

Introduction To Hedge Funds - Part One

by David Harper, CFA, FRM ([Contact Author](#) | [Biography](#))

Story Tools

[Hedge funds](#) are like [mutual funds](#) in two respects: (1) they are pooled investment vehicles (i.e. several investors entrust their money to a manager) and (2) they invest in publicly traded securities. But there are important differences between a [hedge fund](#) and a mutual fund. These stem from and are best understood in light of the hedge fund's charter: investors give hedge funds the freedom to pursue absolute return strategies.

Mutual Funds Seek Relative Returns

Most [mutual funds](#) invest in a predefined style, such as "[small cap value](#)", or into a particular sector, such as the Internet sector. To measure performance, the mutual fund's returns are compared to a style-specific [index](#) or [benchmark](#). For example, if you buy into a "small cap value" fund, the managers of that fund may try to outperform the S&P Small Cap 600 Index. Less active managers might construct the portfolio by following the index and then applying stock-picking skills to increase (over-weigh) favored stocks and decrease (under-weigh) less appealing stocks.

A mutual fund's goal is to beat the index or "beat the [bogey](#)", even if only modestly. If the index is down 10% while the mutual fund is down only 7%, the fund's performance would be called a success. On the [passive-active](#) spectrum, on which pure index investing is the passive extreme, mutual funds lie somewhere in the middle as they semi-actively aim to generate returns that are favorable compared to a benchmark.

Hedge Funds Actively Seek Absolute Returns

Hedge funds lie at the active end of the investing spectrum as they seek positive absolute returns, regardless of the performance of an index or sector benchmark. Unlike mutual funds, which are "[long-only](#)" (make only buy-sell decisions), a hedge fund engages in more aggressive strategies and positions, such as [short selling](#), trading in [derivative instruments](#) like [options](#) and using [leverage](#) (borrowing) to enhance the risk/reward profile of their bets.

This activeness of hedge funds explains their popularity in [bear markets](#). In a [bull market](#), hedge funds may not perform as well as mutual funds, but in a bear market - taken as a group or asset class - they should do better than mutual funds because they hold short positions and [hedges](#). The absolute return goals of hedge funds vary, but a goal might be stated as something like "6 to 9% annualized return regardless of the market conditions".

Investors, however, need to understand that the hedge-fund promise of pursuing absolute returns means hedge funds are "liberated" with respect to registration, investment positions, [liquidity](#) and fee structure. First, hedge funds in general are not registered with the [SEC](#). They have been able to avoid registration by limiting the number of investors and requiring that their investors be [accredited](#), which means they meet an income or net worth standard. Furthermore, hedge funds are prohibited from soliciting or advertising to a general audience, a prohibition that lends to their mystique.

In hedge funds, liquidity is a key concern for investors. Liquidity provisions vary, but invested funds may be difficult to withdraw "at will". For example, many funds have a lock-out period, which is an initial period of time during which investors cannot remove their money.

Lastly, hedge funds are more expensive even though a portion of the fees are performance-based. Typically, they charge an annual fee equal to 1% of assets managed (sometimes up to 2%), plus they receive a share - usually 20% - of the investment gains. The managers of many funds, however, invest their own money along with the other investors of the fund and, as such, may be said to "eat their own cooking".

Three Broad Categories and Many Strategies

Most hedge funds are entrepreneurial organizations that employ proprietary or well-guarded strategies. The three broad hedge fund categories are based on the types of strategies they use:

1. Arbitrage Strategies (A.K.A., Relative Value)

[Arbitrage](#) is the exploitation of an observable price inefficiency and, as such, pure arbitrage is considered riskless. Consider a very simple example. Say Acme stock currently trades at \$10 and a [single stock futures](#) contract due in six months is priced at \$14. The futures contract is a promise to buy or sell the stock at a predetermined price. So by purchasing the stock and simultaneously selling the futures contract, you can, without taking on any risk, lock in a \$4 gain before transaction and borrowing costs.

In practice, arbitrage is more complicated, but three trends in investing practices have opened up the possibility of all sorts of arbitrage strategies: the use of (1) derivative instruments, (2) trading software, and (3) various trading exchanges (for example, electronic communication networks and foreign exchanges make it possible to take advantage of "exchange arbitrage", the arbitraging of prices among different exchanges).

Only a few hedge funds are pure arbitrageurs, but when they are, historical studies often prove they are a good source of low-risk reliably-moderate returns. But, because observable price inefficiencies tend to be quite small, pure arbitrage requires large, usually leveraged investments and high turnover. Further, arbitrage is perishable and self-defeating: if a strategy is too successful, it gets duplicated and gradually disappears.

Most so-called arbitrage strategies are better labeled "relative value". These strategies do try to capitalize on price differences, but they are not risk free. For example, convertible arbitrage entails buying a corporate [convertible bond](#), which can be converted into common shares, while simultaneously selling short the [common stock](#) of the same company that issued the bond. This strategy tries to exploit the relative prices of the convertible bond and the stock: the arbitrageur of this strategy would think the bond is a little cheap and the stock is a little expensive. The idea is to make money from the bond's yield if the stock goes up but also make money from the short sale if the stock goes down. However, as the convertible bond and the stock can move independently, the arbitrageur can lose on both the bond and the stock, which means the position carries risk.

2. Event-Driven Strategies

Event-driven strategies take advantage of transaction announcements and other one-time events. One example is [merger arbitrage](#), which is used in the event of an [acquisition](#) announcement and involves buying the stock of the [target company](#) and hedging the purchase by selling short the stock of the acquiring company. Usually at announcement, the purchase price that the acquiring company will pay to buy its target exceeds the current trading price of the target company. The merger arbitrageur bets the acquisition will happen and cause the target company's price to converge (rise) to the purchase price that the acquiring company pays. This also is not pure arbitrage. If the market happens to frown on the deal, the acquisition may unravel and send the stock of the acquirer up (in relief) and the target company's stock down (wiping out the temporary bump) which would cause a loss for the position.

There are various types of event-driven strategies. One other example is "distressed securities", which involves investing in companies that are re-organizing or have been unfairly beaten down. Another interesting type of event-driven fund is the activist fund, which is predatory in nature. This type takes sizeable positions in small, flawed companies and then uses its ownership to force management changes or a restructuring of the [balance sheet](#).

3. Directional or Tactical Strategies

The largest group of hedge funds uses directional or tactical strategies. One example is the macro fund, made famous by George Soros and his Quantum Fund, which dominated the hedge fund universe and newspaper headlines in the 1990s. Macro funds are global, making "top-down" bets on currencies, interest rates, commodities or foreign economies. Because they are for "big picture" investors, macro funds often do not analyze individual companies.

Here are some other examples of directional or tactical strategies:

- [Long/short strategies](#) combine purchases (long positions) with short sales. For example, a long/short manager might purchase a portfolio of core stocks that occupy the S&P 500 and hedge by selling (shorting) S&P 500 Index futures. If the S&P 500 goes down, the short position will offset the losses in the core portfolio, limiting overall losses.
- [Market neutral](#) strategies are a specific type of long/short whose goal is to negate the impact and risk of general market movements, trying to isolate the pure returns of individual stocks. This type of strategy is a good example of how hedge funds can aim for positive, absolute returns even in a bear market. For example, a market neutral manager might purchase Lowe's and simultaneously short Home Depot, betting that the former will outperform the latter. The market could go down and both stocks could go down along with the market, but as long as Lowe's outperforms Home Depot, the short sale on Home Depot will produce a net profit for the position.
- [Dedicated short](#) strategies specialize in the short sale of over-valued securities. Because losses on short-only positions are theoretically unlimited (because the stock can rise indefinitely), these strategies are particularly risky. Some of these dedicated short funds are among the first to foresee corporate collapses - the managers of these funds can be particularly skilled at scrutinizing company fundamentals and [financial](#) statements in search of red flags.

Conclusion

You should now have a firm grasp of the differences between mutual and hedge funds and understand the various strategies hedge funds implement to try to achieve absolute returns. Next (in [Part Two](#) of this series), we will review the "fund of hedge funds [vehicle](#)", highlight the risk/reward features of hedge fund investing, and propose key questions to ask when considering a hedge fund investment.

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In addition to writing for Investopedia, David Harper, CFA, FRM, is the founder of [The Bionic Turtle](#), a site that trains professionals in advanced and career-related finance, including financial certification. David was a founding co-editor of the Investopedia Advisor, where his original portfolios (core, growth and technology value) led to superior outperformance (+35% in the first year) with minimal risk and helped to successfully launch Advisor.

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