

1 What exactly is a hedge fund?

A **hedge fund** is a privately pooled investment vehicle—almost always organised as a limited partnership or limited liability company—whose general partner (the “hedge-fund manager”) has an unconstrained mandate to pursue **absolute return** (positive performance irrespective of market direction). Unlike long-only mutual funds, hedge funds can go both *long* and *short*, freely use derivatives and leverage, and negotiate investor liquidity terms rather than promise daily dealing.

The industry positions itself as *alternative* to traditional funds because its primary commercial proposition is the delivery of **alpha** (skill-based excess return) rather than simple beta exposure to broad equity or bond indices.

2 Why are they called “hedge” funds?

The expression dates back to Alfred Winslow Jones’s 1949 partnership, which “hedged” long stock positions with short sales to dampen market risk. Today, the term is historical: many strategies (for example, global macro or distressed credit) do not attempt to maintain a strict hedge but still borrow the label because they operate under the same structural freedoms—performance fees, leverage, limited investor access, use of derivatives, and light regulatory touch. ([IMF eLibrary](#))

3 Fund structure and participants

Role	Function	Notes
General Partner / Investment Manager	Makes all portfolio decisions, sets strategy, signs service-provider contracts.	Must register with the SEC if assets > US \$150 m (or with SEBI as Category III AIF in India).
Limited Partners (LPs)	Provide capital, typically high-net-worth individuals, family offices, pension plans, sovereign-wealth funds.	Must meet sophistication tests (e.g., US “qualified purchaser”, Indian “accredited investor”).
Prime Broker	Offers leverage, short-stock borrow, trade execution, and custody.	Sometimes multiple primes to reduce funding risk.

Administrator	Independent NAV calculation, investor services, anti-money-laundering checks.	Outsourcing improves transparency for LPs.
Auditor, Legal Counsel, Compliance & Risk teams	Ensure the vehicle passes annual audits, files Form PF (US) or periodic SEBI filings (India), and monitors market, liquidity, and counterparty risk.	Scale has institutionalised these once-informal functions.

4 Fee model—still “2 & 20”, but falling

Classic economics allowed managers to charge a **2 % management fee** on assets and **20 % performance fee** above a high-water mark. Competitive pressure plus institutional bargaining have pushed the averages closer to **1.5 % & 15 %** in 2025, with hurdles, claw-backs, and longer crystallisation periods commonplace.

5 Liquidity terms

Most hedge funds offer **monthly or quarterly redemptions with 30–90 days’ notice**, sometimes preceded by a *soft lock-up* period (exit allowed but with a penalty) or a *hard lock-up* (no exit). Gates and side-pockets give managers discretion to delay withdrawals in stressed markets, protecting remaining investors from forced liquidations—an arrangement regulators scrutinised after the March 2020 Treasury-market turmoil. ([IME](#))

6 Core strategy families

Category	Typical instruments	Objective / return driver
Long/Short Equity	Listed stocks, single-name options	Capture stock-picking alpha while hedging market beta.
Market-Neutral	Pairs trading, statistical arbitrage	Target near-zero net exposure; profit purely from relative mis-pricing.
Event-Driven / Merger Arb	Risk arbitrage spreads, convertible bonds	Harvest premia around M&A, spinoffs, restructurings.
Relative-Value / Fixed-Income Arb	Government-bond futures, repos, swaps	Exploit small pricing gaps between closely related securities, often with high leverage.

Global Macro	Futures, FX forwards, rates options	Top-down bets on macroeconomic themes (rates, currencies, commodities).
Managed Futures / CTA	Trend-following models on liquid futures	Systematic momentum across asset classes.
Credit / Distressed	Corporate bonds, CDS, bank loans	Capture spread compression or restructuring recoveries.
Multi-Strategy	Blend of the above with capital-allocation overlay	Offers smoother risk/return by rotating into best opportunity set.

7 Risk management toolkit

- **Gross vs. net exposure** – managers track both; the former indicates balance-sheet size, the latter directional market risk.
 - **Value-at-Risk & stress tests** – scenario analysis for tail events.
 - **Liquidity buckets** – mapping assets to expected time-to-cash.
 - **Margin analytics** – daily monitoring of financing haircuts at each prime broker to pre-empt collateral calls. ([IME](#))
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8 Performance metrics

Hedge-fund investors look beyond raw returns to:

- **Sharpe & Sortino ratios** – reward per unit of volatility / downside volatility.
- **Alpha vs. custom factor models** – separation of skill from exposures such as size, value, momentum.
- **Max drawdown & time-to-recovery** – gauge capital impairment risk.
- **Correlation to equities & bonds** – diversification benefit.

Industry benchmarks include the **HFRI Fund-Weighted Composite** and **Barclay Hedge indices**, though dispersion among strategies limits the meaning of any single index. ([IME eLibrary](#))

9 Regulatory landscape

United States

Post-2008 reforms (Dodd-Frank §404) require managers \geq US \$150 m AUM to register under the **Investment Advisers Act** and file confidential **Form PF**, detailing leverage, liquidity, and counterparty exposures. The SEC can demand stress-test data and has tightened rules on marketing performance. ([IMF](#))

European Union

Directive **AIFMD** imposes authorisation, depositary oversight, and leverage caps expressed as gross and commitment ratios.

India

Under **SEBI (Alternative Investment Funds) Regulations 2012**, domestic hedge funds fall into **Category III AIFs**, permitted to employ complex trading and leverage but subject to:

- ₹20 crore minimum corpus,
- ₹1 crore minimum commitment per investor (₹25 lakh for employees/ directors),
- quarterly leverage reporting, and
- mandatory custodian.

10 Why allocators use hedge funds

1. **Diversification** – strategies such as managed futures or market-neutral often exhibit low or negative correlation to traditional assets.
2. **Downside protection** – hedged-equity, merger-arb, or long/short books strive for shallower drawdowns.
3. **Access to specialised alpha** – distressed credit workouts, volatility trading, statistical arbitrage signals.
4. **Inflation and rate hedging** – macro funds can go long commodities or short duration.

11 Case-study snapshots from priority managers

11.1 Voya Investment Management – *Alternative Alpha Fund*

Voya’s publicly available fact sheet highlights a **multi-asset, non-traditional strategy** that “includes the use of derivatives, leverage, hedging and short selling” with AQR, Campbell & Co., and internal Voya teams as sub-advisers. The fund targets cash + 4 % and caps participant allocations at 15 % of plan assets, illustrating how a mainstream retirement provider packages hedge-fund-style exposures inside a **daily-priced “liquid alternative.”**

Voya’s 2025 **Firm Overview** further shows US \$97 bn in private-market assets and a strategic build-out of quantitative and derivative-overlay capabilities—evidence that the firm regards alternatives as a growth pillar.

11.2 Vanguard – *Alternative Strategies Fund (VASFX)*

Vanguard offered its own multi-strategy liquid-alt vehicle (merger arb, global macro, EM currency overlay) but **liquidated the fund on 19 April 2023**, citing limited scale and overlap with investors’ broader portfolios. The episode underscores both investor demand for simplicity and the operational complexity of running hedge-style books within a retail mutual-fund wrapper.

11.3 Fidelity – *Hedged Equity Fund*

Launched in 2022, Fidelity’s fund pairs an S&P 500 core with a **systematic put-buying programme** to reduce drawdown. Management notes the “insurance-like cost” depresses returns in bull markets but delivered lower volatility versus the benchmark over 2024–25—a textbook example of an options-overlay hedge-fund technique in a 1940-Act fund format.

12 Service-provider ecosystem

- **Prime brokers** – Goldman Sachs, Morgan Stanley, JPMorgan.
- **Administrators** – Citco, SS&C, Northern Trust.
- **Auditors** – PwC, KPMG, EY (independent opinion critical for institutional LPs).
- **Law firms** – Seward & Kissel, Maples (Cayman), AZB (India).
- **Technology & data** – portfolio-risk engines (Imagine, RiskMetrics), OMS/EMS (FlexTrade), alt-data feeds.

13 Current themes & outlook (2025)

1. **Institutionalisation** – > 65 % of global hedge-fund AUM now originates from pension and sovereign sources, demanding lower fees and daily transparency. ([IMF](#))
2. **Fee compression & hurdle rates** – investor bargaining plus the rise of *liquid alts* push economics toward 1 % & 10 %, often above cash + a hurdle.
3. **AI & systematic strategies** – natural-language news parsing and reinforcement-learning agents are increasingly embedded in quant funds.
4. **Private-credit overlap** – many multi-strategy managers now operate private-credit sleeves, blurring the line between Category II and Category III AIFs in India. ([IMF](#))
5. **ESG & climate-transition trades** – carbon-allowance futures, relative-value plays in green vs. brown bonds, and stewardship activism in public equities.

14 Hedge funds in the Indian context

Although the domestic hedge-fund scene is younger than its US counterpart (first Category III licences in 2013), assets crossed **₹55 000 crore** in 2024. Strategies cluster around quant equity (factor and momentum), event-driven special situations, and derivative income funds writing options on the Nifty. SEBI forbids more than **2× NAV leverage** and demands a designated custodian, which tempers systemic-risk concerns that dominate global debates. Foreign hedge funds can access India through FPI Category I or II routes but face position limits in derivatives.

15 Putting it all together

Hedge funds occupy a spectrum—from classic market-neutral equity pairs to macro funds trading cross-asset derivatives—united by the pursuit of **idiosyncratic, risk-adjusted return**. Their value proposition for allocators lies in diversification and flexible risk budgeting, while their challenges remain fee justification, transparency, and episodic liquidity stress. Mainstream groups such as **Voya, Vanguard, and Fidelity** have experimented with hedge-style “liquid alternative” vehicles, signalling that the toolbox once reserved for Cayman partnerships is permeating regulated fund land. For Voya India’s wealth-domain chatbot, capturing these nuances—definitions, strategies, fee mechanics, regulatory frameworks, and real-world fund examples—will equip the model to answer both basic and advanced client queries with authority.

