A bit about hedge funds

Sometimes it seems as though fund managers are going out of their way to make things complicated. This is particularly true of the hedge fund industry. In this note we run through a few of the basics and some of the terminology associated with this sector.

What is a hedge fund?

The term hedge fund covers a multitude of different investment strategies. They tend to be structured as limited liability partnerships or companies. A few will allow an investor to enter or exit on a daily basis but most commonly this will be monthly or quarterly, some are even longer. They invest in all sorts of assets. They will often include an element of hedging within the investment strategy.

What is shorting

Hedging is the art of trying to reduce your exposure to a particular asset or risk, often by selling something you don't own – this is called shorting.

Short postions

A short position is a negative holding in an investment.

Long positions

A long position is a positive holding in an investment.

Net Long / Net Short

Net long refers to a portfolio that, on balance – adding up the long positions and deducting the short positions – still has a positive exposure to the group of assets that the portfolio is invested in. Net short portfolios have an overall negative exposure.

Derivatives

Many hedge funds invest all or part of their money in derivatives. Derivatives are securities whose value depends on the value of another asset. Derivatives can be used to get exposure to the underlying asset without having to put up all of the cost of buying the asset itself – they can be a lot riskier than buying the asset but not necessarily. For example different combinations of derivatives can be used to protect the downside on an investment or benefit from volatility in the price of the asset. They can be hard to understand however and, sometimes, hard to value.

Futures

Futures are contracts to buy or sell a specific quantity of a commodity or a financial instrument such as a currency or an interest rate at a specified time in the future and at a fixed price.

Hedge funds are categorised according to the investment strategy they adopt.

Macro Funds

Macro funds tend to invest on a global basis and seek to make profits by predicting what will happen to things like currencies, interest rates, bonds and equity prices.

Discretionary Macro

Discretionary macro funds try to form a view of the state of the world, analyse the implications of this for asset prices and construct a portfolio to take advantage of the situation. For example, a discretionary macro fund may decide to bet that the Euro will fall in value relative to the US dollar and may try to take advantage of that by being short of Euros and long of US dollars. The discretionary part of the description refers to the manager's ability to make these decisions for the fund themselves.

Systematic Macro

Systematic Macro funds use quantitative (number based) models to try to predict changes in the prices of assets. The system generates the investment ideas. These models are trying to take advantage of market inefficiencies that arise because we humans don't always invest

Trend Following

Managed Futures

CTAs

rationally. Some of these strategies will be trend following. For example, investing on the lines that if the value of one currency has fallen relative to the value of another for three straight days, it is likely to do so for a fourth. Managed futures funds, which hold long and short positions in futures contracts exposed to a wide range of assets, and CTA (Commodity Trading Advisor) funds are systematic macro funds.

Short-term trading

Short-term trading is another form of macro investing. Day traders fall within this area. These funds turnover (buy and sell) their portfolios very rapidly, sometimes holding an investment for minutes or even seconds. Some of these funds use trend following techniques or otherwise try to identify patterns in market moves. Some try to capture and react to news affecting the value of an asset before the rest of the market. Some of these funds use leverage (investing using borrowed money) to try to magnify their returns.

Equity Long/Short

Market Neutral

Equity hedge funds can be long/short – funds that have a portfolio where the long positions are more or less offset by short positions or equity long bias – funds that are almost always net long. These funds may seek to sell an investment they think is going to fall in value and buy a corresponding investment that they think is going to rise in value, using the short position to help finance the long position and thereby to create leverage. Funds that seek to match long and short positions exactly are called market neutral funds. Part of the transaction may involve an index or futures and options based on an index or a basket (selection) of stocks

Credit Long/Short

Credit long/short funds operate much in the same way as equity long/short funds but investing in debt in some form rather than equities.

Event Driven

Event driven funds try to identify assets that they think are particularly under or over-valued based on fundamental analysis (an analysis based on the realities of the factors affecting the value of the asset – in the case of a stock this would include things like profits and the strength of a company's balance sheet). Having identified a pricing mismatch, event driven funds try to find a catalyst that will cause the asset price to align with its fundamental value.

Credit Event Driven

Some event driven funds invest in credit (debt of some form) instead of or as well as equities.

Merger / Risk Arbitrage

Merger or risk arbitrage is a form of event driven investing where the manager invests in a situation after an event such as a merger or a takeover has been announced. The managers focus on the likelihood of the deal being completed as well as the relative value of acquirer and acquired.

Special Situations

Funds that invest around other types of event may be described as special situations funds.

Activists

Some event driven funds try to be the catalyst themselves – these are usually known as activists.

Distressed

Restructuring

Some event driven funds restrict themselves to investing in failing or failed companies. Distressed assets may be cheap as investors take an unduly pessimistic view of a company's ability to turn itself around. Debt Restructuring can allow a company that has borrowed too much money to survive – often the fund will buy the company's debt, nurse it through bankruptcy and emerge as the owner of both the debt and the equity in the revitalised company.

Interest Rate Arbitrage

Fixed income hedge funds include Interest rate arbitrage funds which invest in debt and seek to profit from predicting moves in interest rates (yields). They are often market neutral and may be quite highly leveraged as they seek to exploit small changes in value.

Structure Arbitrage	Capital structure arbitrage funds seek to exploit anomalies in the value of different debt instruments issued by the same borrower.
Volatility Arbitrage	Volatility Arbitrage funds try to make money by exploiting changes in the volatility (how far the value of something moves up and down over a period of time) of an asset. One way of doing this is to construct a delta neutral portfolio by selling / buying an underlying security and buying / selling an option on that security. The portfolio won't change in value when the price of the underlying security changes (this is the delta neutral bit) but it will change in value if the option price changes in response to a change in the volatility of the price of the underlying security.
Multi Strategy Relative Value	Multi Strategy Relative Value arbitrage funds try to benefit from changes in the relative values of a range of different types of asset. As an example, they might seek to exploit the link between the oil price and the Japanese stock market (Japan imports most of its oil so benefits when the oil price falls).
Negative Correlation	Some hedge fund strategies are designed to make money when other assets are falling in value. The simplest of these is a net short equity or credit fund but other types exit including Negative Correlation funds that seek out investments that benefit when certain asset prices fall.
Tail Hedging	Tail Hedging Funds are designed to benefit when extreme events occur. So-called Black Swan events (named after Australia's Black Swans, an animal so alien to European minds that its existence couldn't be foretold) could impact the value of all assets (when assets fall or rise in tandem they are said to be positively correlated). Tail Hedging Funds are supposed to protect against that risk. They do things like buying very out of the money derivatives (derivatives that won't have any real value unless the value of the underlying changes significantly).