HEDGE FUNDS

Introduction:

The hedge fund industry, once a cottage industry that was the domain of ultra high net worth individuals and managed by a few hundred bright investment managers, has undergone major changes over the past decade. Due to continued outperformance, particularly during times of market downturns, the industry has undergone exponential growth, not only in terms of the number of hedge funds available but also in the types of investment strategies available, and the number and type of hedge fund investors. Today, the industry is over a 4 trillion dollar industry managed by thousands of hedge fund managers, many of whom are among the brightest minds in the financial industry.

Meaning: A hedge fund is an aggressively managed portfolio of investments that uses advanced investment strategies such as leverage, long, short, and derivative positions in both domestic and international markets with the goal of generating high returns (either in an absolute sense or over a specified market benchmark). It may be characterized as private investment programme where the manager seeks positive returns by exploiting investment opportunities, while protecting principal from financial loss. Hedge funds are quite diverse, as several strategies and techniques can be employed to attain the same investment objectives. Consequently, hedge funds are synonymous with the term "alternative investment strategies." Some hedge funds follow very conservative strategies while others are more aggressive.

Legally, hedge funds are most often set up as private investment partnerships that are open to a limited number of investors and require a very large initial minimum investment. Investments in hedge funds are illiquid as they often require investors keep their money in the fund for at least 1 year.

For the most part, hedge funds (unlike mutual funds) are unregulated because they cater to sophisticated investors. You can think of hedge funds as mutual funds for the rich. They are similar to mutual funds in that investments are pooled and professionally managed, but differ in that the fund has far more flexibility in its investment strategies.

The term "hedge funds" is often times a misnomer as some funds may not hedge their underlying positions. It is important to note that hedging is actually the practice of attempting to reduce risk, but the goal of most hedge funds is to maximize return on investment. The name is

mostly historical, as the first hedge funds tried to hedge against the downside risk of a bear market by shorting the market (mutual funds generally can't enter into short positions as one of their primary goals). Nowadays, hedge funds use dozens of different strategies, so it isn't accurate to say that hedge funds just "hedge risk." In fact, because hedge fund managers make speculative investments, these funds can carry more risk than the overall market.

Top Hedge Funds 2017

Fund Name	City	Country	AUM (millions of USD)	Fund Strategy
AQR Capital Management	Greenwich	United States	243,982	Multi Strategy
Bridgewater Associates	Westport	United States	239,323	Long/Short
Millennium Management	New York	United States	207,626	Multi Strategy
Citadel Investment Group	Chicago	United States	152,656	Convertibles
Fortress Investment Group	New York	United States	56,936	Private Equity
Cerberus Capital Management	New York	United States	47,972	Aerospace/Defense
Capula Investment Management	London	United Kingdom	45,811	Absolute Return
GAM Fund Management	Hong Kong	Hong Kong	40,318	Fund of Funds
Tudor Investment Corporation	Greenwich	United States	39,661	Multi Strategy
Angelo Gordon & Co.	New York	United States	38,253	Real Estate

Largest Hedge Fund Firms

Rank	Firm	AUM 2019 (millions of USD)
1	Bridgewater Associates	$132,050
2	Renaissance Technologies	$110,000
3	Man Group	$62,000
4	AQR Capital Management	$60,840
5	Two Sigma Investments	$42,900
6	Millennium Management	$38,776
7	Elliott Management	$37,769
8	BlackRock	$32,909
9	Citadel LLC	$32,243
10	Davidson Kempner Capital Management	$30,880

Difference between Mutual Funds and Hedge Funds

Hedge funds, like mutual funds, are vehicles of collective investment. Nevertheless, there are some important differences between the two:

(a) Though mutual funds are open to the general investing public, hedge funds are typically open only to wealthy individuals and institutional investors.

(b) Mutual funds are heavily regulated entities, whereas hedge funds are only lightly regulated.
(c) Hedge fund managers can engage in leverage, short sales, and heavy use of derivatives across various markets, whereas mutual fund managers cannot.

Typically, hedge funds seek to exploit short-lived misalignments in security valuations. They buy securities that appear to be relatively underpriced and sell securities that appeared to be relatively overpriced.

A market-neutral position does not necessarily mean low risk. If the valuation difference across the two sectors persists or even accentuates, the hedge fund can lose money. Since hedge funds typically take highly leveraged positions, their returns tend to be highly volatile.

A major reason for the impressive growth in recent years is the belief that hedge funds produce superior risk-adjusted returns relative to traditional investment structures like mutual funds.

Characteristics of Hedge Funds

A hedge fund can create separate accounts for each investor or commingle investor capital into a common pool of assets. It has several important characteristics as follows:

1. Hedge fund investments are far less liquid than mutual fund shares as there are more restrictions on when and how capital can be contributed or withdrawn from the partnership.

2. Hedge funds, compared to mutual funds, have greater flexibility in how and where they can invest. Most hedge funds allow managers to use leverage, sell short and employ derivatives. By contrast, the vast majority of mutual fund managers are restricted from employing these investment tools.

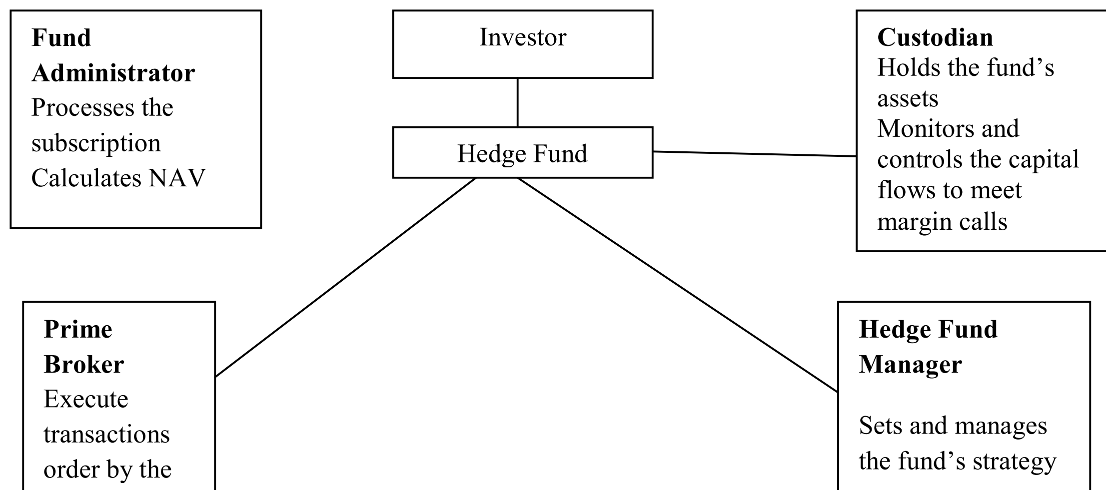
3. Most hedge fund managers receive their compensation in two parts, a regular management fee (which is about 1% of assets under management) and a performance fee (which is about 20% of a fund’s profits in excess of a benchmark).

4. Most hedge fund managers invest a substantial amount of their own capital into the fund, to inspire faith in outside investors.

Structure

Hedge funds are generally organized as limited partnerships, in which the investors are limited partners and the managers are general partners. As general partners, the fund managers generally invest a considerable portion of their personal wealth into the partnership. This ensures the alignment of economic interests among the partners. Investors in the partnership are charged a performance-based fee where the potential payout to successful managers can significantly exceeds the fixed management fee. This organization structure has survived for more than 50 years.

Structure



Hedge Fund Strategies

Hedge funds employ many different trading strategies, which are classified in many different ways. They can be classified on the basis of their style; the market in which they operate; the instruments they invest in; the nature of exposure; the sectors in which they invest; the method of asset allocation; and diversification as follows.

• Style: global macro, directional, relative value (arbitrage) event driven, managed futures (CTA)
• Market: equity, fixed income, commodity, and currency

• Instrument: long/short, futures, and options

• Exposure: directional, and market neutral

• Sector: emerging market, technology, healthcare, etc.

• Method: discretionary/qualitative (where the individual investments are selected by managers), and systematic/quantitative (or "quant" – where the investments are selected according to numerical methods using a computerized system)

• Diversification: multimanager, multi strategy, multi fund, and multimarket.

The term global macro is used to classify the strategy of certain hedge funds – those that take positions in financial derivatives, on the basis of forecasts and analysis about interest rate trends, movements in the general flow of funds, political changes, government policies, inter-government relations, and other broad systemic factors.

Relative value is the attractiveness measured in terms of risk, liquidity, and return of one instrument relative to another, or for a given instrument, of one maturity relative to another. Some hedge funds engage principally in arbitrage strategies in the global equity and corporate debt securities markets taking advantage of mispricings between two related and correlated securities. Typical arbitrage strategies include fixed income arbitrage, convertible bond arbitrage, mortgaged-backed arbitrage and derivative arbitrage.

Event-driven strategies try to exploit pricing inefficiencies caused by anticipated specific corporate events like mergers. In a cash merger, an acquirer proposes to purchase the shares of the target for a certain price in cash. Until the acquisition is completed, the stock of the target typically trades below the purchase price. An arbitrageur buys the stock of the target and makes a gain if the acquirer ultimately buys the stock. In a stock-for-stock merger, the acquirer proposes to buy the target by exchanging its own stock for the stock of the target. An arbitrageur may then short sell the acquirer and buy the stock of the target. This process is called "setting a spread." After the merger is completed, the target's stock will be converted into stock of the acquirer based on the exchange ratio determined by the merger agreement. The arbitrageur delivers the converted stock into his short position to complete the arbitrage.

Long/short equity refers to long equity position hedged with short sales of stocks or stock index options.

An investment strategy is considered market neutral if it seeks to entirely avoid some form of market risk, typically by hedging. In order to evaluate market neutrality, it is first necessary to specify the risk being avoided. For example, convertible arbitrage attempts to fully hedge fluctuations in the price of the underlying common stock.

A portfolio is truly market neutral if it exhibits zero correlation with the unwanted source of risk. Market neutrality is an ideal which is seldom possible in practice. A portfolio which appears to be market neutral may exhibit unexpected correlations as market conditions change. The risk of this occurring is called basis risk.