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HEDGE FUNDS – ALTERNATIVE INVESTMENT

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Abstract

This paper presents an aggregated picture of hedge funds industry activity, illustrating key trends and risks. A hedge fund is an alternative investment vehicle available only to sophisticated investors, such as institutions and individuals with significant assets. Alternative investment strategies used to be synonymous with hedge funds and the endowments and wealthy investors that bought into them. Given the unpredictability of today's financial markets, many investors are looking to reduce the impact of market volatility on their portfolios. Hedge fund strategies may help by offering additional diversification, new sources of return and the potential for reduced risk. Hedge funds are structured as limited partnerships, LLCs or offshore investment companies. Hedge funds are not subject to some of the regulations that are designed to protect investors.

Key words*: hedge fund, sophisticated investors, investment structure, alternative investment strategies.*

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1. Introduction

The lucrative nature of hedge fund compensation makes entering the industry an attractive proposition for successful money managers. A hedge fund is

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a regulated investment fund that is typically open to a limited range of investors who pay a performance fee to the fund's investment manager. In fact, the name "hedge fund" is derived from the fact that hedge funds often seek to increase gains, and offset losses, by hedging their investments using a variety of sophisticated methods, including leverage. Generally, hedge funds are informed traders that help improve market quality and corporate governance.

The hedge fund sector was created by the private banking and family office business in the seventies, as investors no longer accepted relative return results, and demanded absolute return strategies; hedging a stock portfolio with an index was the simplest way of doing it. Hedge funds, along with private-equity and venture-capital funds, are private partnerships, typically with a general partner as the manager of the fund and investors as limited partners. Hedge funds are made available only to certain accredited investors and cannot be offered or sold to the general public. As such, they generally avoid direct regulatory oversight, bypass licensing requirements applicable to investment companies, and operate with greater flexibility than mutual funds and other investment funds. Hedge funds have a number of unique characteristics such as their managerial compensation structure, flexibility arising from restrictions on capital withdrawals, light regulatory environment, and managerial co-investment.

Hedge funds pioneered many money-management techniques, including:

- Simultaneous trading in a broad range of markets and financial products;
- Long/short strategies;
- Employing/developing traders' skills in specific markets; &
- Incentive-based fee structures along with owner/manager participation in fund performance.

Hedge funds serve many key functions: risk management, arbitrage, liquidity providers, and financial innovation. Key benefits of Hedge Funds:

- Huge variety of hedge fund investment styles (many uncorrelated with each other) provides investors with a wide choice of hedge fund strategies to meet their investment objectives;

- Many hedge fund strategies have the ability to generate positive returns in both rising and falling equity and bond markets;

- Inclusion of hedge funds in a balanced portfolio reduces overall portfolio risk and volatility and increases returns;

- Adding hedge funds to an investment portfolio provides diversification not otherwise available in traditional investing;

- Academic research proves hedge funds have higher returns and lower overall risk than traditional investment funds;

- Hedge funds provide an ideal long-term investment solution, eliminating the need to correctly time entry and exit from markets; &
- The hedge fund's principal quality is their search for uncorrelated returns. Investors need uncorrelated returns for diversification.

In an increasingly globalized world, economies are rapidly becoming highly dependent on each other's, and hedge funds owe their popularity largely to the fact that they present to the investors one of the few alternatives to economic-dependent, highly correlated investments worldwide. Hedge funds obtain returns by taking risks; understanding their risks therefore becomes the key factor to understanding them as an industry.

The hedge fund's offering documents and agreements contain important information about investing in the fund, including the investment strategies of the fund, whether the fund is based in the national economy or abroad, the risks of the investment, fees earned by the hedge fund manager, expenses charged to the hedge fund and the hedge fund manager's potential conflicts of interest.

Hedge Fund Research (HFR) estimates that the total assets under management (AUM) of the hedge fund industry increased from $39 billion in 1990 to more than $2.97 trillion as of the second quarter of 2015. During the same period, the total number of active hedge funds rose from 610 to over 10,000. Hedge funds also hold an increasingly large percentage of the stock market.

2. Methodology

To achieve the object of this paper, the hedge fund data has been collected. At first, historical and comparative data are involved, as well as a full range of quantitative research methods. The secondary information is mostly from websites, books, journals, etc. Also, a lot of facts and date from foreign recent hedge funds and alternative strategies literature are taken into consideration.

3. Literature review

Hedge funds have become increasingly important players in financial system. This importance has spawned a large academic literature focused on issues pertinent to hedge fund managers, investors, regulators, and policymakers. Thanks to the availability of hedge fund return data from sources such as Altvest, the Center for International Securities and Derivatives Markets (CISDM), HedgeFund.net, Hedge Fund Research (HFR), and TASS, a number of empirical studies have highlighted the unique risk/reward profiles of hedge fund investments.

Stulz (2007) summarizes the literature comparing the performance of hedge funds with mutual funds. He suggests that the hedge fund industry exists and has grown rapidly because it has outperformed the mutual fund industry and offers complex investment strategies that the mutual fund industry is not allowed to offer. Several recent empirical studies have challenged the uncorrelatedness of hedge fund returns with market indexes, arguing that the standard methods of assessing hedge funds' risks and rewards may be misleading. For example, Asness, Krail, and Liew (2001) show that in several cases where hedge funds purport to be market neutral (i.e., funds with relatively small market betas), including both contemporaneous and lagged market returns as regressors and summing the coefficients yields significantly higher market exposure. Agarwal, Arisoy, and Naik (2014) examine whether uncertainty about aggregate volatility is priced in hedge fund returns. Kosowski, Naik, and Teo (2007) apply the seven-factor model proposed by Fung and Hsieh (2004b) to examine hedge fund performance using a robust bootstrap methodology. In addition to examining the performance of individual hedge funds, academic research has also studied the performance of funds of hedge funds (FOFs), vehicles that invest in a portfolio of hedge funds.
Another strand of literature focuses on the capital allocation decisions of investors by studying the relation between investor flows and fund performance. There are two related strands of literature that study how fund size and investor flows affect future fund performance. The first strand examines how fund size affects future performance while the second investigates whether investor flows predict future fund performance. Aggarwal and Jorion (2010a) examine both emerging funds and young managers by using an event time approach. Bernhardt and Nosal (2013) develop a model to explain the finding that hedge fund returns decline with manager experience. Papageorgiou, Parwada, and Tian (2014) study the impact of managers' prior work experience on fund performance. Boyson (2008b) studies the effects of a fund belonging to a particular fund family and reports several findings.
Siegmann, Stefanova, and Zamojski (2013) examine first-mover advantages in the hedge fund industry. Gao and Huang (2011) examine the relation between hedge fund lobbying expenses and fund performance. Ozik and Sadka (2012) investigate whether media coverage predicts future hedge fund performance.

Hodder and Jackwerth (2007) build on the early literature by examining the impact of the typical hedge fund contract on the risk-taking behavior of a risk-averse manager. As in Panageas and Westerfield (2009), their model proves that a manager's risk-taking behaviour depends on his horizon. Kouwenberg and Ziemba (2007) apply the behavioural framework of prospect theory and find that hedge funds with incentive fee contracts do not take significantly more risk than funds

without such contracts. Clifford, Ellis, and Gerken (2014) focus on the role of boards in offshore hedge funds. Lan, Wang, and Yang (2013) examine the trade-off between leveraging an alpha-generating technology and increasing the likelihood of fund liquidation. Aragon and Strahan (2012) use the Lehman Brothers bankruptcy as an exogenous shock to hedge funds' funding liquidity. Agarwal, Aragon, and Shi (2014) focus on the funding liquidity risk of FOFs. Collectively, these studies show that the dynamics of hedge funds are quite different from those of more traditional investments.

4. Analysis and discussion

4.1. Hedge fund industry & alternative strategies

Hedge funds are often classified according to investment style. Within each style category, funds are then classified according to the underlying markets traded. Hedge funds are extremely flexible in their investment options because they use financial instruments generally beyond the reach of mutual funds, which have SEC regulations and disclosure requirements that largely prevent them from using short selling, leverage, concentrated investments, and derivatives. This flexibility, which includes use of hedging strategies to protect downside risk, gives hedge funds the ability to best manage investment risks.

The hedge fund sector not only has improved by extending the investor group to institutions, but also a wide range of hedging strategies are available to hedge funds: Investing in anticipation of a specific event - merger transaction, hostile takeover, spin-off, exiting of bankruptcy proceedings, etc.; Investing in deeply discounted securities - of companies about to enter or exit financial distress or bankruptcy, often below liquidation value, commodity trading and financing, fixed income arbitrage, mortgage arbitrage, risk arbitrage, convertible securities, etc.

Hedge funds are speculative investment vehicles designed to exploit superior information held by their managers. In order to compare performance, risk, and other characteristics, it is helpful to categorise hedge funds by their investment strategies. Strategies may be designed to be market-neutral or directional. Market neutral funds have a low correlation with the overall market return. Directional funds specifically take bets on market movements, and so their returns are often strongly correlated with the market. Selection decisions may be purely systematic (based upon computer models) or discretionary (ultimately based on a person). A

hedge fund may pursue several strategies at the same time, internally allocating its assets proportionately across different strategies.

Hedge funds typically use long-short strategies, which invest in some balance of long positions and short positions. Long/short strategies separate individual stock risk from market risk:

- Equity Market Neutral Strategy is the classic hedge fund strategy and is related to the concept of portable alpha. Generally, a market neutral strategy uses the combination of buys and short-sales to offset any correlation between the portfolio return and the overall market return. By using a market neutral hedge fund to exploit his superior information, the stock selector/fundamental analyst allows final investors to make their own choices about the market risk exposures of their aggregate portfolios.

- Equity long/short is the same as equity market neutral except without any explicit promise to maintain market neutrality. This increases the flexibility of the manager to choose net-long or net-short (positive beta or negative beta) market exposure, while still focussing primarily on stock-selection opportunities.

- Dedicated Short Bias differs from the other long/short strategies in concentrating on the short side and thereby sacrificing the market-neutrality feature.

Event-driven investing is a hedge fund investment strategy that seeks to exploit pricing inefficiencies that may occur before or after a corporate event, such as earnings call, bankruptcy, merger, acquisition, or spinoff. An event-driven strategy focuses on exploiting the tendency of the equities of companies in a time of change to drop in price. Event Driven: (Corporate transactions and special situations) subindices including Deal Arbitrage (long/short equity securities of companies involved in corporate transactions; Bankruptcy/Distressed (long undervalued securities of companies usually in financial distress). Multi-strategy includes deal funds dealing in both deal arbitrage and bankruptcy. Two main divisions within this category are distressed securities investing and risk or merger arbitrage:

- Distressed securities are bonds, shares and other financial claims on companies that are in, or about to enter or exit, bankruptcy or other financial distress. Investing in distressed securities allows the investor who has gained adequate knowledge through his research and due diligence to limit the downside of his investment by effectively buying $1 for 50 cents. This usually results in distressed securities investing yielding consistent returns to competent practitioners of the strategy. Investment in distressed securities has boomed in the last decade. With the market increasing in size and diversity, more and more investors have

been getting on board with this type of hedge fund investment strategy. The market certainly is not a new one, with distressed securities having been around from the start, whether they be US railway bonds and shares, or other specific struggling companies over the decades.

- Merger arbitrage is a type of Event-Driven investing, which is an investing strategy that seeks to exploit pricing inefficiencies that may occur before or after a corporate event, such as a bankruptcy, merger, acquisition or spinoff. The main risk factors for a merger arbitrage strategy are: deal risk and portfolio risk. Deal risk includes all the factors that could prevent or delay the closing of the deal, while portfolio risk includes factors that arise in the assembly and management of the merger arbitrage fund or portfolio.

Table no 1 – Hedge Fund Industry - Assets under Management

Assets Under Management (USD Billions)	2nd Qtr 2016	1st Qtr 2016	4th Qtr 2015
Hedge Funds *	$2948.1B	$2861.7B	$2720.7B
Funds of Funds	$378.0B	$399.5B	$443.1B
Sectors			
Convertible Arbitrage	$23.3B	$22.4B	$23.7B
Distressed Securities	$113.1B	$117.2B	$119.6B
Emerging Markets	$248.4B	$238.4B	$252.5B
Equity Long Bias	$228.6B	$222.2B	$219.3B
Equity Long/Short	$216.6B	$214.4B	$207.1B
Equity Long-Only	$130.2B	$135.6B	$139.6B
Equity Market Neutral	$81.3B	$73.5B	$63.4B
Event Driven	$201.0B	$222.2B	$251.5B
Fixed Income	$550.6B	$529.0B	$531.7B
Macro	$244.0B	$252.7B	$221.4B
Merger Arbitrage	$63.8B	$33.4B	$34.2B
Multi-Strategy	$340.1B	$319.7B	$305.5B
Other **	$99.1B	$94.0B	$70.6B
Sector Specific ***	$145.9B	$137.6B	$146.9B

*Excludes Fund of Funds assets
**Other: Include funds categorized as Regulation D, Equity ShortBias, Option Strategies, Mutual Fund Timing, Statistical Arbitrage, Closed-End Funds, Balanced, Equity Dedicated Short and any uncategorized funds.
***Sector Specific: Includes sector funds categorized as Technology, Energy, Bio-Tech, Finance, Real Estate, Metals & Mining and Miscellaneous oriented.

Source:http://www.barclayhedge.com/research/indices/ghs/mum/Hedge_Fund.html

Hedge funds are expert practitioners of tactical trading. Tactical trading strategies attempt to profit by forecasting the overall direction of the market or a market component. The payoffs of hedge funds specialising in this area depend on how well a hedge fund manager can forecast price movements as well as predict the exact timing of these movements. Hedge funds that specialize in global macro strategies generally use two tactical trading sub-strategies – discretionary macro, which is focused on expected shifts in government policies; and systematic macro, which uses quantitative models across multiple asset classes.

In the period from 2013 to 2015, discretionary macro was a popular tactical trading strategy, as quantitative easing (QE) became the favoured course of monetary policy for a number of major central banks. Following the success of the Federal Reserve's QE programs, tactical trading strategies that invested in Japanese and European equities at the beginning of 2013 and 2015 respectively – in anticipation of QE measures that would replicate the U.S. experience – generated windfall profits.

Relative value strategies are designed to take advantage of perceived mispricing among related financial assets, such as a single company's debt and equity securities. Relative Value: Balanced, or hedged, long and short positions with subindices such Market Neutral or Long/Short equity (long undervalued equities/short overvalued equities usually on an equal dollar bases); Convertible hedging (long convertible bonds or preferred, short underlying common); Bond hedging (yield curve arbitrage or long/short debt positions); Rotational (multiple relative value strategies, including all of the above).

Additionally, many hedge funds invest in "derivatives," which are contracts to buy or sell another security at a specified price. Derivative transactions allow hedge funds to acquire market/economic exposures (refers to the Gross Notional Exposure) that are bigger than the capital of the fund. It should be underlined that all institutions, entering derivative transactions with hedge funds, require funds to provide collateral. This protects the counterparty against losses on the transaction if the hedge fund defaults on its commitments under the transaction. As hedge funds increasingly clear their transactions with central counterparties (CCPs), this will also help ensure appropriate collateralisation and default management.

Hedge funds use leverage to increase the size of the positions taken in financial markets. In some cases, the use of leverage allows them to become large enough to suggest they could impact the wider financial system in certain situations. Hedge funds obtain leverage either by borrowing money or securities directly from counterparties (financial leverage) or indirectly by using derivative

instruments such as options, futures or swaps (synthetic leverage). In fact, the name "hedge fund" is derived from the fact that hedge funds often seek to increase gains, and offset losses, by hedging their investments using a variety of sophisticated methods, including leverage.

Table no 2 – Hedge Fund Manager Assets under Management by Region

Region	**Assets under Management ($bn)**
North America	2,314
Europa	685
Asia – Pacific	159
Rest of World	39
Total	**3,197**

Source: Pregin Hedge Fund Analyst

North America is the most established region in the hedge fund industry and accounts for the majority (60%) of managers. Nineteen percent of hedge fund managers are based in Europe; of these, more than half (52%) are headquartered in the UK. Asia Pacific hedge fund managers constitute 17% of all firms within the industry, with the majority of these based in the financial centres of Hong Kong, Australia and Singapore. Beyond North America, Europe and Asia-Pacific, the industry is less developed and only 4% of managers are located outside these key regions (Rest of World). Of the Rest of World based hedge fund managers, 37% are headquartered in Brazil, followed by 23% in South Africa and 8% in the United Arab Emirates. Hedge fund industry assets, as of 30November 2015, stood at just under$3.2tn, increasing by $178bn from 2014.

Table no 3 – Hedge Fund Manager Assets under Management by Manager Headquarters

Manager Headquarters	**Asset under Management ($bn)**
US	2,279
UK	472
Hong Kong	67
Sweden	38
France	38
Singapore	35
Jersey	34
Switzerland	34
Australia	31
Brazil	29

Source: Pregin Hedge Fund Analyst

North America saw the greatest absolute increase as the assets of managers in the region grew by $116bn to over $2.3tn over the course of the year. However, in percentage terms, the 5% increase in North American assets was surpassed by 12% growth in Europe, as the assets under management (AUM) of Europe-based managers increased by $76bn to $685bn.

The Asia-Pacific c region manages $159bn, a 10% increase from 2014. The largest change was observed in regions beyond North America, Europe and Asia: AUM in Rest of World fell from $67bn in 2014 to $39bn in 2015, a decrease of 52%.

4.2. Risks in hedge funds

For a hedge fund manager, the market drops out as a source of return, leaving just two factors: strategy and skill. The market drops out largely because the hedge fund manager has the ability to take either long positions or short positions.

Hedge funds make uncorrelated returns because they take different risks. Analysing their risks is the beginning of any investment operation. The following is risks categories specific to hedge funds: Lack of transparency; Fraud; Counterparty risk; Portfolio liquidity and redemption orders; Capacity risk; Style drift; Data; Legal risk. Generally, hedge funds are exposed to investment risks in general:

- Market Risk. The risk in reducing the value of the portfolio's positions due to changes in markets.
- Credit Risk. The risk in reducing the value of the portfolio's assets due to changes in the credit quality of the counterparties.
- Liquidity Risk. The risk of losses because of travel-time delays of assets.
- Common factor risk: industry specific, geographical risk, etc.
- Operational Risk. Internal systems, people, physical events.
- Corporate event risk: earnings revisions, mergers, etc.
- Model risk.
- Legal and Regulatory Risk.

All these risks must be analysed and conclusions about the invest ability of a hedge fund must be made prior to the investment, and periodically during the life of the investment.

4.3. Hedge fund regulatory environment

Hedge funds conduct their operations within a highly complicated regulatory framework. Although the popular press often refers to hedge funds as "unregulated investment vehicles," in fact, hedge funds are designed to take advantage of various exemptions, exclusions, and "safe harbors" that are explicitly provided within the regulatory framework.

On the securities side, there are three crucial laws: the Securities Act of 1933, the Investment Company Act of 1940, and the Investment Advisers Act of 1940. The Securities Act regulates the process by which securities are offered to the general public. Both hedge funds and mutual funds are securities, but hedge funds do not offer their interests to the general public; they are "private placements" offered only to "accredited investors." The private placement process is defined within Regulation D of the 1933 act, so private placements are sometimes called Reg D offerings.

The Investment Company Act was designed for mutual funds, and it exempted funds with fewer than 100 investors. In 1996, it was amended so that more investors could participate, so long as each "qualified purchaser" was either an individual with at least $5 million in assets or an institutional investor with at least $25 million [President's Working Group, 1999].

Depending on the amount of assets in the hedge funds advised by a manager, some hedge fund managers may not be required to register or to file public reports with the SEC. Hedge funds, however, are subject to the same prohibitions against fraud as are other market participants, and their managers owe a fiduciary duty to the funds that they manage.

Hedge funds are subject to many of the same restrictions on their investment and portfolio trading activities as most other securities investors, including the following requirements:

- Anti-fraud and anti-manipulation requirements, such as Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, as well as insider-trading prohibitions, both in the funds' investment and portfolio-trading activities, and in the funds' offers and sales of units to their own investors;
- Margin rules, which limit use of leverage to purchase and carry publicly traded securities and options;
- SEC Regulation SHO, which regulates short selling;
- Williams Act amendments63 to the Securities and Exchange Act of 1934 and related SEC rules, which regulate and require public reporting on the acquisition of blocks of securities and other activities in connection with takeovers and proxy contests;

- SEC, CFTC, and Treasury portfolio and other reporting requirements for large positions; and,
- FINRA "new issues" rule 2790 (which governs initial public offering allocations.

Hedge funds must also abide by the rules and regulations of markets in which they seek to buy or sell financial products.

The Commodities Futures Trading Commission (CFTC) regulates those hedge fund advisers registered as commodity pool operators (CPO) or commodity trading advisers (CTA). The CFTC has authorized the National Futures Association (NFA), a self-regulatory organization for the U.S. futures industry, to conduct day-to-day monitoring of registered CPOs and CTAs. The CFTC, like the SEC and bank regulators, "can use their existing authorities—to establish capital standards and reporting requirements, conduct risk-based examinations, and take enforcement actions—to oversee activities, including those involving hedge funds, of broker dealers, of futures commission merchants, and of banks, respectively.

5. Conclusion

Hedge funds play a critical role in the financial markets, broadening the use of investment strategies, increasing the number of participating investors, and enlarging the pools of capital available. Hedge funds are a clear example of active investment management. The active manager tries to earn superior returns through a combination of diligent research, insightful analysis, savvy trading, and intelligent risk management. For investors, hedge funds can serve a risk-management purpose since their returns are often uncorrelated to those in the equity and fixed-income markets. Hedge funds provide liquidity, price efficiency, and risk distribution, and contribute to the further global integration of markets.

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