CIO Perspectives

DBS Chief Investment Office

ALTERNATIVES

An Introduction to Hedge Funds

Key Points

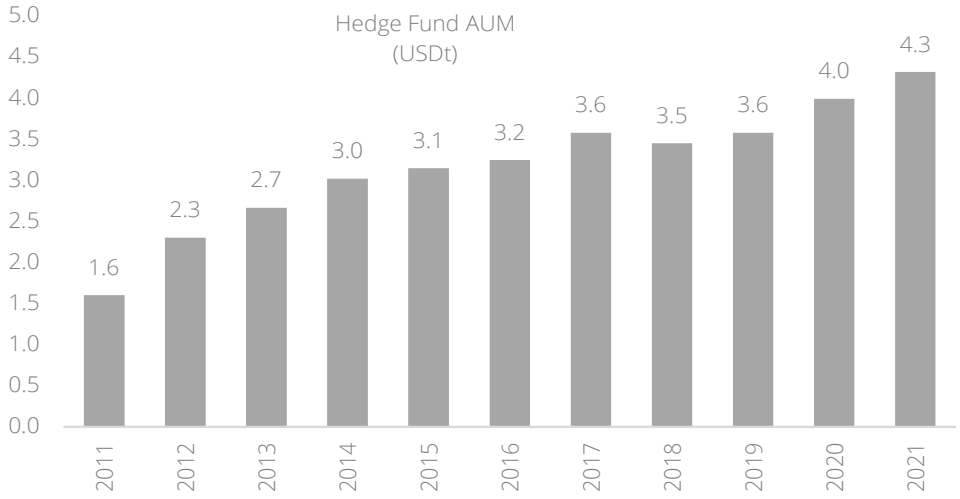
- Hedge funds have distinguished themselves with fewer legal constraints and more flexible investment mandates
- Active management and exclusivity of hedge funds have also made it the second largest alternatives investment class
- Main hedge fund strategies include market neutral, event-driven, relative value, macro, and specialist strategies
- Benefits include proprietary strategies, greater agility, and diversification benefits
- Investors have to be aware of the potential for large losses and high fees, among other risks
- With the wide variety of hedge funds, it is crucial for investors to analyse suitability of the hedge fund
- The inclusion of the appropriate hedge fund exposure will elevate investors' portfolios

Unique characteristics distinguishing hedge funds from traditional investment vehicles. Hedge funds are private investment vehicles that get their name from their historic focus on hedging risk by simultaneously taking long and short positions. While early fund managers mostly adopted a long-short equity strategy, today, hedge funds have evolved to adopt a myriad of strategies exploiting different market opportunities. The following characteristics distinguish hedge funds from other investment vehicles:

1. Lower legal and regulatory constraints – Regulations on hedge funds are generally less strict than those imposed on other vehicles such as mutual funds. This gives them the liberty to adopt profitable strategies that are inherently risky.
2. Flexible investment mandates – Because of the lower regulatory restrictions, hedge fund mandates tend to be flexible, allowing fund managers the latitude to employ aggressive strategies across a wide investment universe, and agility to quickly respond to market changes and opportunities.
3. Active management – Through hedge funds, investors can tap on the expertise of the hedge fund managers. Fund performance depends closely on the fund manager's ability to identify opportunities and react accordingly. Naturally, this also comes with substantial fees to attract the top talent in the industry.
4. Exclusivity – Hedge funds are sophisticated products accessible exclusively by institutions and wealthy individuals. They elevate an investment portfolio by providing diversification benefits and enhancing returns.

Given their attractive features, hedge funds form the second largest alternative investment class, representing AUM of approximately USD4.3t globally with a CAGR of 10% over the past decade.

Figure 1: Hedge fund global AUM



Source: Preqin, based on September 2021 data

The main categories of hedge funds strategies. Hedge funds can be categorised based on their risk exposures, underlying asset classes, and investment philosophy. Most strategies fall within the following broad categories:

1. Equity Strategies – These are the most popular and oldest hedge fund strategies. Equity hedge funds take long positions in stocks believed to be undervalued, and short positions in overvalued stocks. Types of equity hedge funds include long-bias, short-bias, and market-neutral funds, each categorised according to the ratio between the fund's long and short positions. These lead to varying amounts of market exposure and risk.
2. Event-driven Strategies – These strategies involve company-specific exposure to exploit mispricing before or after an event such as an IPO, financial distress, restructuring, or M&A. When an M&A is announced, a hedge fund may take a long position on the expected target company while shorting the acquiring firm. The profits come from the target company trading below the acquisition price, but the fund is subject to the risk that the acquisition does not materialise.
3. Relative Value Strategies – These strategies aim to benefit from price differentials between highly correlated securities. Quantitative models may be adopted to identify arbitrage opportunities due to pricing inefficiencies. For example, a relative value trade may involve simultaneously taking long and short positions on relatively mispriced on-the-run and off-the-run Treasury Bills that have the same duration. Relative value strategies include fixed income arbitrage, capital structure arbitrage, and statistical arbitrage.
4. Macro Strategies – These strategies aim to profit from their view of market movements caused by events affecting global financial markets. Using derivatives and other financial instruments, macro funds take positions on factors such as commodity prices and currencies, based on their expectation of the market environment. These funds can profit in any economic environment, and can offer reduced portfolio volatility.
5. Specialist Strategies – These strategies are concentrated on niche areas such as real estate, insurance settlements, or cryptocurrencies.

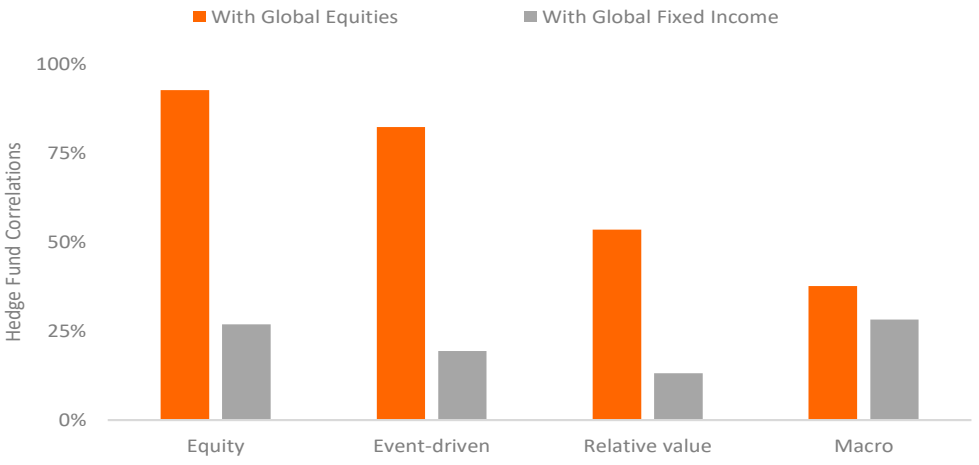

Source: iStock

In addition to these categories, there are also funds that employ multiple strategies:

1. Multi-strategy Funds – These funds seek to deliver consistently positive returns regardless of the directional movement in markets, and this is achieved by combining a variety of the above strategies to reduce volatility of returns.
2. Funds of Funds – These are funds that primarily invest in other hedge funds, with the aim to provide investors with a variety of fund categories wrapped in a single portfolio.

Each fund has different characteristics depending on its strategy. Investors seeking portfolio diversification should consider overlaps between the fund's strategy and their existing portfolios, seeking funds with minimal correlation to their portfolios.

Figure 2: Diversification benefits depend on strategy

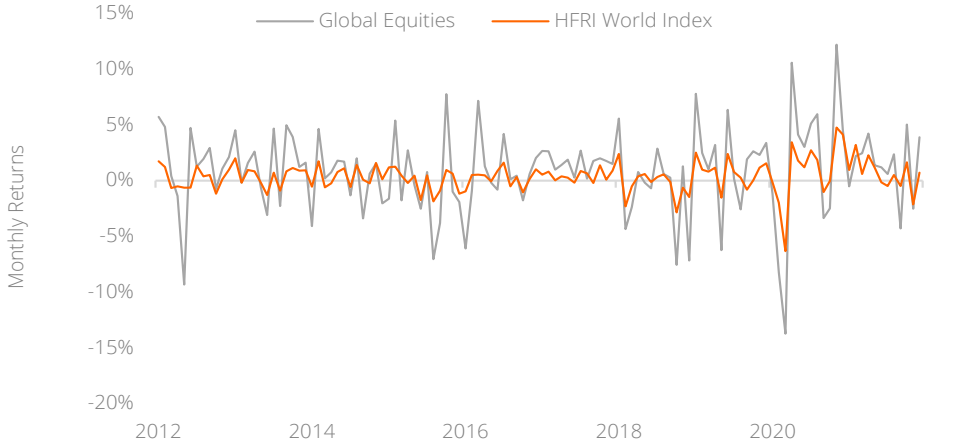


Source: Bloomberg, DBS

Benefits of hedge funds investing. With their proprietary strategies, agility, and diversification benefits, hedge funds bring with them various benefits when included in investment portfolios.

1. Management expertise – Investing in hedge funds gives one access to the top investment talent. The best hedge fund managers adroitly navigate across a wide universe of markets seeking trading opportunities. Investors in hedge funds can rely on these experts to be active in the market and take investment positions based on their convictions.
2. Attractive returns – Hedge funds have the flexibility to use short selling, derivatives, and amplify returns using leverage. While presenting inherent risks, these allow hedge funds to realise higher potential returns.
3. Profiting from volatility – Hedge funds are known to shine in volatility. Uncertain conditions and market movements create opportunities for relative value strategies. Global macro hedge funds can also capitalise on mispricing in macroeconomic shifts.
4. Diversification – Unlike mutual funds that invest in more conservative and traditional approaches, hedge funds also deploy capital to non-traditional assets. Because of the wider investment universe available, the inclusion of hedge funds to a traditional investment portfolio diversifies risks associated with the conventional equity and bond markets. This applies especially for funds that produce returns uncorrelated with traditional assets.
5. Loss reduction – Hedge funds increase the stability of portfolios. This feature is particularly beneficial in declining markets. Over the past decade, hedge fund indices have outperformed the stock market during periods of significant declines, illustrating how the addition of hedge fund exposure to a portfolio provides investors with loss protection.

Figure 3: Hedge funds exhibit much lower return volatility



Source: Bloomberg, DBS

Risks of hedge funds investing. While these benefits may seem alluring, investors must also be aware of the inherent risks before investing in hedge funds.

1. Manager selection – Returns vary widely across hedge funds as they are attributable to manager acumen. For this reason, the bulk of hedge fund AUM flows to the strongest managers, with more than 60% of AUM managed by the top 5% of managers. Selecting the right fund manager is essential, and investors should look out for experienced managers with consistent track records.
2. High fees – Given the importance of manager skill, hedge fund managers command significant fees. The most common compensation structure is the "2 and 20" arrangement – an asset management fee comprising 2% of assets, plus a performance fee of 20% of profits exceeding a high watermark. The performance fee incentivises managers to generate larger returns for investors. Before investing in a hedge fund, investors should understand the fund's unique fee model and determine if they are willing incur these charges.
3. Potential for large losses – Some hedge fund strategies involve taking on concentrated risks, which amplify profits but also potential losses. In considering the returns of a hedge fund, investors should evaluate their portfolio holistically, bearing in mind other factors such as diversification benefits.
4. Restrictions on redemption – Hedge fund investors have limited opportunities to redeem their shares. This is because hedge funds impose lock-up periods, during which share redemption is not allowed. Fixed redemption schedules and redemption notice periods allow fund managers the flexibility to invest in illiquid securities without concern about maintaining excess cash on hand for anticipated redemptions.

Choosing the right fund. Hedge funds vary widely in philosophy, strategy, and performance. It is important for investors to analyse the suitability of a hedge fund. Given the crucial role of fund managers in driving performance, investors would do well to familiarise themselves with the manager's track record and expertise.

Of equal importance is understanding the fund's investment objectives, risk and return profile, what it invests in, and how the investments are valued. The fund's performance should be commensurate with its strategy and its purported risks. Fund managers should provide regular and comprehensive updates, allowing investors to monitor the fund for deviations from its purported strategy.

The benefits and drawbacks of hedge fund investing are often two sides of the same coin. By dedicating adequate resources to careful fund selection, investors can elevate their portfolios with the inclusion of the appropriate hedge fund exposure.

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