



Hedge Funds

INTRODUCTION



Hedge funds were once differentiated from traditional investment management firms by several traits. First, hedge funds typically were able to take short as well as long positions, primarily in equities, enabling them to protect assets during market downturns. This no longer necessarily serves to distinguish hedge funds since certain mutual funds and traditional asset managers may also take short positions, especially the market-neutral investment managers. In fact, the majority of hedge funds are now long-only or long equity bias funds in equities, fixed income securities, or commodities.

Two other hedge funds traits, the use of leverage and derivatives, have also been preempted by traditional fund managers and, with the increased use of indexed products, may be more widely used by investors in the future. Hedge funds are now commonly defined by their structure. They are private investment pools organized as limited partnerships or limited liability corporations with the investment manager as general partner and investors as limited partners.

These funds generally charge a performance fee on top of a management fee. Finally, in most if not all hedge funds, the fund principals have their own capital at risk in addition to funds raised from clients. Because many hedge funds are organized as offshore vehicle or have fewer than 499 limited partners, they are largely free of government regulations. Hedge funds have evolved to encompass a wide range of styles including trend-following, market-neutral, relative value, macro, event-driven, arbitrage, distressed securities, investments in private equity, and LBOs.



TYPES OF FUNDS

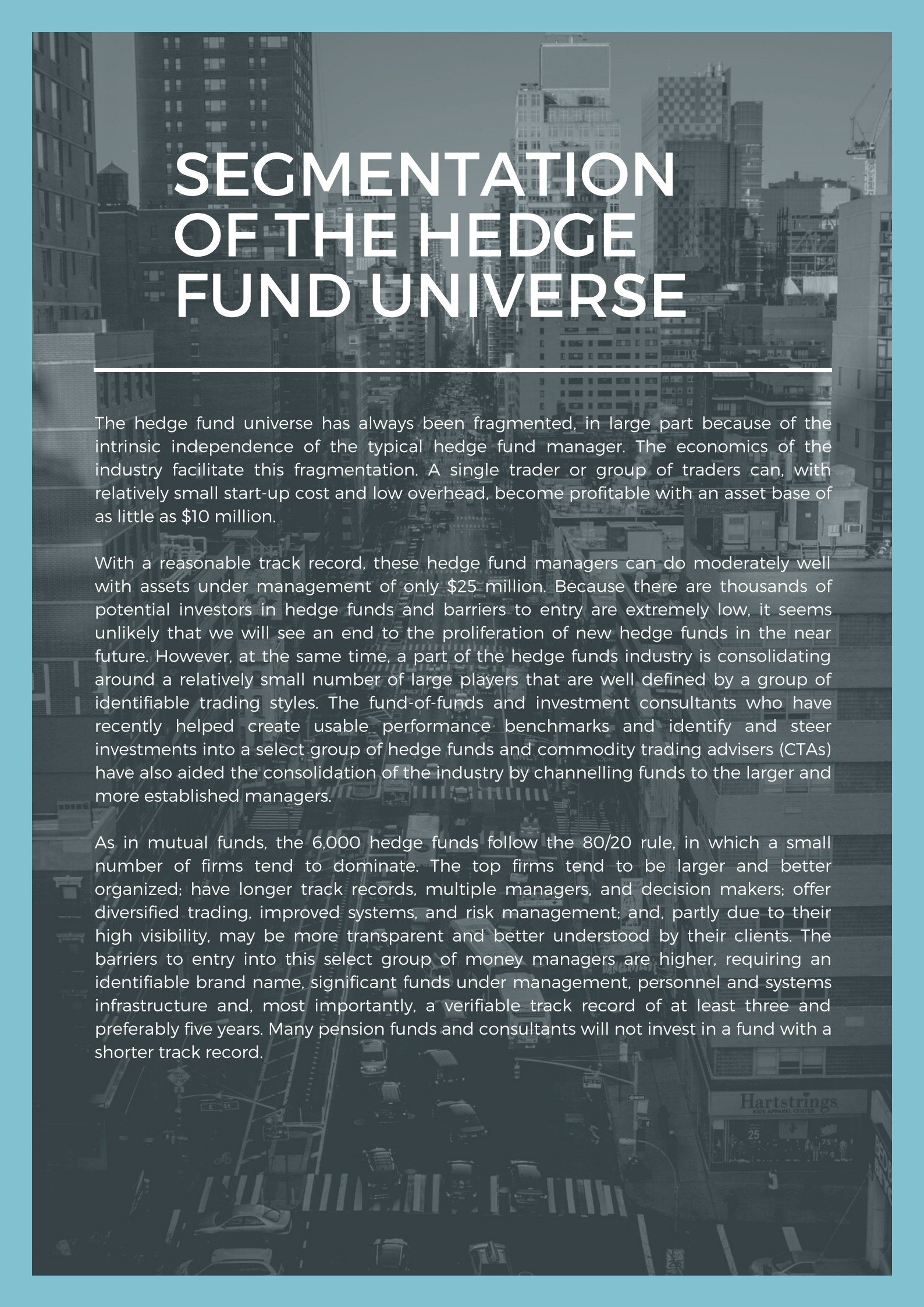
Style	Subtype	Comment/Description
Event-Driven	Distressed Securities	Securities of companies in reorganization and/or bankruptcy.
	Risk Arbitrage	Fund buys stock in a company being acquired and sells stock in its acquirers.
Fund of Funds	Diversified	Allocates capital to a variety of fund types.
	Niche	Allocates capital to one specific type of fund.
Global	International	Bottom-up-oriented equity investments around the world (except U.S.).
	Regional-Emerging	Manager invests in less mature financial markets. Usually focus on specific regions.
	Regional-Established	Focuses on opportunities in established markets (i.e., U.S., European, and Japanese).
Global Macro		The classic Soros-Steinhardt-Robertson type hedge fund using leverage and derivatives to enhance positions.
Long-Only Leveraged		Traditional equity fund with leverage and incentive fee.
Market-Neutral	Long/Short	Allocations on the long and short sides of the market.
	Convertible Arbitrage	Manager goes long convertible securities and short underlying equities.
	Stock Arbitrage	Fund buys a basket of stocks and sells short stock index futures contract, or reverse.
	Fixed income Arbitrage	Manager buys bonds and goes short instruments that replicate the owned bond.
Sector		Follows economic sectors and/or industries (e.g., large-cap, high-tech, etc.).
Short-Sellers		A hedge fund borrows stock and sells it, hoping to buy it back at a lower price.



INDUSTRY STRUCTURE AND ORGANIZATION

Similar to the worlds of mutual funds and investment managers, the hedge fund universe is likely to become segmented along two lines. One area of the universe will continue to be fragmented as it is geared toward high-net-worth individuals, family trusts, overseas investors, and smaller institutions. The other will become dominated by a smaller number of large players that direct their activities to the larger institutional marketplace—the pension fund plan sponsors, endowments, and foundations.

A number of private equity investment pools have already started to build their businesses with the objective of servicing institutional clients. In the following discussion, how hedge funds are following mutual funds and institutional investment managers toward industry concentration and institutionalization is described.

An aerial, high-angle photograph of a city street, likely in New York City, showing a grid of streets with cars and tall buildings in the background. The image is in black and white with a dark, moody tone. The title 'SEGMENTATION OF THE HEDGE FUND UNIVERSE' is overlaid in large, white, sans-serif capital letters at the top. A thin white horizontal line separates the title from the text below.

SEGMENTATION OF THE HEDGE FUND UNIVERSE

The hedge fund universe has always been fragmented, in large part because of the intrinsic independence of the typical hedge fund manager. The economics of the industry facilitate this fragmentation. A single trader or group of traders can, with relatively small start-up cost and low overhead, become profitable with an asset base of as little as \$10 million.

With a reasonable track record, these hedge fund managers can do moderately well with assets under management of only \$25 million. Because there are thousands of potential investors in hedge funds and barriers to entry are extremely low, it seems unlikely that we will see an end to the proliferation of new hedge funds in the near future. However, at the same time, a part of the hedge funds industry is consolidating around a relatively small number of large players that are well defined by a group of identifiable trading styles. The fund-of-funds and investment consultants who have recently helped create usable performance benchmarks and identify and steer investments into a select group of hedge funds and commodity trading advisers (CTAs) have also aided the consolidation of the industry by channelling funds to the larger and more established managers.

As in mutual funds, the 6,000 hedge funds follow the 80/20 rule, in which a small number of firms tend to dominate. The top firms tend to be larger and better organized; have longer track records, multiple managers, and decision makers; offer diversified trading, improved systems, and risk management; and, partly due to their high visibility, may be more transparent and better understood by their clients. The barriers to entry into this select group of money managers are higher, requiring an identifiable brand name, significant funds under management, personnel and systems infrastructure and, most importantly, a verifiable track record of at least three and preferably five years. Many pension funds and consultants will not invest in a fund with a shorter track record.



TRANSPARENCY AND RISK MANAGEMENT

Key concerns of institutional investors contemplating a hedge fund investment have been transparency and risk management. The fact that hedge funds are largely unregulated makes it difficult for investors to gain information on their strategies and positions. This lack of transparency makes hedge fund investments especially difficult for institutions, such as pension funds, that have a fiduciary responsibility. Because most hedge fund prospectuses allow their managers a wide latitude in investment instruments and strategies, “style drift,” in which a hedge fund’s investments fall outside their stated investment style, occurs more frequently than desired.

Finally, investors are concerned with excessive leveraging, as in the case of Long-Term Capital Management. These concerns are being dealt with at a number of levels: regulatory, legislative, industry and banking, resulting in improvements in the transparency and risk management practices of the leading hedge funds.

We believe that transparency will improve in the future as a result of pressure from important investors, credit providers (i.e., banks and brokers), government and regulatory bodies, and the Internet’s relentless spotlight. The Risk Control Division of Bear Stearns Securities Corporation, for example, has developed a tool that allows hedge fund managers to demonstrate to clients how the fund’s portfolio would respond under different market or interest rate scenarios.

Standard & Poor’s has started service with Ernst & Young that tracks the actual positions of funds and evaluates their risk in normal markets and financial crises. More than a dozen websites now provide investors with information on hedge fund and private equity performance, allowing a level of scrutiny not previously available. We are convinced that this trend will only accelerate in the future and prove to be an important source of hedge fund transparency.

Increasing professionalization of the hedge fund industry has also led to greater transparency and improved risk management practices. There are an increasing number of fund managers who have experienced at least two financial crises and have track records that exceed five years. Many of these managers came out of traditional investment management organizations, where transparency and risk management practices are more fully developed and taken for granted.



RISK MANAGEMENT

Hedge fund managers have come under the same pressure as all financial institutions to measure, communicate, and control the risk of their market positions. This pressure comes from a variety of sources: clients, government regulators, international associations, investment community.

The result has been the widespread adoption of state-of-the-art risk management techniques such as Value-at-Risk and Monte Carlo simulations, scenario analyses, stress testing, and portfolio optimization. Unfortunately, none of these risk management strategies are able to do more than extend the recent past into the future, making them less useful for anticipating future developments, especially those that deviate substantially from recent events.

It seems likely that the hedge fund community will continue to suffer from over-leveraging as market volatility declines in the near term, setting up many funds for larger than anticipated losses as volatility returns



REGULATION AND LEGISLATION

Government regulation and legislation are a constant threat to the hedge funds' status as stateless entities and their sometimes-visible role in relatively small and illiquid markets. In fact, as their importance increases along with the assets they manage, and crises continue to occur, we believe that some form of regulation will be inevitable. In a more modest approach, twelve Wall Street firms sought to establish a code of practice for banks and securities firms on how the market extends credit to leveraged positions, issuing their own report, "Improving Counterparty Risk Management," in June 1999.

One important result of these initiatives (and the LTCM losses) has already been seen: banks are markedly less willing to provide capital to hedge funds to increase their leverage. Before the most recent debacles, the 1997 National Securities Market Improvement Act (3)(c) (7) raised investment pool limits from 99 investors to 499.

This Act also provided for new exemptions for qualified individual purchasers with \$5 million in investments, for family companies with \$5 million in investments, and for persons who own and invest on a discretionary basis at least \$25 million in investments (on their own or others' behalf) if each beneficial owner of the company's securities is a qualified purchaser.

These changes effectively increased the number of hedge funds and investors that would be exempt from government regulation in marked contrast to the trends described above that seek to increase government regulation.

STATISTICAL RESULTS: PORTFOLIO AND INVESTMENT DIVERSIFICATION

The analytical argument for investing in hedge funds must address four factors: first, the wide variety of styles and types of hedge fund makes generalizations difficult; second, hedge funds sometimes change styles without notification; third, unsuccessful hedge funds tend to go out of business and are not included in most analyses; finally, analysis by Barra indicates that it takes 16 years of data to conclude that an active investment manager is actually in the top quartile of results, a track record not achieved by many managers.

By some estimates, the “survivorship bias” in most hedge fund performance data overstates average annualized returns by 2% or more. As a result of the first and second factors, the literature shows widespread disagreement regarding the performance, style consistency, volatility, and portfolio benefits of hedge funds. Most analysts conclude that alternative investments, as an asset class, have a role to play in diversified investment portfolios, although performance varies widely by hedge fund style and methodology. Hedge funds offer diversification benefits to portfolios otherwise consisting only of traditional bonds and stocks because of the less than perfect correlation to major market movements.

However, as we point out below, this diversification benefit has decreased in recent years with the increase of the number of hedge funds that are primarily long stocks and bonds. Additionally, because of their ability to go short, hedge funds can theoretically provide at least a partial hedge against declining stock markets. While hedge funds outperform passive benchmarks over several up and down cycles, they are unlikely to outperform passive benchmark indexes for shorter periods as when the indexes are well above their long-term historical average. This has been made clear over the past four years when few hedge funds were able to beat the stock market indexes. While hedge fund volatility has been a long-standing argument against these products, the increased volatility of stocks and bonds (and their increased correlation to each other both domestically and internationally) has made the traditional volatility of hedge funds less of a negative factor than in the past.

In fact, hedge funds and commodities trading advisors have been shown to reduce the volatility of an investment portfolio composed only of stocks and bonds. One key consideration in the development of hedge fund indexes is the extent to which hedge funds actually do trade along with a number of definable styles that are consistent over time.

The evidence here is that the hedge fund universe has begun to develop standardized trading styles and results, which has allowed the development of benchmarks and indexes for alternative investments.



TOP HEDGE FUND INDUSTRY TRENDS IN 2022 AND BEYOND:

The hedge fund industry has not enjoyed one of the best performances in the past decade, but recent data shows that this could change in 2022. In fact, this class has surpassed the S&P 500 last year, starting to prove its worthiness not only as a means for diversification but also for returns. The coronavirus pandemic has brought unexpected challenges for investors, and some trends created in 2020 are bound to continue in the next years. The following sections look at the top hedge fund industry trends in 2022 and beyond.

Hedge fund performance in the past has not been very rewarding, but the recent market crash showed investors why hedging is so essential. Despite a negative public perception, hedge funds managed to record impressive performance, although the allocation was reduced from approximately 40% in 2018 to only 23% in 2020. Being actively managed, hedge funds might perform better than expected in the following years. Let's see the most prevalent hedge fund trends of the future and why they are likely to impact investment decisions.



The Trends

1. Continuous growth and outperformance

Hedge fund assets are expected to balloon in 2022, fueled by the most significant growth in the past ten years. The last decade was marked by performance growth, while this year is expected to record an all-time peak due to net inflows.

In 2020, fund performance in this industry generally met investors' expectations despite the pandemic. A continued positive performance after Q1 led to improving investor confidence; the continuous growth in the hedge funds industry is expected to come from allocating funds to strategies with higher expected returns, shifting away from low-yielding fixed-income investments.

2. The revival of long-short equity

The hedge fund industry used to be dominated by long-short equity, reaching approximately 40% of all the industry assets. Long-short equity refers to taking a long position in underpriced stocks and short stocks that investors expect to decrease. However, this strategy started to underperform in the past ten years, showing investors that other strategies, such as CTAs or other fixed income strategies, have a better performance.

One of the causes for the decreases in long-short equity was related to prominent tech names and passive S&P 500 index funds. This ballooned the large growth stocks and the index, negatively impact the relative valuation of small and large-cap stocks, value and growth stocks, and US and foreign stocks.

3. Hedge funds and private equity

Hedge funds and private equity firms adopted similar strategies; typically, private equity firms offer a drawdown structure, while hedge funds provide evergreen structures. However, the last ten years registered a more blurred offering. In other words, hedge fund managers started to provide both evergreen and drawdown funds.

Another change brought by the blurred line between hedge funds and private equity refers to research departments. While these used to be organized according to fund structure, teams are now shifting to organization according to asset class or strategy. This convergence between the two can impact the entire hedge fund industry. For instance, private equity firms are already included in capital introduction events.

4. Growth of alternative investments

The current pandemic is not the only factor behind healthcare institutions' emergence as a standalone investing category. This was already fueled by existing characteristics, such as an aging population and massive medical technology investments. This segment has always been one of the fastest growing and is likely to retain this position in the future.

Numerous healthcare institutions invested billions of dollars in a broad range of assets, including pension funds, foundations, and others. As the expertise in alternative investments continues to grow, the hedge fund industry will see major improvements in this category.



The Trends

5. Better access to investor meetings

The pandemic has changed the way people work. The broad adoption of virtual meetings forced the hedge fund industry to adapt. In turn, this led to reduced time and expenses for investors and managers, among others. Scheduling flexibility and other benefits of virtual meetings allow investors to take advantage of this new practice, so it is likely to remain in 2022 and beyond.

Another benefit is that early-stage virtual meetings allow smaller funds to enjoy better access to investor meetings. As a result, it is expected that a substantial portion of introductory meetings and other events are carried out virtually. In contrast, later-stage meetings might still take place physically when possible.

6. Focus on ESG

Although ESG in the hedge fund industry is not news, there was little to no implementation. In the past years, many European institutions have already integrated ESG in investment diligence, and it seems that it will become the new standard.

The coronavirus pandemic has highlighted economic and social inequalities, so there is an increased focus on social justice. Public and private pension funds, sovereign funds, and endowments foundations reach about 65% of the hedge fund industry and play a crucial role in this matter.

While ESG criteria started simple, such as restrictions for tobacco or alcohol industries, they are now becoming more complex. Investors can filter companies according to third-party ratings, and those companies with low ESG scores can be excluded from the portfolio.

7. Workforce diversity

A current method is to focus on different sub-categories of ESG, such as adding assets related to renewable energy to address climate change. While this practice is quite common for private equity, it is expected that it will find its way into the hedge fund industry, too. Even more, it is expected that the ESG criteria will also apply to the investment manager; for instance, institutional investors are screened according to workforce diversity, so hedge fund managers are expected to adopt diversity policies to ensure future success.

8. Growing interest for North American investors

It is expected that a significant and permanent change in 2022 and beyond is related to Brexit. In the European Union, free trading between the member countries puts non-EU countries at a major disadvantage because of the struggle to comply with EU regulations. UK hedge funds are the second largest market worldwide, so some argue that the focus will shift to North American investors rather than European ones after the finalization of Brexit.



The Trends

9. Decreasing fees and outsourcing

The hedge fund industry is under current transformation due to the increasing costs of having a hedge fund firm while fees decrease. As a result, more and more small- and medium-sized businesses will seek to outsource many activities to reduce expenses, including technology, accounting, compliance, marketing, and other research- and investment-related activities.

Outsourcing these aspects of hedge fund businesses will offer lower fees, higher efficiency, and greater expertise. Large hedge fund businesses with their own infrastructures may seek revenue diversification strategies, such as acquiring competing firms.

10. The growing importance of private credit strategies in markets

Although institutional investors have been increasing their focus on private credit strategy markets, this is expected to be maintained throughout 2022 and beyond. Last year changed the way business works and even challenged many firms' viability, even though governments offered extensive liquidity support. Many firms could not access these funds, so private credit managers had to fill in this need.

For investors, private credit helped to achieve a new type of income, hedge, and even diversification due to the increasing volatility of their investments and lower fixed-income yields as a result of the pandemic.

11. Technological developments

The digitalization trend has reached new peaks due to the coronavirus pandemic. Many businesses realized the necessity of having a robust infrastructure, and many firms in this industry turned their attention to ICT abilities. Many have already started to use alternative data as one of the main components of their decision-making process, and there are numerous opportunities for technological developments to impact the hedge fund industry trends in 2022 and beyond.

Apart from upgrading the investment process, digital assets, including cryptocurrency, continue to grow. For instance, more and more hedge funds stand out from the crowd due to their attention to blockchain and DLT (distributed ledger technology) space. This alternative asset class is still in its infancy, but it is expected to grow and become more and more important in the next years.

12. Machine learning and artificial intelligence

The investment world is rapidly expanding to include non-standard methods in an attempt to beat the market. For instance, more and more hedge funds now include AI (artificial intelligence) and machine learning methods in their processes.

These developments help hedge fund managers to increase the accuracy of their predictions by using alternative data. For example, investment decisions can be made using non-traditional information, such as geolocations, credit card transactions, and more. It was proved that these hedge funds had better performance in the long run compared to others.



The Trends

13. Adoption of defensive hedge fund strategies

The hedge fund industry trends seem to focus more extensively on defensive strategies, which means that it becomes more stable. Some of the most favorable options include hedge funds that adopt quant investing, but also multi-strategy ones. Generalist equity has also registered some increase, but not as high as market neutral, sector-specific, and others.

14. Increased challenges in raising funds

There is a rising gap between small hedge fund firms and larger businesses. The latter category has been able to raise money, while less established businesses are not as successful in fundraising. In other words, mid-sized companies and those without a strong track record have issues with attracting investors. Despite this, the general sentiment regarding fund allocation to hedge funds is optimistic for 2022.

15. The emergence of cryptocurrency hedge funds

As technological developments affect the world of investment, most of the current cryptocurrency hedge funds were founded in 2018 and 2019. These are not only funds that have exclusive cryptocurrency portfolios but may also combine other financial assets using different hedge fund strategies. Many of these cryptocurrency hedge funds are located in the United States and the United Kingdom, but it is expected to become widespread in the following years.

16. Active management in 2022 and beyond

According to a global survey, allocations to hedge funds dropped from 40% in 2018 to only 23% in 2020. This decline was correlated with increases in private equity, credit, and real estate. Despite this lack of investor confidence in hedge funds' ability to perform, they registered impressive results during the 2020 coronavirus pandemic. In fact, many specialists argue that hedge funds will continue to rise in the next years because hedge fund strategies using active management are known to perform well during volatile, uncertain times.

17. Lower barriers to entry and fewer restrictions

Traditionally, hedge funds have always required six figures initial investments, which means that not everyone has access to them. However, this restrictive environment is bound to change in the next years. More specifically, retail-oriented and publicly traded funds already have a much smaller minimum, so there might be looser restrictions when it comes to who can invest in hedge funds, allowing for a broader expansion.

5 OF THE TOP HEDGE FUNDS IN 2021:

What do the world's top hedge funds look like? The obscure corner of Wall Street has long been insular, inaccessible and almost entirely disconnected from the individual investor. No matter, the field has still been romanticized and played up in Hollywood and the media for years on end.

some of the best hedge funds are time-tested, market-walloping machines. Here's a look at five of the top hedge funds in the world and the strategies they utilize:

- Renaissance Technologies (Medallion fund)
- Bridgewater Associates
- Pershing Square
- Jana Partners
- Tiger Global Management

1. Renaissance Technologies (Medallion fund)

In the ultra-competitive, dog-eat-dog world of Wall Street, it's awfully hard to be the best. It's even tougher to stay at the top. For decades on end now, one fund has quietly crushed the market by margins so large they'd make Warren Buffett blush.

With 66% average annual returns since 1988 – 39% after fees – Renaissance's Medallion fund is in a league of its own.

Their advantages include better talent, a unique management approach and a strategy of betting on the relationships among investments, rather than wagering on which will rise and fall.

Those numbers, good through the end of 2019, only improved throughout 2020, when the fund reportedly jumped 76% before fees – a legendary year by most standards, but for Medallion, just the third-best year in its history.

The fund, which is closed to new investors and only allows Renaissance employees to put their money in, uses a bit of a "black box" strategy, staying very secretive about what exactly the secret sauce consists of. What is known, however, is that the Medallion fund employs a "quant" strategy, trading largely on data and mathematical relationships rather than fundamentals and often owning positions for extremely short periods.



Top Funds

2. Bridgewater Associates

Bridgewater Associates is the biggest hedge fund in the world, managing about \$150 billion in investor money. Founded by Ray Dalio out of his apartment in 1975, the company shares some similarities with Renaissance – most importantly, the principle of accumulating massive troves of data and allowing an algorithm to make investment decisions.

Although the proverbial investing machine has proved its mettle over time, it's still not infallible. The firm reportedly lost \$12.1 billion for investors in 2020, just one year after its flagship fund, Pure Alpha II, lost 0.5%.

Despite the enormous loss last year, Dalio's Bridgewater remains one of the strongest hedge funds of all time, with profits of more than \$46 billion over its lifetime.

Another thing setting Bridgewater apart is its culture, which Dalio has carefully engineered through the decades. The firm prizes "radical transparency," encouraging blunt feedback between co-workers to foster an idea of meritocracy. While this entails a higher turnover rate, it also seems to have worked.

3. Pershing Square

Getting away from data-obsessed, extremely secretive firms like Renaissance Tech and Bridgewater Associates, Pershing Square Capital Management is another one of the top hedge funds in the world. Run by Bill Ackman, a savvy Wall Street billionaire, the fund's top holding is currently home improvement retailer Lowe's (ticker: LOW). It's a highly concentrated fund, with only seven total stocks, five of which hail from the consumer discretionary sector.

Ackman has considered an activist investor spotting companies with the potential to create a lot of value, then acquiring a large stake and agitating as a shareholder for changes that will drive up the stock price. Alternatively, Ackman sometimes sells stock short in a company that's struggling or that his research indicates is worth far less than it's trading for, then makes his concerns and research public to persuade the market.

Launched in 2004, Ackman became famous for a reason, beating the S&P 500 for seven straight years, and making various successful bets including Wendy's (WEN), Target (TGT), General Growth Properties and Canadian Pacific Railway (CP). A horrible losing stretch between 2015 and 2018, characterized by a record \$4 billion loss in Valeant Pharmaceuticals – since renamed Bausch Health Companies (BHC) – seems to have recently been broken.



Top Funds

4. Jana Partners

Another firm using a strategy similar to Ackman's is Jana Partners, run by Barry Rosenstein, considered one of the top hedge fund managers in the game. Founded in 2001, it claims to ignore the crowd and typically focuses on value stocks in its "event-driven," or activist, endeavors.

Like many of its peers, Jana Partners is essentially a fund family of sorts, offering multiple different funds with different focuses. The one it has become famous for, agitating for change at companies like Whole Foods and Apple (AAPL), to name a couple, is called Jana Strategic Investment. Over its lifetime the fund returned 17.5% annually through the end of 2019, the most recent year for which there's reporting on its performance.

Recently, Jana has taken a big position in life sciences company Laboratory Corp. of America Holding (LH), using that influence to nominate members to the board of directors. After selling a long-held position in Callaway Golf (ELY), Labcorp is now the fourth-largest holding in its portfolio. ConAgra Brands (CAG) is its largest holding.

5. Tiger Global Management

Last but not least, Tiger Global Management has been one of the world's top hedge funds for several years now. Founder Chase Coleman is a disciple of hedge fund legend Julian Robertson, whose Tiger Management was legendary on Wall Street, beginning with \$8 million in 1980 and reaching \$22 billion in assets by the late 1990s.

As far as reported long positions go, Tiger Global was the single best performer among large hedge funds between 2016 and mid-2019, returning 22.4% annually.

Tiger's hot streak continued in 2020 as well, with Tiger Global finishing the pandemic-ravaged year as the single most lucrative hedge fund among a list of 20 top funds compiled by LCH Investments. Tiger Global returned \$10.4 billion for investors last year alone.

One advantage of being a well-capitalized hedge fund is the ability to finance hot companies that aren't yet public, something mutual funds can only do to a very limited degree. Tiger Global has enjoyed some great private equity investments over the years, funding companies like Facebook (FB), Alibaba Group Holding (BABA), Uber (UBER), Airbnb, Stripe, LinkedIn, Juul, Flipkart and Square (SQ) when they were privately held.



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