
Hedge Funds are an investment option that can provide unique sources of return and diversification within a portfolio. While they can be worthwhile investments, hedge funds are complex and should be fully understood before being incorporated into a financial strategy.

What is a Hedge Fund?

A hedge fund is an actively managed private investment vehicle that pools capital from qualified investors (typically, as defined by the Investment Company Act of 1940). Professional fund managers actively pursue attractive risk-adjusted return opportunities across a wide range of assets and strategies, many of which are not available in traditional equity or bond investing.

Why They're called Hedge Funds

Early hedge funds¹ sought to “hedge” market risk by holding both long and short positions, reducing exposure to broad market movements. While not all modern hedge funds follow this model, the name has lasted.

How Hedge Funds Work and Common Characteristics

Hedge funds can be highly versatile in their investment implementation strategies. They may pursue opportunities that are less correlated to equity markets or in underrepresented sectors of the public market, or access alternative asset classes and financial tools unavailable to traditional long-only investments.

Common characteristics include:

- *Partnership Structure:* Commonly organized as Limited Partnerships governed by a Limited Partnership Agreement (“LPA”). The General Partner (“GP”) makes investment decisions, while Limited Partners (“LPs”) provide passive capital. Structures such master-feeder funds may be used for tax efficiency.
- *Leverage:* Borrowing capital amplifies investment capacity with the goal of increased returns. Leverage, which includes the use of margin to short stocks, can have two sided results- increasing gains, as well as the risk of loss.
- *Non-traditional assets:* Hedge funds may use non-traditional assets such as derivatives (financial instruments whose value is derived from an underlying asset) to execute investment strategies.

¹ A.W. Jones & Co. was formed in 1949 and considered by many to be the world's first hedge fund. This fund used a long/short equity strategy with leverage and performance fees.

Each manager develops a distinct investment philosophy ranging from risk mitigation (through hedging and short positions) to risk amplification (through leverage and concentrated bets).

Hedge Fund Fees: Management and Incentive Fees

Hedge funds often charge higher overall fees than conventional long only investment funds.

- *Management fee*: Typically, 1-2% of assets under management (“AUM”), used to cover operating expenses.
- *Incentive (performance) fee*: Typically, 10-20% of profits, often with investor safeguards that help ensure fees are fairly calculated:
 - *Hurdle rate*: A minimum return must be met for performance fees to apply (i.e., 8%).
 - *High water mark*: Assurance that performance fees are only charged on gains above the investor’s previous peak net asset value (“NAV”).
 - *Fees on invested capital*: Management fees are calculated on invested, not committed, capital.

Performance should always be evaluated net of fees.

Liquidity: A Key Differentiator

Hedge funds are less liquid than portfolios of stocks or bonds. Investor capital can be subject to restrictions such as:

- *Lock-up periods*: Minimum required investment periods, often a year or more.
- *Redemption windows*: Withdrawals limited to specific intervals of time (i.e., quarterly or annually) and require advanced notice (i.e., 30-90 days).
- *Gating provisions*: Caps placed on how much capital LPs can redeem at once, often impacted by the liquidity of underlying investments.

As a result, hedge funds tend to appeal primarily to qualified investors or institutions that can commit capital for the longer periods of time.

The Investors: Who Can Invest in Hedge Funds?

Hedge funds are private offerings, not open to the public markets. Investors are typically:

- Qualified or accredited individuals and family offices who meet specific income or net worth requirements².
- Qualified institutions such as pension funds, endowments, foundations, and insurance companies³.

The private nature of hedge funds also means they are subject to less regulatory oversight than public investment vehicles. Careful due diligence is essential prior to investing.

Common Hedge Fund Strategies

Examples of opportunistic strategies hedge funds employ to seek returns include:

- *Long/Short Equity*: This strategy balances long positions (betting on price increases) and short positions (betting on price declines) in either domestic or global equities.
- *Global Macro*: These actively managed funds attempt to profit from broad market swings caused by political and economic events (for example, investments in global indices, commodities, interest rates or currencies).
- *Event-Driven*: These funds seek to exploit stock mispricings due to corporate events such as restructurings, spin-offs, acquisitions, and bankruptcies.
- *Relative Value Arbitrage*: These funds exploit price discrepancies between related securities.
- *Credit & Distressed Debt*: These funds invest in investment grade, stressed, and distressed debt. The lower the quality, the more upside is expected.

Risks to Consider

While hedge funds offer diversification opportunities, they also present risks⁴:

- *Transparency*: Limited reporting and disclosures compared to public funds.
- *Liquidity*: Fund terms and the ability to sell underlying assets can restrict capital.
- *Leverage*: Borrowing money magnifies both gains and losses.
- *Manager/ Key Person*: Success may depend on the skill of the fund manager and its team.
- *High Fees*: Returns should always be evaluated *net of fees*.

² The Investment Company Act of 1940 defines a qualified investor as individuals or family-owned companies with \$5 million or more in investments.

³ The Investment Company Act of 1940 defines qualified institutions as those with \$25 million or more in investments.

⁴ This list is not all inclusive. Please speak with an advisor to review potential risks in more detail.

- *Style Drift & Capacity:* Investment strategies may change or perform differently as fund size and economic conditions change.
- *Operational:* Counterparty failures, valuation challenges, and cybersecurity issues can impact performance.

The Bottom Line

Hedge funds can provide differentiated sources of return. The appeal of many hedge funds lies in the reputation and skill of their managers, so careful due diligence is essential.

With proper guidance, hedge funds can be a valuable diversification tool in building and preserving wealth.

Have Questions?

We would love to discuss with you our approach to hedge fund investing and determine if they are appropriate for your investment portfolio.

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