# HEDGE FUND STRATEGIES FOR INDIVIDUAL INVESTORS

## A Starting Point for Discussions with Your Financial Advisor

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As individual investors, many of us think we're missing out when the media report impressive hedge fund returns. The reality is that the grass may well not be greener.

Hedge funds are limited to institutional and high-net-worth ("accredited") investors because the risks associated with these investments are inappropriate for many of us. Hedge funds operate with limited regulatory oversight, usually have very high investment requirements, and may limit your ability to withdraw funds. They also often impose high management fees, including a share of investment profits as well as a percentage of managed assets.

If your heart is set on a hedge fund strategy, not all hope is lost. Several classes of retail mutual funds use hedge fund–like investment styles but offer better transparency, lower costs, and superior regulatory protection.

Over time, the meaning of "hedge" has drifted. Originally, investors were understood to be hedged when they held two positions with offsetting risks (e.g., a common stock and a put option; bonds and commodities). Today, many so-called hedge funds are simply long assets and in no sense are hedged.

### INVESTMENT INSIGHT

- An exchange-traded fund, or ETF, is a type of closed-end mutual fund that pools assets in order to meet certain identified objectives, often matching the return of a particular index (e.g., S&P 500 Index, Russell 2000 Index, or an index representing a sector, such as gold or oil). Unlike a conventional, or open-end, mutual fund, ETFs trade throughout the day, with market arbitrage providing some level of confidence that the value of the ETF over time will track the performance of the relevant index.

- "Arbitrage" is term that is popular in hedge fund descriptions. Generally speaking, arbitrage seeks to profit from the differential in pricing between two related assets. There are several different arbitrage strategies.

Hedged mutual funds are a relatively new category of investment vehicle. They are less restricted than traditional mutual funds: They can sell stocks short, invest in illiquid securities, use derivatives in certain situations, and leverage of up to one-third of the fund's total assets. They must provide investors with such disclosures as daily liquidity reports and semi-annual audited reports. There are also limits on the amount of leverage they can use, and the fund must have an independent board of directors and custodian.

## EQUITY LONG–SHORT

A popular hedge fund strategy is known as equity long–short. The strategy involves using leverage to buy some stocks ("going long") while borrowing and then selling ("going short") other, less attractive stocks in the same portfolio.

There are many retail mutual funds available today that use a long–short strategy, including a class of funds called 1X0–X0. The "1X0" portion stands for 1X0 percent exposure to the fund's long position, and the "X0" portion stands for X0 percent exposure to its short position, with 130–30 being the most popular split. The fund's goal is to meet or exceed the performance of a benchmark, usually an index, such as the S&P 500 Index. Managers will overweight, or buy more of, the securities in the index they believe will outperform while shorting those they expect to underperform. Long–short funds are available both as traditional mutual funds and as exchange-traded funds.

## MERGER ARBITRAGE

Merger, or risk, arbitrage funds seek to profit from investing in companies that have announced, or are expected to announce, a merger. It's not uncommon for the stock of the acquirer to fall while the stock of the company being acquired rises following a merger announcement. Merger arbitrage managers will usually purchase the stock of the target company while shorting the stock of the acquiring company to profit on that market dynamic. There are many obstacles, however, to completing a merger, so one of the major risks with this investment strategy is that the deal may ultimately fail to occur.

## CONVERTIBLE AND FIXED-INCOME ARBITRAGE

Convertible arbitrage consists of buying convertible securities of a company while shorting the common stock. Fixed-income arbitrage profits from the difference, or spread, between the income generated by the higher-yielding securities (like emerging market debt, "junk" bonds, and structured securities) that the fund buys and the rate the fund pays to borrow money to buy the securities.

These are just some of the strategies that fall under the category of arbitrage, and mutual funds in this sector may use just one or a number of these strategies.

## GETTING WHAT YOU PAY FOR

If you are paying managers to pursue a specialized strategy, you should understand what exactly they are proposing to do. Are they using strategies that you cannot easily replicate with passive investments (e.g., engaging in true hedge or arbitrage strategies), or are you paying high fees to earn broad market returns? Be sure to read and understand the prospectus.

If you're thinking about allocating a portion of your invested assets to funds using alternative strategies, consider talking with an investment professional first. Fees for funds in this class can be higher than for traditional mutual funds, and risks can be greater. You should have an open dialogue with an adviser about your investment goals to be sure you're maintaining an appropriate level of risk.

**For more information, please consult http://www.cfainstitute.org/about/investor/**