CFA LEVEL 1

Alternative Investments

Hedge Funds

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HEDGE FUND INVESTMENT FEATURES

Hedge Fund Investment Forms

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Direct Investment Forms	Limited Partnerships or LLCs
	Master-Feeder Structures
	Separately Managed Accounts (SMAs)
	Funds of One
Indirect Investment Forms	Fund of Hedge Funds (FoFs)
	Hedge Fund Replication Products
	Structured Products with Hedge Fund Exposure

Direct Investment Forms

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Direct Hedge Fund Structures

•Hedge funds usually formed as **private limited partnerships** or **LLCs**.

•**General Partner (GP)**: Manages fund operations and receives performance-based compensation.

•**Limited Partners (LPs)**: Investors share in fund returns after fees.

•Fund documents (e.g., **private placement memorandum**) define the legal relationship.

Benefits:
•Tax efficiency, especially offshore
•Customizable terms via agreements and side letters
•Access to illiquid, complex strategies

Risks:
•Illiquidity (lock-ups, gating)
•High fees (“2 and 20”)
•Limited transparency

Key Considerations:
•Ideal for accredited/institutional investors
•Requires thorough due diligence
•Long holding periods and capital commitments

Limited Partners (LPs) vs General Partner (GP)

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Feature	Limited Partners (LPs)	General Partner (GP)
Role	Investors who provide capital to the fund	Manager who operates and manages the fund
Liability	Liability limited to amount invested	Unlimited liability for fund obligations
Control	No day-to-day control over investments	Full control over investment decisions and operations
Compensation	Share in fund profits (after fees)	Earns management fees and performance-based incentive fees
Capital Commitment	Provide majority of the fund’s capital	May contribute a small amount to align interests
Legal Status	Passive owners	Active manager with fiduciary responsibility
Examples	Pension funds, endowments, high-net-worth individuals	Hedge fund firm, managing partner

Side Letters

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Side Letters: Special Deals for Special Investors

•Customized agreements outside of standard fund documents.

•Address legal, tax, reporting, or operational needs of a specific investor.

•Can grant **enhanced information rights** or fee concessions.

•Adds complexity — critical for investor due diligence.

Master-Feeder Structures

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Master-Feeder Structure: **Maximizing Tax Efficiency**

•**Offshore Feeder Fund** + **Onshore Feeder Fund ➔** feed into a **Master Fund**.

•Pools capital (tax) efficiently from global investor base.

•Provides economies of scale and regulatory flexibility.

•Common for hedge funds targeting global investors.

Master-Feeder structures allow hedge funds to efficiently pool different types of investors into a single managed investment portfolio while optimizing for taxes and regulations

Master-Feeder Structures

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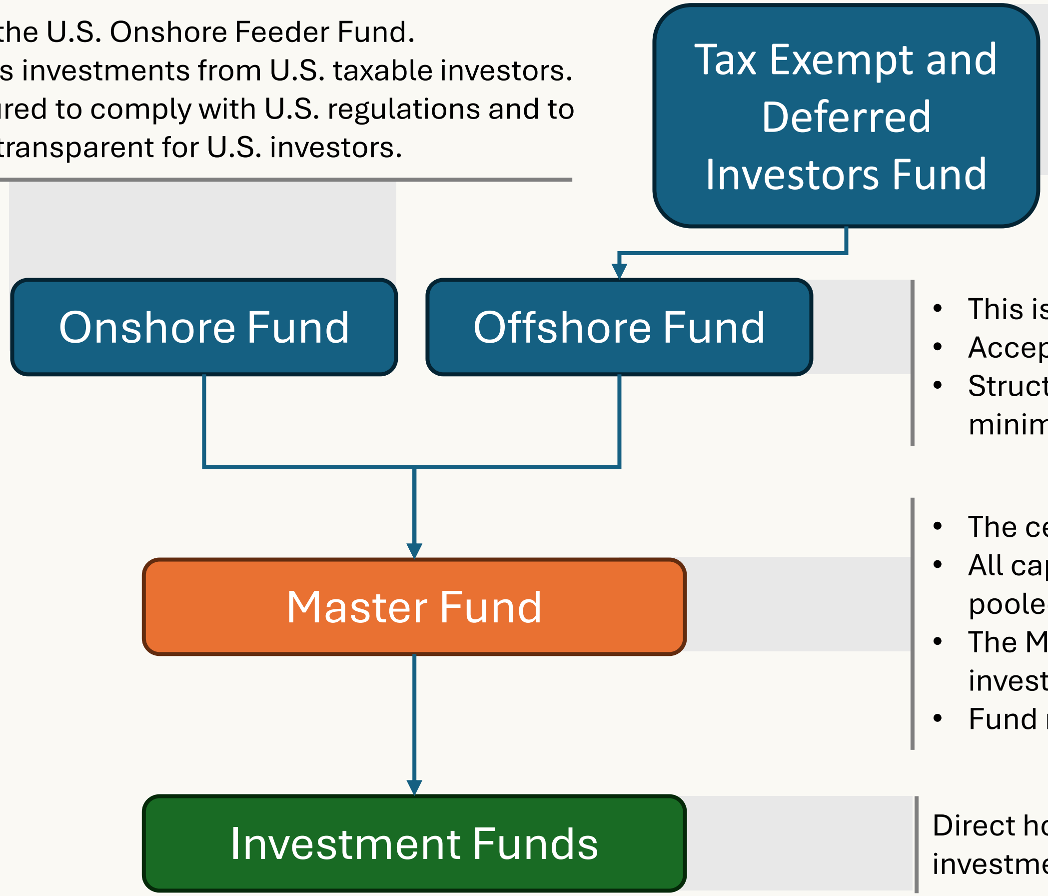

- This is the U.S. Onshore Feeder Fund.
- Accepts investments from U.S. taxable investors.
- Structured to comply with U.S. regulations and to be tax-transparent for U.S. investors.

- Accepts investments from U.S. tax-exempt entities (e.g., pension funds, endowments) and retirement accounts.
- Often structured to preserve tax advantages (e.g., avoid unrelated business taxable income — UBTI issues).

- This is the Offshore Feeder Fund.
- Accepts investments from non-U.S. investors.
- Structured in a jurisdiction like the Cayman Islands to minimize taxes and regulatory burdens on foreign investors.

- The central investment vehicle.
- All capital from the onshore and offshore feeders is pooled here.
- The Master Fund actually owns and manages the investment portfolio — stocks, bonds, derivatives, etc.
- Fund manager trades only inside the Master Fund.

Direct holdings (equities, bonds), Partnerships, Private investments, Derivatives positions, etc

Master-Feeder Structures

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Important Master-Feeder Points for CFA Exam

•U.S. taxable investors typically invest through onshore feeders.

•Non-U.S. and tax-exempt investors typically invest through offshore feeders.

•The Master Fund is where all trading happens — feeders are just pass-throughs.

•Returns and fees flow back to investors via their respective feeders.

•Fee structures (management fees, incentive fees) are typically applied at the feeder fund level but calculated based on Master Fund performance.

Fund of One and Separately Managed Accounts (SMAs)

More Control: Fund of One vs. SMA

•**Fund of One:** Hedge fund structured specifically for a single investor.

•**SMA:** Investor retains ownership of asset,; manager executes trades.

•Benefits: **Customization**, **transparency**, **liquidity, governance**.

•Downsides: **Higher minimums, complexity, oversight, lower manager alignment** (without ownership stake).

An SMA gives sophisticated investors full control and transparency —
but demands greater governance and incurs more complexity than a pooled hedge fund investment.

Fund of One and Separately Managed Accounts (SMAs)

The investor (often a large institutional client or a high-net-worth individual)retains ownership and control of their assets.
Responsibilities:
- Asset Control: The investor legally owns the underlying portfolio.
- Governance: The investor often sets specific investment guidelines or restrictions.
- Monitoring: The investor can monitor portfolio holdings, performance, and risk exposures in near-real time.
- Risk Management: Investor has oversight of the risks taken on their behalf.

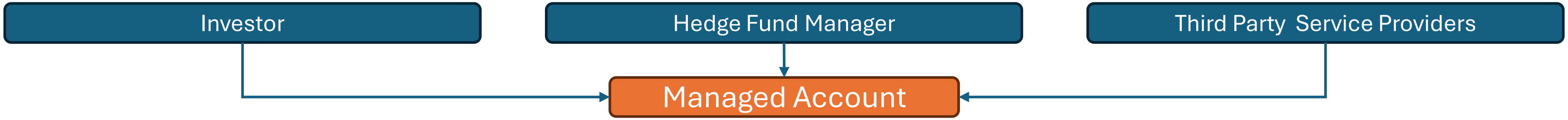
✅ In a typical hedge fund, you buy shares of the fund. In an SMA, you own the actual underlying securities directly.

Professional investment manager running the strategy.
Responsibilities:
- Investment Philosophy: The big-picture beliefs guiding investment decisions
- Investment Process: How securities are selected and portfolios constructed.
- Governance: Ensuring adherence to mandates and risk guidelines.
- Trading and Operations: Executing trades, maintaining operational discipline.
- Monitoring and Reporting: Providing regular reports back to the investor.

✅ A formal Investment Management Agreement (IMA) governs this relationship

Support entities that handle critical infrastructure tasks for the SMA.
Examples:
- Prime Broker: Provides execution, financing, and sometimes margin lending.
- Custodian: Safeguards assets, ensures legal ownership is clear.
- Accounting and Administration: Handles books, NAV calculations, reports.
- Legal, Tax, Compliance: Ensures regulatory and tax compliance.

✅ A Service Agreement connects the Managed Account with Third Party Service Providers.



✅ Think of it as a personal hedge fund account.

This is the investment portfolio created and operated in the investor's name.
Nature:
- Segregated from other clients' assets.
- Customized according to the investor's specific mandate.
- Operational hub through which investments are executed.

SUMMARY – DIRECT INVESTMENT FORMS

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Key Takeaways – Direct Investment Forms

•Hedge funds mainly structured as **private partnerships**.

•**Master-feeder structures** streamline capital and tax strategies.

•**Side letters** customize investor terms.

•**Fund of One** and **SMA** models offer increased control but higher operational burden.

Indirect Investment Forms - FoF

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Indirect Hedge Fund Access

- **Funds of Hedge Funds (FoFs):** Diversified portfolios of hedge funds.
- **Benefits:** Lower minimums, access to otherwise closed funds, more liquidity.
- **Costs:** Extra management + incentive fees → **fee layering**.
- Appeal to smaller institutions and high-net-worth individuals.

Hedge Fund Replication ETFs

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Hedge Fund Strategies Without Hedge Funds?

- **ETFs** replicate hedge fund strategies using **liquid public securities**.
- Offer **higher liquidity**, **lower fees**, and **greater transparency**.
- Limitations: **No use of heavy leverage**, tracking error vs real hedge funds.

Key Considerations:

- Suitable for cost-conscious investors seeking passive or semi-active exposure.
- Cannot replicate illiquid or event-driven strategies well.
- Increasingly used as hedge fund replication tools, though often with lower return potential.

Investment Form Liquidity Spectrum

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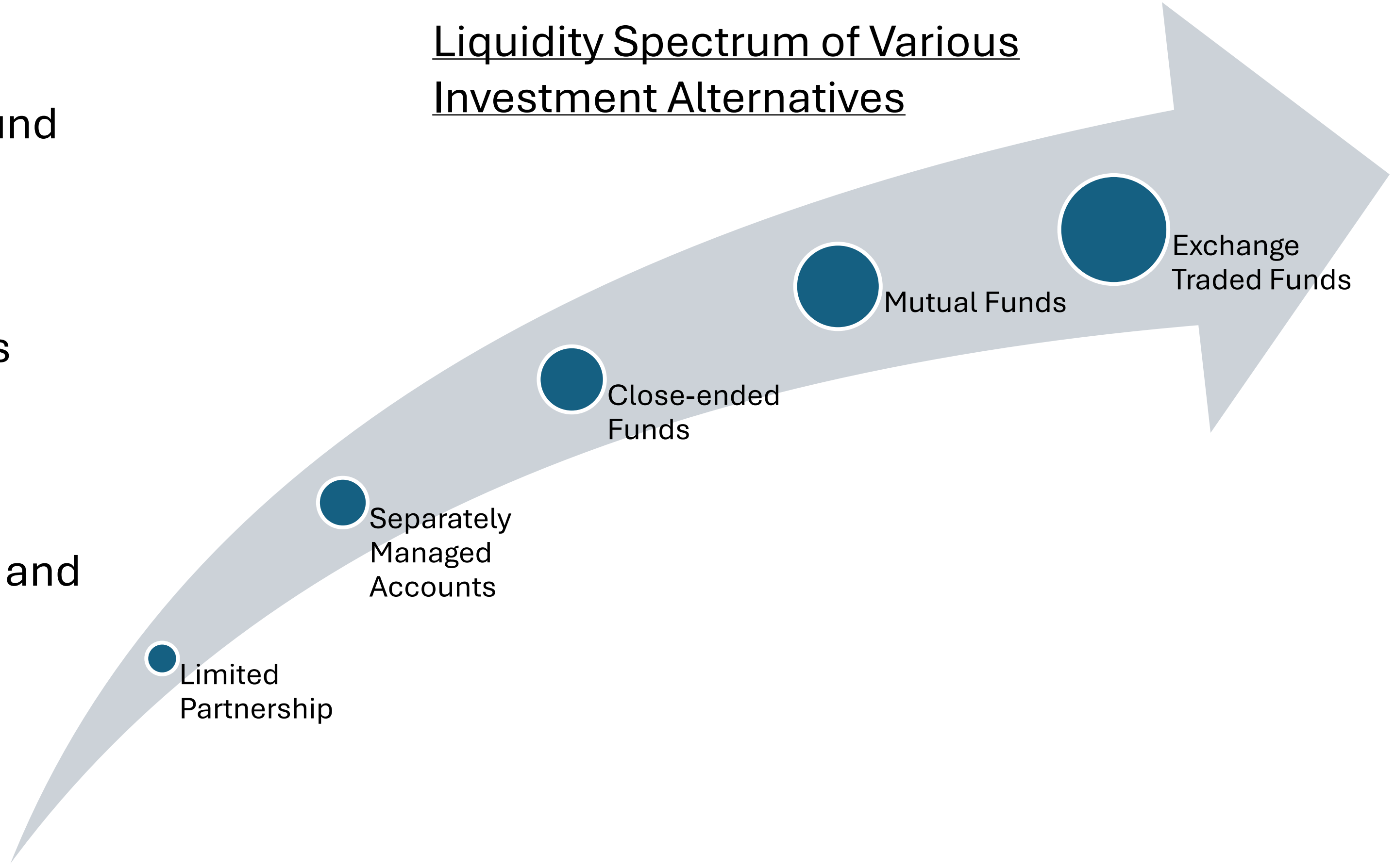
Key Takeaways

•**Funds of funds** provide diversified hedge fund exposure but at higher fees.

•**Replication ETFs** mimic hedge fund returns without the restrictions — but not perfectly.

•**Liquidity trade-offs** crucial between direct and indirect hedge fund investing.



SUMMARY – INDIRECT INVESTMENT FORMS

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Key Takeaways – Investment Forms

Indirect investment forms provide exposure to hedge fund strategies without direct ownership. These structures are designed for broader investor access, improved liquidity, and streamlined administration.

Funds of Hedge Funds (FoFs): Pooled investment in multiple hedge funds to achieve diversification, lower entry barriers, and easier redemption.

Hedge Fund Replication Products (e.g., ETFs): Use quantitative models and liquid securities to mimic hedge fund returns without investing in the actual funds.

Hedge Fund Investment Forms

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Investment Form	Type	Investor Control	Liquidity	Minimum Investment	Transparency
Limited Partnership / LLC	Direct	Low	Low	High	Low
Master-Feeder Fund	Direct	Low	Low	High	Low
Separately Managed Account	Direct	High	Medium	Very High	High
Fund of One	Direct	High	Medium	Very High	High
Fund of Hedge Funds	Indirect	Low	Medium	Medium	Medium
Hedge Fund ETFs / Replication Funds	Indirect	None	High	Low	High
Structured Hedge Products	Indirect	None	Medium	Medium	Medium

Practice Question 1

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Which of the following is NOT a benefit of a master-feeder structure?

A. Economies of scale.

B. Eases global fundraising.

C. Total avoidance of tax liability for investors.

D. Simplification of regulatory requirements.

Practice Question 1

CHARTER DOOZY

Which of the following is NOT a benefit of a master-feeder structure?

A. Economies of scale.

B. Eases global fundraising.

C. Total avoidance of tax liability for investors.

D. Simplification of regulatory requirements.

Correct Answer: C

Offshore structures don't eliminate investor tax liabilities.

Practice Question 2

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Which statement about SMAs is LEAST accurate?

A. SMAs offer customization and control.

B. SMA fee structures are simpler than mutual funds.

C. SMAs require heavier governance oversight.

D. SMAs offer better transparency than pooled funds.

Practice Question 2

CHARTER DOOZY

Which statement about SMAs is LEAST accurate?

A. SMAs offer customization and control.

B. SMA fee structures are simpler than mutual funds.

C. SMAs require heavier governance oversight.

D. SMAs offer better transparency than pooled funds.

Correct Answer: B

SMA fees are negotiated and complex — not simpler than mutual fund fees.

Practice Question 3

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Funds of hedge funds offer investors:

A. Lower fees and better performance.

B. Diversified exposure across hedge fund strategies.

C. Full avoidance of hedge fund management fees.

D. Direct control over underlying fund holdings.

Practice Question 3

CHARTER DOOZY

Funds of hedge funds offer investors:

A. Lower fees and better performance.

B. Diversified exposure across hedge fund strategies.

C. Full avoidance of hedge fund management fees.

D. Direct control over underlying fund holdings.

Correct Answer: B

Funds of funds provide diversification, but with higher layered fees.

Practice Question 4

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Which investment method is most liquid?

A. Limited Partnerships

B. SMAs

C. Closed-end Funds

D. Exchange-Traded Funds (ETFs)

Practice Question 4

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Which investment method is most liquid?

A. Limited Partnerships

B. SMAs

C. Closed-end Funds

D. Exchange-Traded Funds (ETFs)

Correct Answer: D
ETFs are the most liquid among these choices.

You Mastered

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- Direct vs Indirect hedge fund investment forms.
- Limited Partnerships. Master-feeder, SMA, Fund of Funds, and ETF structures.