



AIMA Investor Education: Hedge Funds 101

April 2019

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THE ALTERNATIVE INVESTMENT
MANAGEMENT ASSOCIATION

Learning Objectives



- Understand what Hedge Fund is
- Understand the range of hedge fund investment strategies
- The role of hedge funds in investor portfolios
- Review key considerations and due diligence questions when investing in hedge funds
- Understanding hedge fund performance

What is a hedge fund?

Alternative investing

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Real assets

- Real estate
- Infrastructure
- Natural resources

Private Equity

- Buyout
- Mezzanine
- Venture capital

Alternative Credit

- Direct lending
- Securitization
- Distressed investing

Hedge Funds

- Directional
- Absolute return

Less liquid

More liquid

What is a hedge fund?



An asset class

Tools to customise portfolios
to enable investor to
achieve risk/return
objectives

Provide diversification to
long only strategies, access
to hard to access
strategies/deals, access to
strategies that require
leverage

Key Hedge Fund Characteristics

The AIMA logo consists of the letters "AIMA" in white, sans-serif font, positioned above a solid magenta horizontal bar. The entire logo is set against a dark blue background.

Only open to
"accredited" or
qualified investors

Wider investment
latitude

Often employ
leverage or
borrowed money

Can charge both
management and
performance fee
(Two and Twenty)

Further hedge fund characteristics

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Use some form of short asset exposure (short selling)

Use derivatives

May seek to magnify returns through borrowings

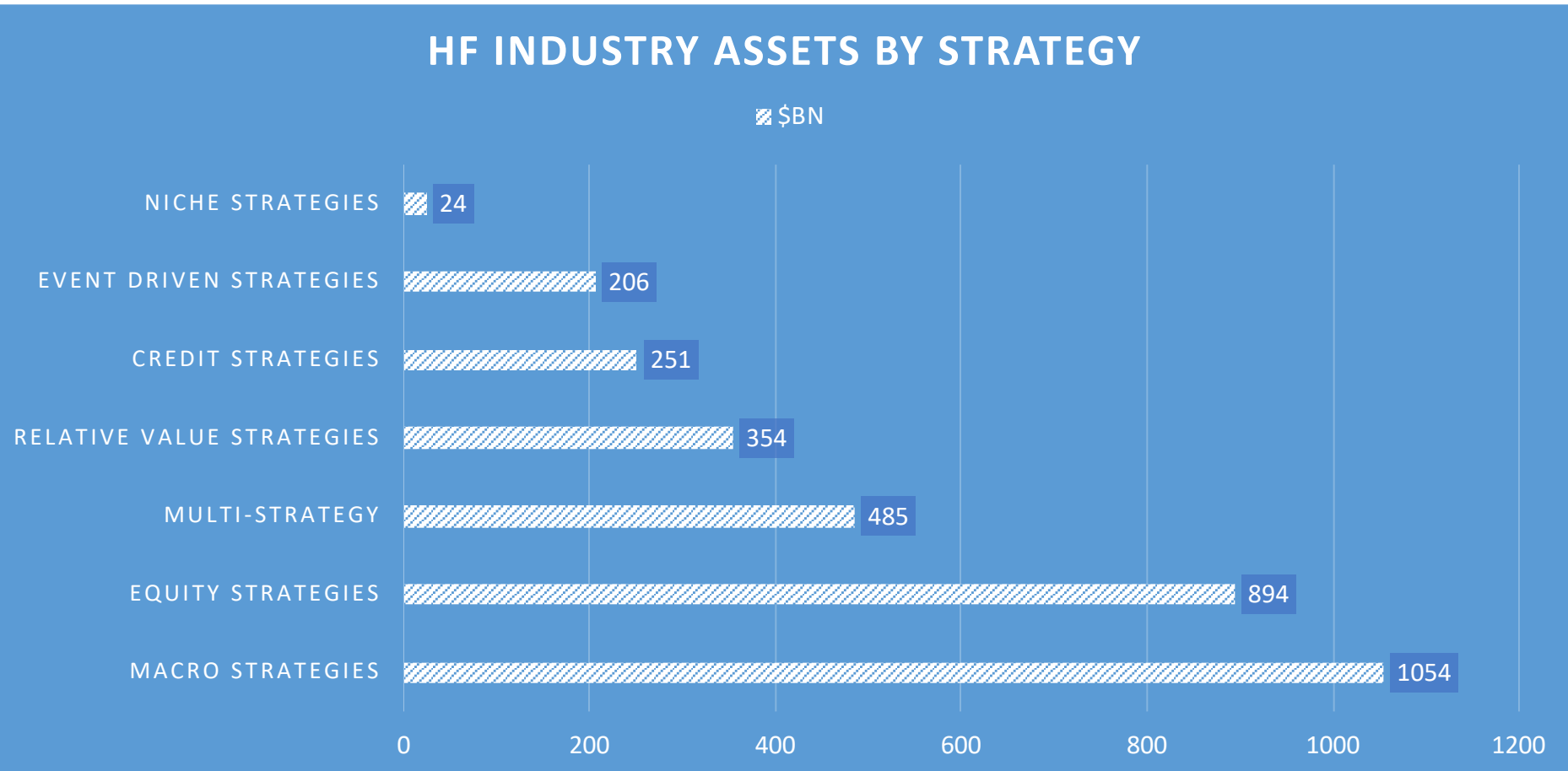
Charge a fixed fee to manage the fund as well as a performance fee

Fund investors are permitted to withdraw capital periodically

Managers who set up the fund are significant investors within the hedge fund themselves

Are all hedge fund strategies the same?

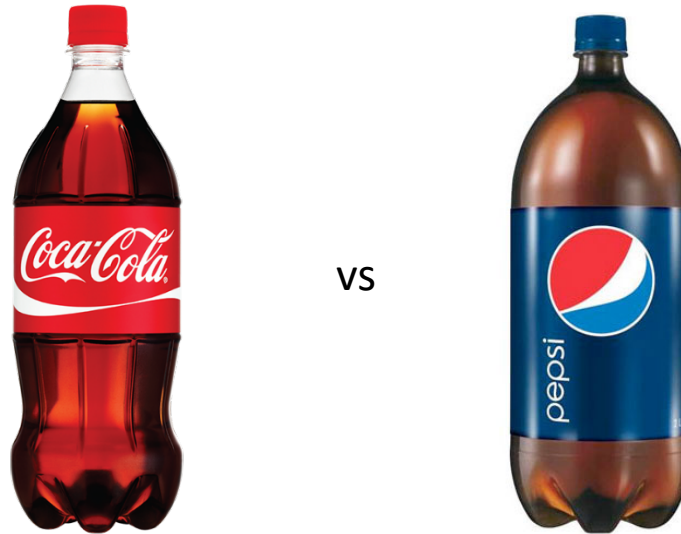
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Source: 2018 Preqin Global Hedge Fund Report

Hedge Fund Strategies

Equity hedge (long/short)



These kinds of funds invest in company shares (public equity). Essentially, they buy under-valued stocks (“going long”) and borrow and then sell overvalued stocks (“going short”) with the aim of buying it back at a lower price at a later date. Shorting or being “hedged” allow managers to reduce losses during bear markets - when the stock market falls. During “bull” markets – extended periods of stock market rises –hedges used may mean they under-perform the stock market as a whole.

Event-driven



Under an event-driven strategy, (e.g., activist, merger arbitrage, special situations, distressed securities) a hedge fund takes positions based upon an event, which can include: (1) a merger between two or more companies; (2) an activist manager influencing a company's management to take action to increase the value of the company's stock; (3) taking a controlling position in the debt or equity of a distressed company with severe financial problems; and (4) seeking to profit from other types of stock-specific events, such as spin-offs or changes in capital structure.

Relative value



Relative value strategies seek to take advantage of differences in the pricing of related financial instruments. Strategies that fall under relative value typically have less market exposure to the underlying equity or bond market than long/short strategies. Their objective is to extract or capture value from any structural anomalies that exist in the markets between related securities.

Global macro

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Managers that deploy a global macro strategy research the global economic landscape and seek to profit from any macro-economic imbalances and/or geopolitical events. Often having no limitation in terms of the types of instruments, asset classes, markets and geographies that they can invest in, macro hedge funds enjoy the broadest investment mandate of any of the major hedge fund strategies.

Managed futures/CTA

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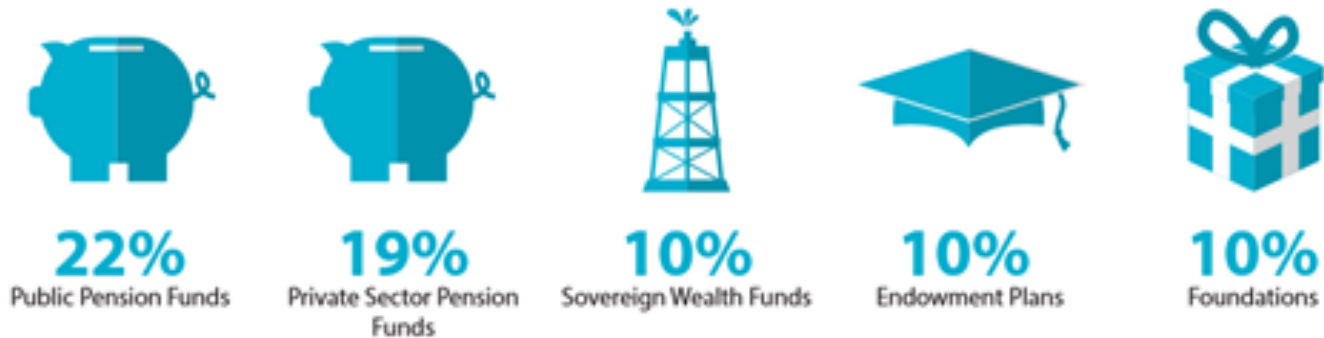
The term managed futures (or CTAs) refers to the active trading of futures and forward contracts on physical commodities, financial assets and exchange rates to earn the risk and return of active management within the futures market. Managed futures tend to be based on systematic trading more than discretionary trading. Systematic trading strategies are generally categorized into three groups: trend-following; non-trend following; and relative value.

Role of hedge fund in investor portfolios

Who invests in hedge funds?

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SOURCE OF CAPITAL



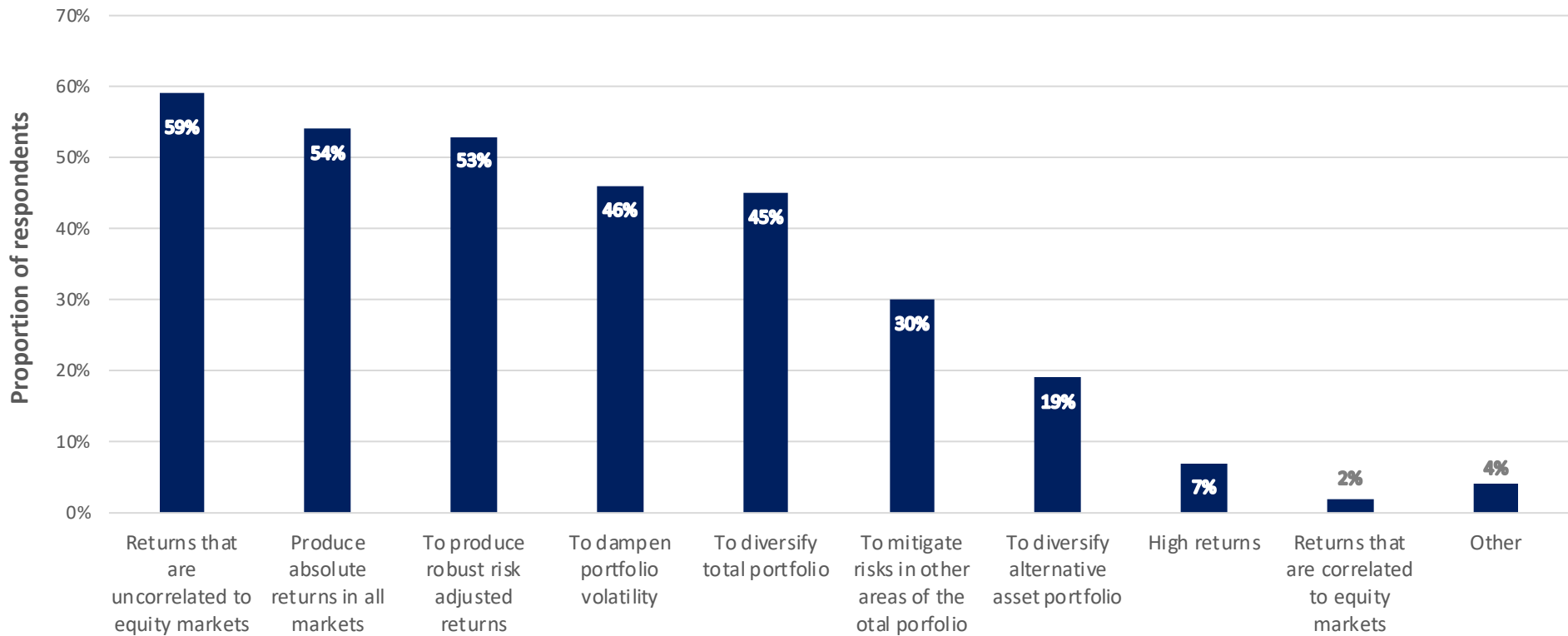
45% of industry AUM is invested on behalf of institutions

Source: 2018 Preqin Global Hedge Fund Report

What do investors want from HFs?

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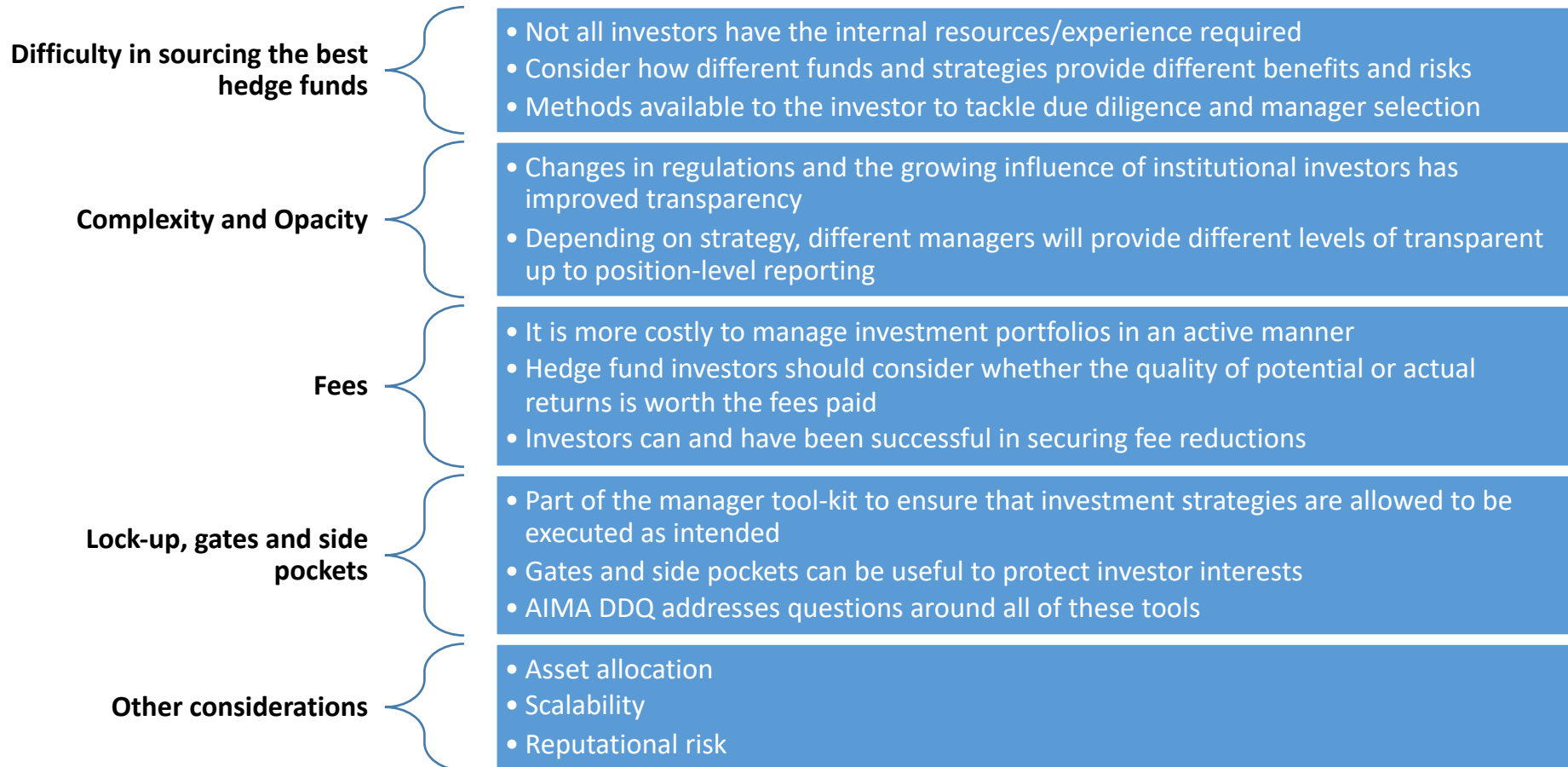
Key objectives of institutional investors from their hedge fund portfolios



Source: AIMA, Preqin

Considerations when investing

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AIMA Due Diligence Questionnaire

AIMA DDQ for Retail Advisors



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INVESTMENT MANAGER

- What is the background and experience of investment manager & the investment team?
- What is the governance surrounding the investment manager & investment team?
- What are the features of the investment manager's compliance culture?
- What risk management frameworks are in place (independent reporting lines, operational risk management, conflicts of interest, etc.)?
- Are the members of senior management of the investment manager, the portfolio manager and/or the fund directors personally invested in the fund?

AIMA DDQ for Retail Advisors continued



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STRATEGY

- What is the fund's investment objective and principal investment strategies?
- Have the objectives of the investment strategy changed in the past 5 years?
- From where are the underlying positional data, market data and any underlying models sourced for this strategy? Position limits?
- Who makes the portfolio management decisions and how are they made?
- Performance history? In what type of markets would this strategy be expected to outperform or underperform?
- What method(s) does the investment manager use to measure the total risk of a portfolio using this strategy?
- How much financial leverage does the fund use on average? Limits? Sources?

AIMA DDQ for Retail Advisors continued

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STRATEGY

- Are there any capacity constraints?
- Offering documents, subscription agreements, and process for purchases and redemptions? Fees? Performance fees and calculation methodology?
- Valuation policy and frequency?
- How long would it take in normal market conditions and stressed market conditions to liquidate the fund without incurring unusual costs?
- What portfolio data does the investment manager provide to investors, and with what frequency and time lag?
- Who are the outsourced service providers of the fund (i.e., prime broker, auditor, custodian, administrator, legal)?

UNDERSTANDING HEDGE FUND PERFORMANCE

How is success measured?



The simplest way of assessing a fund's success is to look at the change in the fund's value over the course of a year or more. This is measured as a "return". Typically, average fund returns are compared to stock markets and bond markets.

Drawdown is a key risk metric which measures how much investors will lose when market crashes

Volatility, another risk metric, measures the degree to which an investment or category zigzags in value from month to month or year to year basis

Headlines often misrepresent hedge funds

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Hedge funds' horror year *(The Telegraph)*

Investors retreat from hedge funds after tough December *(Reuters)*

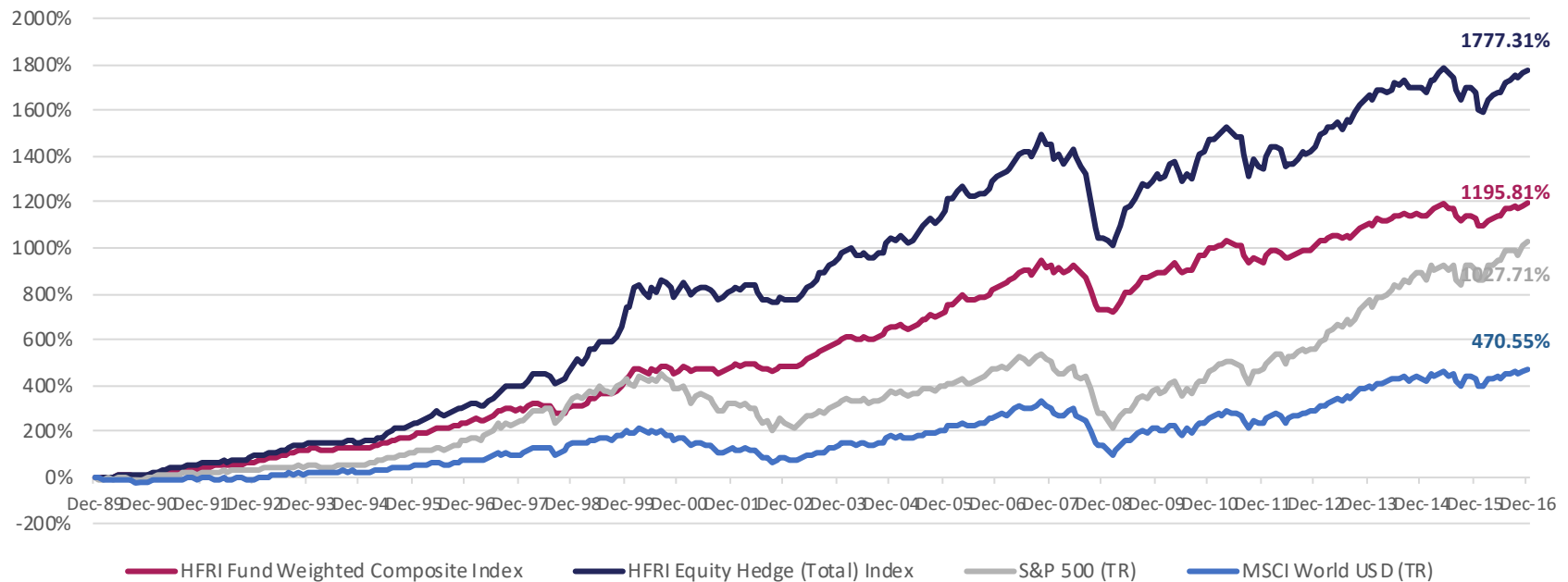
Hedge funds have sucked for a decade *(Pension Partners)*

Hedge funds overpriced, underperforming *(Financial Times)*

Performance protects capital

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Hedge funds versus main asset class cumulative returns:
Jan 1990 – December 2016

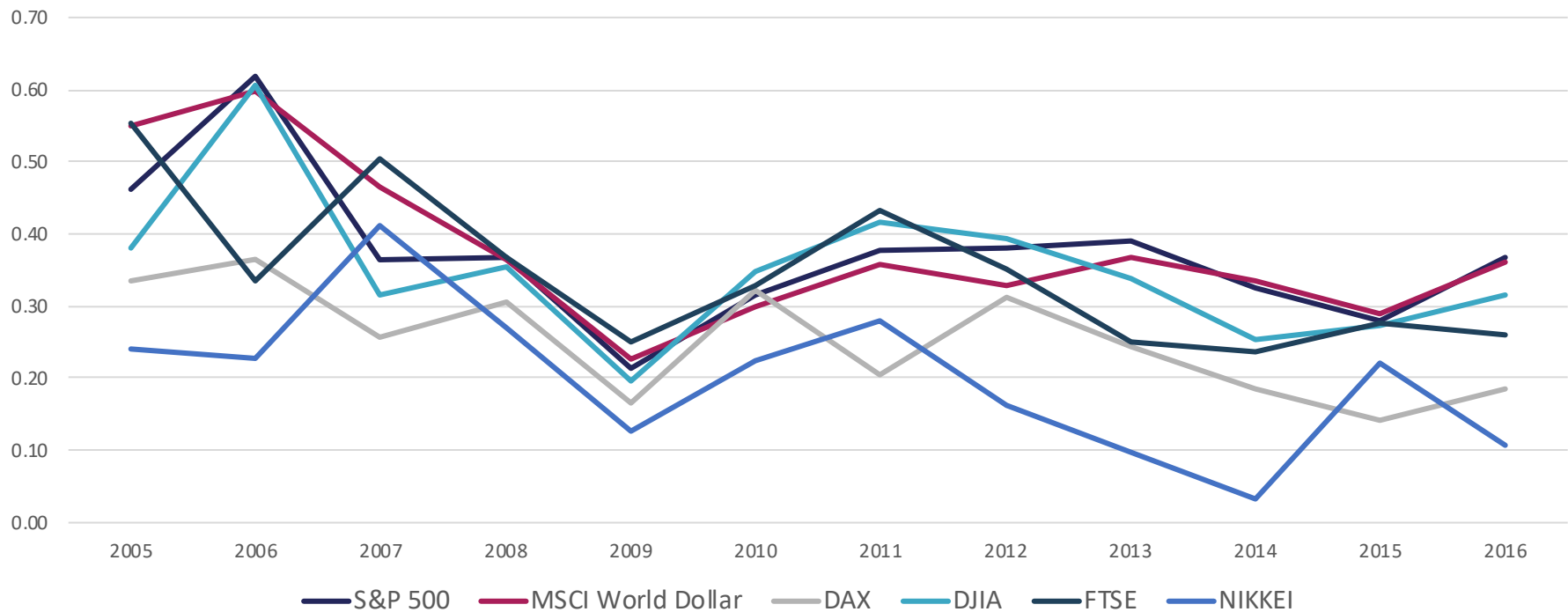


Source: AIMA Research, HFR, MSCI, Barclays, S&P

Hedge fund benchmarks?

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HFRI Fund Weighted Index Beta with equity markets



Source: AIMA Research, HFR

It's about risk-adjusted performance

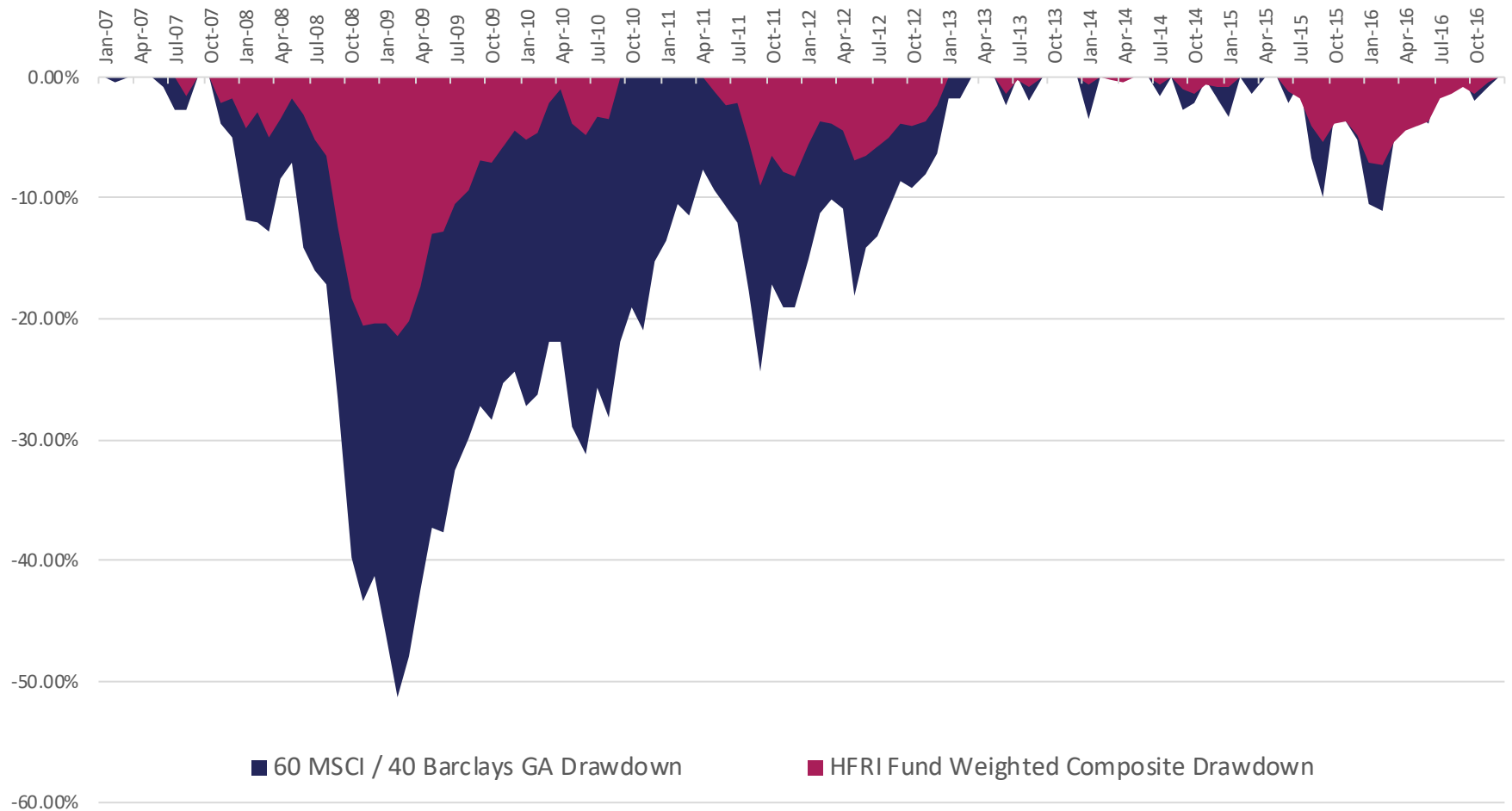
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20 Year Analysis				
Index	Cumulative Return	Annualised Return	Annualised Standard Deviation	Sharpe Ratio
HFRI Fund Weighted Composite	281.23%	5.31%	6.88%	0.56
HFRI Equity Hedge (Total) Index	360.70%	6.62%	9.12%	0.73
MSCI World Dollar TR	235.15%	4.37%	15.50%	0.28
S&P 500 TR	339.33%	6.30%	15.29%	0.41
Barclays Global Aggregate	136.52%	1.57%	5.65%	0.28
60 MSCI / 40 Barclays GA	229.39%	4.24%	14.68%	0.29

Source: AIMA Research

And drawdown protection

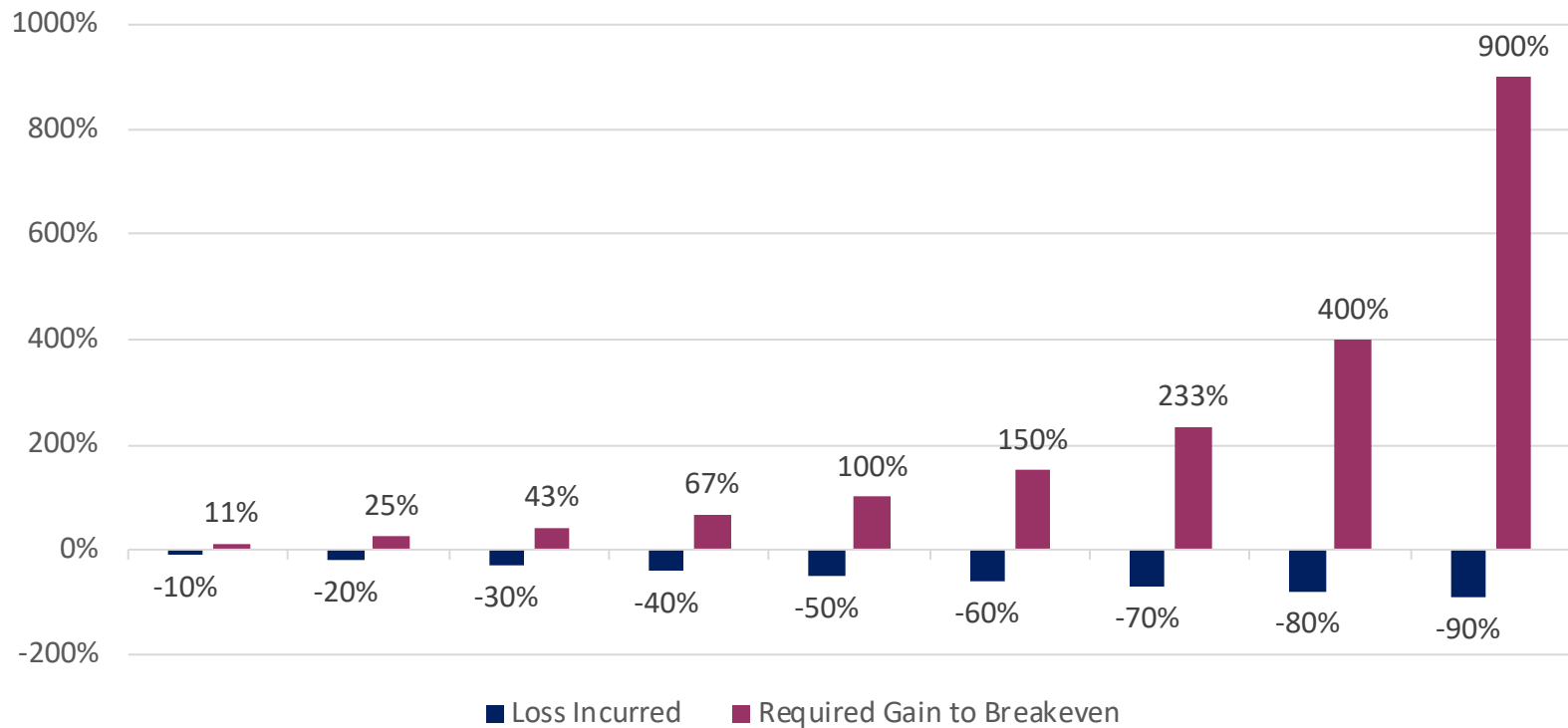
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Importance of drawdown protection

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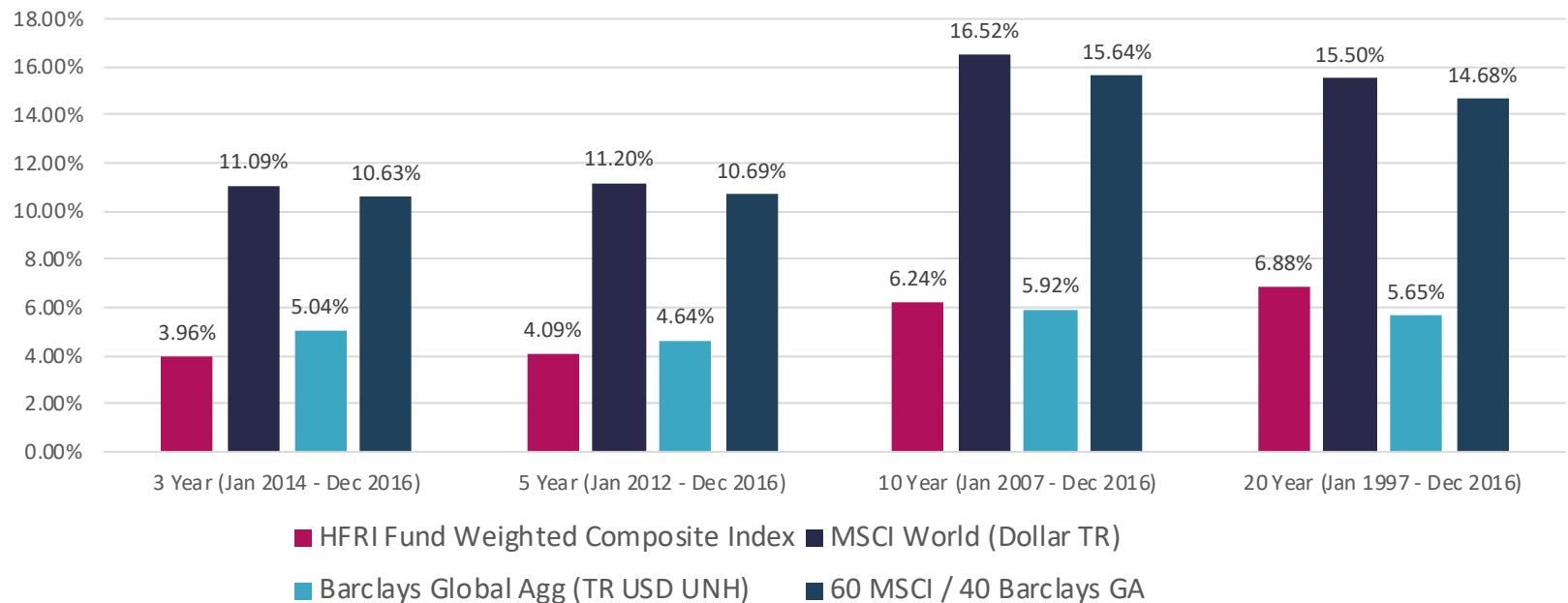
Power of Negative Returns



Volatility comparison

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Comparison of annualized volatility of hedge funds, equities and bonds

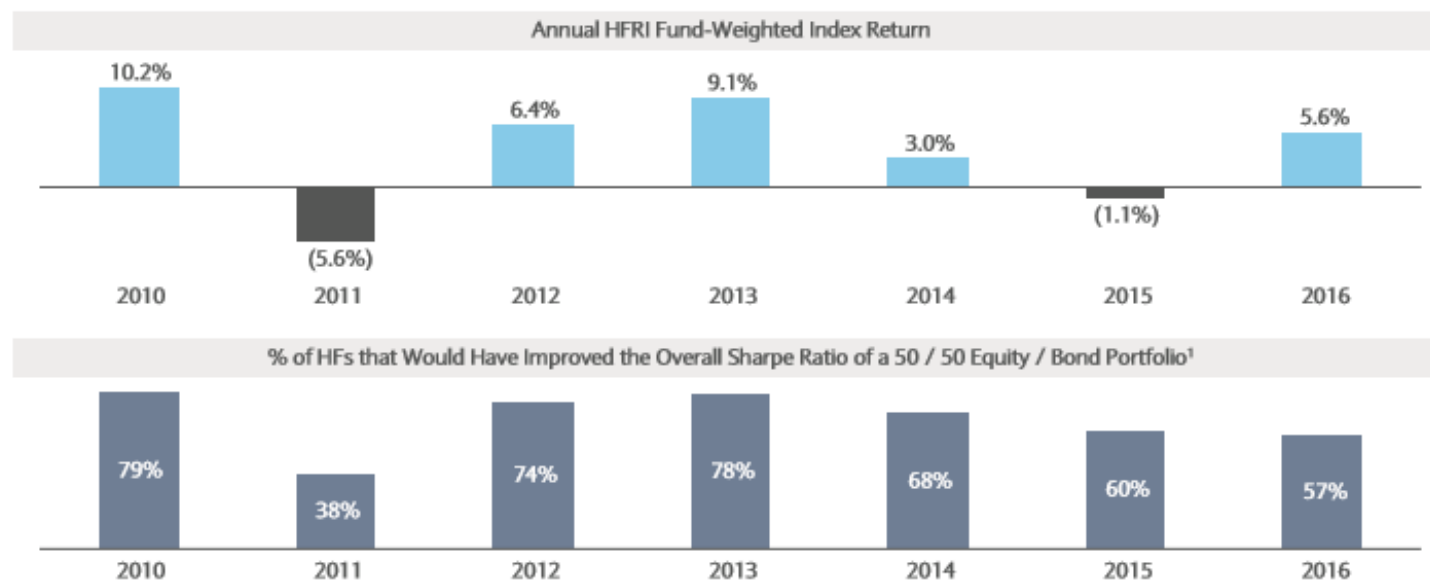


Source: AIMA Research, HFR

Adding value to investor portfolios

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FIGURE 10: HF Contribution to a 50 / 50 Equity / Bond Portfolio



Source: HFR, Strategic Consulting analysis. Data as of November 2016

1. 50 / 50 US portfolio composed of S&P500 Total Return Index and Barclays US Aggregate Bond Index. Fund judged to have improved the Sharpe Ratio of the portfolio if: Sharpe Ratio of Fund > Sharpe Ratio of 50 / 50 Portfolio * Correlation of Fund and 50 / 50 Portfolio

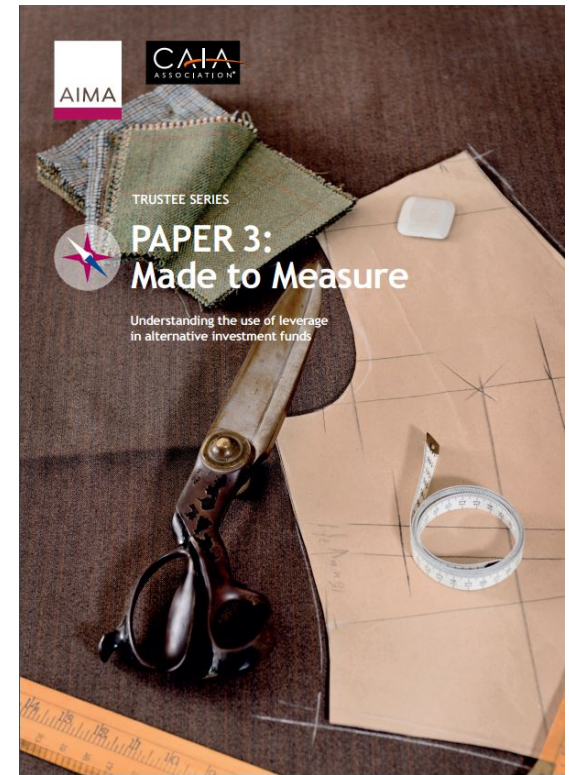
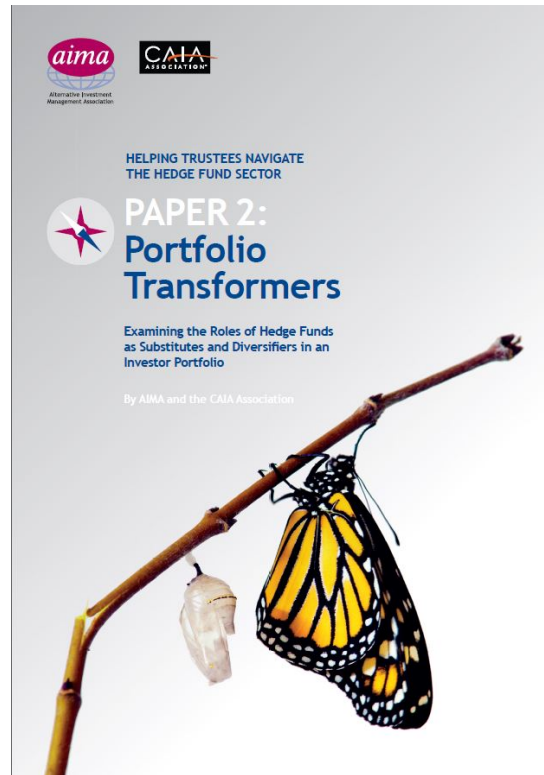
FIGURE 11: 2016 Achieved HF Returns versus Investor Expectations



Source: Barclays "Turning the Tide: 2017 Global Hedge Fund Industry Outlook and Trends"

AIMA Research at www.aima.org

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Source: AIMA Research

AIMA Canada contact

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