HEDGE FUNDS

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Investment in equity and bond markets is usually made via direct investment – called a '**long**' investment style. Hedge funds, however, can use **alternative investment structures** in addition to this, aiming to generate either superior returns or lower volatility.

Here we look at the **methods** hedge funds may employ, and the **risks** and **costs** undertaken in doing so. The world of hedge funds can, at its worst, be unregulated and costly, and it is important to be fully informed before investing.

Please refer to our note on Risk and Asset Allocation for a discussion on how to determine the level of risk you should take, and consequently the proportion of investments in each asset class which might be suitable for you.

SUMMARY

Hedge Funds, in principle, are a way of **managing overall portfolio risk whilst maintaining returns**. However, much of the industry is shrouded in **secrecy** and investors must appreciate the very real risks involved in investing in funds based in **less regulated offshore locations**.

Hedge Funds can invest in a **variety of different 'alternative' manners**, although in private client portfolios the most common target is a superior absolute return with low volatility. This generally means that the Hedge Fund (or Fund of Funds typically) will target, with varying degrees of success, returns that underperform in a rising market, but seek to protect fund value in a falling market. Please note that this is merely an intention: **there are no guarantees**.

The price of this 'smoothing' is generally high, especially in Fund of Funds. As with all investments, **the investor must therefore consider whether the potential returns, net of charges, are worth the level of risk incurred**. However, as Hedge Funds can be opaque, it may be **difficult to evaluate** with any certainty both the potential returns and this level of risk.

Despite their considerable presence in world financial and investment circles, hedge funds are still regarded as an arcane investment. Many questions naturally arise: What are hedge funds and who runs them? What investment opportunities do they offer and why should I invest in them? What are the potential risks and benefits? What should I look for when evaluating a hedge fund and what should I seek to avoid? Historically, perhaps the two most infamous examples of hedge funds are:

- The Quantum Fund, which was run by George Soros and reputed to have caused, at least in part, the withdrawal of Sterling from the European Monetary Union in 1992.

- Long Term Capital Management (LTCM) which was reputed to have come close to causing the collapse of the western world's financial systems due to taking very large Bond positions in 1998.

REGULATION

Hedge Funds purport to be one of the few ways to make investment gains irrespective of the direction of the stock market (long only position). The term "Hedge Fund" has become widely used and is synonymous with a wide variety of "alternative" investment strategies (see below). These funds are "alternatives" to traditional investment management where a share or other instrument is purchased in anticipation of superior income and / or capital returns than could be achieved through the purchase of other comparable investments.

To an extent hedge funds give their managers the opportunity to invest flexibly wherever and however they choose and have developed in response to the heavy regulation and control that exists in most developed investment markets.

However, this increased flexibility comes at a price as Hedge Funds are less highly regulated and tend to be located in offshore territories. Although the introduction of the Alternative Investment Funds Management Directive in 2013 has gone some way to improving investor protection, hedge fund failure rates remain very high.

MINIMUM INVESTMENTS

Although there are undoubtedly some highly talented individuals operating Hedge Funds, the best managers are in high demand and can set very high minimum investment thresholds, typically £250,000 to £1,000,000. For investors not willing or able to make this level of commitment there is arguably a much poorer talent pool available operating with reduced regulation - although see "Fund of Funds."

FUND OF FUNDS

Often, the answer for individuals is to invest in a "Fund of Hedge Funds" product. This is an investment vehicle that invests in other Hedge Funds and is available from well-known UK based investment houses. Not only does the investor benefit from detailed in-house research but also the Fund of Funds will diversify managers and style by investing in a variety of different risk graded Hedge Funds and, due to buying power, will be able to obtain entry into some of the most highly sought after funds.

COSTS

Quite often the charges levied by Hedge Fund managers will be far higher than charges levied by typical Unit Trusts or OEICs. There is often a set annual fee together with a performance fee triggered when the manager achieves a set performance hurdle, often up to 20% of any performance achieved. In the case of a Fund of Funds there will be an additional layer of fees for the manager selecting the underlying funds. Charges may reach 3%p.a. and above, although many Fund of Fund managers quote performance figures net of all charges. The argument employed by hedge fund managers is that their clients should not fear paying high fees for above average performance. Of course, if performance is not above average then the fees will seriously erode the actual investment returns.

SMOOTHER RETURNS?

Source: FE fundinfo 2025 (28/02/2020 - 28/02/2025)

The graph above shows the returns from the Credit Suisse Hedge Fund index, and All Hedge index, set against returns from various equity market and private client portfolio indices over the past 5 years. Data points on a monthly basis are shown for a more equal comparison, as the hedge fund indices are priced monthly. However, the non-hedge indices are priced daily and so in practice exhibit greater volatility than that shown. You will see from the graph above that Hedge Fund returns on average have been somewhat smoother over this period. Of course, evaluating whether any particular fund will deliver similar returns over a future period is much more difficult. One of the advantages claimed by "Fund of Fund" Hedge Funds is that returns tend to be less volatile than equity returns with lower peaks and shallower troughs. However, returns do still tend to be correlated with the markets to some degree, belying the claim of funds to be genuine hedges against the markets.

Many Hedge Funds will pursue a fairly defensive investment philosophy and will focus on trying to preserve their investor's money (not guaranteed) in the bad years at the expense of potentially lower returns, as against equities, in the good years. Mathematically this makes much sense, as a 50% fall in the value of a portfolio requires a 100% increase to return to the starting point. Consider the following example:

- **Portfolio A of £100,000** is invested in equities and falls 50% over the first 3 years and then rises 60% over the following 3 years. Final value = £80,000 i.e. a loss of 20%.
- **Portfolio B of £100,000** is invested in defensive Hedge Funds and does not fall at all over the first 3 years but then increases at only 30% over the next 3 years (half the gain in equities).
  Final value = £130,000 i.e. a gain of 30%.

This shows how important it is to try to preserve capital in bad years so that there is more remaining capital to benefit from any upturn.

STRATEGIES

The main investment strategies employed by Hedge Fund managers are detailed below. Some managers use a blend of different strategies. First of all it is important to understand the difference between holding investments "long" and holding investments "short".

- **Long**: the idea is to buy and hold investments, normally equities, to benefit from any capital appreciation i.e. to sell at some time in the future at a profit. Equity "long" management is the more traditional way of managing share portfolios.

- **Short**: the idea is to sell shares that the manager does not own in anticipation of a fall in price. If the expected fall takes place, the manager then buys the underlying shares and settles the trade at a profit.

  For example, an equity short manager believes that Vodafone shares are overpriced at £3. He therefore sells the shares at £3 with settlement of the transaction not due for a further 30 days. After 30 days the Vodafone shares have fallen to £2 and the manager buys the shares and settles the transaction. He therefore has a profit of £1 per share, less the costs of the transaction. Of course, if the Vodafone share price had risen then the manager would have incurred a loss.

- **Market Neutral (Equity Long Short)**: the manager holds a mix of long and short stocks. He moves from net long (more long than short positions) to net short (more short than long positions) depending on market conditions.

- **Short Selling**: the manager profits from taking a number of short positions in both individual equities and index tracking shares and, therefore, hopes to profit from a falling market.

- **Convertible Arbitrage**: the manager focuses on obtaining returns with a low or no correlation to the market. He attempts to profit from owning different securities of the same issuer, for example equities and convertibles. Often the pricing differential is very small and the opportunity short lived. The strategy aims to exploit inefficiencies in pricing of different financial instruments.

- **Fixed Interest Arbitrage**: the principle is the same as above except the manager profits from pricing differentials between bonds and bond derivatives. Long Term Capital Management (LTCM) was an arbitrage based manager, borrowing heavily to profit from pricing inefficiencies and ultimately collapsing with huge debts.

- **Macro**: a global or international manager who employs an opportunistic approach following major changes in global economies and seeking to profit from changes in global interest rates and currency movements. The Soros Quantum fund was a Global Macro fund reputed to have profited from the extreme movement in UK interest rates and currency in the Autumn of 1992.

- **Distressed Securities**: this strategy focuses on buying the equity of companies facing bankruptcy in the expectation that the company will come out of bankruptcy or have sufficient assets to repay to security holders more than the current share price.

STRATEGIES

- **Emerging Market**: investing in the equity or debt of emerging market economies where there can be very large daily price fluctuations.
- **Event Driven**: the manager takes significant positions in a limited number of companies where situations are unusual and offer profit opportunities.
- **Fund of Funds**: the manager invests in other managers or pooled vehicles that may utilise a variety of investing styles, creating a diverse investment vehicle.

RISKS

An investor should bear in mind that an investment into a Fund of Hedge Funds may not be registered on any authorised stock exchange, and may not be subject to regulatory supervision/investors compensation scheme. They may follow a variety of alternative investment strategies, including arbitrage, short selling and the application of gearing. They may invest in derivatives, options, futures and warrants, based on shares, currencies bonds or commodities, and in any combination deemed fit by the portfolio manager concerned. This means that a Fund of Hedge Funds' performance may not be correlated with movements in any share price index, and the value of your investment may prove highly volatile.

You should note that it may be difficult to obtain reliable information about the value of the Hedge Funds or the extent of the risks to which they are exposed. In addition, holdings in Hedge Funds may be highly illiquid.

You should not subscribe to a Hedge Fund until you: (i) have read and understood the terms and conditions and (ii) are aware of the risks involved in such shares and such schemes.

Important information: Our views are based upon our understanding of current legislation in England, unless stated otherwise. Levels and bases of, and reliefs from, taxation are subject to change and their value to you will depend upon your personal circumstances.

Risk Warning: The past is not necessarily a guide to future performance. The value of your investment and the income from it can fall as well as rise and is not guaranteed. You may not get back the full amount invested. This document is provided for information only and does not constitute advice. You should not act on any of the information without seeking professional advice.