Hedge Funds 101

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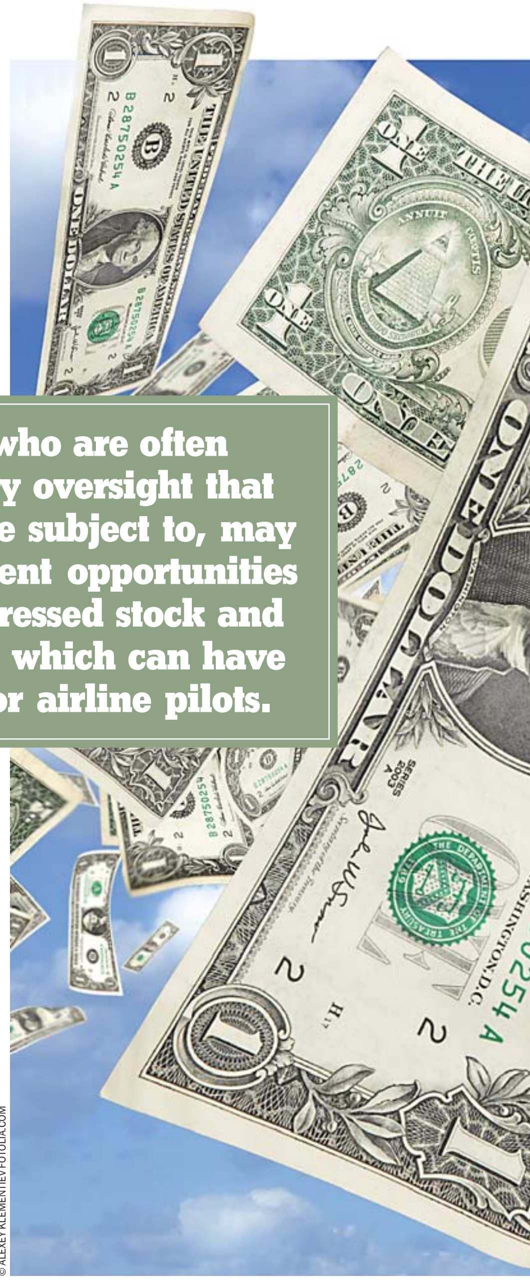
Throughout the past decade, and especially since the events of 9/11/01, the investing activities of nontraditional investors have had a notable influence on stock and bond prices in U.S. and, increasingly, international financial markets. Print and broadcast news media generally refer to these nontraditional investors as hedge funds. This article attempts to provide an overview of hedge funds and then highlight some of the activities of these funds that have and might affect airline pilots.

The term hedge fund is used to describe private (those not registered with the Securities and Exchange Commission) investment funds that buy and sell all types of securities listed on both public and private exchanges. The term encompasses a vast universe of private investment funds with various investment strategies. Much of the investing activities of hedge funds involves aggressive or sophisticated use of such portfolio management tactics as financial leverage (i.e., borrowing on margin), derivatives, concentrated positions, and shorting of securities and financial instruments.

Hedge funds not only invest often in stocks and bonds, but also take positions in the futures, options, commodities, and currency markets. Some hedge funds also make direct private loans and equity investments in companies. Hedge funds are often established as limited partnerships in which the fund sponsor acts as the general partner and fund manager. The limited partners are usually wealthy individuals and institutional investors (often foundations, endowments, and some public or private sector defined-benefit plans). Private equity firms own many of the hedge funds, 75 percent of which are based offshore to avoid taxes and regulation. Hedge fund managers usually earn an annual management fee (from 1 to 2 percent) and also are paid a percentage (from 10 to 20 percent) of the gains realized by the fund. Several thousand hedge funds controlling more than a trillion dollars of capital are currently estimated to be in operation.

In addition to individual investors, traditional investors are considered to be business entities such as mutual funds, trust companies, financial organizations, public sector institutions, and corporations that purchase stocks and bonds for taxable and tax-deferred retirement accounts using conventional securities' buy-and-sell tactics and strategies. These investors and their investment activities are subject to a wide array of regulatory compliance requirements and oversight from public (e.g., the SEC, the Department of Labor, federal and state bank examiners) and private (e.g., stock exchanges, accounting rulemaking and standards boards) entities. Nontraditional investors are often free of much of this regulatory oversight.

Hedge fund investors, who are often free from the regulatory oversight that traditional investors are subject to, may find attractive investment opportunities in the volatile and depressed stock and bond prices of airlines, which can have serious ramifications for airline pilots.



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Hedge funds can be regarded as one type of investment fund that specializes in making alternative asset class investments, a term that captures all types of public and private (asset class) investments that might not be actively traded on conventional stock or bond exchanges (e.g., NYSE, LSE, etc.) or that trade on conventional exchanges but do so in a largely unregulated manner. Alternative asset class investments would include items such as commercial real estate, commodities, currencies, and collectibles, as well as venture capital and private equity investments.

Many folks somewhat incorrectly use the term hedge fund interchangeably with the concept of alternative asset class investments. As previously noted, the term hedge fund really defines private investment companies (neither a mutual fund company nor an investment advisor registered with the

SEC) that undertake a wide range of investment trading strategies involving all types of asset class investments. These trading strategies can involve taking both long and short positions in stocks, bonds, options, futures, loans, and other financial instruments. There are all types of hedge funds—some very specialized and others general and broad-ranging.

Given all of the financial difficulties and corporate upheavals in the airline industry over the past decade-plus, prices of many airline stocks and bonds have been extremely volatile and depressed. Sensing an opportunity to make a profit, and potentially a significant profit, in the financial markets, various elements of the hedge fund investment community are attracted by this type of environment, which can also attract interest from other financing parties, such as private equity investors. As a result, ownership of many of the airlines continues to be subject to significant changes.

These changes have had and might continue to have significant ramifications for airline pilots and their families. "Private Equity, Hedge Funds, and You," next month, will provide an overview of global financial forces and some of their effects on airlines and investors.