COMMERZBANK

Product Group

Hedge Funds

In this information sheet, Commerzbank provides information on the underlying characteristics as well as the opportunities and risks of the hedge funds product group.

General characteristics and investment opportunities
In a hedge fund, a capital management company pools the money of many investors. The company invests the funds in different assets according to a defined investment strategy and following the principle of risk diversification and manages them professionally. The price of a fund unit depends on the price performance and the income generated by financial instruments held by the fund, such as securities and derivatives, and may therefore be subject to considerable fluctuations. However, a broad risk diversification reduces the reliance on the performance of individual financial instruments. This diversification effect decreases, though, if the investment fund is dedicated to specific investment themes, such as specific countries, sectors or currencies.

Hedge funds are classified as so-called "alternative investments". There is no generally recognised definition for alternative investments. Rather, alternative investments are a collective term for various types of investment that cannot be assigned to the traditional asset classes of equities, fixed income and real estate. They are the alternative to traditional types of investment. There is also no precise definition of the term hedge fund. The term "hedge" usually refers to a hedging transaction to minimise potential losses. As such, the term can be misleading, as hedge funds do not focus on hedging activities, but rather on strategies for increased return generation through the intentional assumption of elevated risks. Hedge fund performance is particularly determined by the decisions of the fund's management. If the management's market predictions are not realised, investors may be exposed to high capital losses or even a total loss of capital.

Typical product characteristics
Hedge funds are generally subject to few restrictions on asset selection as well as investment strategies and instruments. They are often subject to lower regulatory standards as many of them are based in financial offshore centres. Hedge funds generally pursue the goal of generating positive absolute returns independent of market trends (so-called total or absolute return strategy). They can use all financial instruments available on the financial markets, independent of a benchmark. Hedge funds invest in high-risk assets. This means they may invest some or all of their funds in risky transactions. These include, among others, the acquisition of high-risk securities, short selling, the use of derivatives, investments in commodity futures and the use of leverage through credit financing or other forms of financing.

Using a wide variety of investment and trading strategies as well as instruments, a hedge fund may enter into unique risk-reward positions. Most hedge fund managers, however, focus on specific strategies, such as Relative Value, Event Driven, Global Marco, Equity Hedge, Managed Futures. Some strategies pursue ambitious return targets with a high potential for return but also for loss, while others aim for steady performance over time. Hedge fund managers usually have an ownership interest in the capital of the hedge fund they manage. Moreover, the remuneration structure can differ significantly from those of conventional investment fund managers. Furthermore, in contrast to traditional investment funds, assets values are not determined on a daily basis, but only at specific, longer periods, which means that the current market value of the investment may not be available. For hedge funds, the terms and conditions may specify that unit pricing and redemption only take place on defined dates.

Hedge funds can also be designed as so-called funds of funds, i.e. the capital management company itself does not invest the investors' money directly in suitable assets, but invests in a variety of hedge funds. Typically, funds of funds invest in several hedge funds to achieve a sufficiently broad risk diversification.

Material risks of the product group

By investing in hedge funds, investors benefit from return opportunities, but are also exposed to additional material risks. These include the following:

Risk of loss - The price of a fund unit depends on the price performance and the income generated by financial instruments held by the fund, such as securities and derivatives, and may therefore be subject to considerable fluctuations. Factors that are beyond the scope of rational analysis are also relevant in the pricing process. In this context, the psychology of market participants plays a significant role. When sold, the proceeds may be less than the value of the original capital invested.

Issuer risk, i.e. investors are exposed to a default risk on the part of the issuer of the securities held in the fund if there is no collateral or insufficient collateral in the event of realisation. Sustainability-related decisions relating to the environment, social aspects and corporate governance also impact on the credit quality.

Interest rate and price risk - When interest rates rise, bond prices held by an investment fund generally fall. A downgrade in the issuer's credit rating reduces the value of a security during its term. Asset prices are subject to unpredictable and often strong volatility on the capital markets. In addition to company-specific factors, political and general economic trends - the economic risk - are also key drivers of asset prices.

Leverage risk - Hedge funds frequently use credit financing to increase investment returns. This may result in additional risks such as the need to sell assets to repay debt or the need to close uncovered forward transactions because of margin calls at an unfavourable time.

Risk through short selling - If the fund manager uses this strategy, the risk of loss is theoretically unlimited, since the short seller must buy the borrowed securities at current market prices to return them within the agreed time period.

Foreign currency risk - The fund as well as the assets held in it may be denominated in either euro or a foreign currency. If denominated in a foreign currency, investors are exposed to adverse changes in the exchange rate of the foreign currency.

Liquidity risk - During the term of the securities held in the fund, the fund may not be able to sell a security or may only be able to sell it at a possibly much lower price.

Holders of investment fund units are subject to special risks, for example that unit redemption may be temporarily suspended due to insufficient fund liquidity, for example in the event that many investors wish to redeem their units at the same time, or that a fund may be liquidated in an orderly manner.

When funds experience liquidity shortages, fund management companies have certain options to address them. They may, for example, introduce redemption notice periods. This means investors would have to notify the fund company of their intention to redeem their fund units some time in advance.

The fund company may also impose redemption restrictions. For example, fund companies may choose not to meet redemption requests for a certain period of time, or only partially, if the number of redemption requests exceeds a certain threshold.

Furthermore, a fund company may allocate transaction costs arising from unit redemptions or unit issues based on the cost originators. These transaction costs may be included in the calculation of the net asset value of a fund, up to a predefined rate.

These options are intended to prevent fund companies from having to completely suspend unit redemptions, which would be even more detrimental to investors.

Further information and costs

For further details on these aspects and the product, please refer to the relevant sales prospectus and basic information sheet. In principle, inflation trends impact your investment performance. A resulting loss of purchasing power affects both the income generated and your capital invested. When acquiring, holding and eventually selling securities and derivatives, costs will impact returns. For further details, please refer to the respective cost information before entering into a securities transaction.

For further details on the characteristics and risks of the products, please refer to the brochure “Basic Information on Securities and Other Investments”.