Background

Glossary on the alternative investment fund managers directive

This glossary is intended to assist in the understanding of the underlying terms which are central to the alternative investment fund managers (AIFM) directive. At the same time it also attempts to place the terms within the context of the current financial environment and policy debates on regulating the financial sector.

No official, legal or linguistic value attaches to the definitions and explanations contained in this text, which serves only as an aid for journalists seeking to become familiar with some of the terms used in the discussion surrounding the directive. More technical and legally valid definitions are to be found in the text of the directive itself.

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Hedging

In finance, a hedge is undertaken to reduce risk by taking a position in one market in an attempt to offset exposure to price fluctuations in another market.
There are many specific financial instruments to accomplish this, the most well known being 'futures contracts' for hedging the values of energy, precious metals, foreign currency, agricultural products and interest rate fluctuations. In these cases a company signs a contract for its future purchase of an essential product at a given price which means its costs for those products are predictable, enabling better planning. For more on this, see the definition of 'derivatives' below.
Hedge funds use similar strategies to increase the predictability of their returns and protect themselves from shocks in one of their areas of activity, at a specific moment in time.

Hedge fund

As the name implies, hedge funds were initially designed with the aim of hedging (protecting against) some of the risks inherent in their investments using a variety of methods, including short selling (see below) and derivatives. However, the term "hedge fund" has also come to be applied to funds that do not, in fact, hedge their investments, but which may use “hedging” techniques and a wide range of other investment methods with the aim of increasing the return on their investment. Hedge funds also tend to differ from traditional investment funds in that a performance fee of perhaps 20 per cent of the increase in a fund’s value, if any, is paid to the fund manager.
In most jurisdictions hedge funds are not open to general retail investors, but only to a limited range of professional investors or wealthy individuals who meet certain criteria set by regulators. Hedge funds, meanwhile, have until now been exempt from many regulations that govern ordinary investment funds, such as those restricting short selling, the use of derivatives and leverage (see below), and fee structures. The legislation now before the European Parliament aims to bring hedge funds within a more structured regulatory framework.

Private equity fund

This is a fund that invests specialised investors' money directly in private companies. The strategy of managers of a private equity fund is to use its investors' contributions to acquire a controlling or substantial minority position in a company and then look to maximize the value of that investment. Private equity funds generally receive a return on their investments by offering shares of the company to the public, selling the company for cash or exchanging it for shares in another company. They can also distribute funds to the investors by recuperating some of the company's profits or increasing the company's debt.

A common way for private equity funds to acquire a significant stake in a company is through a leveraged buyout (LBO) whereby a significant percentage of the finance used to purchase the stake is obtained through borrowing (leverage). In this case most of the finances needed do not come from the fund's investors but from debt. The assets of the acquired company are used as collateral for the borrowed capital, with much of the debt ending up on the books of the company.

Proponents of private equity investments argue that removing a company from the stock market enables its management to take a longer term view of the business's interests, and that having debt on the company's books acts as an incentive for managers to run their businesses more efficiently. Critics counter that the long-term viability of acquired companies can be put at risk by excessive debt and have compared some private equity deals to asset stripping.

Investment trust

An investment trust is a form of collective investment found mostly in the United Kingdom which holds a portfolio of securities on behalf of its own shareholders. Because an investment trust is itself a listed company, its shares can be bought and sold in the usual way.

An investment trust manager is legally allowed to borrow capital to purchase shares. This leverage may increase investment gains but also increases investor risk. Investment trusts can also invest in unquoted or unlisted companies, which may not be trading on the stock exchange either because they don't wish to or because they do not meet the given criteria. This possibility, combined with the ability to borrow money for investments, can make investment trusts more volatile.

Unlike hedge funds, most investment trusts are open to retail/inexperienced investors.

Valuator

A valuator is the entity responsible for the process of estimating the potential market value of a financial asset or liability. In the case of AIF, valuations would be carried out on the assets, for example, the investments in marketable securities such as stocks and options. Valuations are required in many contexts including investment analysis, capital budgeting, merger and acquisition transactions, and for financial reporting.

Depositary

This is a legally separate organisation where the formal documents showing who owns shares, bonds, etc. can be kept safely.

A depositary generally has three core functions:

- the safe-keeping of the assets of the fund (the depositary holds the title of the assets when they are transferable instruments such as shares, or operates as a book-keeper complementing a broker’s job when it comes to derivatives);
- the day-to-day administration of the assets of the fund (the depositary receives the income generated by the assets);
- the control of the fund's operation (compliance with investment policies, notably proper creation/redemption/cancellation of the units/shares issued to the investors)

Sub-depositary/Sub-custodian

This body (typically a bank) would act as an agent to the main depositary with regard to custodial functions in a country where the depositary is not represented (usually a country outside the EU in the case of this directive). The main task would therefore be the safe-guarding of a fund's financial assets. The control over the fund's operation cannot be dele-gated to a sub-depositary or sub-custodian.

Private placement

Private placement (or non-public offering) is a way of raising capital through a sale (offering) of shares without an initial public offering, usually to a small number of chosen private investors. Purchasers are often institutional investors such as banks, insurance companies or pension funds. Such an offering is exempt from many of the reporting and information requirements necessary in the case of a public offering.

Short selling

It is possible to make a profit from a fall in the price of a particular company’s shares or in a generally falling market. When a trader expects a company's shares to fall, they can borrow these shares for a fee from its shareholders, sell them and then purchase them back in order to return them to the original shareholders. Provided the price has fallen between the selling and re-purchase the trader would make a profit. On the other hand a loss is incurred if the price of the shares rises.

Short selling is useful in providing liquidity in the market (i.e. making sure shares are available for sale to investors who want them) and also has a corrective function in adjusting the share price of a company which may be overvalued.

The mechanics behind short selling result in some unique risks, theoretically including infinite losses, and have sometimes been associated with concerted efforts to drive down share prices to levels which do not reflect a company's true value. For these reasons this practice is regulated and at times prohibitions have been imposed on short selling securities of a specific company or sector. Regulation however varies between countries.

Naked short selling

Naked short selling is a case of short selling without first arranging to borrow the shares. If the stock is in short supply, finding shares to borrow can be difficult. The seller may also decide not to borrow the shares because of the lending costs.

This practice allows an unlimited number of shares to be sold short with the result that a company's share price can be driven down faster than by regular short selling. In 2008 it was argued that naked short selling contributed to the rapid demise of Lehman Brothers and Bear Stearns. As in short selling, naked short selling, notably of shares of financial institutions, faces tightened legislation in view of the recent crisis but rules vary from country to country.

Leverage

Leverage, in general, means using techniques to increase the returns offered by an investment strategy, for example investing borrowed money alongside capital. If the gains from investing the borrowed money are larger than the cost of borrowing, the leverage used pays off a profit.

Leverage is attractive to companies because it can increase returns for shareholders and can allow large investments to be made through debt and not by issuing new shares (which would dilute the existing owner's stake in the company) It can also have tax advantages, since interest payments are deductible from the company's pre-tax profits, unlike dividend payments to shareholders.

If kept at sound levels leverage can therefore contribute to increasing a company's wealth. But if companies borrow too much – become too "highly leveraged" – they can be vulnerable in the event of a crisis or downturn – or simply if their plans turn out to be over-optimistic.

This was the case with a number of banks prior to the financial crisis of 2007-2008, with Lehman Brothers for example having 30 times more debt than capital on its books. When profits were not being made through the money borrowed, the interest expense on the vast debt and credit risk of default destroyed all shareholder value.

It should be noted that capital requirement rules in themselves do not limit the use a company can make of leverage.

Asset-stripping

A company perceived to have poor management or poor economic performance is sometimes taken over by investors with the intent of breaking it up and selling all or part of its assets. Asset strippers look for companies whose composite parts are worth more than the current value of the company as a whole.

Asset stripping goes much further than the process of restructuring which new owners can sometimes impose, as restructuring has the long-term goal of creating a healthy business. While uncontroversial when a company is seen as failing beyond rescue, when an apparently healthy company is the target, the process is much criticised, with investors accused of destroying a viable business for a fast profit. The term has acquired such negative connotations that few investors would use it to describe their own activities.

Derivatives

Derivatives are financial instruments based on a contract between two or more parties. As their name indicates, their value is derived from other products since the fluctuations in these underlying products affect the resulting value of the derivative. Derivatives were created centuries ago to protect intensive users of a certain product from severe price movements.

Thus, airlines buy fuel futures contracts (a type of derivative) to allow them to be certain of the price they will pay for airline fuel in a year's time. Without such futures, business decisions could not be made within a predictable environment.

Derivatives are also used to insure against fluctuations in exchange rates, interest rates, as well as share prices and, more recently, the risk of a default on bonds (credit default swaps or CDS).

Derivatives can be traded on markets before their expiration date in the same way as shares in a company. This has led them to be used as a speculative instrument. The latest case making the headlines related to the market activity in CDS tied to Greek government bonds.

Derivatives can be traded privately ("over the counter" or OTC) or publicly through dedicated exchange platforms such as Eurex or the NYSE Euronext. For exchange-traded derivatives, the market price is usually transparent. However, complications can arise with OTC contracts, as trading is handled manually, with little opportunity for those other than the direct participants to learn the prices involved or the trades undertaken. In particular with OTC contracts, there is no central exchange to collate and disseminate prices. This lack of transparency as to, effectively, who owes what to whom, has made judging the value and even solvency of some financial firms extremely complex and has led to calls to limit the trade in OTC derivatives.

UCITS

Undertakings for Collective Investment in Transferable Securities (UCITS) are a particular class of investment funds that comply with the terms of an EU directive of the same name. The EU rules allow fund managers to market their UCITS EU-wide without needing to register in each of the member states they are marketing in. These funds are typically sold to retail investors .

Until the entry into force of an EU law regulating alternative investment funds (AIFs), the requirements imposed on UCITS are much more stringent than those on AIFs.

Master-feeder funds

The master-feeder fund structure allows fund managers to benefit from the efficiencies of larger pools of finances while providing the flexibility of designing smaller funds, which are tailor-made for different market situations.

One or more investment vehicles pool their finances within another vehicle – i.e. there are several smaller feeder funds and one master to which they contribute. This master fund is then responsible for performing all the investments of the assets transferred to it from the feeders.

Sometimes, especially when the feeders are hedge funds, this is a way of complying with the distinct legal systems of separate jurisdictions.

Fund of funds

A fund of funds (FOF) is an investment fund that invests in other funds with the main idea being that of tapping into the expertise of many managers and achieving maximum diversification. The concept is founded on the premise that not all investment managers are good in all markets and that not all managers are successful at all times.

There are different types of 'fund of funds', each investing in a different type of collective investment scheme (typically one type per FoF), eg. hedge fund FoF, private equity FoF or investment trust FoF.

Closed-ended fund

Like a company, this type of fund issues a set number of shares in an initial public offering and they trade on an exchange. Its share price is determined not by the total value of the assets it holds, but by investor demand for the fund.

Because an investor pulling out of a closed-end fund must sell its share of the fund on the market to another buyer, the fund's manager is not faced with the prospect of repaying large sums to his investors himself. In difficult times the fund manager can therefore continue taking more long-term decisions than an open-ended fund manager.

Being quoted on stock markets, closed-ended funds have more reporting requirements than open-ended funds.

Open-ended fund

This fund does not have restrictions on the number of shares to be issued. If demand is high enough, the fund will continue to issue shares no matter how many investors there are. Open-ended funds also buy back shares when investors wish to sell. An investor will generally purchase shares in the fund directly from the fund itself rather than from the existing shareholders.

The price at which shares in an open-ended fund are issued or can be redeemed will vary in proportion to the value of the fund's assets and will therefore directly reflect the fund's performance.
Hedge funds are typically open-ended funds.