Alternative Investments

Hedge Funds

Exam Focus

- Investment features of hedge funds in contrast with other asset classes
- Investment forms and vehicles used in hedge funds
- Sources of risk, return, and diversification among hedge fund investments

Definition of a Hedge Fund

Hedge funds originally were equity investments with **long** and **short positions** that hedged against major stock market movements.

Hedge funds today are not restricted to equities or even to hedging strategies:

- **Wide variety of assets:** equities, fixed income, derivatives, FX, real assets
- **Private investments:** hedge funds are not available to public investors
- **Light regulation:** in many jurisdictions, as they are not available to the public
- **Leverage and short selling:** few restrictions, as these are private funds

It is the investment approach, rather than the assets, that distinguish hedge funds.

Hedge Fund Objectives and Benchmarks

The objective of a hedge fund is to generate high returns:

- Either on an **absolute basis**
- Or, on a **risk-adjusted basis**, relative to portfolio volatility

Finding a suitable benchmark

- Is difficult for hedge funds, as many strategies have limited beta exposure
- More common to assess performance on an **absolute return basis**

Diversification potential

- Hedge funds have a **low correlation** to traditional assets

Hedge Funds vs. Mutual Funds

Hedge funds are private, pooled, less regulated investments aimed at **accredited investors** and **institutional investors** and have high minimum investments.

- The managers are required to be investors in the fund.
- HFs have **fixed fees** and **performance fees** based on achieving hurdle rates.
- Performance fees may also include high-water marks.

Mutual funds are public, pooled, regulated investments for **any investor** and have low minimum investments.

- The managers are **not necessarily investors** in the fund.
- Investment managers are paid a **fixed fee** (% of assets under management).

Classification of Investment Strategies

Broad categories of hedge fund strategies

- Equity hedge funds
- Event-driven hedge funds
- Relative value hedge funds
- Opportunistic hedge funds
- Multi-manager hedge funds

Short positions and leverage

- Not all strategies use short positions or leverage
- **Fund-of-funds** invests in various hedge funds

Hedge Fund Strategies

Equity	Event Driven	Relative Value	Opportunistic	Multi-Manager
Long/short equity	Merger arbitrage	Convertible bond arbitrage	Global macro	Fund-of-funds
Short biased	Distressed	Fixed-income arbitrage	Managed futures	
Market neutral	Special situations	Multi-strategy		
	Activist			

Equity Hedge Fund Strategies

Equity hedge fund strategies focus on stock selection to combine long and short equity positions, often using a bottom-up approach:

- **Fundamental analysis:** company level, industry level, overall market analysis
- **Long positions** in undervalued stocks; **short positions** in overvalued stocks
- **Net beta** may be net long, net short, or neutral, depending on the strategy

Fundamental long/short: long undervalued, short overvalued stocks, net long

Fundamental growth or value: long/short focusing on either style, net long

Short biased: use quantitative, technical, and fundamental analysis; contrarian

Market neutral: long and short positions with a **net-zero beta**; stock picking

Event-Driven Strategies

Event-driven strategies seek to profit from correctly anticipating the outcomes of defined events.

- **Merger arbitrage:** a proposed merger will or will not proceed
  - *Buy the target, sell the acquirer; HF bets the merger will proceed*
- **Distressed/restructuring:** distressed firm will either fail or recover
  - *HF may be involved in creditor meetings; buy fulcrum securities*
- **Activist:** shareholders actively creating change and adding value to public firms
  - *Shareholders may advocate divestitures, restructuring, change in strategy*
- **Special situations:** rescue finance, asset sales/spinoffs

Relative Value Strategies

Relative value strategies seek to profit from pricing discrepancies, where one asset is overpriced and another underpriced.

- **Sell** the overpriced asset; **buy** the underpriced asset
- **Leverage** is used to profit from small price differences
- **Mean reversion:** identify assets that have moved away from historical norms
  - Bet that the assets will revert to their “normal” relationships

Relative Value Strategies

Convertible bond arbitrage: a market-neutral (zero-beta) strategy

- **Buy a convertible bond** containing valuable stock options (long equity)
- **Short sell the stock** of the firm (short equity)
- The strategy wins if the value of the embedded options rises
- The strategy has credit risk of the convertible, which may be hedged

Fixed income arbitrage: focuses on relative pricing differences

- **Relative value:** sovereign debt and investment-grade bond pricing discrepancies
- **Capital structure trades:** long/short positions in debt/equity of distressed firms
- **MBS, ABS, and high-yield** trades focus on mispricing

Opportunistic Strategies

Opportunistic strategies focus on macro events and commodity trading.

- **Macro strategies:** use a *top-down approach* to identify economic trends
  - Aim to correctly anticipate global events
  - Does well in periods of global volatility
- **Managed futures:** use *technical* and *fundamental analysis* for futures trading
  - Commodity trading advisers (CTAs) are managed futures funds
  - Does well in trending markets, up or down
  - Useful for diversification in falling markets due to short futures positions

Hedge Funds: Question

Which of the following statements about relative value strategies is *least accurate?*

A. Relative value strategies seek to profit from a price or return discrepancy between securities based on a short-term relationship.

B. Relative value funds are inherently structured to minimize net market risk and credit risks.

C. The investments made under a relative value strategy are all within a single asset class or sector, using assets with a sufficient price differential to arbitrage their movements to equilibrium prices.

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Hedge Funds: Question

Which of the following statements is *least accurate* about hedge funds?

A. Merger arbitrage strategies generally assume that an acquirer will be overpaying for the target.

B. Event-driven hedge funds flourish in a stable market environment, where minor deviations in asset prices quickly converge to equilibrium.

C. An activist strategy expects to realize higher returns due to the manager being more effective in driving the corporate policies or strategic direction of the investment.

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Hedge Funds: Question

An investor wants to invest in a diversified hedge fund that minimizes the return correlation with the traditional asset classes but would prefer the fund to be more liquid and transparent while minimizing the leverage obtained by borrowing or shorting. What would be the *most appropriate* hedge fund the investor can choose?

A. Fundamental value.

B. Managed futures.

C. Multi-strategy.

D. Fund of funds.

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Distinguishing Characteristics of Hedge Funds

Key characteristics that **distinguish hedge funds** from traditional investments

- Less regulation, higher risk of fraud
- Unrestricted use of shorting, leverage, and derivatives
- Larger investment universe
- Concentrated exposures
- Nontraditional strategies with exposure to credit, volatility, and liquidity risks
- Liquidity constraints for investors (i.e., lockups and liquidity gates)
- Higher fee structures with management fees and incentive fees

Direct Forms of Hedge Fund Investment

Private investment partnership

Hedge funds are often set up as a private investment partnership:

- *Limited liability partnerships* or *limited liability companies*
- *General partners* and *limited partners*

Master-feeder structure

- **Onshore** and **offshore feeder funds** feed into a **master fund**
- General partner invests capital based on partnership agreements
- *Side letters* add further terms and conditions to partnership agreement

Direct Forms of Hedge Fund Investment

Separately managed account (SMA)

- For larger investors, allowing them to retain more influence
- Investors may wish to create their **own investment vehicle** to hold the assets
  - Day-to-day management of account is delegated to HF manager
  - Investors negotiate lower fees and fund expenses
  - Requires additional agreements
- Often invest in the most liquid trades
- **Motivation** of hedge fund managers **may be reduced** due to the lower fees

Hedge Funds: Question

Choose the correct statements regarding benefits of a master feeder structure.

A. It allows investors in taxable jurisdictions to invest in an offshore hedge fund without any tax liability.

B. Pooling funds from offshore and onshore funds creates economies of scale.

C. This structure allows hedge funds to accept funding from global investors with relative ease.

D. Many regional regulatory requirements can be avoided by such a structure.

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Indirect Forms of Hedge Fund Investment

Funds of hedge funds approach

- More accessible for smaller institutional and retail investors
- Lower minimum investments
- Access to hedge fund managers and nontraditional investment strategies
- Increasing performance transparency
- Improved liquidity with reduced lockup periods

Disadvantages

- **Higher fee structure:** fund-of-funds manager fees and hedge fund fees

Indirect Forms of Hedge Fund Investment

Exchange-traded funds (ETFs)

- Increasing number of ETFs **seeking to replicate** hedge fund **investment styles**
- ETFs don't invest in hedge funds directly; they invest in more liquid assets
- Lower fees, greater liquidity, and increased transparency

Disadvantages

- ETFs are regulated: unlike most hedge funds, which are lightly regulated
- Lower returns
- Limits on leverage and asset concentrations

Hedge Funds: Question

Which of the following is not a characteristic of hedge funds?

A. Hedge funds are mostly illiquid, with little trading possibilities.

B. Hedge fund managers use leverage; however, the overall risk is lower.

C. Hedge funds are a different asset class, with a distinct risk/reward profile.

D. Managers demand higher remuneration and have more discretionary freedom in the choice of investments

Hedge Funds: Question

Identify the investment structure most appropriate for the investor:

Investment Structure	Investor Type
Managed futures	A high-net-worth investor who requires tax-efficient investment channels with a high degree of control over allocation decisions
SMA	An institutional investor intending to invest in commodity markets
Fund-of-funds	A small investor who would like hedge fund exposure at a lower risk

Hedge Fund Risk, Return, and Diversification

Risk and return exposures of hedge funds

- Hedge funds generally have a **low exposure** to market risk
  - *Low net beta, low systematic risk*
- Hedge funds generally have a **high exposure** to idiosyncratic risks
  - *Focus on alpha returns, rather than beta (market) risk and return*

Hedge fund performance attribution

- **Market beta:** the broad market beta
- **Strategy beta:** the beta of the investment strategy and leverage used
- **Alpha:** the manager-specific returns, correct timing, and implementation

Hedge Funds: Question

Both hedge funds and private equity invest in equity stock of public or private enterprises, and there are many commonalities between them. The following statements are some of the commonalities, and one of these statements is false. Choose the false statement.

A. Both are structured as partnerships of investors with private pooling of funds and are primarily intended for high-net-worth individuals.

B. Both utilize leverage to invest in a variety of marketable securities.

C. Both are less liquid than mutual funds or ETFs.

D. Both are less regulated, and the transparency/reporting requirements are not strict.

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Hedge Fund: Question

Selecting investment trades with high idiosyncratic risk is *most likely* associated with the management of which type of fund?

A. Equity index ETF.

B. Long-only equity mutual fund.

C. Long/short equity hedge fund.

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Hedge Fund Data

Several sources of bias suggest hedge fund returns are overestimated:

- **Voluntary reporting** of performance data
- **Selection bias:** inconsistent allocation of funds to style categories
    - *Control over the inclusion or exclusion of fund data, and the timing*
- **Survivorship bias:** data only includes active funds; dead funds are removed
    - *Leaving out the losers creates an upward bias in performance*
- **Closed to new investors:** closed funds often don't report their performance
    - *Many indices only report data for investible funds*
- **Backfill bias:** HFs wait to see which funds are winners before reporting data

Hedge Fund Investment Performance

Higher returns

- Over the long term, hedge funds have had **higher returns** than stocks and bonds
- The standard deviation of HF returns has been **comparable to bonds**
- Returns are analyzed before fees

Correlations

- Modest correlation with global stock returns
- Negligible correlation with global bond returns
- Overall, hedge funds add value to **portfolio diversification**

Hedge Funds: Question

Select the statements that are true:

A. The primary drivers of returns from stocks are growth projections, dividends, and retained earnings.

B. The primary drivers of returns from a bond are interest rates, credit risk, and coupon payments.

C. The primary drivers of return from hedge funds are market volatility and market inefficiency.

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Hedge Fund: Question

Which of the following is *least likely* a bias that hedge fund investors should be aware of when evaluating the performance of hedge fund benchmarks and indexes?

A. Survivorship bias: Unsuccessful and liquidated hedge funds are removed from an index, resulting in their underperformance not being accounted for in the index.

B. Self-reporting bias: Hedge funds have the freedom to not report their performance, and only the ones that report are included in an index.

C. Societal bias: This relates to the perception of hedge funds at a societal level, where hedge funds that are perceived to be high performing are included in the index.

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Due Diligence Needed

Selecting a hedge fund manager

- Hedge funds have only light regulation
- Little investor protection
- Higher levels of fraud and operational risks

Investors should conduct thorough **due diligence** in selecting suitable hedge fund managers.

Solutions

Hedge Funds: Question

Which of the following statements about relative value strategies is *least accurate*?

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Relative value strategies often involve investments in different asset classes.

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Event-driven hedge funds thrive in a rising market environment with a high level of corporate activity (M&A) in a strong economy.

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A. Fundamental value.

B. Managed futures.

C. Multi-strategy.

D. Fund of funds.

Managed futures have, historically, exhibited low correlation with traditional assets and invest in active futures in liquid commodities and foreign exchange markets. They are also able to increase exposure without resorting to borrowing or shorting.

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Hedge funds invest in traditional asset classes but use a specific investment strategy. They are not a distinct asset class.

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Private equity funds invest directly in private operating companies.

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B. Long-only equity mutual fund.

C. Long/short equity hedge fund.

Long/short equity hedge funds are the most likely type of fund to seek out trades with high idiosyncratic risk, so their performance is driven primarily by stock selection and less by other factors, such as sector and market exposures. B is incorrect because long-only mutual funds are more likely to seek returns from market risk and sector risks with less emphasis on undiversifiable, security-specific risks. A is incorrect because equity index funds simply try to mimic the performance of an index.

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