Scope of Hedge Fund in Pakistan

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By

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Abstract

This study analyzes and explores the Scope of Hedge Fund in Pakistan. Due to time constraint the research is limited to certain core point. Main focus is to find out the reason why Hedge fund is not started in Pakistan till yet, what are the major problems hedge fund has to encounter. What style and strategies will be successful in Pakistan and what are the main challenges that the hedge fund has to face in Pakistan. Due to shortage of primary data availability in references of Pakistan, the study is design in an exploratory form to get the maximum insight over the topic with in limited time period. Data is gathered through questionnaire and interviews both are structured. The respondents of the study are the top head of Investment banks as the investment bank play a big role in bringing Hedge funds in Pakistan economy and financial market. One interview is conducted with Dr. Ishrat Husain to find out the view of regulatory bodies over the issue. Through this research it is found that there are very few investment strategies/option available for hedge fund which can limit the huge investment style menu to very few options. And if we start hedge fund on this stage it would not as successful idea as it globally.

So, it's better to wait for same until the financial market increases or expands derivative instruments, till the government changes its policies regarding short selling and leverage and till we achieve more depth in bond and equity market. There is the need to increase volatility in the market. All these change might take the time period from three to four years. And if we starts hedge fund after making all these improvement hedge fund can do more than better this for the economy.

Chapter # 1

Background Of The Topic And Statement of problem:-

a) Introduction:-

Over the last ten years, the hedge fund market has grown dramatically. Although hedge funds have existed since Alfred Winslow Jones created the first one in 1949, the market began experiencing its most rapid growth in recent years. since the start of the bear market in stocks four year ago, hedge funds have been growing at the rate of 20% per year. A total of 8,500 such funds controls $ 1.0 trillion, up from $ 400 billion five year ago and $100 billion 10 year ago; the hedge fund market is expected to increase to 1.5 trillion in the next two to five years.

There are several factors driving the growth and interest in this area. Hedge fund provides the investor new source of return as well as opportunities for diversification. In addition to the allure of higher absolute returns, hedge funds, with generally low correlations to traditional investments, are being considered as complements to traditional investment strategies in order to improve total portfolio performance.

The research is conducted to explore the importance of hedge fund from the perspective of the Pakistani investor. Hedge fund is another good way for money management beside mutual fund and other traditional techniques, i.e. stocks and bonds. As hedge fund provide absolute return regardless of market condition so it has an ability to do better in Pakistan economy were we have great uncertainties because of instability in political and financial environment.

b) Hedge Fund:-

A hedge fund is an investment structure for managing a private, loosely regulated investment pool that can invest in both cash (physical securities) and derivative markets on a leveraged basis. Legally, it may take the form of a limited partnership, corporation, trust or mutual fund depending on where the fund is domiciled and the type of investors it seeks to attract. The domicile or legal location of the hedge fund determines the structure i.e domestic or offshore fund. As with more traditional styles of management, investor funds are allocated either in a separate account or, more typically, in a commingled fund. The hedge fund structure gives investors access to hedge fund managers with specialized investment skills.

Unlike traditional asset managers, many hedge fund managers try to create value primarily through positions uncorrelated with systematic exposure to capital markets. Instead, they seek to generate portfolio performance regardless of the direction of the capital markets.

Return opportunities come from two sources: an expanded universe of securities from which to trade; and a wider array of trading strategies implemented without the constraints of regulation common to most traditional products. For example, hedge fund strategies may access financial and commodity markets and may take Long, short, spread, option and levered positions in any of these markets. Therefore, Hedge funds provide unique risk and return characteristics that are not accessible by traditional asset management strategies. The hedge fund structure encompasses a diverse set of strategies that attempt to create value by exploiting specific arbitrage opportunities. Investment objectives vary widely among hedge fund managers. Some hedge fund strategies, such as market neutral, attempt to avoid systematic exposure to the capital markets and are true diversifiers. Other hedge fund strategies, such as equity long/short, are more sensitive to the same market factors as traditional stock strategies.

The institutional investment universe consists of traditional investments and a growing list of alternative investments. Figure 1 illustrates where hedge funds fall within the universe of investment opportunities with respect to their composition versus more traditional investments:

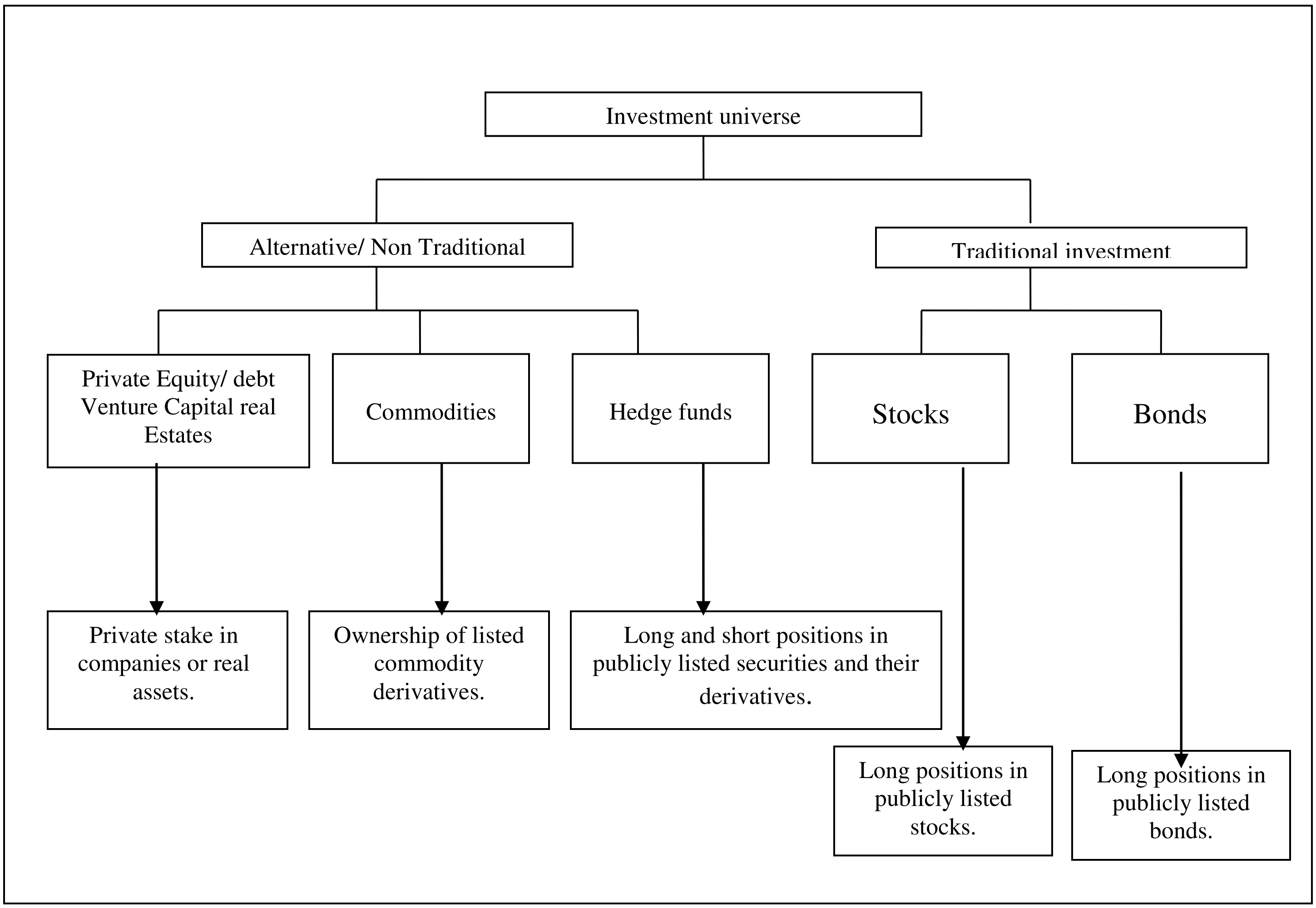


Figure # 1:- Universe Of Investment Opportunities.

c) <u>Hedge Fund Structure:-</u>

Hedge funds are structured as limited partnerships to avoid the application of most securities laws. A typical Hedge fund structure is depicted in figure **2.** There are two types of partners in a hedge fund, a GP and LPs. The GP is the entity who started the hedge fund. The GP handles all trading and day-to-day operations. The LPs contribute most of the capital but are not involved in trading or day-to-day operations. The typical entity of a GP is the limited liability partnership (LLP). The LLP is preferred because the GP of a limited partnership is liable beyond the extent of his or her investment in a limited partnership. The GP often serves as the fund manager. Sometimes the GP relies on advice by an investment adviser to identify investment opportunities.

The GP and LPs typically sign a partnership agreement. The partnership agreement sets forth some of the following items:

- Investment objectives, strategies, and risk factors.
- When partners can invest, increase investments, and withdraw from the fund.
- Details of management fees and incentive fees.
- Details of how full withdraws will be handled.

The majority of hedge funds charge the standard "one-and-twenty"-1% management fee and 20% incentive fees. The 1% fee is usually charged in 0.25% increments quarterly, in advance. There are variations in incentive fees. Most funds observe a "high-water mark". If in a given performance fee period a fund loses money, the investors will not be charged in later periods until the losses have been recovered. Another variation is the preferred return. A fund will not collect an incentive fee until a certain set rate of return has been achieved. Furthermore, most funds require a minimum duration of investments into the funds, known as a *lockup period.* The common lockup period is one year, even though a three-year lockup is not unheard of.

Investment advisor are responsible for making portfolio selections in accordance with the objective set forth in the prospectus, the advisor carry out their responsibilities pursuant to a written contracts. They are provided for the annual fee based on the percentage of the fund average net assets during the year.

An ***Administrator*** is the advisers or an affiliated entity that provides an administrative service including compliance with applicable SEC regulation and other legal issues. Fund administrators typically pay for the Office spaces, equipment, personnel and accounting services. Other responsibilities cover filling taxes and queries entertainment.

Most funds use ***bank custodians***, a separate account that segregates the investment pool from the rest of other assets. ***Fund transfer agent*** maintain records of the partner i.e. residential and office addresses, contact numbers, percentages of ownership, date of joining and withdrawal and so on.

Prime brokerage is a suite of services providing hedge funds with custody, clearance, financing, and securities lending. These services make it possible with multiple brokers while maintaining one brokerage account. A prime broker acts as the back office for the fund by providing the operational services necessary for the money manager to effectively manage a business. This enables the GP to focus on investment strategies rather than on operational issues. The services a good prime broker provides include:

- Centralized custody
- Clearance
- Securities lending
- Competitive financing rates
- One debit balance/ one credit balance
- Real time, daily, monthly, and annual portfolio accounting
- Position and balance validation
- Electronic trade download
- Wash sale reports

- Office facilities in selected markets.

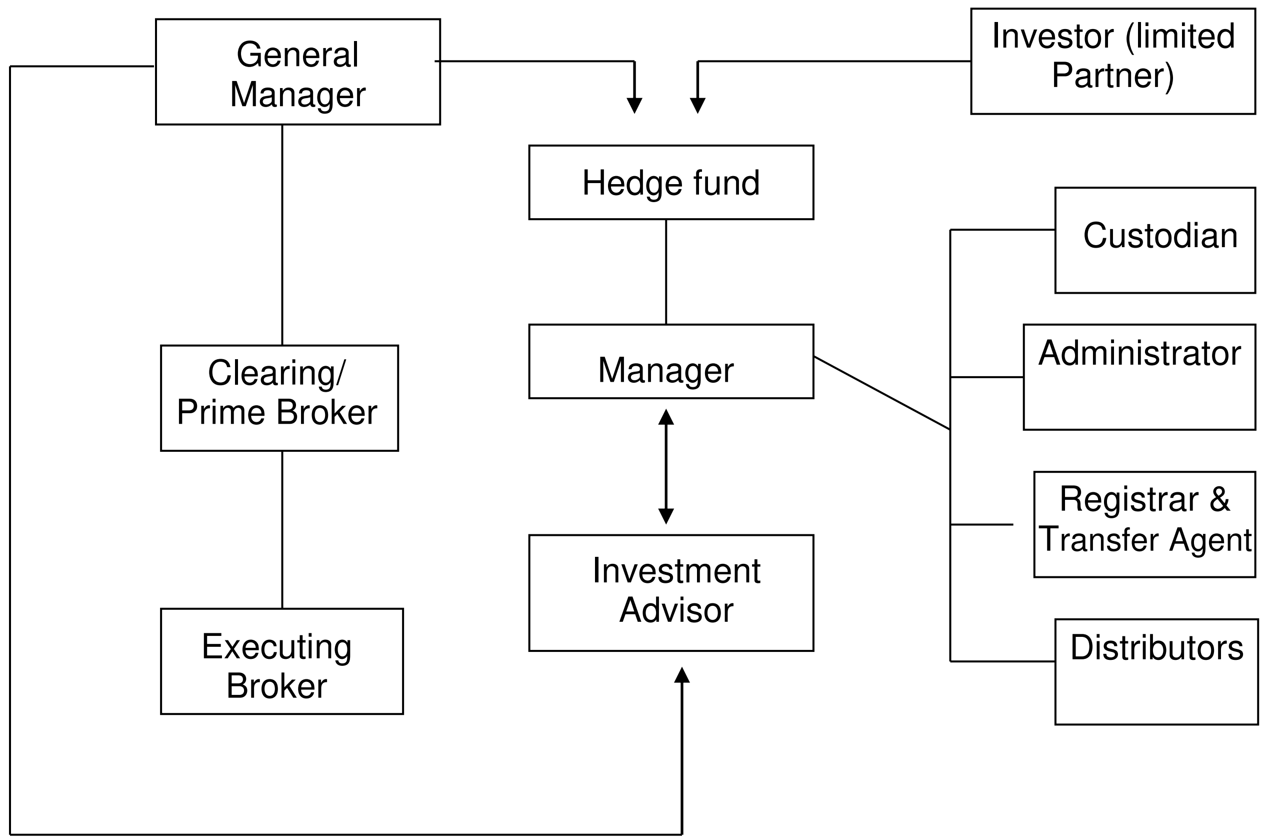


Figure # 2:- Hedge fund Structure

d) **Brief History:-**

The traditional story about the origin of hedge fund is that they were invented in late 1940's by *Alfred Winslow Jones*. Jones began life as an academic, pursuing a PhD in sociology at Columbia University in the late 1930's. He worked as a writer for *Fortunes* in the 1940s, where he became increasingly interested in the workings of the financial market. In 1949, he formed an investment partnership, "A.W. Jones and Co." which lays claims to being the first hedge fund. His fund kept going at least through the early 1970s, compiling an impressive long-term record. Jones's fund was what we will later classify as an *opportunistic equity hedge fund*. Jones's strategy was to invest in individual stocks, taking either a long position or a short position depending upon the results of his analysis. The total portfolio could be "*net long"* or "net short". And the portfolio also employed leverage to increase return so, in theory, Jones fund has the potential to do well even in the difficult market environments, which of course, being with it the possibility of doing not so well in the friendly market. Although it is a traditional to consider Jones as the founder of hedge fund business but the two contradictions are there.

First, it is likely that there were investment partnerships prior to Jones's that engaged in one or more hedge fund strategies but did not attract as much attention as Jones fund get. Benjamin Graham formed an investment in undervalued stock, and may also do some shorting, before the Jones funds. Second, if we regard Jones as the founder of the hedge fund business, other organizations were using hedge fund strategies outside the hedge fund arena. The preeminent examples of this phenomenon are the Wall Street brokerage and trading firms, who practiced (and continue to practice) a wide variety of hedge fund strategies for their own account. Some of these strategies were essentially *risk less arbitrage* (buying from one market at low price and sell in another market at high price). Other strategies involved hedging with some element of risk, and still other strategies were "directional" and "speculative" that relied on inside information.

Jones success attracted imitators. One source estimates that in 1970 there were approximately 150 hedge funds, with about $1 billion in aggregate assets. *Even Warren*

Buffet was an early participant in the hedge fund business. Buffet partnership, Ltd., started in the mid-1905s and compiled an excellent record that lasted through most of the 1960s. Buffett dissolved the partnership in 1969. In 13 year through 1969, he produced a 24 percent annualized return with no down year.

The list of early practitioners also includes *George Soros* and *Michael Steinhardt*. George Soros started his hedge fund career in 1969, launching a fund within a Wall Street brokerage firm that went on to many successes, leading ultimately to some of the problems in 2000. Steinhardt with his friends formed, "Steinhardt, fine and Berkowitz" a hedge fund, in 1967. Then the three partners unwound their partnerships in 1981 and went their separate ways.

The decade of the 1970s saw, high inflation, rising interest rate and falling stock prices globally. But commodities performed well. Oil, gold and other assets "hard assets" went into a bull market of their own as stock and bonds languished. Future and other derivatives product came into existence and attracted so many customers as they permit great deal of leverages, Future fund or commodity pool get popularity but does not have any negative impact on hedge fund performance.

The financial environment changed dramatically in the early 1980s, as rising inflation gave way to falling inflation and strong commodity prices gave way to a strong stock market. At the same time, the future markets were evolving to include futures contracts on financial assets: foreign currencies, bond and stock market indices. During 1980 and 1990s, the equity hedge fund community began to merge along the edges. Now fund managers who had solely focused on Domestic equities, became more active in foreign exchange, bonds, stock, offshore equities and some time even physical commodities. At the same time, CTA (Commodity Trading Advisors) who had begun their careers focused mainly on physical commodities became more active in financial futures and ultimately became active in the stock, bond and currency markets directly relying on future contract. So on the one hand, Fund managed by people like *Michael Steinhardt* and *Julian Robertson* evolved from being pure equity hedge funds into being Global assets allocators, for which the managers survey the entire universe of the stocks, bonds, currencies and physical commodities. On the other hand, managers like *Paul Tudor Jones*, *Louis Bacan* and *Beuce Kouner*, having as pure commodity traders, become increasingly involved in the stock and bond market. George Soros was apparently a global assets allocator right from start, equally at home with stocks, bond, currencies, and physical commodities.

The history of the hedge fund also includes such figures as *Julian Robertson* who was the stockbroker at Kidder Peabody in the late 1950s. Robertson formed the family of the hedge fund and enjoyed a great period of success from start, till it came into grief in 2000, when tech bubbles burst. The other names are; *Dennis Levine*, *Dean Witter*, *Ivan Boesky, Martin Siege, Michael Milken* and *Swensen David* and are unforgettable to mention.

e) **Hedge Funds Investment Styles:-**

1. Convertible Arbitrage.
2. Distressed Securities.
3. Emerging Markets.
4. Equity Hedge.
5. Equity Market Neutral.
6. Equity Non-Hedge.
7. Event-Driven.
8. Fixed Income: Arbitrage.
9. Fixed Income: Convertible Bonds.
10. Fixed Income: Diversified.
11. Fixed Income: High-Yield.
12. Fixed Income: Mortgage-Backed.
13. Macro.
14. Market Timing.
15. Merger Arbitrage.
16. Regulation D.
17. Relative Value Arbitrage.
18. Sector: Energy.
19. Sector: Financial.
20. Sector: Healthcare/Biotechnology.
21. Sector: Metals/Mining.
22. Sector: Real Estate.

23. Sector: Technology.

24. Statistical Arbitrage.

25. Short Selling.

26. Fund of Funds.

    FOF: Conservative.

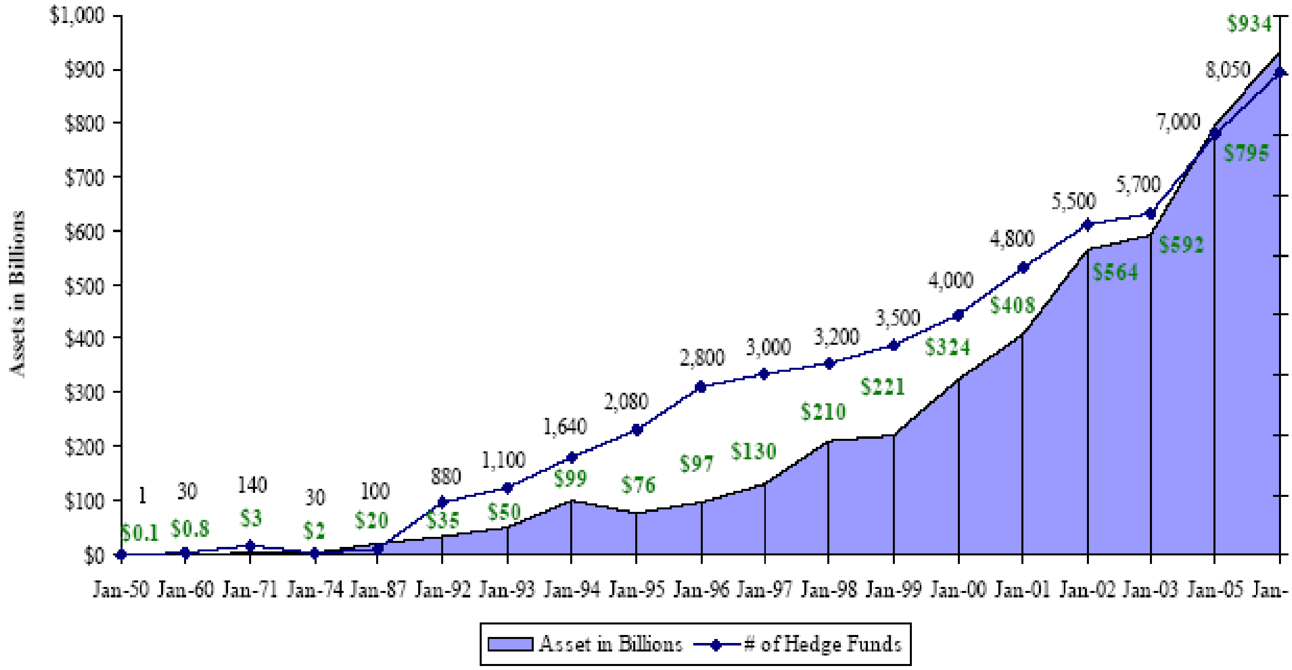
    FOF: Diversified.

    FOF: Market Defensive.

    FOF: Strategic.

f) **Present And Projected Status:-**

As evidenced below in Chart 1, the flow of global capital to hedge funds has risen dramatically over the last decade. Hedge funds have been growing at the rate of 20% per year. A total of 8,500 such funds control $ 1.0 trillion, up from $ 400 billion five year ago and $100 billion 10 year ago; the hedge fund market is expected to increase to 1.5 trillion in the next two to five years.



Source: *Hennessee Group LLC*

Figure # 3:- present status of Hedge fund.

g) **Statement Of Problem:-**

The Research Objective is to analyze "The Scope Of Hedge Fund In Pakistan". The idea is to explore the difficulties faced by the investors without Hedge funds.
The Research objective is to explore the following

1) Hedge fund will or will not Successful in Pakistan?
2) What will be the sources of Capitals for Hedge fund?
3) What Improvements are required in infrastructure and Legal Regulation?
4) Who are the potential users of Hedge fund?
5) How hedge fund operation Support the Pakistan Economy?

h) **Significance Of Study:-**

This research is helpful for those who are interested in starting Hedge Fund in Pakistan i.e. Brokerage Houses, trading Firms, Private Individual and Institutional investors. The research is also helpful for those who want to learn about the hedge fund importance within Pakistan. It is useful for all Bahria students who want to do their research in same direction and all faculty members.

i) **Scope:-**

Due to the limited time and resource availability, Research will be conduct in Karachi. The time period is for 3 month. The hedge fund is started its operation since 1949 but this research will only analyzed the data from 2000 to 2005.

j) **Delimitation:-**

There are number of delimitation that affects the validity and effectiveness of research. Some of them are government policies, performance of financial sector of Pakistan on the broadest level.

k) Definition Of Terms:-

1. CTA = Commodity trading advisor.
2. Leverage = Borrow money from other.
3. Long = A bet on rising price i.e. Buyer.
4. Short = A bet on falling price i.e. seller.
5. Net long = The value of longs exceed the value of short.
6. Net short = Short exceed the long.
7. Riskless arbitrage = Buying from one market at low price and sell in another market at high price

Chapter # 2

Research Methodology & Procedures:-

a) Research Design

b) Respondent Of The Study

c) Instruments

d) Treatment Of Data/Information/Analysis

e) Presentation Analysis

CHAPTER # 2

Research Methodology & Procedures:-

a) Research Design:-

Research is design in a way to get as much as information possible within limited time. As there is no hedge fund in Pakistan, so the primary data is conducted through interviews and questionnaire so the research is exploratory in nature. The purpose is to get the enough information that supports the research objectives. The causal study is also done to find out weather or not the hedge funds provide any good opportunities for the big investors. For this purpose investment styles of hedge fund are analyzed and also define their pros and cons. Graphical representation is used to present the data for analyzing past, present and projection trends. Interviews are conducted with sophisticated investors like PIPIC, Arif Habib, Jhangir Siddique. In the end final interview is done with the Governor, State bank of Pakistan that defines the Scope and Hedge fund in Pakistan.

b) Respondent Of The Study:-

Respondents for the research are the financial institutions specially the top heads of investments bank.

See Appendix A for detail.

c) Instruments:-

The data for research is conducted through primary and secondary Sources.

For primary Data Collection;

a) Questionnaires (structured and open-end).
b) Interviews (structured).

For secondary Data Collection;

a) Magazines.
b) Periodicals.
c) Newspapers.
d) Books.
e) Internet.

d) Treatment Of Data/Information/Analysis:-

The data gathered through the sources are analyzed by quantitative and qualitative methods and verbal analyses also done.

e) Presentation Analysis:-

The final presentation of the data is in the form of tables, graph and charts and in qualitative fame work to present the clear picture of the Scope of hedge fund in Pakistan.

Chapter # 3

Review Of Literature And Studies.

a) Explanation Of The Investment Style.

b) Hedging Strategies.

c) Benefits Of Hedge Funds.

d) Reason Of Resistance.

e) Who are the Investors?

f) A Global Hedge Fund Picture.

g) A Tactical Guide for Style Selection.

Chapter # 3

Review Of Literature And Studies.

a) Explanation Of The Investment Style:

1) **Convertible Arbitrage** involves purchasing a portfolio of convertible securities, generally convertible bonds, and hedging a portion of the equity risk by selling short the underlying common stock. Certain managers may also seek to hedge interest rate exposure under some circumstances. Most managers employ some degree of leverage, ranging from zero to 6:1. The equity hedge ratio may range from 30 to 100 percent. The average grade of bond in a typical portfolio is BB-, with individual ratings ranging from AA to CCC. However, as the default risk of the company is hedged by shorting the underlying common stock, the risk is considerably better than the rating of the unhedged bond indicates.

2) **Distressed Securities** strategies invest in, and may sell short, the securities of companies where the security's price has been, or is expected to be, affected by a distressed situation. This may involve reorganizations, bankruptcies, distressed sales and other corporate restructurings. Depending on the manager's style, investments may be made in bank debt, corporate debt, trade claims, common stock, preferred stock and warrants. Strategies may be subcategorized as "high-yield" or "orphan equities." Leverage may be used by some managers. Fund managers may run a market hedge using S&P put options or put options spreads.

3) **Emerging Markets** funds invest in securities of companies or the sovereign debt of developing or "emerging" countries. Investments are primarily long. "Emerging Markets" include countries in Latin America, Eastern Europe, the

former Soviet Union, Africa and parts of Asia. *Emerging Markets – Global* funds will shift their weightings among these regions according to market conditions and manager perspectives. In addition, some managers invest solely in individual regions. *Emerging Markets – Asia* involves investing in the emerging markets of Asia. *Emerging Markets - Eastern Europe/CIS* funds concentrate their investment activities in the nations of Eastern Europe and the CIS (the former Soviet Union). *Emerging Markets - Latin America* is a strategy that entails investing throughout Central and South America.

4) **Equity Hedge** investing consists of a core holding of long equities hedged at all times with short sales of stocks and/or stock index options. Some managers maintain a substantial portion of assets within a hedged structure and commonly employ leverage. Where short sales are used, hedged assets may be comprised of an equal dollar value of long and short stock positions. Other variations use short sales unrelated to long holdings and/or puts on the S&P 500 index and put spreads. Conservative funds mitigate market risk by maintaining market exposure from zero to 100 percent. Aggressive funds may magnify market risk by exceeding 100 percent exposure and, in some instances, maintain a short exposure. In addition to equities, some funds may have limited assets invested in other types of securities.

5) **Equity Market Neutral** investing seeks to profit by exploiting pricing inefficiencies between related equity securities, neutralizing exposure to market risk by combining long and short positions. One example of this strategy is to build portfolios made up of long positions in the strongest companies in several industries and taking corresponding short positions in those showing signs of weakness.

6) **Equity Non-Hedge** funds are predominately-long equities although they have the ability to hedge with short sales of stocks and/or stock index options. These funds are commonly known as "stock-pickers." Some funds employ leverage to enhance returns. When market conditions warrant, managers may implement a hedge

in the portfolio. Funds may also opportunistically short individual stocks. The important distinction between equity non-hedge funds and equity hedge funds is equity non-hedge funds do not always have a hedge in place. In addition to equities, some funds may have limited assets invested in other types of securities.

7) **Event-Driven** is also known as "corporate life cycle" investing. This involves investing in opportunities created by significant transactional events, such as spin-offs, mergers and acquisitions, bankruptcy reorganizations, recapitalizations and share buybacks. The portfolio of some Event-Driven managers may shift in majority weighting between Risk Arbitrage and Distressed Securities, while others may take a broader scope. Instruments include long and short common and preferred stocks, as well as debt securities and options. Some managers may use leverage. Fund managers may hedge against market risk by purchasing S&P put options or put option spreads.

8) **Fixed Income: Arbitrage** is a market neutral hedging strategy that seeks to profit by exploiting pricing inefficiencies between related fixed income securities while neutralizing exposure to interest rate risk. Fixed Income Arbitrage is a generic description of a variety of strategies involving investment in fixed income instruments, and weighted in an attempt to eliminate or reduce exposure to changes in the yield curve. Managers attempt to exploit relative mispricing between related sets of fixed income securities. The generic types of fixed income hedging trades include; yield-curve arbitrage, corporate versus Treasury yield spreads, municipal bond versus Treasury yield spreads and cash versus futures.

9) **Fixed Income: Convertible Bonds** funds are primarily long only convertible bonds. Convertible bonds have both fixed income and equity characteristics. If the underlying common stock appreciates, the convertible bond's value should rise to reflect this increased value. Downside protection is offered because if the underlying common stock declines, the convertible bond's value can decline only to the point where it behaves like a straight bond.

10) **Fixed Income: Diversified** funds may invest in a variety of fixed income strategies. While many invest in multiple strategies, others may focus on a single strategy less followed by most fixed income hedge funds. Areas of focus include municipal bonds, corporate bonds, and global fixed income securities.

11) **Fixed Income: High-Yield** managers invest in noninvestment grade debt. Objectives may range from high current income to acquisition of undervalued instruments. Emphasis is placed on assessing credit risk of the issuer. Some of the available high-yield instruments include extendible/reset securities, increasing-rate notes, pay-in-kind securities, step-up coupon securities, split-coupon securities and usable bonds.

12) **Fixed Income: Mortgage-Backed** funds invest in mortgage-backed securities. Many funds focus solely on AAA-rated bonds. Instruments include: government agency, government-sponsored enterprise, private-label fixed- or adjustable-rate mortgage pass-through securities, fixed- or adjustable-rate collateralized mortgage obligations (CMOs), real estate mortgage investment conduits (REMICs) and stripped mortgage-backed securities (SMBSs). Funds may look to capitalize on security specific mispricing. Hedging of prepayment risk and interest rate risk is common. Leverage may be used, as well as futures, short sales and options.

13) **Macro** involves investing by making leveraged bets on anticipated price movements of stock markets, interest rates, foreign exchange and physical commodities. Macro managers employ a “top-down” global approach, and may invest in any markets using any instruments to participate in expected market movements. These movements may result from forecasted shifts in world economies, political fortunes or global supply and demand for resources, both physical and financial.

Exchange-traded and over-the-counter derivatives are often used to magnify these price movements.

14) **Market Timing** involves allocating assets among investments by switching into investments that appear to be beginning an uptrend, and switching out of investments that appear to be starting a downtrend. This primarily consists of switching between mutual funds and money markets. Typically, technical trend-following indicators are used to determine the direction of a fund and identify buy and sell signals. In an up move “buy signal,” money is transferred from a money market fund into a mutual fund in an attempt to capture a capital gain. In a down move “sell signal,” the assets in the mutual fund are sold and moved back into the money market for safekeeping until the next up move. The goal is to avoid being invested in mutual funds during a market decline.

15) **Merger Arbitrage**, sometimes called Risk Arbitrage, involves investment in event-driven situations such as leveraged buy-outs, mergers and hostile takeovers. Normally, the stock of an acquisition target appreciates while the acquiring company’s stock decreases in value. These strategies generate returns by purchasing stock of the company being acquired, and in some instances, selling short the stock of the acquiring company. Managers may employ the use of equity options as a low-risk alternative to the outright purchase or sale of common stock. Most Merger Arbitrage funds hedge against market risk by purchasing S&P put options or put option spreads.

16) **Regulation D** Managers invest in Regulation D securities, sometimes referred to as structured discount convertibles. The securities are privately offered to the investment manager by companies in need of timely financing and the terms are negotiated. The terms of any particular deal are reflective of the negotiating strength of the issuing company. Once a deal is closed, there is a waiting period for the private share offering to be registered with the SEC. The manager can only convert into private shares and cannot trade them publicly during this period; therefore, their

investment is illiquid until it becomes registered. Managers will hedge with common stock until the registration becomes effective and then liquidate the position gradually.

17) **Statistical Arbitrage** utilizes quantitative analysis of technical factors to exploit pricing inefficiencies between related equity securities, neutralizing exposure to market risk by combining long and short positions. The strategy is based on quantitative models for selecting specific stocks with equal dollar amounts comprising the long and short sides of the portfolio. Portfolios are typically structured to be market, industry, sector, and dollar neutral.

18) **Short Selling** involves the sale of a security not owned by the seller; a technique used to take advantage of an anticipated price decline. To effect a short sale, the seller borrows securities from a third party in order to make delivery to the purchaser. The seller returns the borrowed securities to the lender by purchasing the securities in the open market. If the seller can buy that stock back at a lower price, a profit results. If the price rises, however, a loss results. A short seller must generally pledge other securities or cash with the lender in an amount equal to the market price of the borrowed securities. This deposit may be increased or decreased in response to changes in the market price of the borrowed securities.

19) **Fund of Funds** invest with multiple managers through funds or managed accounts. The strategy designs a diversified portfolio of managers with the objective of significantly lowering the risk (volatility) of investing with an individual manager. The Fund of Funds manager has discretion in choosing which strategies to invest in for the portfolio. A manager may allocate funds to numerous managers within a single strategy, or with numerous managers in multiple strategies. The minimum investment in a Fund of Funds may be lower than an investment in an individual hedge fund or managed account. The investor has the advantage of diversification

among managers and styles with significantly less capital than investing with separate managers.

20) **FOF: Conservative:** FOFs classified as "Conservative" exhibit one or more of the following characteristics: seeks consistent returns by primarily investing in funds that generally engage in more "conservative" strategies such as Equity Market Neutral, Fixed Income Arbitrage, and Convertible Arbitrage; exhibits a lower historical annual standard deviation than the HFRI Fund of Funds Composite Index. A fund in the HFRI FOF Conservative Index shows generally consistent performance regardless of market conditions.

21) **FOF: Diversified:** FOFs classified as "Diversified" exhibit one or more of the following characteristics: invests in a variety of strategies among multiple managers; historical annual return and/or a standard deviation generally similar to the HFRI Fund of Fund Composite index; demonstrates generally close performance and returns distribution correlation to the HFRI Fund of Fund Composite Index. A fund in the HFRI FOF Diversified Index tends to show minimal loss in down markets while achieving superior returns in up markets.

22) **FOF: Market Defensive:** FOFs classified as "Market Defensive" exhibit one or more of the following characteristics: invests in funds that generally engage in short-biased strategies such as short selling and managed futures; shows a negative correlation to the general market benchmarks (S&P). A fund in the FOF Market Defensive Index exhibits higher returns during down markets than during up markets.

23) **FOF: Strategic:** FOFs classified as "Strategic" exhibit one or more of the following characteristics: seeks superior returns by primarily investing in funds that generally engage in more opportunistic strategies such as Emerging Markets, Sector specific, and Equity Hedge; exhibits a greater dispersion of returns and higher volatility compared to the HFRI Fund of Funds Composite Index. A fund in the HFRI

FOF Strategic Index tends to outperform the HFRI Fund of Fund Composite Index in up markets and underperformed the index in down markets.

b) Hedging Strategies:-

The wide ranges of hedging strategies are available to hedge funds. Some of them are as follows.

- **Selling Short** - selling shares without owning them, hoping to buy them back at a future date at a lower price in the expectation that their price will drop.
- **Using Arbitrage** - seeking to exploit pricing inefficiencies between related securities - for example, can be long convertible bonds and short the underlying issuer's equity.
- **Trading Options Or Derivatives** - contracts whose values are based on the performance of any underlying financial asset, index or other investment.
- **Investing In Anticipation Of A Specific Event** - merger transaction, hostile takeover, spin-off, exiting of bankruptcy proceedings, etc.
- **Investing In Deeply Discounted Securities** - of companies about to enter or exit financial distress or bankruptcy, often below liquidation value.
- **Using leverage** - borrowing to try to enhance returns
- Investing in **Out-Of-Favor Or Unrecognized Undervalued Securities** (debt or equity)
- Attempting to take advantage of the **Spread between the Current Market Price** and the **ultimate purchase price** in event driven situations such as mergers or hostile takeovers.

Many of the strategies used by hedge funds benefit from being non-correlated to the direction of equity markets

c) <u>Benefits Of Hedge Funds:-</u>

Institutions and individuals alike are increasingly becoming aware of the unique benefits of this alternative asset class.

Hedge Funds Reduce Risk;

- **Potential To Reduce Overall Portfolio Risk Through An Additional Asset Class;**

Hedge funds represent a different way of managing money with generally low correlations to equity and debt investments. Adding them to a portfolio of stocks and bonds is likely to reduce overall portfolio risk.

- **Potential To Provide Returns In Both Up And Down Markets;**

Hedge funds are designed for the potential to achieve the positive returns in all market environments.

- **Potential For Superior Risk-Adjusted Performance;**

- Specialized managers are focused on very precise areas of expertise
- Greater freedom and flexibility to take advantage of investment opportunities than mutual fund managers/
- Broader range of financial instruments at disposal

- ### Focused On Absolute Vs. Relative Performance;

Hedge fund managers are only concerned with generating positive returns, as opposed to benchmarking their performance against an equity index that could end up in a negative position.

- ### Hedge Fund Managers Are Paid By Performance;

Hedge fund managers' interests are aligned with those of the investor, often with the managers' own capital invested.

Some other benefits are;

- Recognized by pension funds, banks, insurance companies and sophisticated investors as a way to reduce portfolio volatility and potentially enhance returns.

- Many hedge fund strategies have the ability to generate positive returns in both rising and falling equity and bond markets.

- Inclusion of hedge funds in a balanced portfolio reduces overall portfolio risk and volatility and increases returns.

- Huge variety of hedge fund investment styles - many uncorrelated with each other - provides investors with a wide choice of hedge fund strategies to meet their investment objectives.

- Hedge funds provide an ideal long-term investment solution, eliminating the need to correctly time entry and exit from markets.

- Adding hedge funds to an investment portfolio provides diversification not otherwise available in traditional investing.

d) <u>Reason Of Resistance:-</u>

There are a number of possible explanations for this resistance:

1. Lack of Transparency: Hedge funds, inherently private investment vehicles, have not met traditional institutional levels of transparency and accountability. In recent years, institutional investors and funds of hedge funds have exerted enormous pressure on hedge funds to provide greater transparency. The reason is simple: fiduciaries find it difficult to justify investing in a fund with unknown risks and exposures. Hedge fund managers must further develop investment processes and infrastructure in order to meet these institutional requirements. As knowledge increases, institutional investors may be more willing to accept "risk transparency"; i.e. sufficient information to measure risks, rather than total transparency of holdings. For their part, hedge funds may be more willing to accommodate higher levels of transparency in order to attract institutional assets.

2. Insufficient Diversification: Another consideration has been skepticism regarding the ability to achieve "true" diversification through uncorrelated hedge funds. Cliff Asness points out in "Do Hedge Funds Hedge?" that many hedge funds underestimate their relationship to traditional markets. By examining hedge funds' implicit exposure to the market as a function of multiple time periods, Asness' paper finds a more significant relationship than one would initially conclude.

3. Headline Risk: Another meaningful issue is career risk. Although a portfolio of hedge funds may in aggregate benefit an investor, a rogue fund can sometimes conspicuously impair overall performance and generate very adverse publicity. Well-known examples of hedge fund implosions include the Manhattan Fund and Long Term Capital Management.

4. Fees: The higher fees charged by hedge fund managers have been an additional deterrent to institutional investors. Similar to private equity partnerships, hedge funds tend to charge 1% of assets plus 20% of profits. This fee structure is referred to as a "1 and 20" arrangement.

5. Liquidity: Finally, hedge funds are relatively illiquid investments with "lockup" and "liquidity" provisions. Most hedge funds specify a lockup period ranging from 6 months to 5 years. An investment cannot be redeemed during this initial period. After this initial lockup period, the fund becomes subject to standard liquidity provisions. For example, a fund may offer quarterly liquidity with days notice or in some cases funds may only offer year-end liquidity.

e) Who are the Investors?

1. Financial
2. Institutions
3. Funds of hedge Fund.
4. Endowments/
5. Foundations
6. Pension Fund of Funds HNW/Family
7. Office
8. Other

f) <u>A Global Hedge Fund Picture:-</u>

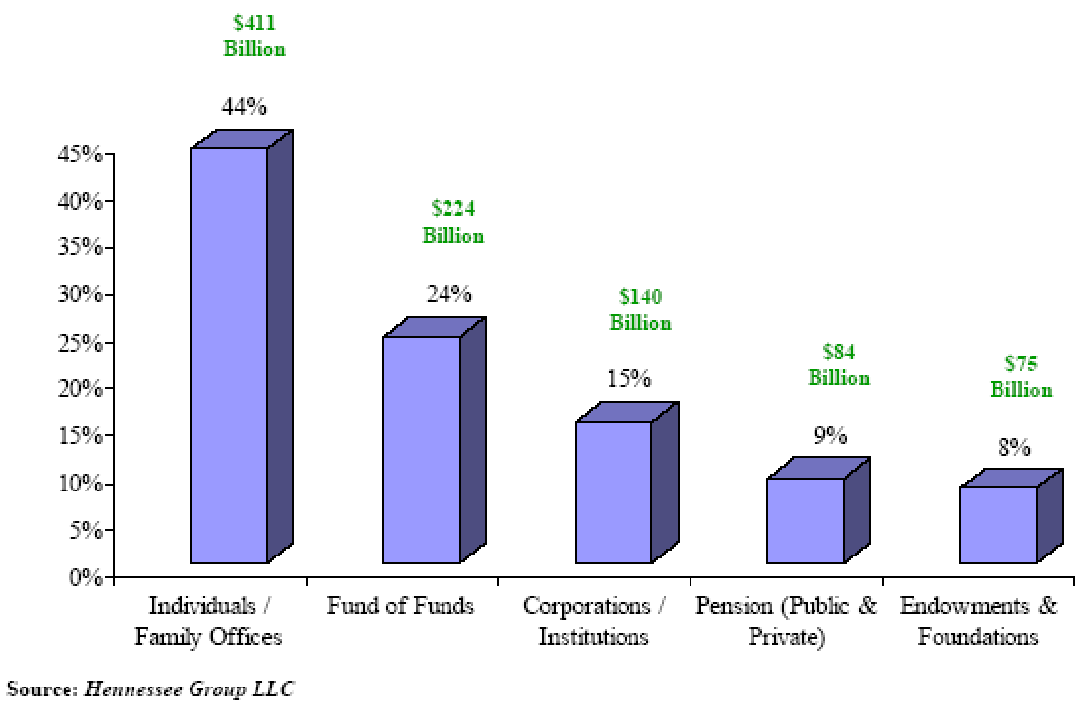
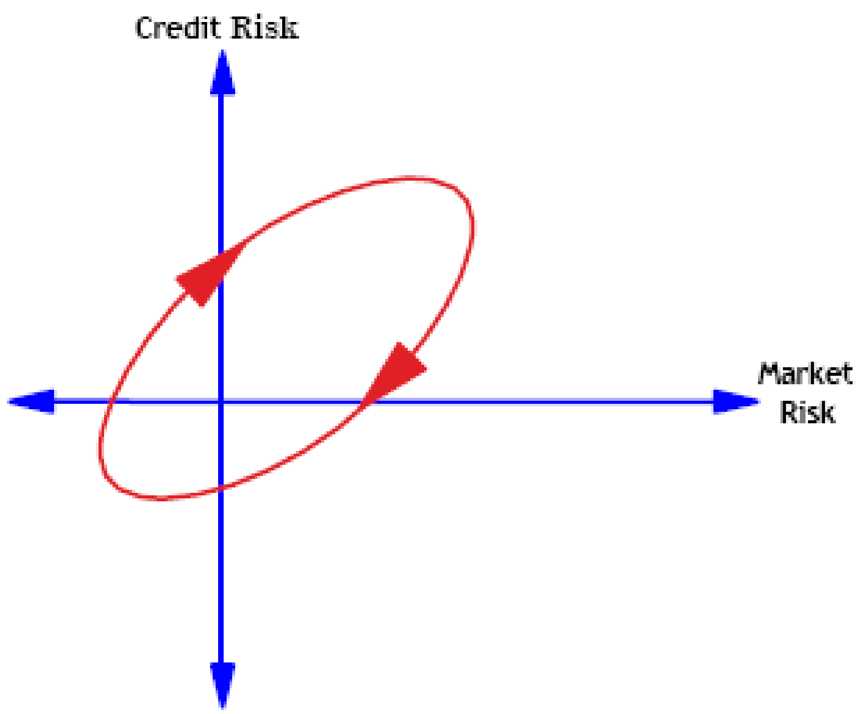


Figure # 4:- Hedge Fund Sources of Capital (January 2005)

g) **<u>A Tactical Guide for Style Selection:-</u>**

Tactical Style Selection is a tactical allocation tool designed to boost the alpha of hedge fund investing by dynamically managing the portfolio mix of hedge fund styles over a typical 4-5 year financial market cycle. All asset market returns, whether conventional or alternative, directly depend upon the amount of risk taken.

This is a fundamental law: *investing in hedge funds will not make apples fall to the sky.* ***<u>The greater the risk, the greater the likely long-run return,</u>*** but hedge funds do differ from conventional assets insofar as they involve credit risk and market risk. The Tactical Style Selection method of active asset allocation blends together those aspects of monetary theory and finance theory that explain credit risk and market risk. Market risk and credit risk both fluctuate, often wildly and usually together. Figure 3 plots credit risk and asset market risk in a two-dimensional phase diagram.



<u>Figure 3:</u> <u>Credit Risk versus Asset Market Risk</u>

Hedge fund returns (HFR) are determined by three main risk factors:

• The risk free return (αi);

• Market risk (πm), and

• Credit risk (πc).

These vary according to the ith investment style:

$$HFR_i = \alpha_i + \beta_i . \pi_m + \delta_i . \pi_c$$

For example, *credit arbitrage* funds, such as *Fixed Income Arbitrage*, typically take large leverage but position themselves with a small net market exposure. *Directional* funds, e.g. *Global Macro* and *Equity Long/Short* funds have high leverage and high net exposure. Conventional (i.e. long only) investment styles are characterized by high net market exposure but zero or very low leverage. But projecting investment returns becomes far more difficult when the underlying risk environment itself changes. If risks generally rise from low to high levels, each asset will again react differently to the change. In other words, the returns from some investment styles will be negatively correlated with rising risk, but other style returns may be positively correlated.

In a changing risk world, hedge fund returns can be modeled by the following equation. The return to the ith Hedge fund style is:

$$HFR_i = \alpha_i + \beta_i . \pi_m + \delta_i . \pi_c - \lambda_i . D . \Delta\pi_m - \theta_i . D . \Delta\pi_c$$

Where Δπm is the change in market risk; Δπc is the change in credit risk, and D is average asset duration. The equation tells us that a change in general financial risk (i.e. πm + πc) will detract from short-term returns according to the respective risk sensitivities (i.e. the parameters λi. and θi) and the average asset duration (D).

In short, if λi is 1.2 times and D is 7 years, then each 100bp change in market risk will reduce returns by 8.4% (=1.2 x 7). Equally, if λi is minus 1.2 times, returns will be magnified by 8.4%. Unlike conventional assets, hedge funds returns are not always negatively related to increasing market risk.

Chapter # 4

PRESENTATION ANALYSIS

No.	Name of style	Expected Volatility	Leverage	Derivatives	Risk	Return	Correlation To Markets	Holding Period
1.	Aggressive Growth	High	Possible	No	Enhancer	Enhancer	Low	Medium/ long
2.	Distressed Securities	Low – Moderate	Possible	Yes	Enhancer	High	Very Low Or No	Short
3.	Emerging Markets	Very High	Few	Depends	High	Limited	High	Short/ Medium
4.	Funds Of Hedge Funds	Low - Moderate – High	Highly possible	Yes	Diversified	High	Low	Medium
5.	Income	Low	Possible	Yes	High	Limited	high	medium
6.	Macro	Very High	Zero	Yes	Low	Enhancer	High	Medium
7.	Market Neutral - Arbitrage	Low	Possible-	Yes	Enhancer	Limited	Low Or No	Short

Table #1:- Major Characteristics Of Selected Hedge Fund Styles.

8.	Market Neutral - Securities Hedging	Low	Possible	Yes	Reducer.	High	Low	Medium
9.	Market Timing	High	Possible	Yes	Enhancer	Limited	High	Short.
10.	Opportunistic	Variable	Low	No known	Reducer	Enhancer	No	Short
11.	Multi Strategy	Variable	High	Possible	Diversified	High	High	Can be any
12.	Short Selling	Very High	Low	Itself	High	High	No	Medium
13.	Special Situations	Moderate	Possible	Yes	Low	High	High	Medium
14.	Value	Low – Moderate	High	Yes	Reducer	Enhancer	Low	Long

Graphical Representation of **Aggressive Growth**, **Distressed Securities**, **Emerging Market** and **Fund of Hedge Fund**.

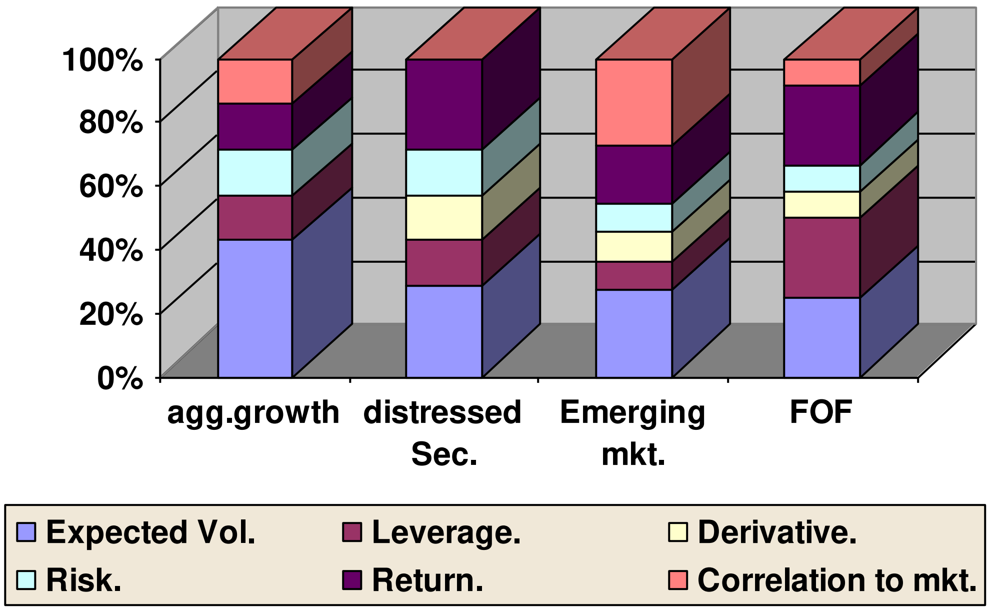


Figure # 5

<u>Ranking:</u>

High = 3, Medium = 2, Low = 1.

Reducer = 1, Enhancer= 2.

Yes = 1, No = 0.

Graphical Representation of **Income, Macro, Market Neutral – Arbitrage and Market Neutral-Securities Hedging.**

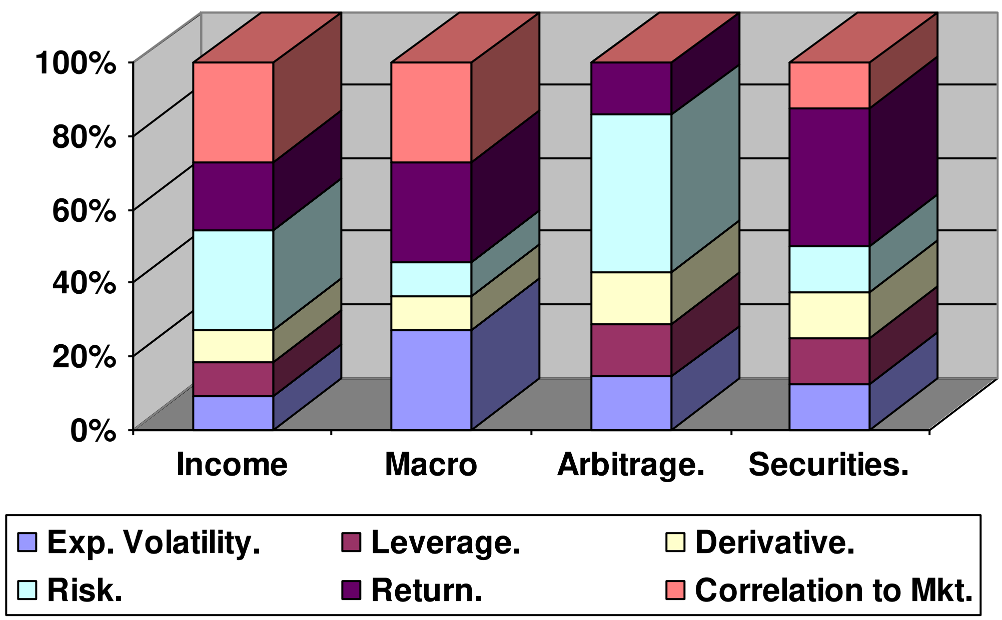


Figure # 6

<u>Ranking:</u>

High = 3, Medium = 2, Low = 1.

Reducer = 1, Enhancer= 2.

Yes = 1, No = 0.

Graphical Representation Of **Market Timing, Opportunities, Multi Strategy, Short Selling and Value.**

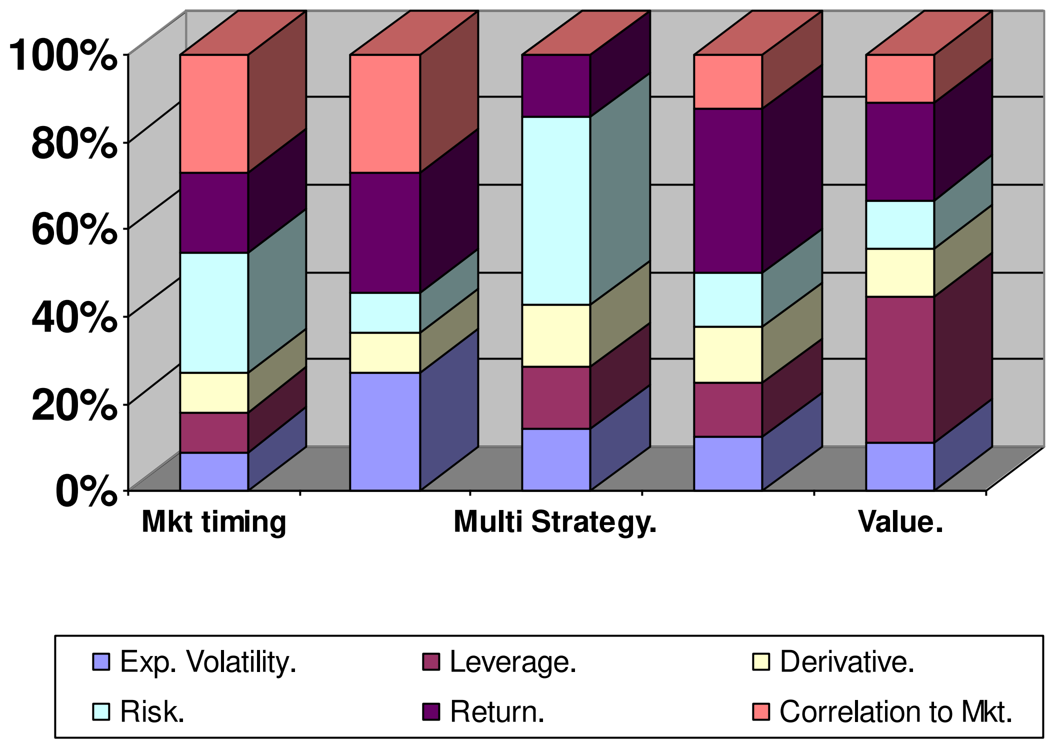


Figure # 7

<u>Ranking:</u>

High = 3, Medium = 2, Low = 1.

Reducer = 1, Enhancer= 2.

Yes = 1, No = 0.

Question no. 1:

In reference to hedge fund business in Pakistan, which from will be more successful?

a) Limited Liability Partnership,

b) Corporation,

c) Trust Or

d) Mutual Fund

Purpose of Question:-

To determine which from of Hedge fund business the investors wants to adopt in Pakistan.

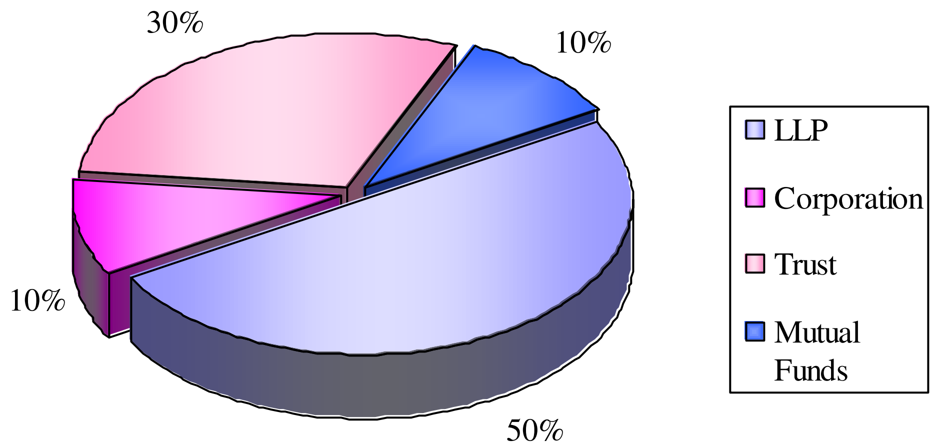


Figure # 8

Analysis:-

Majority of respondents are in favor of structuring hedge fund as LLP, well Trust will be next favorable option.

Question no. 2:

Should the Hedge fund industry be regulated through SECP?

a) Yes
b) No

Purpose of Question;

To find out, what are the opinions of Pakistan's Institutional Investors about the regulation of hedge fund, which is now a days hot issue in hedge fund industry.

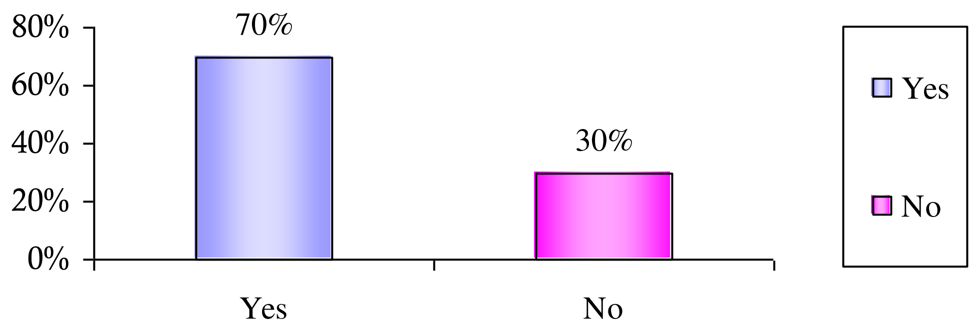


Figure # 9

Analysis:-

By the analysis of result, it is prove that most of the invertors are in favor of hedge fund regulation, only 30% (3) asking for its non-regulation.

Question no. 3:

What is the most important ingredient you look for before making an investment in a hedge fund? (Rank them)

a) The Fund Returns
b) The Length Of The Fund's Track Record
c) The Portfolio Manager's Background
d) The Fund Volatility
e) The Fund Strategy
f) The Fund Liquidity And Transparency
g) Whether The Fund Has Had An Audit
h) The Fund Infrastructure Providers

Purpose Of Question;

To find out what will be the most important thing that has to be analyzed before making an investment in hedge fund.

Presentation Of Result:-

The Fund Returns	27.59% (8)
The Length Of The Fund's Track Record	6.90% (2)
The Portfolio Manager's Background	27.59% (8)
The Fund Volatility	6.90% (2)
The Fund Strategy	20.69% (6)
The Fund Liquidity And Transparency	3.45% (1)
Whether The Fund Has Had An Audit	3.45% (1)
The Fund Infrastructure Providers	3.45% (1)

Figure # 10

Analysis:-

Majority of respondents are interested in Fund Returns and Manager’s background while the strategy fund employed is also important to analyze.

Question no. 4:

What should be the “LOCK UP” period? (Normally, 6 month)

a) Six months.
b) One year.
c) One and half year.
d) Two year.
e) Above 2 year

Purpose Of Question;

The idea behind the question is to find out what will be minimum duration for investment in hedge fund. It shows investor’s desire for liquidity.

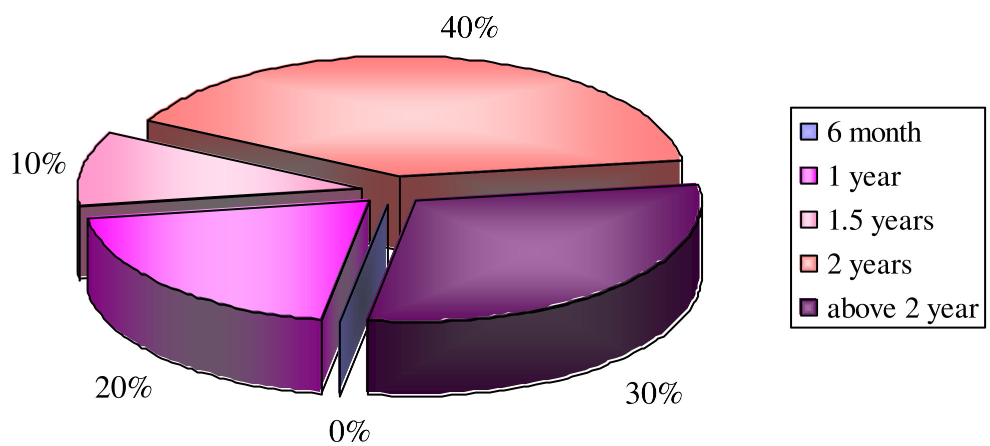


Figure # 11

Analysis:-

The result is quite ambiguous. Still we can say minimum duration can be 2 years or any time period above 2 years. No respondents are in favors of 6 month lock up period. While the other options also get some marks.

Question no. 5:

The Return of hedge fund mostly depends upon,

a) Performance of the market in which hedge fund manager invest.
b) The style and strategies that hedge fund managers employ.
c) Level of manager skill and expertise.

Purpose Of Question:-

To find out the factor that is most important in generating the returns from hedge funds.

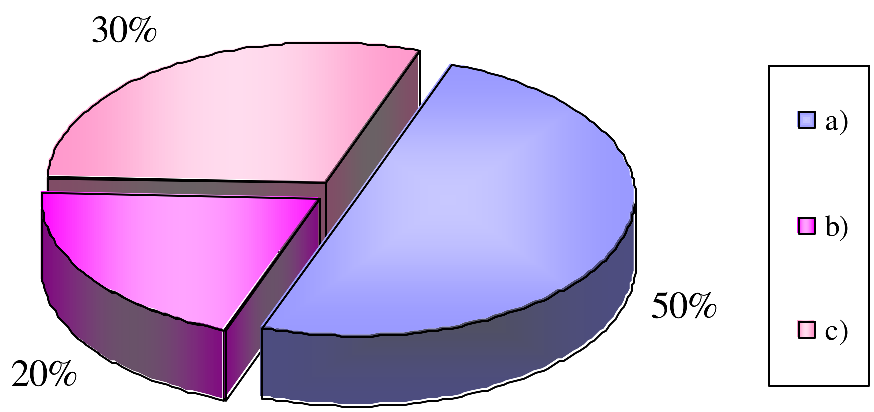


Figure # 12

Analysis:-

Amongst the three, the most important one is the performance of the market in which the hedge fund manager makes investment. The other two are also very important in driving the return.

Question no. 6:

What should be the minimum amount of investment? (In US minimum amount for investment is $ 250,000)

a) Rs. 5 million.
b) Rs. 10 million.
c) Other ___________

Purpose Of Question:-

To find out the investor's desirability to invests in Hedge fund as a new investment opportunity. It shows the tolerance level against the risk bring by any new financial product.

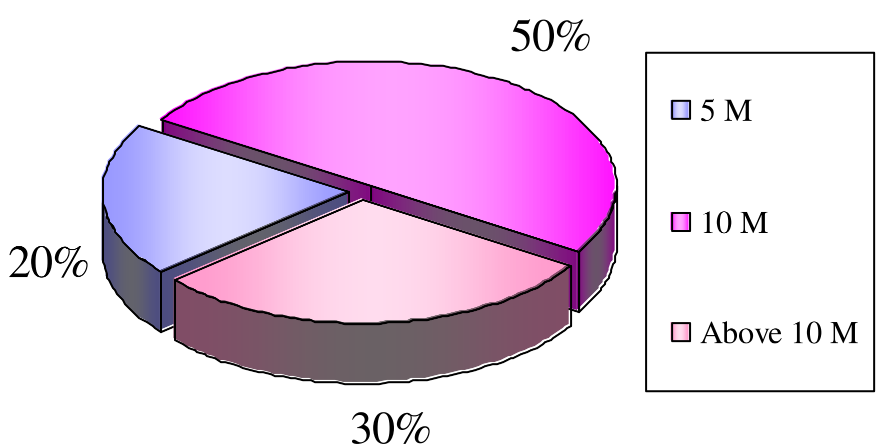


Figure # 13

Analysis:-

50% of the respondents think that the minimum investment should be 10 million and 30% are in favor of option 3 i.e. above 10 million. So the favorable option according to respondents is option 1.

Question no. 7:

From the following, which strategy will be more successful in Pakistan?

a) Selling Short
b) Using Arbitrage
c) Trading Options Or Derivatives
d) Investing In Anticipation Of A Specific Event
e) Investing In Deeply Discounted Securities
f) Using leverage
g) Investing in "Out-Of-Favor" Or "Unrecognized Undervalued Securities"(Debt and bond)

Purpose Of Question:-

To determine which strategies hedge fund can easily adopt in Pakistan by keeping in mind the present status of financial market environment.

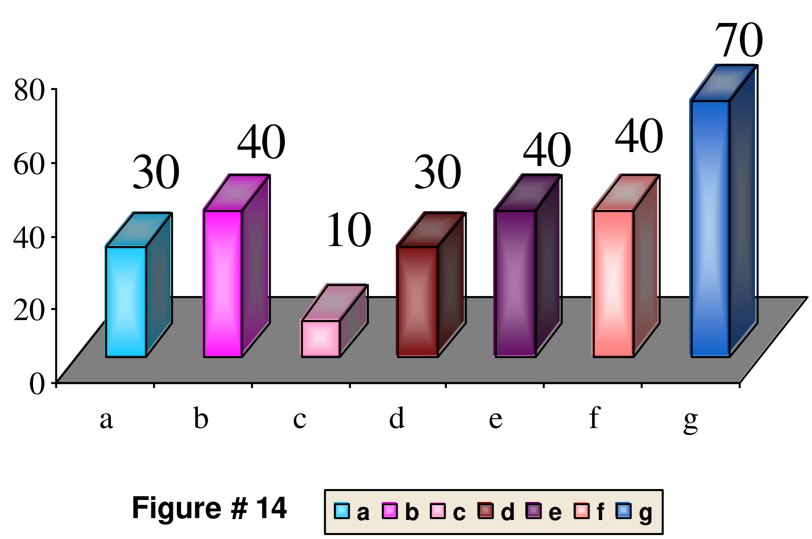


Figure # 14

Analysis:-

Most of the respondents are in favor of option (g) while the other choice can option (b), (e), (f) and (g). These ranking are given by the respondents.

Question no. 8:

What type of Hedge Fund you are most interested to invest?

a) Convertible arbitrage. b) Distressed Securities. c) Equity hedge.

d) Event Driven. e) Fixed Income – High Yield. f) High Growth.

g) Macro. h) Risk arbitrage. i) Relative Value.

Purpose Of Question:-

To find out what style hedge fund can easily adopt in Pakistan from the huge menu.

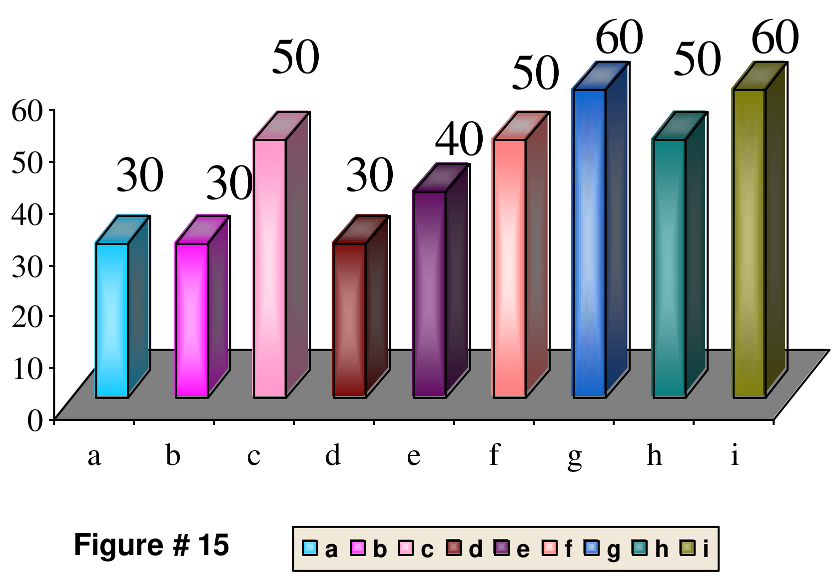


Figure # 15

Analysis:-

According to the respondents, Relative Value and macro can be the best option. The other can also be employed in Pakistan. But the most favorable are choices are c, e, f, g, h, and i.

Question no. 9:

What will be the Source Of capital for Hedge fund in Pakistan? (If possible, define in term of Percentage)

a) Financial Institutions b) Endowments. c) Foundations.
d) Pension Fund Of Funds HNW e) Families/ individual investors.
e) Offices

Purpose Of Question;

To find out the sources of capital for hedge fund industry and the contribution ratios.

Presentation Of Result:-

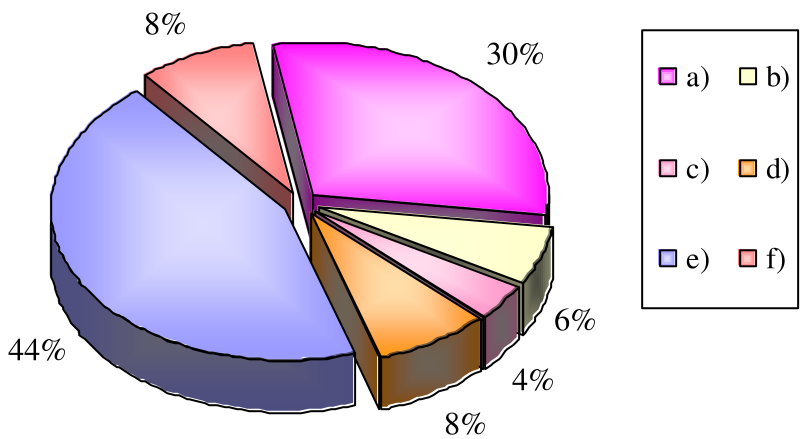


Figure # 16

Analysis:-

The largest source of capital is the Families/ Individual investors they can bring most of the capital for hedge fund while the second biggest source can be financial institutions. Endowments, foundation and Pension fund can also contribute but the ratio will be very low.

Question no. 10:

What should be the Fees Structure for hedge fund? (Normally 1% of assets plus 20% of profits)

a) Performance based.

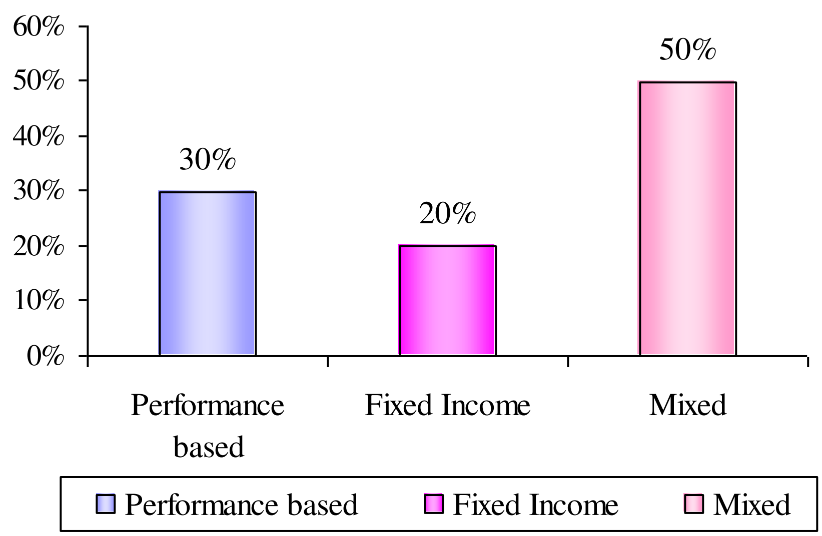
b) Fixed income

c) Mixed (1% of assets plus 20% of profits)

Purpose Of Question:-

To find out the acceptable fee structure in Pakistan from the point out view of investors.

figure # 17



Analysis:-

Majority of respondents are in favor of mixed i.e 1% of the asset plus 20% of Profit, which is one of the common fees structure globally. Some respondents assume that it should be performance based while some give there vote to fixed income.

Question no. 11:

In Pakistan, Hedge fund mostly face

A)	Political Risk.	B)	Transfer Risk.	C)	Settlement Risk.
D)	Credit Risk.	E)	Legal Risk.	F)	Market Risk.
G)	Liquidity Risk.	H)	Operational Risk.		

Purpose Of Question:-

To find out the types of risk hedge fund will has to face in Pakistan. And what safeguard

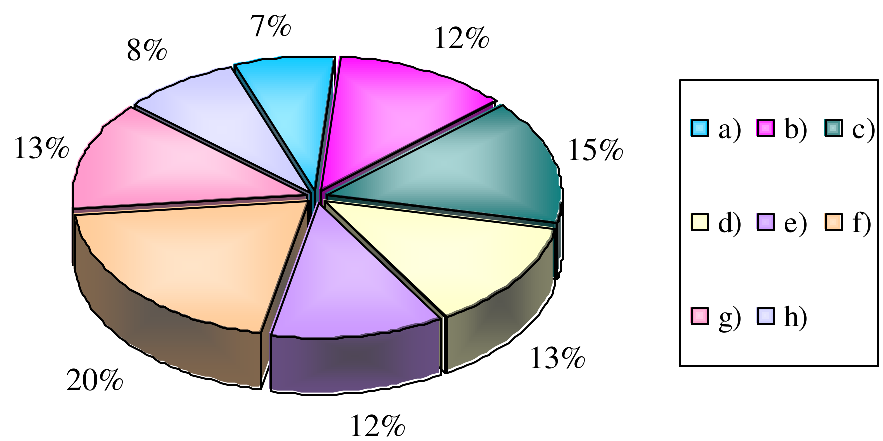


Figure # 18

Analysis:-

According to respondents, on an initial hedge fund has to face almost every type of risk. But the major one will be the operation, marketing and credit risk.

Question no. 12:

What place do you believe that hedge fund investing should have in a investor's portfolio, amongst the other asset classes?

a) 5 % of Assets value.
b) 10 % of Asset Value.
c) 15% of Asset Value.
d) Other ____________

Purpose Of Question:-

To find out what should be the favorable percentage of allocation with respect to total assets.

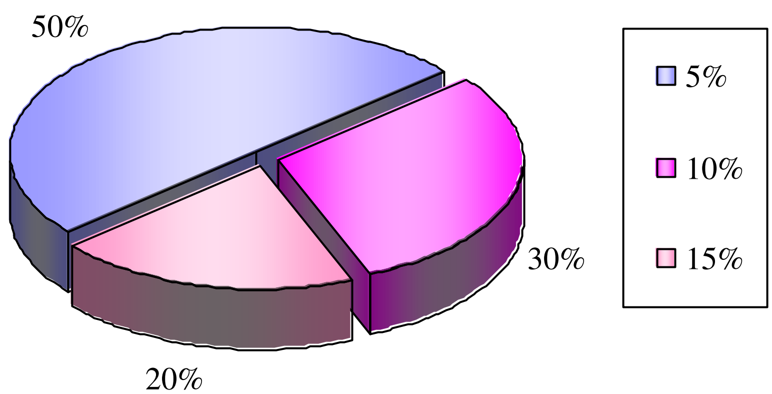


Figure # 19

Analysis:-

According to the majority investor i.e. 50% are saying that , almost 5% of the total assets should be allocated to hedge fund. 30% saying that 10% is the better option and 2% are in favor of the 15%.

Question no. 13:

Does Local Index will provide good bench mark for performance measurement of hedge fund?

a) Yes
b) No

Purpose Of Question:-

To find out bench mark problem faced by the hedge fund in Pakistan what will be possible remedies to reduce problem that occur because of this.

Presentation Of Result:-

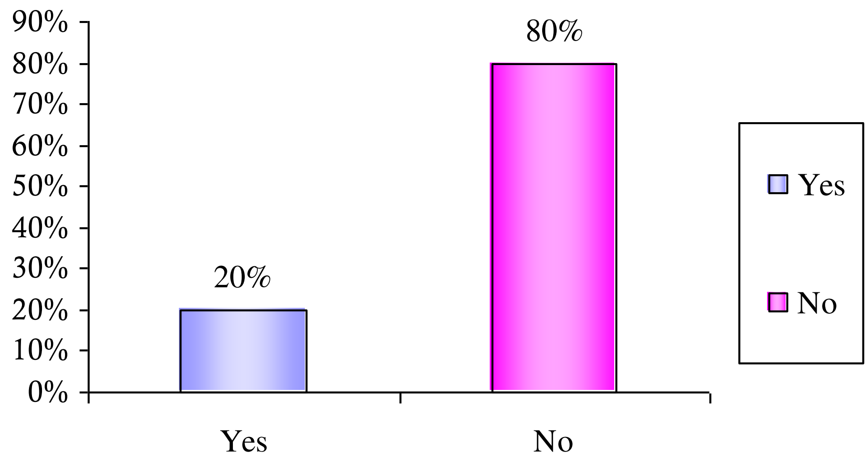


figure # 20

Analysis Of Result:-

Well 80% of the respondents are in favor of that local index will not provide an adequate measure for performance evaluation while 20 % are saying that its better to evaluate the performance by using Local indexes and bench marks.

Chapter # 5

Summary Of Findings, Conclusion & Recommendations:-

a) Findings
b) Conclusion
c) Recommendations

Chapter # 5

Summary Of Findings, Conclusion & Recommendations:-

a) Findings From Interview:-

With Dr. Ishrat Husain (Governor State Bank Of Pakistan)
Coordinated By Mr. Suleman Chhagla (Head Of Risk Management) and
Mr. Sibt-ul-husnain (Assistant Director)

Hedge funds are private, usually unregulated investment pool, in which fund manager and investors invest together. The distinctive feature of such fund is that they yield an absolute return i.e. the return that does not depends on the financial market movement.

In Pakistan, hedge fund can adopt the form as a limited Company or as a limited liability partnership. According to Dr. Ishrat Husain as a regulatory body and as an investor suggested that hedge fund industry should be regulated through federal bodies both globally and also in Pakistan.

"Lock up period can be any timing on which the parties agree. As an investment base the minimum amount of investment for institutional investors can not be more then 5 lacs ($3000) for an initial period. Because there are few firms who have high risk appetite they generally make their investment in traditional investment opportunities (bond and stock Market). 5% of the total asset can be the suitable figure for investment". Said by Dr. Suleman Chhagla. So in order to expand its user the minimum amount of investment should be low as much as possible.

In Pakistan, the investment strategies available for hedge funds are very limited. Short selling is very rare and only done by professional and educated investor. Short selling is totally illegal in Stock exchanges. We don't have mature derivative market. Derivative might take three to four year to become mature. The option can be to invest in "out-of-favor" and "unrecognized undervalued securities", "arbitrage" and "Leverage". Even there are some other hedging techniques available for hedge fund but there are not sufficient to support the hedge fund industry at this stage.

Hedge fund can select very few styles from huge menu. The reason can be again the same the limited investment opportunities. On this stage hedge funds only adopt such styles whose returns don't not require utilizing derivative instrument and short selling. So the better options are Convertible Arbitrage, Macro, Relative Value, Risk Arbitrage, and opportunistic.

The sources of capital are the Family/ Individual investor and financial institution. Endowment, Foundation and Pension funds might also contribute but with very little amount. Hedge fund has to face almost every type of risk on its initial stage in Pakistan. There may be risk to retain the fund manager with business. The other may be market, operational risk and credit risk. Major Challenges can be the Lack of Transparency, limited Investment Option, low professional expertise, disclosures, headline risk and regulatory approval. Mutual fund can also create hurdle for hedge fund.

Yes! Hedge fund has scope in Pakistan but not at this stage. If we start hedge fund in such situation that I mentioned above its impossible for hedge fund to become successful in Pakistan as it globally.

My recommendations are fist we have to get more depth in our Stock and Bond market, extended derivative market and improved financial infrastructure. All such might take the period of three to four year. So what we have to do is to wait for right time to sow the seed to get the fruit.

b) Findings From Questionnaire:-

Hedge funds, including fund of funds ("Hedge 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, including mutual fund requirements to provide certain periodic and standardized pricing and valuation information to investors. Through the research following facts are analyzed.

Hedge fund globally famous as limited liability partnership because of its Tax advantage and to avoid most of the securities laws. After interviewing the respondents it conclude that in Pakistan hedge fund can be structured as LLP and or as a trust. As long as regulation of hedge fund is concern it should be regulated but it directly affects its performance. As freedom is necessary because hedge fund managers require to do anything they want to do i.e they can use leverage short selling and derivative instruments without any limitation. This is a basis difference between Hedge fund and other financial product and by using such hedging techniques, hedge fund yields "absolute return", and because of non regulation it is very risky investment and the money of investors is on sake. Hence to provide security to the money of investor it should be regulated. Well this is up to the fund manager to use its freedom to creates high risk portfolio or risk averse portfolio.

With the freedom to invest in different classes of assets of their fund, hedge fund managers have to accept very substantial limitations on marketing and liquidity. They are not allowed to make IPOs and daily liquidity does not exist in the hedge fund universe. There is no secondary market and no hope for that even in future. Minimum lock up according to the respondents initially set as one year which can be increase to any timing above three to four years as the industry starts growing.

The return that hedge fund generate depends on three factors. One is the performance of the market in which hedge fund manager invest, second is the style and strategies that hedge fund managers adopt and third is level of manager skill and expertise. And according to the respondents the most important is the performance of the market in which manager invest.

Hedge fund is not for every body. Most investors are ineligible to invest in hedge fund. Even not for all those who have high investment horizon and high tolerance for the volatility of the Standard Equity Investing. An investor must keep this in mind that hedge fund represent speculative investment and involve high degree of risk and he/she can lose all or substantial portion of his/her investment. So every investor before making investment in hedge fund or any other financial products must know its positive and negative aspects. The minimum amount of investing can be above 10 million or may be 10% to 15% of total asset value (for institutional investor) which can be increase up to 25%. But important thing is that investor must have the financial ability, experience and willingness to take risk of investment in hedge fund.

Now the question is that which strategies and style will be successful in Pakistan. if we look on the global environment of hedge fund business, we found that the driving force behind the success of hedge fund are the strategies like Leverage, Short selling and Derivative. By using such hedging techniques managers are able to create a portfolio that have low correlation to financial market movement and hence make profit even in down market. Unfortunately, in Pakistan derivative market itself is too depressed and not fully explored. Leverage (margin debt) and short selling activities and also not so common and mostly done only by the professional investors. The reason can be the lack of financial infrastructure or what ever. The need is to recognize such problem and remove them as soon as possible. And with out such strategies hedge fund can’t do anything. In Pakistan hedge fund can employ strategies like arbitrage, investing in deeply discounted securities and investing in out-of-favor or unrecognized undervalued securities (debt and bond) which in reality very limited option.

As long as question concern that which investment style will be successful in Pakistan? Respondents so called investment bankers are unable to provide good input on that. On the basis of the three month research process, following styles are suggested that have potential to do well in Pakistan. These are Convertible arbitrage, Distressed Securities, Equity hedge, Event driven, High growth and Value. If we adopt hedge fund on such stages the chances of success will be very limited.

The sources of capital for hedge fund are financial institution, families and individual investors, endowment and foundation, pension funds. Among them families and individual investor can bring most of the capital. While financial institution can be second big source. Endowment, foundation and pension fund also contribute but with low ratio.

In Pakistan, initially hedge fund will have to face almost every type of risk. That can be operational risk, market risk, structure risk, credit risk, and also liquidity risk. To retain hedge fund manager with business can also be the one type of risk that investor continuously has to face till the life of his investment. But as the industry gets stability in Pakistan the risks factor will be reduce up to the greater extents.

KSE 100 index (KIBOR) might be on initial stage provide good performance measure but it would not be good tool for measuring performance for longer period. So we can take helps from international indices like Hedge fund index, US Treasury, LIBOR, S&P 500 and Russell 2000 etc.

It’s natural, when any new product comes into the where the other products doing well its take some time to make it place in the market. The same is also true for hedge fund. They have to face so many challenges. First there are very few investment opportunities; derivative market is not so matured, so hedge fund has to face difficulties in term of investment option. Other can be peoples are not so educated or better to say unaware about investment tools and techniques. There is a lack of transparency in hedge fund industry that will also be major criticism.

If we analyzed all above facts with the bird’s eye it is conclude that Pakistan Financial market unable to support hedge fund at this stage. The need to improve our financial market infrastructure, get more depth in debt and equity market. Definitely in near future hedge fund industry will support Pakistan economy and its financial market. It provides new way for money management. Hedge fund is not only for rich investors but also for low profile investors.

c) **Conclusion:-**

Globally Hedge fund is one of a very successful product. Hedge fund also possesses an ability to do well in under developing countries as it already do in Srilanka, Malaysia, India. Well in Pakistan after analyzing the facts It is concluded that the scope is not good at this stage. The Essential thing is to educate the peoples about the advantages for this alternative/ non traditional investment. Generally, peoples are looking for the high profit by taking certain type of risk. Over here we have enough institutions and families who can be the potential user of hedge fund. But the need is to create awareness. Investment banks are required to recognize their role. There is also need to develop professional expertise, increase derivative instrument and improved our stock and debt market. These all may take time for about three to four years. And after making all such improvement we will be in better position to get advantage from this different type of financial product.

d) Recommendations:-

Hedge fund provides us new way for money management. It's also called alternative to traditional investment styles. It requires different things to work with. After this three month research process I would like to recommend following suggestion related to scope of hedge fund in Pakistan.

a. There is a strong need to improve our derivative market.

b. To get more depth in stock and bond market.

c. It is also necessary to develop professional expertise in people because the investment decisions require high skills.

d. Investment bank must recognize their role and play their part in the game and they should make things easier to understand even for uneducated investors.

e. And in last, investors must get know-how about the positive and negative aspects of particular financial product before making an investment decision.