



# Important Information about Hedge Funds and Funds of Hedge Funds

We have prepared this document to help you understand the characteristics and risks associated with an investment in securities of hedge funds and funds of hedge funds ("FOHFs"), to assist you in making a more informed decision when buying or selling these securities. This document is compiled for your information and is intended to be a conversation starter between you and your Baird Financial Advisor or other appropriate experts, such as your tax or legal advisors. Your Baird Financial Advisor is available to address your questions and discuss the features, characteristics, costs, and risks of any particular investment. Baird offers eligible clients the opportunity to invest in a limited number of hedge funds, as well as FOHFs. Hedge funds and FOHFs can be an appropriate solution for certain qualified investors and part of an effective approach to achieving financial goals. This document describes various features that generally apply to most hedge funds and FOHFs, including a description of the compensation we and our Financial Advisors may receive if you invest in a hedge fund or FOHF. As with any investment, you should carefully review the fund's offering documents before investing.

This document provides information that generally applies to all Baird clients who invest in hedge funds. However, certain information may not apply to you, depending upon the type of relationship you have with us. You are urged to read this document carefully to identify what information applies to you. If you are participating in an investment advisory program or service offered by Baird, you should also review Baird's Form ADV Part 2A brochure for the particular program or service. The brochure contains additional important information that applies to you. If you would like a copy of the brochure, or if you have questions about the information contained in this document or your relationship with Baird, you should contact your Baird Financial Advisor.

## Characteristics of Hedge Funds

Hedge funds are private investment funds, the equity interests in which are offered to a limited number of qualified investors. Hedge funds are often structured as limited partnerships (or limited liability companies) and managed by a corporate general partner (or manager in the case of an LLC) with full investment discretion. Not all hedge funds

are alike. Hedge funds have different investment objectives and strategies, such as long/short, merger/risk arbitrage, distressed securities, tactical trading, equity-market neutral, convertible and fixed-income arbitrage, capital structure arbitrage, and emerging markets. Some even employ a combination of these strategies. Most hedge funds seek an absolute total return that is not correlated to the equity or debt markets or a particular index or other benchmark. Hedge funds have various fees and operating expenses that are deducted from the assets in the funds and/or each investor's account in the fund. Organizational costs may also be charged against the assets of the hedge fund, often over an initial five-year period. As discussed below, FOHFs invest substantially all of their assets in other hedge funds in an attempt to achieve diversification within a broad spectrum of hedge fund strategies.

## Characteristics of Fund of Hedge Funds

Through an investment in a single vehicle, FOHFs allow investors the opportunity to achieve diversification across multiple hedge funds. FOHFs usually invest in 15 to 25 other hedge funds, employing a multi-manager, multi-strategy approach to diversify against the risks associated with any particular hedge fund manager or strategy.

FOHFs impose management and performance fees that are in addition to the fees imposed by the underlying hedge funds in which the FOHFs invest. Some FOHFs are registered as investment companies and are structured as closed-end funds, and choose to register the offer and sale of their interests so that they can make a public offering. FOHFs often have lower minimum investment requirements than other hedge funds. The majority of the discussion below will focus on individual hedge funds generally but also applies to an investment in a FOHF vehicle.

## Limited Regulation

Hedge funds are largely unregulated. The offer and sale of interests in a hedge fund are not registered under federal or state securities laws, and a prospectus does not need to be delivered to potential investors. In addition, hedge funds are exempt from regulation as investment companies and thus are not subject to the requirements and limitations applicable to mutual funds, such as those relating to corporate governance, disclosures and

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transparency, leverage, diversification, illiquid positions, short selling, options and futures, and other investment techniques. Managers of hedge funds only need to be registered as investment advisers if they meet certain assets under management thresholds.

Offerings of interests in hedge funds are not required to be registered under the Securities Act of 1933 because they are structured as private placements rather than public offerings. In order to be considered a private placement, an offering of interests in a hedge fund is generally made without any form of general solicitation or advertising exclusively to "accredited investors," a term defined by the SEC which includes natural persons with a net worth of more than \$1 million, excluding the value of primary residences, and entities and institutions that are not formed for the purpose of investing in the fund with total assets of more than \$5 million. In addition, due to SEC rules that apply when hedge funds charge performance fees, investors may need to be "qualified clients," which require them to have a net worth of more than \$2 million. As a result, hedge funds are typically not available to the retail investor.

Hedge funds avoid regulation under the Investment Company Act in one of two ways. One way is to limit the number of investors in the fund to not more than 100. These are called "3(c)(1)" funds, named after the applicable exemption under Section 3(c)(1) of the Investment Company Act. The second way is to limit the types of owners in the fund to only "qualified purchasers," a term defined by the SEC which includes natural persons who own not less than \$5 million in investments as well as entities acting for their own accounts or the accounts of other qualified purchasers who own and invest on a discretionary basis at least \$25 million in investments. This type of fund is called a "3(c)(7)" fund. These funds must limit the number of qualified purchasers to less than 500 to avoid the reporting obligations applicable to public companies under the Securities Exchange Act of 1934.

## Domestic and Offshore Funds

Hedge funds can be organized as domestic funds or offshore funds. Domestic funds are structured as limited partnerships or LLCs, which are pass-

through entities for federal income tax purposes. Thus, the income and gains of a domestic fund are reported on the investors' individual tax returns. Offshore funds are not subject to U.S. taxation or other regulation. They are often organized as corporations in such countries as Bermuda, British Virgin Islands, the Cayman Islands and the Bahamas. Offshore funds are offered to persons and institutions that are not residents of the U.S., as well as to U.S. tax-exempt entities such as pension funds, charitable organizations and IRAs. These entities favor offshore funds because their investments in domestic funds may be subject to tax on "unrelated business taxable income" or "unrelated debt-financed income," notwithstanding their tax-exempt status. U.S. taxable investors would generally be harmed by investing in an offshore fund because of onerous U.S. taxes applicable to foreign investments.

## Common Characteristics

The typical hedge fund requires a significant investment (often \$250,000 or more). Investments are considered to be illiquid because interests in hedge funds generally are non-transferable, no secondary trading market exists for them, and interests may only be redeemed on a periodic basis and often merely in increments. As a result, hedge funds are not suitable for persons who have a need for liquidity. Hedge fund managers generally receive a management fee typically in the range of 1% to 2% of the fair market value of the assets in the fund, plus an incentive or performance fee (or allocation) based on a percentage of the fund's net realized and unrealized appreciation over a period of time (usually one year). That percentage can vary but is often in the range of 10% to 20%, and sometimes the incentive fee is not paid until achievement of a "high water mark" or hurdle rate. An incentive fee structure may provide an incentive to hedge fund managers to take greater risks.

Hedge funds typically provide a confidential private placement memorandum (frequently referred to as a "PPM") and a subscription booklet to potential investors. The PPM generally describes a fund's investment objectives and strategies, management, investment considerations or risk factors, purchase and redemption procedures, significant provisions of the partnership agreement, and tax considerations. On an ongoing basis, hedge funds

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generally do not provide much information to investors, other than annual financial statements and Schedules K-1, which provide information to enable investors to report their allocable share of the hedge fund's taxable income or loss and other tax items. Unlike mutual funds, hedge funds are not required to disclose their portfolio holdings or prepare annual or semi-annual reports describing their performance, and many don't, although some voluntarily provide quarterly commentaries and/or hold conference calls to discuss performance.

## Potential Benefits of Hedge Funds

Hedge funds may be appropriate for certain types of sophisticated investors who desire to supplement their traditional investment portfolios and at the same time can bear the special risks associated with hedge funds. Some of the potential benefits of hedge fund investing are described below.

- **Low Correlation to Traditional Asset Classes.** A primary benefit of hedge funds is the low correlation many strategies have to traditional investments. While past performance is not indicative of future results, hedge fund strategies historically offer returns independent from the performance of stock and bond markets. Adding hedge funds to a balanced portfolio of stocks and bonds provides diversification not otherwise available with traditional investing, while potentially reducing overall portfolio risk (volatility) and potentially increasing returns. Hedge funds are designed for the potential to achieve positive returns in all market environments, whether they are declining or advancing.
- **Alignment of Interests of Hedge Fund Managers and Investors.** Hedge fund managers typically are financially motivated to generate positive returns. Unlike many mutual fund managers, hedge fund managers are usually heavily invested in a significant portion of the funds they manage and share in the rewards as well as risks alongside of investors. In addition, fund managers only earn an incentive fee when returns are positive. This fee structure further aligns the goals of investors and fund managers and attracts many of the best practitioners and other financial experts to the hedge fund industry.

- **Flexibility of Investment Vehicles.** Hedge funds are extremely flexible in their investment options because they use financial instruments generally beyond the reach of mutual funds, which have SEC regulations and disclosure requirements that largely prevent them from using short selling, leverage, concentrated investments, and derivatives. This flexibility, which includes use of hedging strategies to protect downside risk, gives hedge funds the ability to manage investment risks. A hedge fund's use of leverage also potentially enhances total returns.

## Understanding the Risks

Risk is inherent in any investment product or strategy. Certain of the common risks and other important considerations associated with investment in hedge funds are highlighted below. Certain of the potential benefits of hedge fund investing also present special risks. You are strongly encouraged to review the prospectuses or other disclosure documents associated with any product for a more fulsome discussion of additional risks and other important considerations before making any investment decision. For additional information regarding investment risks and other important considerations see:

<https://www.bairdwealth.com/retailinvestor>

While the risks will vary from fund to fund, and a hedge fund's PPM will generally describe the primary risks, some of the more common risks include the following:

- **Lack of Regulatory Oversight.** Unlike mutual funds and other investment companies, hedge funds are not subject to regulation under the Investment Company Act and offerings of interests in hedge funds are not registered with the SEC under the Securities Act of 1933. Hedge fund advisers are not required to be registered investment advisers until the fund(s) they manager have \$150 million or more in total assets.
- **Lack of Liquidity.** Ownership interests in hedge funds are considered to be illiquid. They generally cannot be sold or otherwise transferred and there is no secondary trading market for them. Hedge funds also place

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restrictions on the ability to withdraw and redeem (or sell back) interests. Often, hedge funds establish lock-up periods during which redemptions are prohibited and thereafter limit the amount and frequency of redemptions. Hedge fund investing should, therefore, be limited to those who have no need for liquidity with regard to the amount of their investment.

- **Limited Disclosure and Transparency.** Although hedge funds provide disclosure (in the form of a confidential private placement memorandum) to potential investors before they make their investment, such disclosure is not mandated, reviewed or approved by federal or state securities regulators. As a result, the disclosures provided by hedge funds may not contain all the categories of information that must be disclosed by mutual funds. In addition, hedge funds typically do not provide much information to investors on an ongoing basis, other than annual financial statements and required tax reports. Investors usually are not aware of the securities and other holdings of a hedge fund or the fund's performance, nor are they well-informed about the investment strategies employed by the fund.
- **Low Market Correlation; Flexible Investment Strategies.** Hedge funds generally do not seek to measure their performance against any particular index or other benchmark. As a result, there is often little or no correlation of a hedge fund's returns to the returns of the broader equity or bond markets. Hedge funds may tend to underperform in bull markets but outperform in bear markets. Hedge fund managers often give themselves maximum flexibility to pursue any types of investment strategies and to change stated strategies at any time without notice.
- **Use of Leverage and Other Investment Techniques.** Many hedge funds borrow money and use other forms of leverage as an important part of their investment strategy. Certain of a hedge fund's investment techniques, such as short sales, options and futures trading, are sources of leverage. Hedge fund leverage ratios can be considerably higher than mutual funds and applicable margin requirements. While leverage may enhance a fund's return, it can also magnify potential losses.
- **Potentially High Fees; Performance Fee Conflict.** The fees charged by hedge fund managers can be higher than mutual funds because of the fees include a performance fee or allocation based on a significant percentage of the hedge fund's net appreciation. Because of the existence of a performance fee, hedge fund managers may be motivated to make riskier investments that have the potential for significant growth in value. FOHFs impose their own fees and expenses in addition to those imposed by the underlying hedge fund investments that the FOHFs make. FOHFs often charge both a management fee and a performance fee.
- **Valuation of Hedge Fund Assets.** Hedge fund managers are responsible for valuing hedge fund assets. These assets are valued at their fair market values for purposes of determining management and performance fees and the value of investors' interests in a hedge fund. Many hedge funds hold securities and other investments for which market quotations are not readily available, which necessitates the use of "fair value" pricing. Fair value pricing is an inherently subjective process and may not accurately reflect the prices that can actually be obtained upon sale of the assets for which fair values are used.
- **Tax Issues.** Hedge funds are typically partnerships or limited liability companies that are pass-through entities for income tax purposes. Hedge funds typically do not pay taxes at the entity level on their income and gains. Instead, each investor in a hedge fund must typically report his allocable share of the fund's income, gains, losses, deductions and credits on his own tax return. Domestic hedge funds are generally not appropriate for tax-deferred investors, such as retirement plans, foundations and the like, because they generate unrelated business taxable income for such investors. Additionally, most hedge funds do not make annual cash dividends or other distributions to investors. As a result, investors in a hedge fund normally will have an income tax obligation without receiving any cash from the fund to cover that obligation.



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## How Baird is Compensated

Hedge funds and their vendors may compensate Baird based upon upfront or back-end sales charges, if any, paid by a client. The amounts of such charges vary by fund and by share class and the amount paid by such funds and their vendors to Baird is typically a percentage of the net value of the assets invested in a particular fund. Where appropriate, Baird may also receive compensation based on a client's continued investment in a hedge fund in the form of distribution fees or shareholder servicing fees. These fees are also typically a percentage of the net value of the assets invested in a particular fund.

More detailed information on the charges and fees, as well as amounts paid to Baird, if applicable, associated with a client's investment in a hedge fund is set forth in such fund's PPM. If a Baird client holds a hedge fund position in an account that charges an asset-based fee, Baird may assess such a fee, in whole or in part, based on the value of the client's investment in a particular fund.

## More Information

Before investing in a hedge fund or FOHF investment, it is important to understand and discuss with your Baird Financial Advisor the structure, terms, and potential risks and determine whether an investment is right for you.

To learn more about hedge funds, please contact your Financial Advisor or review the Securities and Exchange Commission's Investor Bulletin on Hedge Funds at <https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-bulletins-46>