Hedge Funds

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Hedge Funds Definition

Hedge Funds are alternative investment vehicles that consists of pools of funds which has the ability to invest in wide range of investments, as well as the ability to hold short, leveraged positions and use derivatives.

Despite that Hedge Funds use hedging strategies to minimize their risk, they still hold a higher level of risk relative to the other types of funds

Moreover, as the Hedge Funds industry is an unregulated industry and their high risk profile their availability is limited to high net worth and sophisticated investors either individuals or institutions.

Hedge Funds are mostly less liquid than other types of funds as they encounter long lockup period at which the investors cannot sell or redeem their shares, also these lockup periods could be extended.

Hedge Funds managers' compensation also differs as they are paid a percentage of the returns on top of their management fee, which would create additional motivation to achieve higher returns that could also lead to a higher risk profile.

Hedge Funds Investment Strategies

While Hedge Funds does not have a specific types or investment strategies making it difficult to categorize them by type.

However as they have the freedom to choses their investments of investment strategy, we categorize them by their most popular investment Strategies.

The most popular investment Strategies used by Hedge Funds are listed below:

1. Convertible Arbitrage
   It is an equity strategy, in which the Hedge Funds holds a short position in a common stock and a long position in its convertible securities.

   While the prices between these two securities converge, the Hedge Funds is able to achieve a low risk Arbitrage return.

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2. Distressed Securities

   Similar to Privet Equity Funds the Hedge Funds acquire companies that are underperforming, in distress or facing potential bankruptcy as a deep discount, then restructure it and improve its performance to sell it at profit later.

3. Emerging Markets

   As the title implies the Funds Hedge, invest in emerging markets and its companies, even though the emerging markets may have rapid growth, their growth could be volatile and accompanied by higher inflation rates.

4. Event-Driven Investing

   Is the most versatile strategy, as the Hedge Fund has the freedom in invest short-term infrequent events, allowing the Hedge Fund from benefit from a short-term volatility which sometimes is magnified by their investment.

   These events may consist but not limited to, IPO's, mergers, earnings, acquisition, and any other corporate actions and economic event.

5. Equity-Long Only or Equity-Short Only

   Are the Simplest investment strategies that holds either a long position or a short position in a stock.

   Despite their Simplicity these strategies only benefits from a bear o bull movement, which limits their potential returns.

6. Long and Short Equity

   Similar to Equity-Long Only or Equity-Short Only, however here the Hedge Fund hold both long and short positions in low correlated markets, thus benefiting from both bear and bull movement.

7. Fixed-income arbitrage

   Hedge Funds here try to take advantage to two mispriced fixed income securities with similar debt structure by holding two different position in these securities.

   This strategy is very risky with large potential losses and small returns; however, these losses are less frequent.

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8. Fund of Hedge Funds

   It is a portfolio of Hedge Funds investments that spreads its investments over different investment strategies and styles, it to keep the risks and volatility at a low level through diversification while increasing its rate of return.

9. Macro

   Here Hedge Fund invest in a variety of asset classes such as stocks, bonds, currencies, commodities and other financial instruments.

   However, these investments are only based on the opportunities that arise from macroeconomic event such as changes in government policies, economic policies and interest rates.

10. Market Neutral

    This strategy attempts to hold a hedged or equally long and short position in the same sector to minimize or eliminate market volatility risk.

    Even though this strategy generates small returns, the use of leverage and financial derivatives can magnifies its returns.

11. Merger Arbitrage

    Similar to event-driven strategy, this focus on mergers by hold opposite stock positions of the of two merging companies stocks.

    The Fund will hold a long on the company being acquired as such event will drive its shares prices up, however the shares will trade below the offer price due the uncertainty of whether the merger will actually go through or not.

    On the other hand the short position will be held on the acquiring company, which its shares value tend to decline if the transaction involves an exchange of stock,

Largest Hedge Funds

The below table lists the top ten largest Hedge Funds by their assets under management or (AUM) for short as of September 2016, and are listed in Billions of US Dollars.

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Hedge Fund	Assets Under Management	Headquarter
Bridgewater Associates	103.4B	USA
AQR Capital Management	63.0B	USA
Man Group	53.0B	UK
J.P.Morgan Asset Management	50.0B	USA
Och-Ziff Capital Management	39.2B	USA
D.E. Shaw Group	38.0B	USA
Two Sigma Investments	37.0B	USA
Millennium Management	34.2B	USA
Winton Capital Management	33.0B	UK
Renaissance Technologies	32.0B	USA

The table indicate that eight out of ten Hedge Funds are located in the United States while the remaining two are located in the United Kingdom, which should not be a coincidence as the United States and the United Kingdom are the financial Capitals of the world.

Moreover, the decline of the amount of assets under management between the Hedge Funds in the table seems consistent, except for Bridgewater Associates that has 40% more assets under management than the Hedge Fund below it thus placing by far the largest hedge funds in the list.

The distribution of Hedge Fund's assets under management over its investment strategies in the second quarter of 2016 is as follows:

Sector/Strategy	Assets Under Management
Fixed Income	550.6B
Multi-Strategy	340.1B
Emerging Markets	248.4B
Macro	244.0B
Equity Long Bias	228.6B
Equity Long/Short	216.6B
Event Driven	201.0B
Equity Long-Only	130.2B
Distressed Securities	113.1B
Other	99.1B
Equity Market Neutral	81.3B

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Merger Arbitrage	63.8B
Convertible Arbitrage	23.3B

We can notice that the strategies with the largest assets under management has relatively high risk and returns, while the bottom strategies that has less frequency of occurrence and lower risk.

Moreover, we can also notice the Hedge Funds assets under management are less than other types of funds however the use of leverage by Hedge Funds amplifies their returns thus making up for the deference of the amount of assets under management.

The Main Differences between Hedge Funds and Mutual Funds

Despite that Hedge Funds and Mutual Funds are investment funds with their absolute goal is to achieve returns for their investors that they have fiduciary duty for, there are some key difference between them such as:

1. Strategy
   Hedge Funds can change their strategy to suit the market circumstances at the time or they can adopt their event driven that structured to change on case by case basis.

   While Mutual Funds are must adhere strictly to strategy described when the fund was established or they have limit range on investments to choose from.

2. Regulation
   Mutual Funds are rigorously regulated investment companies that falls under four federal regulatory laws as oppose to Hedge Funds which are mostly unregulated, as we are going go in more detail about Hedge Funds regulation later on.

   However both Funds are subject to the same prohibitions against fraud as are other market participants, and their managers owe a fiduciary duty to the funds that they manage.

3. Fees Structure or Compensation Structure
   Mutual Funds can charged several fees in addition to its management fees such as 12B-1 Fee, however that compensation structure for Mutual Funds is strictly

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regulated thus it imposes a limit on the fees that they can charge.

On the other hand Hedge Funds charge a percentage of returns that the funds achieve over its management fees, also these fees are not limit by regulation.

4. Liquidity

   Mutual Funds are required by law to state their portfolio's value on a daily basis using their market values allowing investors to redeem their shares using their accurate values, as investors are able to redeem their shares anytime.

   Meanwhile it's difficult to determine the Hedge Fund's value as there is no laws or regulations regarding there pricing, moreover it's also difficult for Hedge Funds investors to redeem their shares as they have relatively long lockup periods that could be extended.

5. Investor Characteristics

   Any type of investors that can make the minimum investment to open an account which typically 1000$ or less can invest in the Mutual fund, after which there is no additional minimum investment required.

   Hedge Funds are different story, as they are limit to high net worth and sophisticated investor to their high risk and unregulated nature, moreover Under the Investment Company Act of 1940 Hedge Funds only may accept investments from individuals who hold at least $5 million in investments.

Hedge Funds Regulations

According to the US Securities and Exchange Commission:

Hedge Funds are not required to be registered with the securities markets regulator and are not subject to the reporting requirements, including periodic disclosure of net asset values.

Moreover, the Hedge Funds may not be required to register with the SEC and are not subject to some of the regulations that are designed to protect investors; however, are subject to the prohibitions against fraud as are other market participants, and their managers owe a fiduciary duty to the funds that they manage.

Hedge Funds industry has the ability to use a wide range of flexible investment strategies than any other investment funds.

Also Hedge Funds are able to use leverage, hold short and the ability to use various types of financial instruments that are not available to any other type of investment funds.

Conclusion

Hedge Funds are highly profitable alternative investment vehicles that has accessibility to a wide range of investment strategies and instruments with the freedom to change between them.

Moreover, availably is limited to high net worth sophisticated due to their high risk nature and low liquidity due the long lockup periods that they impose.

Hedge Funds operate in an unregulated industry, thus they have no reporting requirements, unlimited compensation, not subject to periodic disclosure and are not to be registered with the securities markets regulator in some circumstances.

However, Hedge Funds are subject to the prohibitions against fraud as are other market participants, and their managers owe a fiduciary duty to the funds that they manage.

The most popular strategies that Hedge funds use are high risk high return strategies as oppose the least use strategies which are less frequency of occurrence and lower risk.

Large Hedge Funds are more concentrated in the Untitled States than the United Kingdom in the ratio of 8-to-2, also dispute that Hedge Funds are less assets under management than other types of funds however the use of leverage allows them to amplify their retires.

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