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What's All the Hoopla about Hedge Funds?

By Brett Detterbeck

Much of the headline-grabbing news lately has surrounded privately organized, pooled investment vehicles commonly referred to as hedge funds. While most areas of the market have lagged for several quarters, hedge funds have boasted of consistent, positive returns. However, the increased popularity may not capture the fact that a hedge fund investment is not appropriate for everyone. As noted within this article, hedge funds can be very risky in practice. The general consensus is that only investors of high net worth (greater than \$10 million) that are willing to risk a lot of money should consider these loosely regulated instruments. Nonetheless, this \$560+ Billion industry is only getting bigger and is an area within the market that all investors should be at least familiar with.

Hedge funds have grown in popularity recently because of several factors. The economic boom in the late 90's produced an increase in the number of "high net worth individuals" ready to invest in anything with attractive returns. And with the broad equity market currently viewed as stagnant, hedge funds are seen as the surest alternative. Hedge funds are perceived to have high returns. Unfortunately, most studies are prone to survivorship bias, meaning that these studies only use the results of current funds that have been successful and don't include those with less than superior returns that have fallen by the wayside. Another factor is that derivative and other leveraged markets (options,

futures, etc.) have become larger and more liquid. More people are familiar with these and are less likely to shy away from what was once perceived as a highly speculative area. And most importantly, hedge funds tend to have diversification benefits due to their low correlation with the equity market and most other asset classes. This falls back to the idea behind Modern Portfolio Theory that says an asset that is uncorrelated with a portfolio and that has a positive expected return can improve the risk-adjusted return of the overall portfolio. Unfortunately, finding hedge funds with these characteristics can prove to be a difficult task.

So what is it about the hedge funds that theoretically enable them to create consistent, positive returns? There is a universe of different strategies and segments that managers can use – fundamental long/short, quantitative long/short, arbitrage, global mispricing, etc. - but I'll only focus on a couple key issues. Unlike your traditional mutual fund, the hedge fund can "short". To short a stock is to sell it now with hopes that it will go down and subsequently purchase it later at a lower price netting a profit. It is the opposite of buying the stock, or going long, in anticipation of selling it later at a higher price. With a traditional mutual fund, no matter how good the portfolio manager is, if the market is getting killed, most likely his fund is also down.

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FAMILY LIMITED PARTNER-

By Les Detterbeck

Family Limited Partnerships are thriving. Despite the Internal Revenue Service's attempts to restrict their use and benefits, carefully structured and implemented Family Limited Partnerships ("FLPs") remain valuable family planning tools. The key is to avoid I.R.S. landmines in creation, implementation and operation of FLPs in order to maximize their benefits to the family.

By way of quick review, families use FLPs to hold, operate, and transfer family businesses as well as to centralize investment activity and teach business skills to younger generations. Ownership of the FLP is divided into two parts, general and limited partnership units. Typically, the general partner units only account for 2 or 3% of the partnership, yet these units control the management of the whole entity. The limited units (often 97 or 98%) have no control over the entity, but rather hold a "piece of paper" indicating their silent ownership. A typical FLP would structure the parents as the "controlling" general partners and the children as the silent limited ones. The limited partners



Wonderful Planning Vehicles but Watch Those "Land Mines"

would have almost no control over the partnership or its assets. Properly structured, the FLP provides a great mechanism to transfer considerable wealth to future generations at discounted values for gift and estate tax purposes. This is because the limited partnership units can be sold or transferred to family members at considerable discounts due to the fact the limited units represent a minority interest in an investment that an outside third party would not value as highly as the underlying assets of the FLP. Who wants to buy an illiquid, minority interest that may produce no cash flow?

Predictably, the I.R.S. has attacked the use of FLPs to produce valuation discounts. Since they haven't been successful in stopping FLPs generically, they have attacked individual FLPs specifically. Common themes of attack are that the FLP lacks a sufficient business purpose and that the formation of the FLP and subsequent disposition at the death of the controlling partner were a single transaction. They have attacked restrictions of sales of assets and partner withdrawal. They scrutinize creation, implementation and operation details in their attempt to

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Hedge funds have the luxury of offsetting this systematic, or market, risk by taking short positions. One strategy that uses this to the fullest extent is the Market-Neutral Strategy, which tries to completely eliminate beta, the measure of market risk, from the overall portfolio. The manager doesn't care if the market goes up or down; he only cares about alpha – how much his long positions go up and, equally important, how much his short positions go down. It's no longer about the market; it's all about security selection.

Hedge funds also use leverage to augment return on investment. With the use of derivatives, leverage can reach a ratio of 2:1 or even higher. This enables managers to produce effective returns from the smallest of mispricings in the market. At the same time, additional leverage means additional risk. As seen in the case of Long-Term Capital Management, leverage without effective risk management can cause a severe crisis. There are many other factors that need to be considered when evaluating if a hedge fund is for you:

1 – Lack of regulatory oversight: The “fund” is quite different from the traditional mutual fund, in that it is typically set up as a limited partnership. You, as the investor, become a limited partner while the general manager manages the fund. Under this structure, the hedge fund is not required to register with the U.S. Securities and Exchange Commission (SEC). Because of the lack of a regulatory watchdog, there has been a history of bad operations and shady characters taking a stab at this potentially lucrative business. People with no experience and no credentials have persuaded unknowledgeable, innocent investors into giving away the family nest egg. Also, this lack of regulatory oversight means little or no disclosure of fund investments. Most managers don't want to reveal their tricks of the trade, thus there needs to be a commitment of trust by the investor to basically take the manager's word on what is going on in their portfolio.

2 - High turnover can mean high taxes: Most hedge funds are characterized by high turnover that can lead to taxable events. For the taxable investor hoping to achieve the double-digit returns showcased in the brochure, he/she may be surprised when taxes wipe out close to half of that. Tax-exempt accounts are much more suitable for these investments.

3 - High minimums and other standards: Until recently, the minimum to invest in a hedge fund was \$1 Million. Some hedge funds will only talk to investors of net worth greater than \$25 Million. While minimums are starting to come down, the required amount still can represent a substantial portion of the investor's available assets and may not be prudent for the smaller investor. Also, some of these funds attention has shifted from managing the portfolio to gathering assets. Finding managers is difficult. Many of the good managers have already closed their funds and do not allow new money. Extensive due diligence is warranted.

In conclusion, hedge funds can theoretically add value to an investor's portfolio in the right circumstance. This may be tougher to do in reality as there are many risks – lack of disclosure, lack of regulatory oversight, leverage issues, etc. - that need to be analyzed for that particular investor. One of the hardest and most important factors in making the decision whether to invest in a hedge fund is finding a good hedge fund manager that you can trust to maximize returns while effectively managing risk. It's not a decision that the individual investor should do on his own - rather it is one your financial advisor, like DWM, can help you make. For more information on hedge funds, please contact us.



FLP's (Continued from page 1)

eliminate or reduce the discounts.

Accordingly, we believe that every FLP should be created, implemented and operated in a way to best meet any potential I.R.S. challenge. FLPs can provide wonderful business, family and tax benefits. Therefore, the additional time and costs (although probably small) to continually monitor FLPs is well worth it. One of the techniques we use is to follow a checklist made available to us through the Academy of Multidisciplinary Practice, Inc. (“MDP Academy”). Some of the items on the checklist include:

- The FLP should have a business purpose other than reduction of taxes
- The FLP should be setup and managed as a business; including meetings, minutes of meetings, and payment of appropriate management fees to the general partner
- The general partner should be an entity with continuity of life, for example, a limited liability company or corporation
- FLP transfers need to be supported by an appraisal, from a qualified appraiser, designed to withstand IRS scrutiny during an audit
- Investment contributions from two or more initial parties need to be analyzed with respect to possible diversification issues (investment company taxation can apply if contributions diversify the contributors' assets)
- At the time of liquidation, distributions to subsequent partners must be analyzed (due to potential taxes within the first seven years of life of the partnership to subsequent partners)

The above is just a small sample of some of the important items that affect FLPs. There are many more “land mines” that the I.R.S. would like to have partnerships step on. This is why creation, implementation and on-going monitoring by qualified wealth strategies planners are critical to a successful Family Limited Partnership.

If you have any questions about these items or would like to get a copy of the MDP Academy Checklist, please contact Les Detterbeck.



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