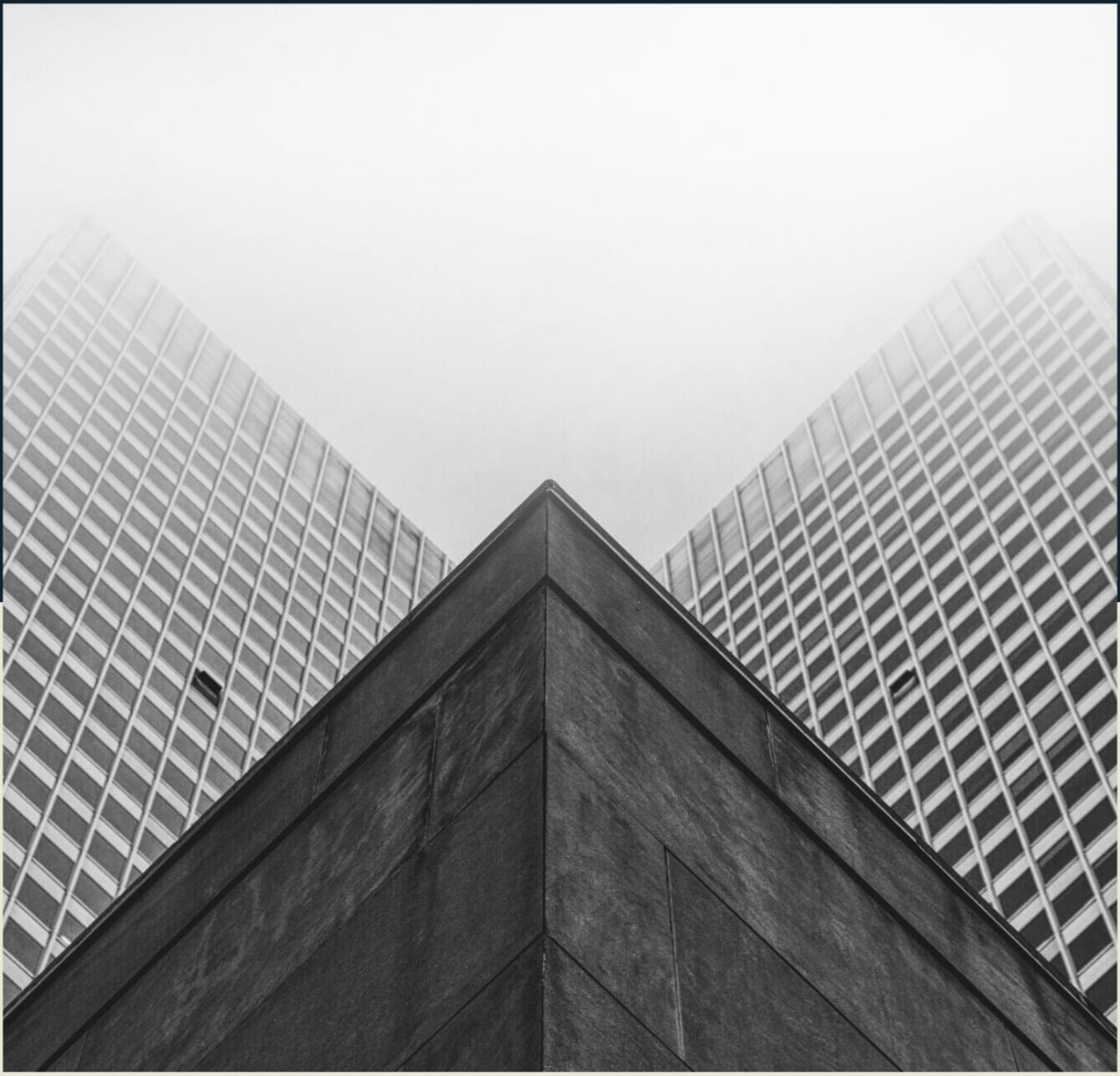
Hedge Funds

MARKET INSIGHTS DIVISION

MATTIA GASPARDIS - TEAM LEADER
MIKOLAJ BOROWIAK - ANALYST
TEODORA PAVLOVIC - ANALYST

BSAMC
Bocconi Students Asset Management Club



Introduction

Since the beginning of the twenty-first century, the use of hedge funds in financial portfolios has increased significantly. A hedge fund is simply a fancy name for an investment partnership with more freedom to invest aggressively and in a broader range of financial products than most mutual funds. It is the union of a professional fund manager, known as the general partner, and investors, known as limited partners at times. They put their money into the fund as a group.

In simpler words, a hedge fund is a pool of money that invests in both short and long positions, buys and sells stocks, engages in arbitrage, and trades bonds, currencies, convertible securities, commodities, and derivative products in order to generate higher returns with lower risk. As the name implies, the fund seeks to mitigate the risks to investor capital posed by market volatility using alternative investment strategies.

The goal of a hedge fund is to maximize investor returns while minimizing risk. This structure and these objectives may sound similar to those of mutual funds, but that's where the similarities end. Hedge funds are thought to be more aggressive, risky, and exclusive than mutual funds. Limited partners contribute funding for assets in a hedge fund, while the general partner manages the fund in accordance with its strategy.

Nevertheless, not every person is eligible to invest in these alternative funds, i.e. investment in hedge funds is best suited to sophisticated and/or institutional investors who have the means, expertise, and capacity to fully understand the risks. These investors are best placed to make their own judgments about the suitability of hedge funds. As a result, many hedge funds are unlikely to be suitable investments for small or retail investors, who typically lack the resources to fully comprehend the nature and risks of such investments. For instance, the SEC[1] was given authority under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 to adjust the net worth and income standards for individuals as it sees fit. Banks and major corporations must have a minimum total asset value of $5,000,000. Many larger hedge fund investors must also meet stricter "qualified purchaser" requirements under the Investment Company Act of 1940, which normally requires participants to have $5,000,000 in investments and companies and pension plans to have $25,000,000 in investments.

The abnormal returns generated come at a price, i.e. a very lucrative fee system that rewards the best in the industry. A pay-for-profit compensation structure causes the manager's goal to be absolute returns rather than simply beating a benchmark. To consistently achieve absolute returns, the hedge fund manager must seek trading strategies that generate returns regardless of market conditions, i.e. strategies with low correlation to the market. A hedge fund incentive fee, on the other hand, is asymmetric; it bonuses positive absolute returns while penalizing negative returns. Generally, managers are compensated by two types of fees: a management fee, typically a percentage of the size of the fund (usually between 1-2% of the AUM[2]), and a performance-based incentive fee (usually 10-20% of the fund's profit) which depends on the returns generated by the fund in a given period of time.

[1] *: abbreviation for U.S. Security and Exchange Commission.*
[2] *: abbreviation of Assets under Management; is the total market value of the investments that a person or entity manages on behalf of clients.*

Due to the complex nature of the strategies employed, investors and regulators in hedge funds require disclosures that include key information about the funds managed. Transparency allows investors to accurately assess their fund holdings and allows supervisors to keep track of the accumulation of risks. Moreover, hedge fund managers are subject to the same trading disclosures and record-keeping criteria as other publicly traded securities investors. They are also subject to additional restrictions and regulations, such as a cap on the number and type of investors which every fund may have.

Types of hedge funds

Long/Short Equity

Long-short equity is an investment strategy in which long positions are taken in stocks that are projected to rise and short positions are taken in equities that are predicted to fall. A long-short equity strategy aims to reduce market exposure while benefiting from stock increases in long positions and price falls in short ones. These long and short positions offset each other and thus such a strategy should be profitable on a net basis. Short selling, as compared to a long-only portfolio, minimizes correlation with the market, gives additional leverage, and allows the manager to profit from both overpriced and underpriced securities. Put more simply, this strategy is essentially an extension of pairs trading, in which investors take long and short positions in two rival businesses in the same industry based on their relative values. Nevertheless, to minimize the risk involved, the long exposure is usually greater than short exposure. It is known that around a quarter of the world's hedge funds employ the aforementioned strategy. Examples of such funds include the Bridgewater Associated, which is considered to be the largest hedge fund in the world with approximately US$140 billion as of March 2021.

Global macro

Global macro funds invest based on assessments of global variables such as interest rates, currency exchange rates, inflation, unemployment, industrial production, foreign trade, and political stability. They forecast how global macroeconomic trends will influence other financial instruments such as currencies, commodities, or stocks, and then take long or short positions in the asset class most vulnerable to their predictions. In addition, to maximize gains, global macro traders may employ leverage, short sells, or derivatives. Even though global macro funds may trade nearly anything, managers often pick highly liquid products like futures and currency forwards. This implies that they do not take stances on specific firms or industries. They look at the world of finance at a macro level and forecast its changes. Two of the most prominent hedge funds in history, such as George Soros' Quantum Fund and the gigantic Julian Robertson's Tiger Fund, identify as global funds. Similarly, prior to the Euro crisis, numerous funds were found to have short bets against European states. When George Soros broke the Bank of England and propelled hedge fund managers to celebrity status, he popularized this strategy.

Event-driven

Event-driven strategies are employed when the underlying opportunity and risk are linked to a specific event. Corporate transactions such as mergers, acquisitions, or bankruptcies provide investment opportunities for fund managers. These funds generally take advantage of perceived mispricing in securities by foreseeing events that are very likely to generate volatility and thus create larger price movements. It is worth noting that analyzing corporate events for successful implementation necessitates the requisite skills. Investors that adopt this approach to investing, employ teams of professionals who are experts in studying business events and determining the impact of the action on the stock price of a firm. This research comprises, among other things, an examination of the existing regulatory environment, potential synergies from mergers or acquisitions, and a new price objective following the action. Based on the present stock price vs the probable price of the stock following the action, a choice is made regarding how to invest. If the analysis is correct, the strategy will make money; if the analysis is flawed, the plan may end up costing money. Such hedge funds can lock in lucrative profits during periods of increased volatility.

Directional / momentum

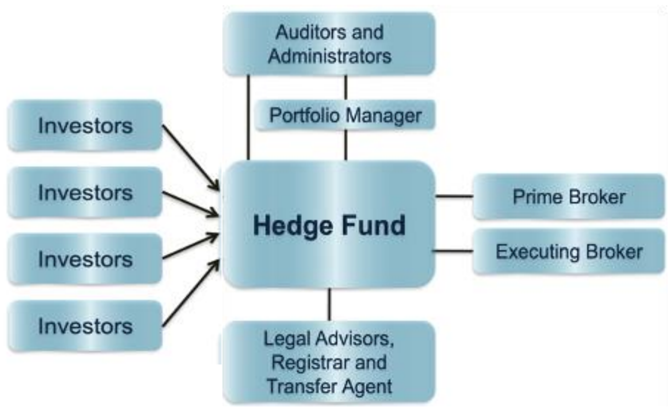
Managers that use the directional strategy bet on the market's directional moves (long or short) because they predict a trend to persist or reverse for a set length of time. A manager examines market movements, patterns, or inconsistencies, which are subsequently used to make investment decisions. The market return of a stock is given a lot of weight in momentum analysis. For many funds, historical performance is the most important criterion for membership. These funds lend credence to the idea that a company's previous success might predict its future returns. Positive performance is frequently achieved through positive sales and earnings compounding over time. However, investors should be wary of these products since they can be strongly tied to systemic risks and frequently lag market returns. One of the most well-known momentum funds includes AQR Capital Management, a Connecticut based hedge fund with over US$100 billion of assets under management.

Funds of funds

These funds, like other hedge funds, collect money from investors, but they do not directly use those funds to trade. This is due to the fund's passive investment strategy. This means that the money is simply distributed to other hedge funds. As a result, there is no active trading, only periodic and passive monitoring of the performance of other funds. Such funds enjoy the chance to diversify their portfolios to avoid the risks associated with hedge fund positions. Usually very experienced people run these funds as their expertise makes them able to recognize and assess other hedge funds.

Structure

While the specific structure can vary from fund to fund, there are a few characteristics that are applicable across the industry. Unique to the investment community, hedge funds are partnerships formed between fund managers and investors. Typically hedge fund managers invest a significant amount of personal capital - in some cases more than 50 percent of the total assets in the fund - aligning their interests with that of their investors; investors, on the other hand, share the partnership's income, expenses, gains and losses. Each partner is taxed according to their respective share of the partnership.



This is an example of the structure of a typical U.S. hedge fund:

To qualify as an **accredited investor**, an individual must have a net worth, or joint net worth with their spouse, that exceeds $1 million at the time of the purchase (the net worth calculation excludes the value of their primary residence) and a yearly income of $200,000, or higher, in each of the two most recent years or joint income with a spouse exceeding $300,000 for those years and a reasonable expectation of the same income level in the current year.

The **investment manager** makes daily investment decisions for the fund, choosing where and when to allocate investment capital; he or she also manages portfolio risk. They may be either direct employees of the hedge fund management firm or employees of another firm hired by the management firm to provide investment advice, pursuant to a sub-advisory agreement.

Prime broker is a financial institution (ex. Investment bank) who provides multiple services to a hedge fund that are beyond the scope of those offered by a traditional broker, such as: Clearing and Settlement of Securities Transactions[3]; Security Lending[4]; Custodial Services (holding of assets) and Research Capabilities, among other things. These services are provided by most of the largest financial services firms, including Morgan Stanley, J.P. Morgan Chase, UBS and Credit Suisse.

An **executing broker** is a type of financial dealer or broker that is accountable and responsible for the completion and processing of an order requested by a client. As part of the process, executing brokers will evaluate the order to make sure it is in line with all current policies and procedures; for hedge funds or institutional clients that have already been qualified, an attempt to fill an order is immediately processed. Among the most famous firms that offer this service there are Goldman Sachs and Deutsche Bank.

The **Financial Auditor** is who audits, reviews, and evaluates the accounts of businesses and companies to ensure that all financial information is recorded correctly, completely, and in compliance with applicable regulations.

Organizational structure

The range of investment strategies available to hedge funds and the types of positions they can take are quite broad. The typical hedge fund structure is really a two-tiered organization. A first characteristic of this is the use of limited partnership model, which is the most common for the pool of investment funds that make up a U.S. hedge fund.

In this model, the general partner is responsible for selecting the service providers that perform the operations of the fund and manage the fund as well as perform any functions necessary in the normal course of business; in exchange for their control, they take on unlimited liability in the fund, which means that their personal assets are at stake if the fund's liabilities exceed its assets. Differently, limited partners (the investors), can make investments into the partnership and are liable only for that amount; this means that investors can lose only the amount they invest in the fund and no more - because of this, if the hedge fund goes belly-up and a landlord comes looking for back rent, he can go after the general partners and their personal assets, but he can't come to the limited partners and ask them for money. Nevertheless, the disadvantages for them are not few limited: investors pay fees to general partners for their management services, they have little or no say in the fund's operations and the fund may limit ongoing communication with general partners to a few times per year. The limited partners can be several: individual investors, pension funds or endowment funds; brokerage firms or investment firms that sponsor general fund partners; other partnerships or companies formed to make hedge fund investments.

---

[3] : clearing and settlement functions are the processes by which transactions in securities or derivatives are finalised - so that the buyer receives the financial instrument, and the seller receives the corresponding payment.
[4] : is the practice of loaning shares of stock, commodities, derivatives contract, or other securities to other investors or firms; it also requires the borrower to put up collateral, whether cash, other securities, or a letter of credit

Fee structure

Fee structures at hedge funds differ from other types of investment vehicles. The more traditional used model is the 2/20 structure, which is composed by a management fee, typically 2%, and a performance/incentive fee, typically set at 20%. To ensure performance fees are not pre-emptively taken, which could trigger investors to exercise a claw-back provision[5], a hurdle rate[6] and/or high-water mark[7] can be set in place. If a fund includes both of them, the managers cannot receive a performance fee unless fund's value is above the high-water mark and returns have exceed the hurdle rate.

Term structure

The actual terms of partnership vary according to the fund; however, they are usually based on a few factors. **Subscription** is when the investor applies to join a particular fund; subscription minimums vary from fund to fund. A **redemption** is when the investor withdraws part or all of their investment from a fund. Unlike registered investment companies, hedge funds are not required to have daily liquidity; for that reason, some hedge funds offer subscriptions and redemptions monthly, while others accept them only quarterly or annually. A **lock-up** is the time period that an initial investment cannot be redeemed from the fund; the length of time varies based on the fund (the average lock-up period for a U.S. hedge fund is eight months). In certain cases, it could be a "**hard lock**", which prevents the investor from withdrawing funds for the full time period, while in other cases, an investor can pay a penalty and withdraw funds early**.**

Industry outlook

Hedge Fund AUM marks the third consecutive year of double-digit growth. Based on the latest surveys, it is expected that in 2022 higher levels of stock and factors dispersion are creating positive a fertile field for hedge fund managers who use relative value and arbitrage strategies that focus on identifying price discrepancies among securities with similar characteristic. In addition, strong growth and alpha opportunities are expected in a diverse array of secular themes like biotechnology and cybersecurity.

[5] : allows the limited partner to claw back any fees paid during the investment period to equal the original percentage agreement if subsequent losses occur.

[6] : *is the minimum rate of return that the hedge fund manager should generate before it is able to charge a performance fee (these rates are either a fixed or variable rate, often linked to a benchmark interest rate, such as Libor).*

[7] : it notes the highest value that an investment fund has ever reached; this means that a hedge fund manager will only paid fees if the fund value exceeds this level.

Is inflation an opportunity or not?

The investors, as a response to inflation (the highest in 30 year), are planning to reduce their exposure to cash (12%), long only fixed income (17%), and passive equity (8%); 35% of them plans to increase exposure to hedge funds and illiquid asset classes[8]. In general, all investor types say they want to increase exposure to alternatives: for 2022, the market environment is expected to be favorable for strategies that aim to obtain revenues from investments such as private infrastructure, real estate and consumer credit. In addition, the themes of sustainability (with a particular focus on carbon footprint reduction as a driver of corporate performance) and technology solutions around cybersecurity will also increasingly gain space in investments decision.

Investors even more bullish on hedge funds in 2022

Investor survey shows 70% of investors' Hedge Fund portfolios met or exceeded their target returns in 2021; furthermore, Hedge Funds generated alpha[9] of 2.4%. Not surprisingly, investors appear even more bullish across most Hedge Fund strategies than they were in the previous year. It is estimated that they plan to allocate $265 million to Hedge Funds in the next year, on average; they also plan to finance about 70% of these investments through redemptions of existing allocations. Overall, this will result in a net increase in their Hedge Fund exposure of about 3%. In addition, strategies that are less sensitive to equity and credit beta[10], such as opportunistic long/short equity, macro diversified and corporate arbitrage strategies, are expected (managers of such strategies should benefit from higher volatility and cross-asset market movements produced by potentially higher long-term returns).

What to expect from the future?

According to Barclays' report, it is expected that Hedge Funds will receive about $30-50 billion in net allocations in 2022, marking growth of about 1% for the industry overall (from a gross perspective, investors are expected to make allocations of $400-450 billion). However, what will be the trends? Investors are strongly interested in all Hedge Fund strategies, but with a preference for Sector Equity, Global Macro, Credit Long/Short, Multi-Strategy and Market Neutral Equity; concurrently, they are also seeking non-traditional equity and credit, ESG[11] and even crypto-focused hedge fund offerings.

In the end, industry surveys suggest that the coming year holds the potential for significantly greater market volatility (a key enabler for hedge funds seeking to generate alpha) and more dispersion in performance. However, alongside with their ability to turn volatility into opportunity, hedge funds can serve as a downside protection and strategic diversification tool in

---

[8] : data provided by the 2022 Investor Survey of Barclays.
[9] : the amount that an investment's Average Rate of Return exceeds the Risk Free Rate, adjusted for the inherent Systematic Risk. Measures the value that an investment manager produces, by comparing the manager's performance to that of a risk-free investment.
[10] : percentage change in the price of a Security for a one percent change in the market; also gauges the risk of a fund by measuring the volatility of its past returns in relation to the returns of a Benchamark.
[11]: abbreviation for Environmental, Social and Governance; they are a set of standards for a company's operations that socially conscious investors use to screen potential investments.

an era of pandemic-induced unease, thus becoming a critical component of a well-diversified portfolio; on the other hand, their success will require sophisticated portfolio construction, supported by a nuanced understanding of hedging as factor exposures change around the world. In this perspective, investors willing to pursue diverse and uncorrelated strategies are likely to benefit from considering hedge funds built with diversified alpha sources and a strong risk management process.

SOURCES

Introduction

- https://www.sec.gov/files/ib_hedgefunds.pdf
- https://www.cfainstitute.org/en/advocacy/issues/hedge-funds#sort=%40pubbrowsedate%20descending
- https://eprints.lse.ac.uk/24675/1/dp477.pdf

Types of hedge funds

- https://corporatefinanceinstitute.com/resources/knowledge/finance/hedge-fund-strategies/
- https://www.preqin.com/academy/lesson-3-hedge-funds/hedge-fund-fees-types-and-structures
- https://www.cfainstitute.org/en/membership/professional-development/refresher-readings/hedge-fund-strategies
- https://www.lw.com/admin/upload/Documents/BoJ_Hedge_Funds-locked-March-2015.pdf

Structure

- https://www.managedfunds.org/wp-content/uploads/2016/06/06.09.16-How-HFs-are-Structured.pdf
- https://www.preqin.com/academy/lesson-3-hedge-funds/hedge-fund-fees-types-and-structures
- https://www.dummies.com/article/business-careers-money/personal-finance/investing/investment-vehicles/funds/types-of-hedge-fund-partnerships-general-and-limited-198329/

What to expect in the future

- https://www.morganstanley.com/im/en-us/financial-advisor/insights/articles/hedge-funds-in-2022-changing-with-changing-risk.html
- https://am.jpmorgan.com/ch/en/asset-management/institutional/insights/portfolio-insights/alternatives/global-alternatives-outlook/hedge-funds/
- https://www.cib.barclays/our-insights/3-point-perspective/Hedge-Fund-Outlook-2022.html?cid=paidsearch-textads_google_google_themes_hedge-fund-outlook_uk-we_hedge-fund-outlook_phrase_1644660175611&gclid=Cj0KCQjwgYSTBhDKARIsAB8Kuku_sEkaDDSCcoqC-I1gV3WWzqMg8fatG9k06CMOMsKXxhxnNBmz24AaAjq_EALw_wcB&gclsrc=aw.ds