An introduction to hedge funds

1). Introduction

In this article we will cover the general characteristics of Hedge Funds, which is one of the main constituent of the “alternative investment” asset class.

2). Introduction to hedge funds

The term hedge fund was born in 1949 when Alfed Winslow Jones set up an investment fund with himself as a GP. He called the portfolio “hedged fund” because he was shorting stocks to offset other long position he had in the market. Now the term has been shorted to “hedge fund” and the characteristics have changed quite a lot, but that was the first example.

Common features of hedge funds nowadays may be:

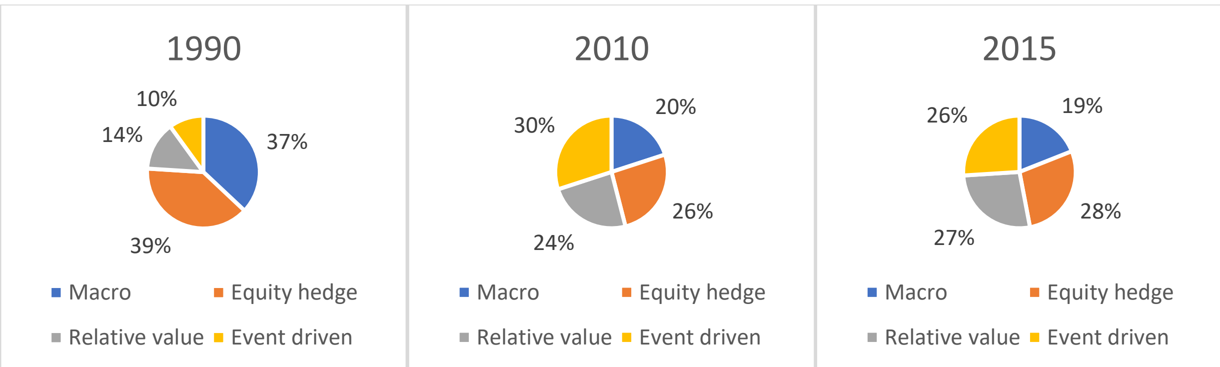
- Aggressively managed portfolio: includes leverages, short position and derivatives or some of these elements
- Goal of generating high returns (absolute or relative) with few or any restrictions
- Set up as a private investment partnership open to a limited number of investors
- Restriction on redemptions
    - Lockup period: money must stay into the fund for a minimum period
    - Notice period: investors can redeem money only upon a certain notice period

Investors are willing to accept the restriction because of the high reported returns of hedge funds in the past and their perceived low correlation with traditional investments. The hedge fund space has grown a lot in the last 3 decades: HFRI reports that AUM grew from $39bn in 1990, to $491 bn in 2000 to $2.9 trillion in 2015. The increase interest has lead to the emergence of a new category: the funds of hedge funds. They are funds that hold a portfolio of hedge funds.

2.1). Hedge fund strategies

Usually hedge funds are classified by strategy, although some another common criteria is the asset class they invest in. In 2015 HFRI identified four categories of HF:

- Event driven
- Relative value
- Macro
- Equity hedge



As can be seen from the graphs above, showing the percentage of AuM by strategy, event driven and relative value grew in popularity, whereas equity hedge and macro declined.

2.1.1) Event driven strategies

Event driven HF follow a bottom up approach: from company level analysis by aggregation to an higher level, such as industry. Further taxonomy by HFRI includes:

- Merger arbitrage. Strategies include going long the stock of the company being acquired and selling the stock of the company leading the transaction. A possible rationale could be the buyer overpaying for the target and possibly incurring in additional debt. The primary risk is the acquisition not taking place.
- Distressed/restructuring. Focus on securities of companies either in bankruptcy or perceived to be close to it. Possible strategies include:
  - Purchasing fixed income securities trading at a significant discount to par, with the goal to resell them after the restructuring of the company
  - Buying senior debt and selling junior debt on the premise of the spread widening
- Activist. Purchase enough equity in order to influence a company's policy or direction.
- Special situations. Focus on opportunities in the equity of companies which are engaged in restructuring activities other than mergers, acquisition or bankruptcy, such as repurchase and special capital distributions.

2.1.2). Relative value strategies

These strategies seek to profit from a pricing discrepancy between related securities, involving buying and selling related securities. Further classification include:

- Fixed-income convertible arbitrage. Zero beta portfolio investment strategy trying to exploit a perceived mispricing between a convertible bond and its component parts (underlying bond + stock option)
- Fixed-income asset backed. Take advantage of mispricing across different ABS
- Fixed-income general. Focus on relative value withing the fixed-income markets: eg. trades between two corporate issuers, between corporate and government issuers…
- Volatility. Use of options to go long or short market volatility in a specific asset or across asset classes.
- Multi strategy. Trade relative value within and across asset classes or instruments.

2.1.3). Macro strategies

Emphasis is on top down approach to identify economic trends evolving across the world; trades are done based on expected development in economic variables. Macro hedge funds can use short and/or long positions to profit from different scenarios.

2.1.4). Equity hedge strategies

This can be thought as the original core of the HF industry: they are focused on public markets and take long/short positions in equity and equity derivatives. Examples of categories inside this space include:

- Market neutral. Tries to maintain a net position in relation to the market, the portfolio should have a beta of approximately 0. The intent is to profit from individual securities movement rather than the market trends
- Fundamental growth. Use fundamental analysis to identify companies expected to exhibit high growth and capital appreciation
- Fundamental value. Use fundamental analysis to find companies which are undervalued.
- Quantitative directional. Use quantitative techniques to build a long/short portfolio of securities.
- Short bias. Identify overvalued securities.

- Sector specific. Use expertise in a specific sector.

Smaller (by AuM) hedge fund focus on one particular strategy, whereas large hedge funds are usually multi-strategy. A multi-strategy funds are an alternative to funds of hedge funds. While funds of hedge funds offer better diversification and are more accessible to smaller investors, they have a double layer of fees which can be impactful in the net returns.

2.2). Hegde Funds and Diversification

HF usually claim that their performance is uncorrelated with stock market returns, but this claim is not substantiated by data, at least in long time periods. Furthermore during financial crisis the correlation might increase. However they have the advantage of being much more flexible and reactive when a financial crisis happens: they can short, leverage more etc… making them more able to seize the opportunities. Finally they also provide the financial community with an important "service": hedge funds focused on arbitrage opportunities play an important role in price discovery. Nevertheless the hedge fund has become more and more crowded, making price discovery more efficient and more difficult for them to exploit mispricing.

2.3). Hedge fund fees

Although HF have witnessed a strong growth in the last years, they still remain a small part of the asset management business. Nevertheless, according to estimates from Citigroup for 2013, managing 3% of total managed funds still accounts for more than 30% of managed fees revenues.

The fee structure can vary a lot, but they have one common logic: there is a fee based on capital committed and one on performance. The common rule used to be 2 and 20: 2% of fee on capital committed and 20% on the returns. For funds of funds these values were 1 and 10. However the increase competition brought these fees down: HFRI reported in March 2016 1.6% and 17.75%.

The incentive fee can have several nuances:

- It may be calculated on profits net of management fees or on profits before management fees
- It can be specified that the fee is calculated only if the HF achieves a specific return: the hurdle rate
    - Hard hurdle rate: the performance fee is calculated on returns in excess of the hurdle rate
    - Soft hurdle rate: the performance fee is calculated on all return
- Water mark: represents the maximum (previous) asset value of the fund. It can be stated that the incentive fee will be paid only if the final NAV for that year is above the water mark. For example if a fund had a bad year this clause implies the fund is not getting any incentive fee: in the following years only after having recovered the losses an incentive fee will be paid. The water mark protects the clients from paying twice for the same performance.

2.4). Hedge Fund valuation nuances

Valuation of NAV are important to determine the returns for an hedge fund. There are particular details to care of when doing the valuation for an HF:

- Market prices. When market prices are used funds vary their approach, a common practice being using the average quote. However, a more conservative would be to report long position at bid price and short position at ask price, since these are the prices at which they can be liquidated.
- Liquidity. This is a very important factor in valuation, but particularly important for strategy involving convertible bonds, CDO, distressed debt etc.. Practitioners, even if the market price for the security is available, apply a liquidity discount (haircut). This method results in HF having 2 reported NAVs:
    - Trading NAV: incorporates liquidity discounts

- Reporting NAV: based on quoted market prices

References

Derivatives and Alternative Investments, CFA Level 1 Material