The Hedge Fund Cheat Sheet

V. 1.6 2/2005 **A Reference Tool for Busy People with an Interest in Hedge Funds** **$12.95**

What is a Hedge Fund?

The term "hedge fund" is applied to a variety of investment styles, but there are some common characteristics. Hedge funds are usually **not regulated** by the SEC (that will change in 2006), and have a clientele of sophisticated wealthy investors and/or institutions. Strategies can involve most asset classes, and **shorting as well as leverage are common**. Manager compensation usually includes a fixed management fee plus an **incentive fee** ***(see "Fees" on page 2)***.

Why Invest in a Hedge Fund?

Hedge funds can make sense in an overall portfolio context, for a number of reasons. Here are a few:

Diversification – hedge funds add a level of diversification to an investment portfolio, since their returns are often not correlated with those of other asset classes. That's the whole idea.

Downside Protection – since hedge funds can hold both long and short positions, they usually are less volatile than typical long-only portfolios, and can provide protection in a declining market.

Absolute Return Focus – hedge funds concentrate on making positive returns in all kinds of markets.

Active Management Focus – hedge fund managers are applying strategies they believe will add alpha. They are using their skill at interpreting information to actively exploit an inefficiency in the market, not to be a "closet indexer". On average, hedge fund risk-adjusted returns apparently have been attractive enough to lead to the current surge in demand.

Who Invests in a Fund?

"Sophisticated investors" do it—those who do not need the protection provided by the regulations that apply to mutual funds. These are entities, or wealthy individuals that must pass either an **"accredited investor"** test or a **"qualified purchaser"** test. An accredited investor is an individual whose net worth exceeds $1 million, or whose income in the last 2 calendar years exceeds $200,000/yr, and who expects more of the same. It can also be an entity with assets exceeding $5 million. A qualified purchaser is someone with over $5 million ***(continued on p. 2)***

Hedge Fund Styles:

There are quite a few hedge fund styles, and their descriptions will vary somewhat from publication to publication. Here are some:

Convertible Arbitrage – the fund manager typically holds a convertible bond long, and sells short the underlying common stock. Returns come from bond coupon payments and the short rebate. There is a cash outflow as well, to cover dividend payments on the short positions.

Dedicated Short Bias – the goal is to earn returns by maintaining net short exposure (more dollars short than long) in securities. There are not as many dedicated short sellers as there used to be, due to the recent long equity bull market. The idea is now to have a "short bias", and still hold some securities long—just in case.

Distressed Securities – an event-driven strategy, focusing on companies in financial trouble. Positions in debt or in equity can be both long and short. The event might be a bankruptcy, a distressed sale or some other form of corporate event for exploitation.

Emerging Markets – involves equity or debt investing in emerging markets around the world. Each market is unique and has its own rules. For example, some countries lack derivative markets or simply prohibit short selling. Hedging is more difficult (or impossible) in markets like these, so most investing here is long-only.

Equity Market Neutral – the equity market neutral manager takes both long and short positions in stocks while minimizing exposure to the systematic risk of the market (i.e., a beta of zero is desired). The long and short sides are equal in dollar amount ("dollar neutral"). Returns are generated by the spread between the longs and the shorts + the short rebate + the difference between dividends earned on long positions and dividends paid on short positions. Quantitative models are often employed in these strategies.

Event-Driven – focuses on opportunities in corporate events like a merger, acquisition, bankruptcy, reorganization, or simply some bad news about a company. An example would be selling Enron short at the right time.

Fixed Income Arbitrage – seeks to profit from price discrepancies in related fixed income instruments. A manager might buy long a bond he thinks is undervalued and sell short a similar bond he thinks is overvalued. One goal is to neutralize interest rate risk.

Fund of Funds – involves active management of a portfolio of hedge funds. See page 4 for more information on hedge funds of funds.

Global Macro – the manager can do just about anything he thinks will be profitable. Leveraged directional bets are made using many of the world's financial instruments (stocks, bonds, commodities, currencies, derivatives, etc.). Some bets can be huge.

Long/Short Equity – picks both long and short stock candidates, but does not attempt to be market-neutral. The manager may switch from net long to net short, but most L/S equity strategies have a long bias. Investors see this strategy as a way to generate returns in a rising market but also reduce volatility.

Managed Futures Strategy – invests in financial and commodities futures markets. Directional bets are made with long and/or short positions. The managers are called Commodity Trading Advisors (CTAs).

Statistical Arbitrage – known as "stat arb", this strategy uses quantitative models to predict price discrepancies in securities. Market neutrality is often used. The models often employ some mean reversion assumptions.

What is Hedge Fund "Due Diligence"?

Due diligence is the term assigned to investigating a hedge fund (or any investment) in detail. It delves into more than just historic returns and their volatilities. It wants to understand the fund **Strategy** and its risks, the **Fund** itself, and the fund **Manager**, and it does so with **quantitative** and **qualitative** research. Quantitative Due Diligence concentrates mainly on the Strategy itself, while Qualitative Due Diligence concerns itself with characteristics of the Fund and of the Manager.

Quantitative Due Diligence digs into the numbers generated and implied by the hedging strategy, and why. It also wants to know how the strategy works (is it model-driven?), whether it makes intuitive sense, and if it is repeatable. Is there good information in the strategy, or is the manager just a lucky or skilled trader without a ***(continued on p. 2)***