

Insights

Evaluating the Major Hedge Fund Strategies

Many investors shy away from hedge funds based on their traditional reputation as highly risky and volatile. What's not well known, however, is that there is a range of hedge funds available and that each category of hedge fund has its own individual risk and return characteristic. Knowing and understanding the characteristics of the main hedge fund strategies is essential to capitalising on their variety of investment opportunities.

What Do Hedge Fund Strategies Have in Common?

It is important to understand the differences between the various hedge fund strategies, because all hedge funds are not the same — investment returns, volatility and risk vary enormously among the different hedge fund strategies. However, the primary aim of most hedge funds is to reduce volatility and risk, while attempting to preserve capital and deliver positive (absolute) returns under all market conditions.

A few of the most common strategies are outlined here:

- **Equity Market Neutral.** This strategy maintains a fairly even number of long and short positions as part of the fund strategy. As an example, US\$ 100 is invested in a promising company in one sector, while US\$ 100 worth of a peer group company that is expected to underperform is sold short. Thus, there is no market exposure and the portfolio's return and risk are purely a function of the relative performance of its long and short positions. Success depends on being able to identify companies that will outperform and underperform and to pair them together. Generally, this hedge fund strategy has the most appeal to conservative investors, since it tends to produce mostly positive monthly returns. While it can have negative monthly returns, generally, the negative months tend to be fewer in number and magnitude than the other strategies.
- **Convertible Arbitrage.** The strategy generally involves buying convertible bonds and selling short the underlying common stock with the objective of capturing a discrepancy in the valuation of the two investments. This approach may also use futures (a contract to buy or sell a particular commodity or financial instrument) to hedge against interest rate risk.
- **Fixed Income Arbitrage.** With this approach, managers aim to capture profit opportunities by establishing long positions in undervalued assets and short positions in overvalued assets within the fixed-income sector. The manager benefits from the profit opportunities that can arise, due to changes in the price relationship between the securities held. Leverage tends to be high and returns, as well as volatility, tend to be relatively low.
- **Event Driven.** Several strategies fall into this category, including merger arbitrage and distressed securities. Merger arbitrage usually involves selling short shares in the acquiring company and buying shares in the target company. Distressed securities can be the debt, equity or trade claims of companies facing bankruptcy or re-organisation and are often sold at deep discount. Volatility tends to be low to moderate, but correlation with equity markets tends to be higher than that of other hedge fund strategies.
- **Long-Short Equity.** This is the most common strategy, as fund managers take long positions (outright purchases) in equities they believe to be undervalued, as well as short positions in equities they believe to be overvalued. The focus could be a specific industry or a specific category of stock, such as growth or value. The composition of a long-short portfolio can move from a higher concentration of long positions to primarily short positions, although most tend towards a higher concentration of long positions.

An example would be to buy US\$ 80 of a promising company in one sector and to sell short US\$ 50 of a company in the same sector that the investor expects to underperform. The net market exposure would be US\$ 30. On the other hand, the US\$ 50 represents risk related directly to the specific stock owned and not to the general direction of the market itself. During down markets, this strategy often performs better than equity funds, while it may lag equity funds during volatile markets (strong downturns quickly followed by sharp rallies).
- **Managed Futures.** This strategy involves contracts to buy or sell a particular commodity, such as gold or oil, or financial instrument, such as currencies, interest rates, bonds or stock indices. Many managed futures managers rely on historical price data to anticipate future price movements, as well as use computers to generate trading signals. This approach, which can have a high degree of volatility, focuses on generating relatively high returns.
- **Global Macro.** This approach focuses on taking advantage of shifts in economic trends, government policies and central bank actions. This strategy is applied to the major asset classes – such as stocks, bonds and currencies – as well as various financial instruments, including cash, futures, etc. Managers take both long and short positions and often rely on large amounts of leverage. This strategy may experience a high degree of volatility.



Maintain a Strategic Focus

Portfolio managers typically use one or more of these strategies in maintaining a hedge fund portfolio. An interested investor should evaluate hedge fund performance on the strategic level, focusing on how the risk and return of a particular hedge fund strategy performed and how it either matches or differs from the investor's individual tolerance levels.

By using sophisticated techniques that are not typically available in traditional investment products, some hedge fund strategies have historically provided better risk-adjusted returns than traditional investments. However, as with all investments, past performance is not an indication of future performance.

If you'd like to learn more about hedge fund strategies and how they can help diversify your portfolio, please consult your Private Banker.

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