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Alternative Investment Group

Hedge Fund Primer
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WHAT IS A HEDGE FUND?

A "Hedge Fund" is a fund that pools investments from multiple investors and is managed for their common benefit, like a mutual fund. Like mutual funds, hedge funds are regulated by the Securities and Exchange Commission ("SEC") and offered to investors through a prospectus. The goal of most hedge funds is to earn attractive positive returns, rather than outperforming a market index, with significantly reduced volatility by "hedging out" some or all market influence. By producing a different return stream, hedge funds are often used as a complement to traditionally-managed portfolios. Hedge Fund assets currently total approximately $3 trillion.

Since hedge funds reduce exposure to the stock market, they typically outperform market indices in weak markets and underperform in strong markets (see "How Does Long/Short Investing Work?" below).

Unlike U.S. mutual funds, hedge funds

- Are typically structured in the U.S. as limited partnerships (the investors are the limited partners and the investment manager is the general partner)
- May be purchased only by investors satisfying income (often annual income of at least $200,000) and wealth (often investment assets of $1 million) tests
- Do not provide daily liquidity. Most hedge funds offer liquidity on a quarterly basis and require a one-year initial holding period
- Compensate managers largely on returns achieved, instead of fixed percentage fees based on assets
- Purchase securities the managers think are undervalued and "sell short" (see below) securities the managers think are overvalued
- Typically have a wider range of investment options, including use of borrowing, to achieve their investment goal
- Are more lightly regulated by the SEC and other regulatory bodies, since hedge funds are not available to retail investors

WHAT IS A FUND OF HEDGE FUNDS?

A "Fund of Hedge Funds" is simply a fund (usually a partnership) that invests in hedge funds. An individual hedge fund may be volatile but a fund of hedge funds spreads its capital across multiple (often ten to twenty) individual hedge funds to diversify and thereby reduce volatility. Most funds of hedge funds have substantially lower volatility than individual hedge funds, just as a portfolio of stocks typically has lower volatility than an individual stock. The goal of the fund of hedge funds manager is to select the optimal package of hedge funds to maximize return with controlled risk.

HOW DOES LONG/SHORT INVESTING WORK?

A traditional ("long-only") investor purchases undervalued securities he or she believes will outperform the broad market index. But when a traditional investor finds a security he believes is overvalued and will underperform, there is no way he can benefit from that judgment. A "long/short" manager, however, can benefit from both undervalued securities (buying them) and overvalued securities (selling them "short"). Long/short investing therefore doubles the extent to which a manager's judgments can contribute to portfolio profits. In addition, since short positions reduce overall exposure to the stock market, a long/short strategy typically has lower net market exposure and lower volatility.

HOW DOES "SHORT SELLING" WORK?

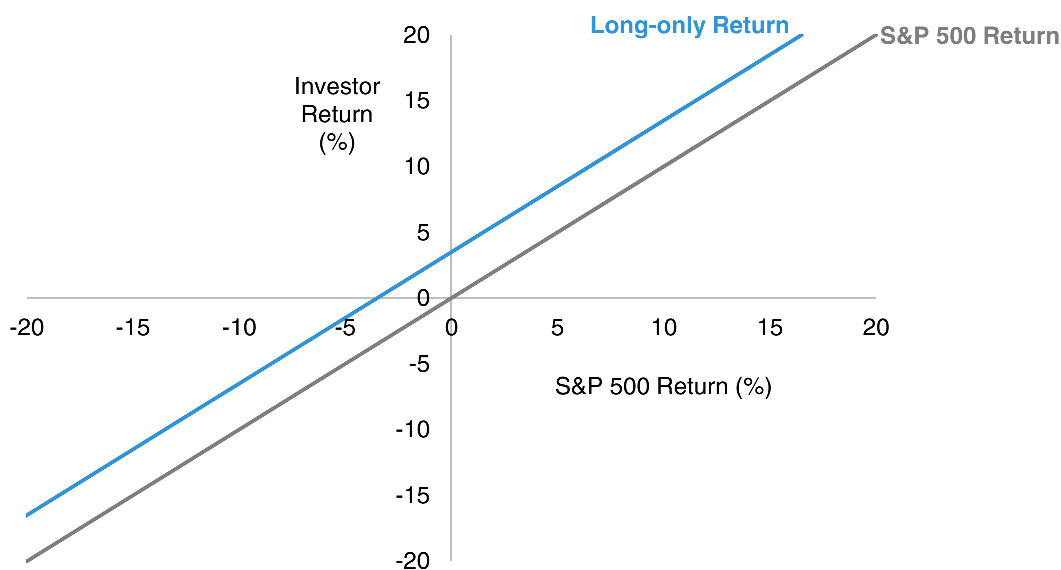
Short selling is the inverse of long investing. Instead of buying securities, and then selling them later, the manager sells securities, then buys them back later.

Here's an example: The manager believes XYZ at $50 is overpriced and will decline. He or she borrows 100 shares of XYZ from his broker, who is holding the stock. As collateral for the $5,000 borrowing, he pledges a percentage of the contents of his brokerage account, which holds stocks and cash. He then sells the borrowed shares for $5,000 and deposits the cash in his brokerage account, providing additional collateral to the brokerage firm. The stock declines to, say $30, at which time he buys 100 shares for $3,000 and delivers the purchased shares to his broker, closing out the original loan of 100 shares. He has received $5,000 from the sale of XYZ and paid $3,000 to buy replacement shares, making a $2,000 profit from the stock decline.

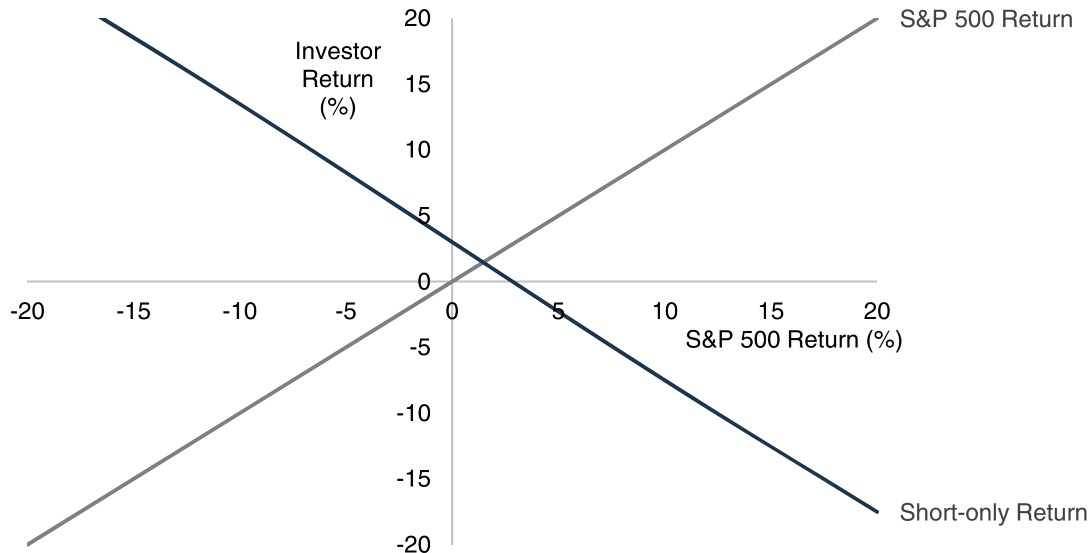
If the price of XYZ had risen, he would have to buy back the shares at a higher price and would lose money.

WHAT IS THE RETURN PATTERN OF LONG-ONLY AND SHORT-ONLY INVESTING?

The chart below shows the return pattern of a successful long-only manager who earns more than the stock market, whatever the market return is. An investor who is highly confident the stock market will go up might be comfortable investing long-only, since he will benefit from the market gain and the manager's value added above that.

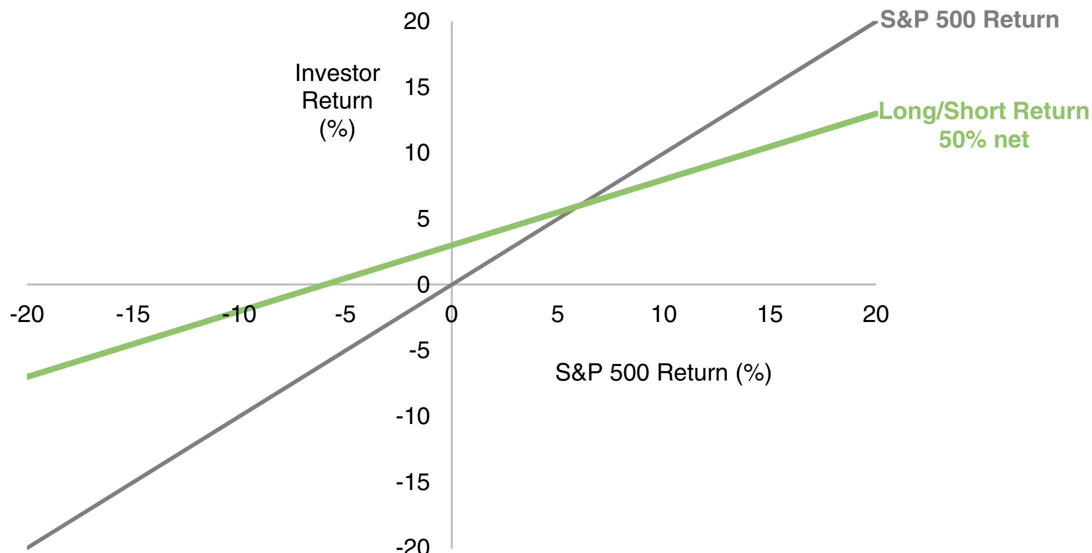


The chart below shows the return pattern of a successful short seller. The investor return is essentially the opposite of the market return; if the market is up, the short seller suffers a loss (since he has to buy stocks back at higher prices) and if the market is down, the short seller makes money. An investor who is highly confident the overall market is likely to decline might be happy to invest in a short portfolio, since he will earn a positive return from the market loss plus his value added above that. But if the market goes up, he is likely to lose money.



Both long-only and short-only strategies are risky, since the ultimate result is largely determined by market movements, which are difficult to predict. They also fail to utilize fully the manager's judgments on individual stocks, since the long-only manager cannot benefit from overpriced stocks and the short-only manager cannot benefit from undervalued stocks. We therefore believe the long/short combined model provides an attractive combination of potentially attractive return with reduced volatility.

The chart below shows the return pattern of a successful long/short investor. Assume the investor buys $100 of stock (long position) and sells short $50 of stock (short position), resulting in a 50% net exposure to the equity market as represented by the S&P 500. If the market does poorly, he protects capital by reducing the loss; if the market is strong, he shares in only a portion of the index return.



Of course, it is possible that the manager gets both sides wrong – his long holdings do worse than the market and his short holdings do better than the market, so his portfolio underperforms. With a well-diversified portfolio of longs and shorts, that is less likely, which is one reason a portfolio of hedge funds is safer than any one hedge fund. It is also possible that the stock market goes up sharply and the short positions, which must be covered at higher prices, eat into the long profits and reduce the potential return.

HOW HAS LONG/SHORT INVESTING DONE IN REAL LIFE?

The historical pattern (which of course may not be the same in the future) is that long/short investing consistently outperforms in weak stock market periods, slightly outperforms in moderate return periods, and significantly lags in strong market periods, as follows:

S&P 500 Annual Returns	Number of Years	S&P 500 Average Return	Fund of Hedge Funds Average Return	Hedge Funds Average Return
Less than -10%	3	-23.7%	-5.9%	-10.3%
-10 to 10%	5	1.2	3.2	4.5
Greater than 10%	8	19.9	7.9	12.3

Source: HFRI data from 1/1/2000 to 10/31/2015

CONCLUSION

This primer is a simplified description of how hedge funds work and their advantages and disadvantages. Every investor must set his own return goals and risk tolerance, so different investment strategies will be appealing. For investors interested in controlling risk or maximizing their return for a given risk level, we believe hedge funds and funds of hedge funds provide an attractive complement to long-only investing.

We would be happy to discuss this issue further. If interested, please contact us at Alternative Investment Group.