

## Insights

### Hedge Funds 101

As investors have become more knowledgeable about alternative investments, the demand for them has grown at a rapid pace. The popularity of these investments has also increased as a segment of investors, disappointed with their returns in down markets, began to look for alternatives.

#### What Are Hedge Funds?

The classic definition of a hedge fund is a pool of assets managed by a fund manager whose goal is to generate a positive return regardless of whether asset prices are falling or rising. Some investors look to incorporate hedge funds into their portfolios in an effort to achieve superior returns.

#### How Do They Differ from Traditional Funds

When added to a traditional portfolio of stocks and bonds, hedge funds can improve returns as well as reduce risk. Hedge fund investments have several unique aspects that make them different from traditional mutual fund investing. For example:

- **They take advantage of pricing anomalies.** With traditional investing, generally stock and bond prices fully reflect market information and therefore, only temporary mispricing occurs. The principal theory behind hedge fund investing is that market inefficiencies do occur. As a result, hedge fund managers can profit from pricing anomalies between related securities or otherwise use their market knowledge to take advantage of opportunities that may arise while at the same time reducing risk.
- **They use techniques not available to traditional fund managers.** Hedge fund managers can invest in a wider range of techniques than traditional fund managers. For example: arbitrage, derivatives, leverage and short selling (selling an asset that is borrowed in the expectation that it can be bought back at a lower price at a later date). These techniques can be used in an effort to generate returns and reduce risk, regardless of the general market's performance.
- **They aim for absolute returns.** Hedge fund managers aim to achieve a positive return whether the market is rising or falling. This is known as generating an "absolute return." This differs from traditional mutual fund managers whose objective is to outperform their benchmarks. Achieving an absolute return may be attractive to investors who want to make money, regardless of how the market is performing.

Investors new to alternative investments might want to consider funds of hedge funds, which are diversified portfolios that include a number of individual hedge funds and are managed by a portfolio manager. As is the case with any investment that involves risk, past performance is not an indication of future performance and potential loss on the investment is possible. Speak with your Private Banker to determine if these are appropriate investments for you, particularly if you want to further diversify your portfolio.

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