).

Classification and Strategies

Mutual funds are classified in four parts: open ended, close ended, Unit Investment Trusts (UTI) and Exchange Traded Funds (ETFs). In open ended funds, investors can buy and sell their shares at the end of each trading day at the Net Asset Value (NAV). Close ended funds can only issue the funds in their initial public offering and gets redeemed at the aforesaid maturity date. UTI's are the portfolios that are not open for change. ETF's are traded on the exchange and are usually close ended in nature. Mutual funds commonly apply strategies like money markets which invest mostly in fixed income securities, bond funds which again invest in non-government fixed income securities, stock/equity funds which invest in common stocks, hybrid funds which are characterized by a portfolio consisting of bonds as well as common stocks, and index funds which are also referred as passively managed funds try to match the performance of stock indices of the countries. Investors in mutual funds inform themselves about the fund's prospectus and the securities the fund aims to invest in (Engelhard, 2012). In mutual funds, the managers are required to adhere to the types of strategies described by the fund when it was first established. Their success is determined by the direction of the market. Thus, the securities they invest in tend to be relatively safe (http://online.pointpark.edu/business/hedge-

fund-vs-mutual-fund/). Hedge fund managers have a wider range of investment vehicles and trading strategies available to them. Because of this diversity, hedge funds are grouped by investment strategy, rather than merely by the type of securities they hold. Strategies are a combination of security type, position type (long or short), and trading style. The strategies include convertible arbitrage, event driven, market neutral, funds of funds, emerging markets, etc. (Ballew, et. al., 2002).

Fees

Mutual funds charge following types of fees: expense ratio which is usually a running fee of the fund, management fee is paid to the managers of the fund and load fee which is generally a sales charge or a commission charge paid by the investor for buying and selling the securities in the fund (Engelhard, 2012). Mutual funds have limits to the amount of fees they can charge, and all investor documents must contain them in a prominent place (http://online.pointpark.edu/business/hedge-fund-vs-mutual-fund/). Hedge funds typically receive compensation in two ways: an annual management fee which is based on a percentage of total assets and an incentive fee which is based on a percent of the gains. However, the incentive fee is sometimes limited with a high water mark that states that the manager only receives gains relative to the highest level the fund has reached (Ballew, et. al., 2002).

Regulations

Mutual funds are highly regulated in comparison to hedge funds. The regulations for mutual funds are far more stringent than those of hedge funds. The regulatory requires mutual fund companies to register with the government before they even begin to work with the public on any investment activities. Furthermore, mutual funds are subject to numerous regulatory bodies and must comply with tax rules set forth by them (http://online.pointpark.edu/business/hedge-fund-vs-mutual-fund/). Mutual funds are also restricted to make the fundamental changes in the structure without the approval of the stake holders. These funds are limited in their fundamental styles and, hence, cannot use the full market potentials due to numerous legislations (Bergshoeff, 2011). Mutual funds are closely regulated entities. The amount of risk that they can take is defined by law. Since mutual funds are in possession of retirement savings of millions of people, the government oversees their functioning to ensure that they do not undertake any sort of speculative investments. However, critics believe that the government also filters out some of the best investment opportunities with its high handed regulation (https://www.managementstudyguide.com/hedge-funds-and-mutual-funds.htm). The legal structure of hedge funds is intrinsic to their nature. Flexibility, opaqueness, and aggressive incentive compensation are fundamental to the highly speculative, information-motivated trading strategies of hedge funds. These features are in conflict with a highly regulated legal environment. Hedge funds are almost always organized as limited partnerships or limited liability companies to provide pass-through tax treatment. The fund itself does not pay taxes on investment returns, but returns are passed through so that individual investors pay the taxes on their personal tax bills. If the hedge fund were set up as a corporation, profits would be taxed twice (Connor and Woo, 2004). Hedge funds are clearly recognizable by their legal structures. Many people think that hedge funds are completely unregulated, but it is more accurate to say that hedge funds are structured to take advantage of exemptions in regulations. It was explained that the justification for these exemptions is that the regulations are meant for the general public and that hedge funds are intended for well-informed, well-financed, private investors (Fung and Hsieh, 1999). Hedge funds have fewer regulatory restrictions than mutual funds. This allows the funds to take short positions in securities, to take on substantial

leverage and to make less detailed financial reports (Ballew, et. al., 2002).

Leverage

The regulators restrict a mutual fund's ability to leverage or borrow against the value of securities in its portfolio. They require that funds engaging in certain investment techniques, including the use of options, futures, forward contracts and short selling should cover their positions. The effect of these constraints has been to strictly limit leveraging by mutual fund portfolio managers (https://www.ici.org/files/faqs_hedge). To leverage their capital, hedge funds buy securities on margin and borrow funds from banks. Most hedge funds do use leverage to enhance their returns (Eichengreen and Mathieson, 1999). Due to the minimal reporting requirements, leverage is difficult for investors to monitor. Therefore, it is difficult for investors to correctly account for the risk they are incurring (Ballew, et. al., 2002).

Discussions

It is important to note that both the types of investments are seasoned investment portfolio vehicles. Each of them has different characteristics, qualities, compliance needs, catering to the needs of different class of investors. Mutual funds are the area where continuous regulations are needed to be complied with because of the investments from the masses having capability of low risk assumptions, whereas, hedge funds rely upon high net worth individuals and corporate. It is interesting to note that sometimes risk assumption level in case of some hedge funds is proportionately very high as compared to the mutual funds.

Conclusions

According to the first objective, it is concluded that both hedge funds and mutual funds are financial portfolios. They represent a collection of investments that are needed to be tracked regularly. They both are investing pools of money invested by a number of investors and also provide little transparency into the portfolio. Hedge funds and mutual funds charge investors management fees and operating expenses. However, there exists a world of difference. Fund investors choose to use which funds depends on their objectives and susceptibility to financial risk.

As far as second objective is concerned hedge funds on average are smaller than mutual funds. Hedge funds employ a wide range of investment tools including options, leverage and shorts. Hedge funds have more concentrated portfolios, i.e., fewer invested positions whereas mutual funds take the long side without extensively using other tools. Hedge fund is organized by the general partner and an investor in his/her own fund whereas a manager of a mutual fund is the owner and may not be a fund investor. Hedge fund managers charge a performance fee at the end of the year but mutual funds do not charge performance fees. Hedge funds are less regulated than mutual funds and have their marketing efforts limited whereas mutual funds can aggressively market themselves. The number of investors in a hedge fund is limited to no more than 100 or no more than 500 depending upon the financial strength of the investors whereas mutual funds have an unlimited number of investors. Hedge funds have high minimum investment requirements of $1 million or more, whereas, on the other side mutual funds have no minimum investment requirement. Hedge funds have lock-up periods usually of one year or more and their withdrawals are permitted with advance notice following the lock-up period. Hedge funds are not as liquid as mutual funds, on the other side, mutual funds have a per share price known as net asset value which is calculated at the end of each trading day, providing more liquidity to the fund.

As far as third objective is concerned, in difficult market periods some hedge funds put up barriers that restrict redemptions whereas investments in mutual funds are liquid and not impacted by lock-ups or any barrier.

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Suggestions

It is suggested that mutual funds and hedge funds are risk reduction investment tools. They may be used by the investors. But, who is to invest in whom, it is to be well understood; small investors having less investing wealth may prefer mutual funds having little knowledge about the stock markets. But at the same time, investors normally who are well versed with stock market operations having high investing capabilities with the capabilities of assuming higher risk should prefer hedge funds or a set of hedge funds that too in different stock markets across the globe. The persons who are willing to invest in hedge funds must focus their research on hedge funds' managers and their previous performances and the fees that they charge. But in case of mutual fund investors, more knowledge of market and market situations, types of mutual funds, their competitive and performance based positions is to be analysed by the investor himself along with timely investment and timely switching or quitting is to be decided by the investor himself.

Implications

It is implicated that both are stock market's investment tools and vehicles but their investor's class normally differs. Individual investments per investor differ a lot. Presumable risks and the volume of investments make the difference in investing both the types of the investments. Mutual funds are more have structured regulated, market driven, popular and varied nature investment tools, whereas, hedge funds are more secretive investment vehicles which are less regulated rather self regulated investment vehicles where fund manager is of prime importance. Fund manager and his previous performance are of prime concern. Hedge funds and mutual funds are complimentary to each other. Existence of hedge funds also explains maturity level and the efficiency of the market. But, a caution is needed on account of hedge funds' owners, countries and their political intentions.

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