
In 1949, Alfred Winslow Jones, a sociologist investigating fundamental and technical research to forecast the stock market for *Fortune* magazine, set up an investment fund with himself as GP. The fund followed three key tenets: (1) Always maintain short positions, (2) always use leverage, and (3) charge only an incentive fee of 20% of profits with no fixed fees. Jones called his portfolio a “hedged” fund (eventually shortened to “hedge fund”) because he had short positions to offset his long positions in the stock market. Theoretically, the overall portfolio was hedged against major market moves.

Although Jones’s original three tenets still have some relevance to the hedge fund industry, not all hedge funds maintain short positions and/or use leverage, and most hedge funds have some non-incentive fees. A contemporary hedge fund may have the following characteristics:

- It is an aggressively managed portfolio of investments across asset classes and regions that is leveraged, takes long and short positions, and/or uses derivatives.
- It has a goal of generating high returns, either in an absolute sense or over a specified market benchmark, and it has few, if any, investment restrictions.
- It is set up as a private investment partnership open to a limited number of investors willing and able to make a large initial investment.
- It imposes restrictions on **redemptions**. Investors may be required to keep their money in the hedge fund for a minimum period (referred to as a **lockup period**) before they are allowed to make withdrawals or redeem shares. Investors may be required to give notice of their intent to redeem; the **notice period** is typically 30–90 days in length. Also, investors may be charged a fee to redeem shares.

Funds of hedge funds are funds that hold a portfolio of hedge funds. They create a diversified portfolio of hedge funds accessible to smaller investors or to those who do not have the resources, time, or expertise to choose among hedge fund managers. Also, funds of hedge funds, commonly shortened to “funds of funds,” are assumed to have some expertise in conducting due diligence on hedge funds and may be able to negotiate better redemption terms than individual investors can. Funds of funds invest in numerous hedge funds and may diversify across fund strategies, investment regions, and management styles. The distinction between a single hedge fund and a fund of funds is not necessarily clear-cut because hedge funds can invest in other hedge funds. Each hedge fund into which a fund of funds invests is structured to receive a management fee plus an incentive fee. The fund of funds itself is also structured to receive a management fee and may also receive an incentive fee.

Hedge fund managers are less restricted than traditional investment managers and

3.1.1 Equity Hedge Strategies

Equity hedge strategies can be thought of as the original hedge fund category. They are focused on public equity markets and take long and short positions in equity and equity derivative securities. Some hedge funds, called “equity-only funds,” invest exclusively in public equity securities. Equity hedge strategies that are not focused on individual equities are categorized generally as event-driven or macro strategies. Equity hedge strategies use a bottom-up, as opposed to top-down, approach. Other investors that are not structured as hedge funds may use some similar strategies. Examples of equity hedge strategies include the following:

- **Market neutral.** These strategies use quantitative (technical) and/or fundamental analysis to identify under- and overvalued equity securities. The hedge fund takes long positions in securities it has identified as undervalued and short positions in securities it has identified as overvalued. The hedge fund tries to maintain a net position that is neutral with respect to market risk as well as other factors (size, industry, etc.). Ideally, the portfolio should have a beta of approximately zero. The intent is to profit from individual securities’ movements while remaining independent from market risk.
- **Fundamental growth.** These strategies use fundamental analysis to identify companies expected to exhibit high growth and capital appreciation. The hedge fund takes long positions in identified companies.
- **Fundamental value.** These strategies use fundamental analysis to identify companies that are undervalued. The hedge fund takes long positions in identified companies. The “deep value” approach takes an extreme, even “distressed,” point of view on its investments.

- **Quantitative directional.** These strategies use technical analysis to identify companies that are under- and overvalued and to ascertain relationships between securities. The hedge fund takes long positions in securities identified as undervalued and short positions in securities identified as overvalued. The hedge fund typically varies levels of net long or short exposure depending on the anticipated market direction and stage in the market cycle. Similar long–short approaches that are based on fundamental analysis exist.
- **Short bias.** These strategies use quantitative (technical) and/or fundamental analysis to identify overvalued equity securities. Although many funds will have some shorts but maintain a “net long” position (more long positions than short ones), this is the opposite approach, usually with only short positions (though possibly some long hedges to be “net short”). The fund typically varies its net short exposure on the basis of market expectations, looking to go fully short in declining markets.
- **Sector specific.** These strategies exploit manager or structural expertise in a particular sector and use quantitative (technical) and fundamental analysis to identify opportunities in the sector. Technology, biotech/life sciences, and financial services are common investment sectors for these types of hedge funds.

3.1.2 Event-Driven Strategies

Event-driven strategies seek to profit from short-term events, typically involving potential changes in corporate structure, such as an acquisition or restructuring, that are expected to affect individual companies. This strategy is considered “bottom up” (company-level analysis followed by aggregation and analysis of a larger group, such as an industry), as opposed to “top down” (global macro analysis followed by sectoral/regional analysis followed by company analysis). Investments may include long and short positions in common and preferred stocks, as well as debt securities and options. Further subdivisions of this category by HFRI include the following:

- **Merger arbitrage.** Generally, these strategies involve going long (buying) the stock of the company being acquired and going short (selling) the stock of the acquiring company when the merger or acquisition is announced. The manager may expect to profit from the deal spread, which reflects the uncertainty of the deal closing, or may expect the acquirer to ultimately overpay for the acquisition and perhaps suffer from an increased debt load. The primary risk in this strategy is that the announced merger or acquisition does not occur and the hedge fund has not closed its positions on a timely basis.
- **Distressed/restructuring.** These strategies focus on the securities of companies either in bankruptcy or perceived to be near to bankruptcy. Hedge funds attempt to profit from distressed securities in a variety of ways. The hedge fund may simply purchase fixed-income securities trading at a significant discount to par. This transaction takes place in anticipation of the company restructuring and the fund earning a profit from the subsequent sale of the securities. The hedge fund may also use a more complicated approach, for example, buying senior debt and shorting junior debt or buying preferred stock and shorting common stock. These transactions take place in expectation of a profit as the spread between the securities widens. The fund may also short sell the company's stock, but this transaction involves considerable risk given the potential for loss if the company's prospects improve.
- **Activist.** The term “activist” is short for “activist shareholder.” These strategies focus on the purchase of sufficient equity in order to influence a company's policies or direction. For example, the activist hedge fund may advocate for

divestitures, restructuring, capital distributions to shareholders, and/or changes in management and company strategy. These hedge funds are distinct from private equity because they operate primarily in the public equity market.

- **Special situations.** These strategies focus on opportunities in the equity of companies that are currently engaged in restructuring activities other than mergers, acquisitions, or bankruptcy. These activities include security issuance or repurchase, special capital distributions, and asset sales/spinoffs.

3.1.3 *Relative Value Strategies*

Relative value funds seek to profit from a pricing discrepancy (an unusual short-term relationship) between related securities. The expectation is that the pricing discrepancy will be resolved over time. Examples of relative value strategies include the following:

- **Fixed-income convertible arbitrage.** These market-neutral (a theoretical zero-beta portfolio) investment strategies seek to exploit a perceived mispricing between a convertible bond and its component parts (the underlying bond and the embedded stock option). The strategy typically involves buying convertible debt securities and simultaneously selling the same issuer's common stock.
- **Fixed-income asset backed.** These strategies focus on the relative value between a variety of asset-backed securities (ABS) and mortgage-backed securities (MBS) and seek to take advantage of mispricing across different ABS.
- **Fixed-income general.** These strategies focus on the relative value within the fixed-income markets. Strategies may incorporate long/short trades between two corporate issuers, between corporate and government issuers, between different parts of the same issuer's capital structure, or between different parts of an issuer's yield curve. Currency dynamics and government yield curve considerations may also come into play when managing these fixed-income instruments.
- **Volatility.** These strategies typically use options to go long or short market volatility either in a specific asset class or across asset classes. Option prices reflect implied volatility, and an increase in market volatility leads to an increase in option prices. Dynamic hedging with the underlying assets or derivatives is used to offset related risks.
- **Multi-strategy.** These strategies trade relative value within and across asset classes or instruments. Rather than focusing on one type of trade (e.g., convertible arbitrage), a single basis for trade (e.g., volatility), or a particular asset class (e.g., fixed income), this strategy looks for investment opportunities wherever they might exist.

3.1.4 *Macro Strategies*

Macro hedge funds emphasize a top-down approach to identify economic trends evolving across the world. Trades are made on the basis of expected movements in economic variables. Generally, these funds trade opportunistically in the fixed-income, equity, currency, and commodity markets. Macro hedge funds use long and/or short positions to potentially profit from a view on overall market direction as influenced by major economic trends and/or events.

Many hedge funds start as a focused operation, specializing in one strategy or asset class, and, if successful, may diversify over time to become multi-strategy funds. Large multi-strategy funds and funds of funds are similar in offering diversification among hedge fund strategies. With funds of funds, the investor is hiring the fund-of-funds manager to select hedge fund strategies among various fund groups. With multi-strategy funds, the strategies are run within one fund group. A multi-strategy hedge

fund does not have the extra layer of fees associated with a fund of funds. However, a fund of funds may offer compensating advantages, such as access by smaller investors, a diversified hedge fund portfolio, better redemption terms, and due diligence expertise.

3.5 Due Diligence for Investing in Hedge Funds

When investing in hedge funds, investors must consider many issues. A basic question is whether one wants to rely on the expertise of a manager of a fund of hedge funds to invest in a portfolio of hedge funds or whether one has the expertise to undertake the hedge fund investment selection process. Funds of hedge funds potentially offer the benefits of providing a diversified portfolio of hedge funds, supplying expertise in conducting due diligence, and negotiating favorable redemption terms. These potential benefits come at the cost of an additional layer of fees. Also, although a fund of hedge funds may provide expertise in due diligence, the investor should still conduct due diligence when choosing a fund of hedge funds.

Investors in hedge funds should consider many factors in their decision-making process. This section highlights some of the key due diligence points to consider but does not provide an exhaustive list of factors. Key factors to consider include investment strategy, investment process, competitive advantage, track record, size and longevity, management style, key person risk, reputation, investor relations, plans for growth, and risk management systems.

Investment strategy and process are challenging to fully assess because hedge funds may limit disclosure in order to maintain their competitive advantage and to not give away information that is considered proprietary. It should be possible, however, to identify in which markets the hedge fund invests, the general investment strategy (for example, long–short, relative arbitrage, and so on), the basic process to implement this strategy, and the benchmark against which the fund gauges its performance.

Track record is a commonly viewed consideration because it should be readily available and is often assumed to be an indicator of future performance and risk (perhaps incorrectly, based on studies of performance persistence).²¹ Investors should determine how the returns are calculated (e.g., based on estimates of value or market prices) and reported (e.g., before or after fees) and how the returns and risks compare with some benchmark. The investor should inquire about the fee structure because, as demonstrated earlier, this information will affect the return to the investor.

Size and longevity are also common items for review.²² The older a fund is, the more likely it has not caused significant losses to its investors (otherwise, it is likely to have experienced redemptions, been unable to raise further capital, and thus liquidated). As a result, older funds are likely to have experienced growth in AUM through both capital appreciation and additional investments (capital injections). Many investors require hedge funds to have a minimum track record of two years before they will invest. This requirement makes it particularly difficult for startup funds to raise money because their managers need capital to invest before they can build a track record. In many cases, startup funds receive money from seed investors who want a share of the business for their investment.

A hedge fund's size can be an important consideration for investors because many investors set a minimum size on their investments to justify the time and expense to conduct due diligence, but they also want to ensure that they do not impose business risk by being too large of a percentage of a fund's overall AUM. For example, if one investor represents 50% of the AUM, then the decision of that investor to liquidate his holdings will likely cause a crisis for the hedge fund's existence. Of course, such an investor may be able to negotiate favorable fees or other terms with the manager. Combining these concepts, if an investor's minimum investment size is \$10 million and the investor's fund ownership limit is 10%, the minimum hedge fund size the investor can consider is \$90 million.

The hedge fund due diligence process also focuses on many qualitative factors, including management style, key person risk, reputation, investor relations, and plans for growth. A thorough due diligence process will also include a review of management procedures, including leverage, brokerage, and diversification policies. The use of leverage and counterparty risk can significantly affect a fund's risk and performance. In addition to gathering information about the fund's prime broker and custody arrangements for securities, the investor should identify the auditor of the hedge fund and ensure that the auditor is independent and known for conducting competent audits.

Risk management of systems is an important consideration for reviewing a hedge fund. Relevant risk management questions to ask are varied and related to the type of securities in which the fund invests. Ultimately, the answers should provide to investors confidence that the fund performs risk management in a rigorous fashion. In many cases, particularly with smaller funds or those that invest in more unusual or illiquid assets, the answers to these questions may indicate either that the systems and processes are simplistic or that the answers themselves are very complex. Commonly, hedge fund managers believe that their strategies, systems, and processes are proprietary, and they are unwilling to provide much information to potential investors. This reluctance can make due diligence very challenging. Regulation of hedge funds is likely to continue to increase in the future, which may further help with the due diligence process.