LEARNING MADE EASY

2nd Edition

Hedge Funds

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Set up a strategy that will deliver results

Diversify your portfolio and put hedge funds to work for you

Learn how to calculate risk and return

Ann C. Logue, MBA

Author, *Day Trading For Dummies*

Hedge Funds

for dummies®
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Introduction

You've seen the headlines in the financial press. You've heard the rumors about mythical investment funds that make money no matter what happens in the market. And you want a part of that action.

I have to be upfront: Hedge funds aren't newfangled mutual funds, and they aren't for everyone. They're private partnerships that pursue high finance. If you don't mind a little risk, you can net some high returns for your portfolio. However, you have to meet strict limits put in place by the Securities and Exchange Commission — namely that you have a net worth of at least $1 million or an annual income of $200,000. Most hedge-fund investors are institutions, like pensions, foundations, and endowments; if you work for an institution, you definitely need to know about hedge funds. I also have to let you in on a little secret: Not all hedge fund mangers are performing financial alchemy. Many of the techniques they use are available to any investor who wants to increase return relative to the amount of risk taken.

Hedge Funds For Dummies tells you what you need to know, whether you want to research an investment in hedge funds for yourself or for a pension, an endowment, or a foundation. I also give you information about investment theories and practices that apply to other types of investments so you can expand your portfolio. Even if you decide that hedge funds aren't for you, you can increase the return and reduce the risk in your portfolio by using some of the same techniques that hedge fund managers use. After all, not everything fund managers do requires a PhD in applied finance, and not everything in the world of investing is expensive, difficult, and inaccessible.

About This Book

First, let me tell you what this book is not: It is not a textbook, and it is not a guide for professional investors. You can find several of those books on the market already, and they are fabulous in their own right. But they can be dry, and they assume that readers have plenty of underlying knowledge.

This book is designed to be simple. It assumes that you don't know much about hedge funds, but that you're a smart person who needs or wants to know about

them. I require no calculus or statistics prerequisite; I just give you straightforward explanations of what you need to know to understand how hedge funds are structured, the different investment styles that hedge fund managers use, and how you can check out a fund before you invest.

Conventions Used in This Book

I'll start with the basics. I put important words that I define in *italic* font. I often **bold** the key words of bulleted or numbered lists to bring the important ideas to your attention. And I place all Web addresses in `monofont` for easy access.

I've thrown some investment theory into this book. You don't need to know this information to invest in hedge funds, but I think it's helpful to know what people are thinking when they set up a portfolio. I also make an effort to introduce you to some technical terms that will come up in the investment world. I don't want you to be caught short in a meeting where a fund manager talks about generating alpha through a multifactorial arbitrage model that includes behavioral parameters. Many hedge fund managers are MBAs or even PhDs, and two notorious ones have Nobel Prizes. Folks in the business really do talk this way! (To alert you to these topics, I often place them under Technical Stuff icons; see the section "Icons Used in This Book.")

During printing of this book, some of the Web addresses may have broken across two lines of text. If you come across such an address, rest assured that I haven't put in any extra characters (such as hyphens) to indicate the break. When using a broken Web address, type in exactly what you see on the page, pretending as though the line break doesn't exist.

What You're Not to Read

I include sidebars in the book that you don't need to read in order to follow the chapter text. With that stated, though, I do encourage you to go back and read through the material when you have the time. Many of the sidebars contain practice examples that help you get a better idea of how some of the investment concepts work.

You can also skip the text marked with a Technical Stuff icon, but see the previous section for an explanation of why you may not want to skim over this material.

Foolish Assumptions

The format of this masterpiece requires me to make some assumptions about you, the reader. I assume that you're someone who needs to know a lot about hedge funds in a short period of time. You may be a staff member or director at a large pension, foundation, or endowment fund, and you may need to invest in hedge funds in order to do your job well, even if you aren't a financial person. I assume that you're someone who has plenty of money to invest (whether it's yours or not) and who could benefit from the risk-reduction strategies that many hedge funds use. Maybe you've inherited your money, earned it as an athlete or performer, gained it when you sold a company, or otherwise came into a nice portfolio without a strong investment background.

I also assume that you have some understanding of the basics of investing — that you know what mutual funds and brokerage accounts are, for example. If you don't feel comfortable with the basic information, you should check out *Investing For Dummies* or *Mutual Funds For Dummies*, both by Eric Tyson. (Calculus and statistics may not be prerequisites, but that doesn't mean I don't have any!)

No matter your situation or motives, my goal is to give you information so that you can ask smart questions, do careful research, and handle your money in order to meet *your* goals.

And if you don't have a lot of money, I want you to discover plenty of information from this book so that you'll have it at the ready someday. For now, you can structure your portfolio to minimize risk and maximize return with the tools that I provide in this book. You can find more strategies than you may know.

How This Book Is Organized

Hedge Funds For Dummies is sorted into parts so that you can find what you need to know quickly. The following sections break down the structure of this book.

Part 1: What Is a Hedge Fund, Anyway?

The first part describes what hedge funds are, explains how managers structure them, and gives you a little history on their development. It also covers the nuts and bolts of SEC regulation and the process of buying into a hedge fund. Go here for the basics.

Part 2: Looking at Alternative Investment Strategies

In this part, I cover the ways that hedge funds invest and cover the ways that ordinary investors can work some of these strategies into their portfolios. Over the years, exchange traded funds and mutual funds have emerged to make many hedge fund strategies accessible. Other strategies can be copied on your own, if you know what to do.

Part 3: Determining Whether Alternative Investments Are Right For You

Part 3 is an overview of the investment process, including information about risk, return, and cash flow. This information can help you evaluate hedge funds, other alternative investments, and maybe even the traditional mutual funds offered in your employer's retirement plan.

This part also covers ways you can evaluate a hedge fund's risk-adjusted performance. You've probably heard of a handful of headline-grabbing hedge-fund scams, and you can find plenty of investors who have learned the hard way just how much risk their hedge funds had.

Part 4: Special Considerations Regarding Hedge Funds

Part 4 covers some additional information that you need to know such as how to get help with your investment and how to check out the background of the fund and fund manager before you invest. My goal is to help you do the right thing with your money, and this section helps you make the decisions that will achieve this goal.

Part 5: The Part of Tens

In this For Dummies-only part, you get to enjoy some top 10 lists. I present 10 reasons to invest in hedge funds, 10 reasons to avoid them, and 10 myths about the hedge-fund business.

Icons Used in This Book

You'll see five icons scattered around the margins of the text. Each icon points to information you should know or may find interesting about hedge funds. They go as follows:

REMEMBER

This icon notes something you should keep in mind about hedge-fund investing. It may refer to something I've already covered in the book, or it may highlight something you need to know for future investing decisions.

TIP

Tip information tells you how to invest a little better, a little smarter, a little more efficiently. The information can help you ask better questions of your hedge fund manager or make smarter moves with your money.

WARNING

I've included nothing in this book that can cause death or bodily harm, as far as I can figure out, but plenty of things in the world of hedge funds can cause you to make expensive mistakes. These points help you avoid big problems.

TECHNICAL STUFF

I put the boring (but sometimes helpful) academic stuff here. I even throw in a few equations. By reading this material, you get the detailed information behind the investment theories, some interesting trivia, or some background information.

Beyond the Book

In addition to the wealth of information on hedge funds that I provide in this book, you also gain access to even more help and information online. Go to `www.dummies.com` and search for "Hedge Funds For Dummies Cheat Sheet" for a additional content that accompanies this book.

Where to Go from Here

Well, open up the book and get going! Allow me to give you some ideas. You may want to start with Chapter 1 if you know nothing about hedge funds so you can get a good sense of what I'm talking about. If you need to set up your investment objectives, look at Chapters 14 and 15. If you want to know what hedge fund managers are doing with your money, turn to Chapters 7 through 10. And if you're about to buy into a hedge fund, go straight to Chapter 18 so that you can start your due diligence.

If you aren't a big enough investor for hedge funds but hope to be some day, start with Chapters 5, 6, and 11 to discover more about structuring portfolios. Chapter 4 can help you meet your investment objectives as a small investor.

A Final Note

Any opinions in this book are mine alone and do not reflect the positions of any employers or clients.

1

What Is a Hedge Fund, Anyway?

IN THIS PART . . .

You read about hedge funds in the financial press. You hear about their ability to generate good returns in all market cycles. And you wonder — just what is this investment? In this part, you find out. Part I covers definitions and descriptions you hear in the hedge fund world, offers the basics on just how much regulatory oversight hedge funds have, and lets you know how to buy into a hedge fund.

IN THIS CHAPTER

- » Knowing the long and short of hedge funds
- » Discovering the history of hedge funds
- » Factoring a fund's position on alpha into your investment decision
- » Distinguishing between absolute-return funds and directional funds
- » Acquainting yourself with the important hedge fund players
- » Perusing the fee structure of hedge funds

Chapter 1

Hedge Funds: Alternative Assets and Alternative Strategies

You see hedge funds in the news all the time, but it's hard to know exactly what they are. That's because, at its essence, a hedge fund is a bit of a mystery. A *hedge fund* is a lightly regulated investment partnership that invests in a range of securities as the managers attempt to increase expected return while reducing risk.

Hedge funds are part of a growing class of *alternative investments*. These are funds that look to upend traditional relationships between risk and return, offering investors better expected returns for a given level of risk. This doesn't mean that they are necessarily safer or better performing, by the way. There's much

mystique surrounding hedge funds and alternatives that make them seem special, but they are not. They're just different.

Over the years, most hedge fund managers have concentrated on their investment strategies rather than the structure of the fund. The investment styles they use have come to be known as alternative strategies, and they're now available in a range of investments, including exchange-traded funds and other formats that are accessible to just about anyone with money to invest.

Hedge fund and alternative managers today take on the roles of risk managers, investment bankers, venture capitalists, and currency speculators, and they affect discussions in boardrooms at brokerage firms, corporations, and central banks all over the world.

In this chapter, I cover the basic vocabulary of alternative investing. Having this knowledge helps you understand the purpose of these funds. Then you can get into the details of the structure. Also, I clarify what a hedge fund is and what it isn't, which is important because you come across a lot of myth and misinformation out there. The information you find here serves as a springboard for the topics I introduce throughout the rest of the book, so get ready to dive in.

Defining Hedge Funds

Here's the first thing you should know about hedge funds: They have no clear identity or definition. In the investment world, "I run a hedge fund" has the same meaning as "I am a consultant" in the rest of the business world. The speaker may be managing money for other people and making millions (or billions), or they may be looking for a socially acceptable reason for not having a real job. The money manager may be investing conservatively or taking aggressive risks, beating the market and then some or barely breaking even.

The term does have meaning. Here's the short answer:

A hedge fund is an investment partnership that uses a range of assets and strategies to generate a high level of return relative to the amount of risk taken.

Of course, if it were that simple, there wouldn't be enough material for an entire book. Consider the pages that come after this to be the long answer.

Defining Alternative Strategies

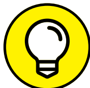
Traditional money management involves buying such real money assets as stocks and bonds, then selling them to take advantage of better opportunities or return money to the account owners. The money can be invested, meaning that the assets are held for a long period of time, or they can be traded, meaning that they're bought and sold frequently to take advantage of short-term changes in market prices. The risk and return of these investments are closely tied to the risk and return of the entire market.

Alternative strategies involve assets and investment techniques that have risk-and-return profiles that are different from those of the stock and bond markets. They fall into two main categories: absolute-return funds and directional funds. I look at the differences between the two in the following sections.

Absolute-return strategies

Sometimes called a "nondirectional fund," an *absolute-return fund* is designed to generate a steady return no matter what the market is doing. The very first hedge fund had an absolute-return objective using a long-short strategy (see Chapter 11), and that approach stuck.

Although absolute-return funds are close to the true spirit of that original hedge fund, some consultants and fund managers prefer to stick with the label "absolute-return fund" rather than "hedge fund." The thought is that hedge funds are too aggressive and alternative funds are too wild, while absolute-return funds are designed to be slow and steady. In truth, the label is just a matter of personal preference.


TIP

An absolute-return strategy is most appropriate for a conservative investor who wants low risk and is willing to give up some return in exchange. (See Chapter 9 for more information on structuring your portfolio.) Portfolio managers can use many different investment tools within an absolute-return strategy, a few of which I present in Part 3 of this book.

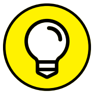
TECHNICAL STUFF

Some say that absolute-return funds generate a bond-like return, because like bonds, absolute-return funds have relatively steady but relatively low returns. The return target on an absolute-return fund is usually higher than the long-term rate of return on bonds, though. A typical absolute-return fund target is 6 percent to 8 percent, which is above the long-term rate of return on bonds and below the long-term rate of return on stock.

Directional strategies

Directional funds are alternative funds that don't hedge — at least not fully (see the section "Hedging is at the heart of it" for more on hedging). Managers of directional funds maintain some exposure to the market, but they try to get higher than expected returns for the risk that they take. Because directional funds maintain some exposure to the stock market, they're said to have a *stock-like return.* A fund's returns may not be steady from year to year, but they're likely to be higher over the long run than the returns on an absolute-return fund.

Directional funds are the glamorous funds that grab headlines for posting double or triple returns compared to those of the stock market. The fund managers may not do much hedging, but they have the numbers that get potential investors excited about hedge funds.


TIP

A directional strategy is most appropriate for aggressive investors willing to take some risk in exchange for potentially higher returns. (See Chapter 9 for more information on structuring your portfolio.)

Introducing Some Basic Concepts

This is a book, not a blog post, giving me plenty of room to cover the background of the investment business. It's an industry with a lot of smart, creative people who spend time thinking about new ways to help businesses raise money while helping investors manage risk. They come up with new tools for speculation and for protection, and they try to stay a step ahead of the competition.

All of this creative energy builds on the basics.

Alternative, to what?

The traditional asset classes are stocks, bonds, and cash. Stocks represent ownership in companies, bonds are a form of loan, and cash is, well, king. These assets form the market and the key metrics, like interest rates, exchange rates, and of course the market indexes.

Alternative assets are all of the things that investors can put their money into that are neither stocks, bonds, nor cash. This includes everything from real estate to bitcoin to the amount of carbon in the atmosphere.