

About Hedge Funds

What is a Hedge Fund?

A hedge fund is a fund that can take both long and short positions, use arbitrage, buy and sell undervalued securities, trade options or bonds, and invest in almost any opportunity in any market where it foresees impressive gains at reduced risk. Hedge fund strategies vary enormously -- many hedge against downturns in the markets -- especially important today with volatility and anticipation of corrections in overheated stock markets. **The primary aim of most hedge funds is to reduce volatility and risk while attempting to preserve capital and deliver positive returns under all market conditions.**

There are approximately 14 distinct investment strategies used by hedge funds, each offering different degrees of risk and return. A macro hedge fund, for example, invests in stock and bond markets and other investment opportunities, such as currencies, in hopes of profiting on significant shifts in such things as global interest rates and countries' economic policies. A macro hedge fund is more volatile but potentially faster growing than a distressed-securities hedge fund that buys the equity or debt of companies about to enter or exit financial distress. An equity hedge fund may be global or country specific, hedging against downturns in equity markets by shorting overvalued stocks or stock indexes. A relative value hedge fund takes advantage of price or spread inefficiencies. **Knowing and understanding the characteristics of the many different hedge fund strategies is essential to capitalizing on their variety of investment opportunities.**

It is important to understand the differences between the various hedge fund strategies because **all hedge funds are not the same -- investment returns, volatility, and risk vary enormously among the different hedge fund strategies.** Some strategies which are not correlated to equity markets are able to deliver consistent returns with extremely low risk of loss, while others may be as or more volatile than mutual funds. A successful fund of funds recognizes these differences and blends various strategies and asset classes together to create more stable long-term investment returns than any of the individual funds.

- Hedge fund strategies vary enormously -- many, but not all, hedge against market downturns -- especially important today with volatility and anticipation of corrections in overheated stock markets.
- The primary aim of most hedge funds is to reduce volatility and risk while attempting to preserve capital and deliver positive (absolute) returns under all market conditions.
- The popular misconception is that all hedge funds are volatile -- that they all use global macro strategies and place large directional bets on stocks, currencies, bonds, commodities or gold, while using lots of leverage. In reality, less than 5% of hedge funds are global macro funds. Most hedge funds use derivatives only for hedging or don't use derivatives at all, and many use no leverage.

Key Characteristics of Hedge Funds

- Hedge funds utilize a variety of financial instruments to reduce risk, enhance returns and minimize the correlation with equity and bond markets. Many hedge funds are flexible in their investment options (can use short selling, leverage, derivatives such as puts, calls, options, futures, etc.).
- Hedge funds vary enormously in terms of investment returns, volatility and risk. Many, but not all, hedge fund strategies tend to hedge against downturns in the markets being traded.

- Many hedge funds have the ability to deliver non-market correlated returns.
- Many hedge funds have as an objective consistency of returns and capital preservation rather than magnitude of returns.
- Most hedge funds are managed by experienced investment professionals who are generally disciplined and diligent.
- Pension funds, endowments, insurance companies, private banks and high net worth individuals and families invest in hedge funds to minimize overall portfolio volatility and enhance returns.
- Most hedge fund managers are highly specialized and trade only within their area of expertise and competitive advantage.
- Hedge funds benefit by heavily weighting hedge fund managers' remuneration towards performance incentives, thus attracting the best brains in the investment business. In addition, hedge fund managers usually have their own money invested in their fund.

Facts About the Hedge Fund Industry

- Estimated to be a \$300-\$400 billion industry and growing at about 20% per year with between 4,000 and 5,000 active hedge funds.
- Includes a variety of investment strategies, some of which use leverage and derivatives while others are more conservative and employ little or no leverage. Many hedge fund strategies seek to reduce market risk specifically by shorting equities or through the use of derivatives.
- Most hedge funds are highly specialized, relying on the specific expertise of the manager or management team.
- Performance of many hedge fund strategies, particularly relative value strategies, is not dependent on the direction of the bond or equity markets -- unlike conventional equity or mutual funds (unit trusts), which are generally 100% exposed to market risk.
- Many hedge fund strategies, particularly arbitrage strategies, are limited as to how much capital they can successfully employ before returns diminish. As a result, many successful hedge fund managers limit the amount of capital they will accept.
- Hedge fund managers are generally highly professional, disciplined and diligent.
- Their returns over a sustained period of time have outperformed standard equity and bond indexes with less volatility and less risk of loss than equities.
- Beyond the averages, there are some truly outstanding performers.
- Investing in hedge funds tends to be favored by more sophisticated investors, including many Swiss and other private banks, that have lived through, and understand the consequences of, major stock market corrections.
- An increasing number of endowments and pension funds allocate assets to hedge funds.

Hedging Strategies

A wide range of hedging strategies are available to hedge funds. For example:

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

Popular Misconception

The popular misconception is that all hedge funds are volatile -- that they all use global macro strategies and place large directional bets on stocks, currencies, bonds, commodities, and gold, while using lots of leverage. In reality, less than 5% of hedge funds are global macro funds like Quantum, Tiger, and Strome. Most hedge funds use derivatives only for hedging or don't use derivatives at all, and many use no leverage.

Benefits of Hedge Funds

- 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.
- Academic research proves hedge funds have higher returns and lower overall risk than traditional investment funds.
- 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.

Hedge Fund Styles

The predictability of future results shows a strong correlation with the volatility of each strategy. Future performance of strategies with high volatility is far less predictable than future performance from strategies experiencing low or moderate volatility.

Aggressive Growth: Invests in equities expected to experience acceleration in growth of earnings per share. Generally high P/E ratios, low or no dividends; often smaller and micro cap stocks which are expected to experience rapid growth. Includes sector specialist funds such as technology, banking, or biotechnology. Hedges by shorting equities where earnings disappointment is expected or by shorting stock indexes. Tends to be "long-biased." *Expected Volatility: High*

Distressed Securities: Buys equity, debt, or trade claims at deep discounts of companies in or facing bankruptcy or reorganization. Profits from the market's lack of understanding of the true value of the deeply discounted securities and because the majority of institutional investors cannot own below investment grade securities. (This selling pressure creates the deep discount.) Results generally not dependent on the direction of the markets. *Expected Volatility: Low - Moderate*

Emerging Markets: Invests in equity or debt of emerging (less mature) markets that tend to have higher inflation and volatile growth. Short selling is not permitted in many emerging markets, and, therefore, effective hedging is often not available, although Brady debt can be partially hedged via U.S. Treasury futures and currency markets. *Expected Volatility: Very High*

Funds of Hedge Funds: Mix and match hedge funds and other pooled investment vehicles. This blending of different strategies and asset classes aims to provide a more stable long-term investment return than any of the individual funds. Returns, risk, and volatility can be controlled by the mix of underlying strategies and funds. Capital preservation is generally an important consideration. Volatility depends on the mix and ratio of strategies employed. *Expected Volatility: Low - Moderate - High*

Income: Invests with primary focus on yield or current income rather than solely on capital gains. May utilize leverage to buy bonds and sometimes fixed income derivatives in order to profit from principal appreciation and interest income. *Expected Volatility: Low*

Macro: Aims to profit from changes in global economies, typically brought about by shifts in government policy that impact interest rates, in turn affecting currency, stock, and bond markets. Participates in all major markets -- equities, bonds, currencies and commodities -- though not always at the same time. Uses leverage and derivatives to accentuate the impact of market moves. Utilizes hedging, but the leveraged directional investments tend to make the largest impact on performance. *Expected Volatility: Very High*

Market Neutral - Arbitrage: Attempts to hedge out most market risk by taking offsetting positions, often in different securities of the same issuer. For example, can be long convertible bonds and short the underlying issuers equity. May also use futures to hedge out interest rate risk. Focuses on obtaining returns with low or no correlation to both the equity and bond markets. These relative value strategies include fixed income arbitrage, mortgage backed securities, capital structure arbitrage, and closed-end fund arbitrage. *Expected Volatility: Low*

Market Neutral - Securities Hedging: Invests equally in long and short equity portfolios generally in the same sectors of the market. Market risk is greatly reduced, but effective stock analysis and stock picking is essential to obtaining meaningful results. Leverage may be used to enhance returns. Usually low or no correlation to the market. Sometimes uses market index futures to hedge out systematic (market) risk. Relative benchmark index usually T-bills. *Expected Volatility: Low*

Market Timing: Allocates assets among different asset classes depending on the manager's view of the economic or market outlook. Portfolio emphasis may swing widely between asset classes. Unpredictability of market movements and the difficulty of timing entry and exit from markets add to the volatility of this strategy. *Expected Volatility: High*

Opportunistic: Investment theme changes from strategy to strategy as opportunities arise to profit from events such as IPOs, sudden price changes often caused by an interim earnings disappointment, hostile bids, and other event-driven opportunities. May utilize several of these investing styles at a given time and is not restricted to any particular investment approach or asset class. *Expected Volatility: Variable*

Multi Strategy: Investment approach is diversified by employing various strategies simultaneously to realize short- and long-term gains. Other strategies may include systems trading such as trend following and various diversified technical strategies. This style of investing allows the manager to overweight or underweight different strategies to best capitalize on current investment opportunities. *Expected Volatility: Variable*

Short Selling: Sells securities short in anticipation of being able to rebuy them at a future date at a lower price due to the manager's assessment of the overvaluation of the securities, or the market, or in anticipation of earnings disappointments often due to accounting irregularities, new competition, change of management, etc. Often used as a hedge to offset long-only portfolios and by those who feel the market is approaching a bearish cycle. High risk. *Expected Volatility: Very High*

Special Situations: Invests in event-driven situations such as mergers, hostile takeovers, reorganizations, or leveraged buyouts. May involve simultaneous purchase of stock in companies being acquired, and the sale of stock in its acquirer, hoping to profit from the spread between the current market price and the ultimate purchase price of the company. May also utilize derivatives to leverage returns and to hedge out interest rate and/or market risk. Results generally not dependent on direction of market. *Expected Volatility: Moderate*

Value: Invests in securities perceived to be selling at deep discounts to their intrinsic or potential worth. Such securities may be out of favor or underfollowed by analysts. Long-term holding, patience, and strong discipline are often required until the ultimate value is recognized by the market. *Expected Volatility: Low - Moderate*

What is a Fund of Hedge Funds?

- A diversified portfolio of generally uncorrelated hedge funds.
- May be widely diversified, or sector or geographically focused.
- Seeks to deliver more consistent returns than stock portfolios, mutual funds, unit trusts or individual hedge funds.
- Preferred investment of choice for many pension funds, endowments, insurance companies, private banks and high-net-worth families and individuals.

- Provides access to a broad range of investment styles, strategies and hedge fund managers for one easy-to-administer investment.
- Provides more predictable returns than traditional investment funds.
- Provides effective diversification for investment portfolios.

Benefits of a Hedge Fund of Funds

- Provides an investment portfolio with lower levels of risk and can deliver returns uncorrelated with the performance of the stock market.
- Delivers more stable returns under most market conditions due to the fund-of-fund manager's ability and understanding of the various hedge strategies.
- Significantly reduces individual fund and manager risk.
- Eliminates the need for time-consuming due diligence otherwise required for making hedge fund investment decisions.
- Allows for easier administration of widely diversified investments across a large variety of hedge funds.
- Allows access to a broader spectrum of leading hedge funds that may otherwise be unavailable due to high minimum investment requirements.
- Is an ideal way to gain access to a wide variety of hedge fund strategies, managed by many of the world's premier investment professionals, for a relatively modest investment.