iCapital® NETWORK

HEDGE FUND

ESSENTIALS

HEDGE FUND ESSENTIALS

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EXECUTIVE SUMMARY

The **hedge fund** industry has come a long way from its hedged equity roots, when some of the earliest hedge funds — like Alfred Winslow Jones' investment partnership created in 1949 — gained notoriety among academics and professional money managers for employing techniques like **short selling** and using **leverage** to enhance returns. Jones' **fund**, for example, lost money in only 3 out of 34 years of business.[1] This ability to hedge market risk helped these funds build a reputation for outperforming traditional long-only investment portfolios — particularly in down markets — and for reducing overall volatility when added to an existing portfolio of stocks and bonds.

In a way, it's come full-circle. In the industry's early days, hedge fund **investors** consisted mainly of high- and ultra-high-net-worth investors, family offices, or others in-the-know. Then, beginning in earnest in the late 1990's, institutional investors began entering in the space. Now, over the last decade, there is again growing interest in hedge funds and other **alternative investments** from advisors and their high-net-worth clients.

This paper covers, in brief, the essential features of the hedge fund landscape. We discuss the key reasons for investing in hedge funds and evaluate the types of strategies employed, including long/short equity, relative value, event-driven strategies, credit, managed futures, and multi-strategy funds that make use of combinations of strategies to seek excess returns across a spectrum of market conditions.

The paper then turns to the question of access to hedge funds and explains the process of **due diligence**, whereby investors evaluate the quality and competency of select hedge funds to determine their suitability and the potential for meeting the investor's objectives. Due diligence is a topic that is covered in greater depth elsewhere, but this description provides a running start.

Moving on, we tackle the subject of fees and investment mechanics in the context of hedge funds. The paper offers insights on incentives, manager and investor alignment, asset allocation decisions, and hedge fund performance. Due to their unique strategy mix and investment process, hedge funds often require lock-ups and **gates**, where redemptions are concerned, in order to ensure liquidity through all phases of the investment fund cycle. However, stipulations on how fees are calculated are also a common feature of the investment agreement, with **high water marks** and **hurdle rates** serving to protect against managerial compensation that is disproportionate to actual performance.

Throughout the paper, charts and data that highlight and support the key points have been provided. We conclude the paper with a short glossary of essential terms.

For advisors and institutional investors alike, alternative investments, including hedge funds, are a valuable but complex feature of the investment universe today. Careful study and consultation with industry experts are the cornerstones for developing an informed view and making the optimal decisions about incorporating these offerings into a well-balanced and robust portfolio.

THE RISE OF THE HEDGE FUND INDUSTRY

The hedge fund industry can be traced back to 1949, when investor Alfred Winslow Jones established an investment partnership structured to be exempt from the regulations of the Investment Company Act of 1940, allowing Jones to employ techniques such as short selling and using leverage. Jones had notable success, losing money in only 3 out of 34 years of business[2], and became known as the "father of the hedge fund industry." The term "hedge fund" is derived from the fact that Jones — seeking to lower the portfolio's overall volatility by shorting and taking positions in negatively correlated assets that offset each other — described his fund as "hedged". Today, however, 'hedge fund' is largely a misnomer, as the range of investment strategies and assets within the hedge fund universe has expanded. In fact, many fund managers do not actually employ hedging as a cornerstone of their strategy.

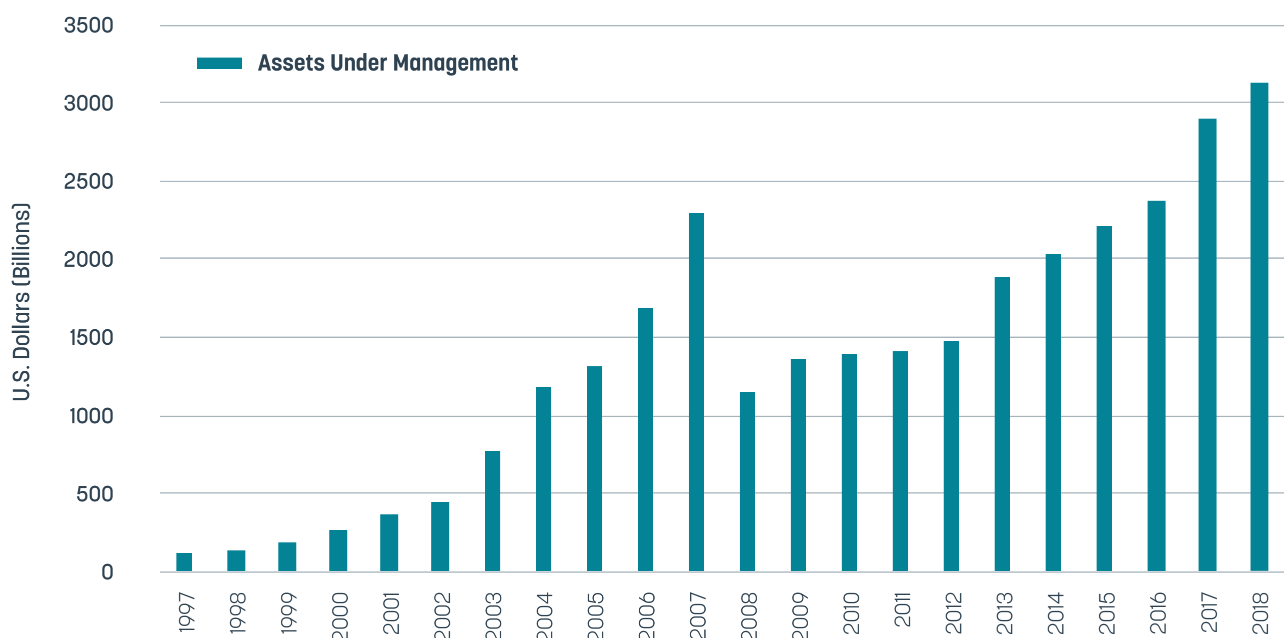
One of the easiest ways to understand what a hedge fund is, is to think of it in relation to mutual funds. The primary difference between the two is a regulatory one. Both are pooled investment vehicles, but mutual funds are publicly available to any investor, while hedge funds are private funds that follow specific regulatory exemptions setting limits on the number and type of investors that can participate, as well as how (and to whom) the funds can be marketed.

As a result, hedge fund managers have considerable investment flexibility. Not only can they invest in publicly traded stocks and debt securities, similar to mutual funds, but they can also be active in private markets, commodities, currencies, futures, swaps, or other derivatives. Further, they are not restricted from engaging in short selling — in effect betting that a particular investment will decline in value. In this way, fund managers can use short selling to build offsetting positions in an effort to 'hedge' the portfolio. Lastly, they have the ability to structure compensation arrangements that may entail charging an **incentive (or performance) fee**[3] in addition to a **management fee** — similar to Alfred Winslow Jones who set the standard of charging a 2% management fee and also taking 20% of gains.

Since its inception, the hedge fund industry has exhibited a significant upward growth trajectory, punctuated by "boom and bust" episodes, most notably with increases in popularity during the bear market of 1973-1974, the aftermath of the early 2000s technology bubble, and following the financial crisis of 2008. Over the last two decades, the number of funds and the aggregate assets under management (AUM) have risen steadily, from about 3,200 funds with approximately $143 billion AUM in 1998 to 11,000 funds with approximately $3.1 trillion AUM by late 2018;[4] see Figure 1.[5] In recent years, there has been a trend towards consolidation, with increased concentration of investor capital in medium-sized to very large funds.[6]

FIGURE 1

HEDGE FUND INDUSTRY ASSETS UNDER MANAGEMENT



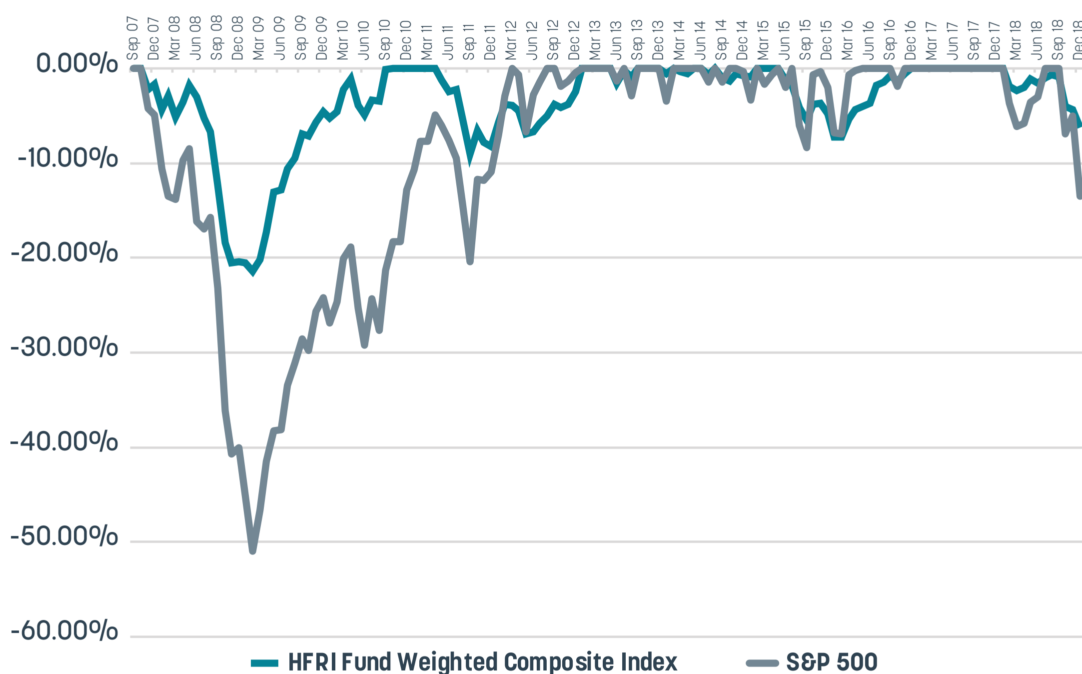
Source: HFR, Inc., as of December 2018

WHY INVEST IN HEDGE FUNDS?

At the most basic level, the ability to hedge investment risk has helped hedge funds to perform better in down markets than traditional long-only vehicles. Figure 2 depicts the lossmaking periods suffered by hedge funds and the S&P 500 Total Return (TR) Index during the global financial crisis and its aftermath, from 2008 to 2014, showing that the S&P 500 TR has seen more instances of **drawdown** and more severe drawdowns than hedge funds have experienced over the same period.

FIGURE 2

HEDGE FUND DRAWDOWNS:
HFRI FUND WEIGHTED COMPOSITE INDEX VS. S&P 500 TR



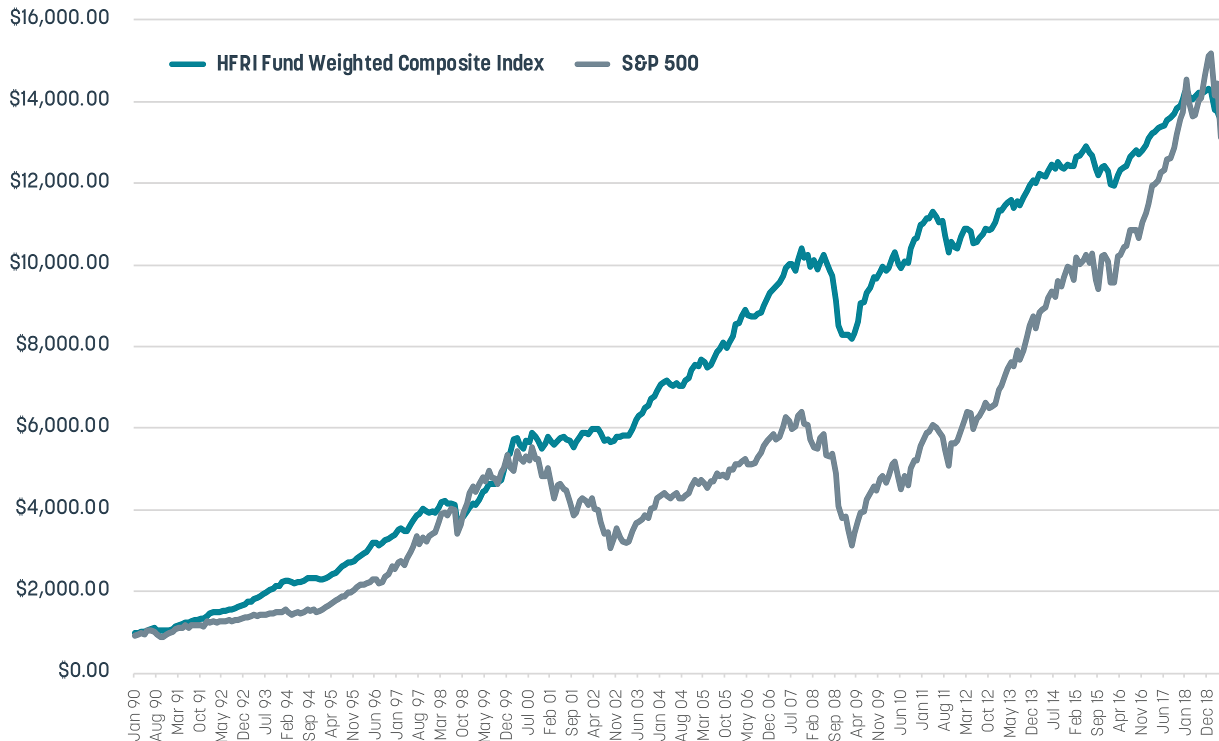
Source: HFR, Inc., as of December 31, 2018
For illustrative purposes only. Past performance does not guarantee future results.

Historically, hedge funds have earned a return similar to stocks, but at a level of volatility that is closer to bonds. From January 1990 to September 2017, the annualized **standard deviation** of the HFRI Fund Weighted Composite Index was 6.6%, compared to 14.3% for the S&P 500 TR and 3.6% for the Barclays Aggregate Bond Index.[7]

As shown in Figure 3, the HFRI outperformed the S&P 500 TR for the majority of the period between 1990 and 2017 in terms of a thousand dollars invested. The exception was the brief period leading up to the dot-com bubble in the late 1990s, but hedge funds outperformed significantly once the bubble burst.

FIGURE 3

HFRI WEIGHTED COMPOSITE INDEX VS. S&P 500 TR



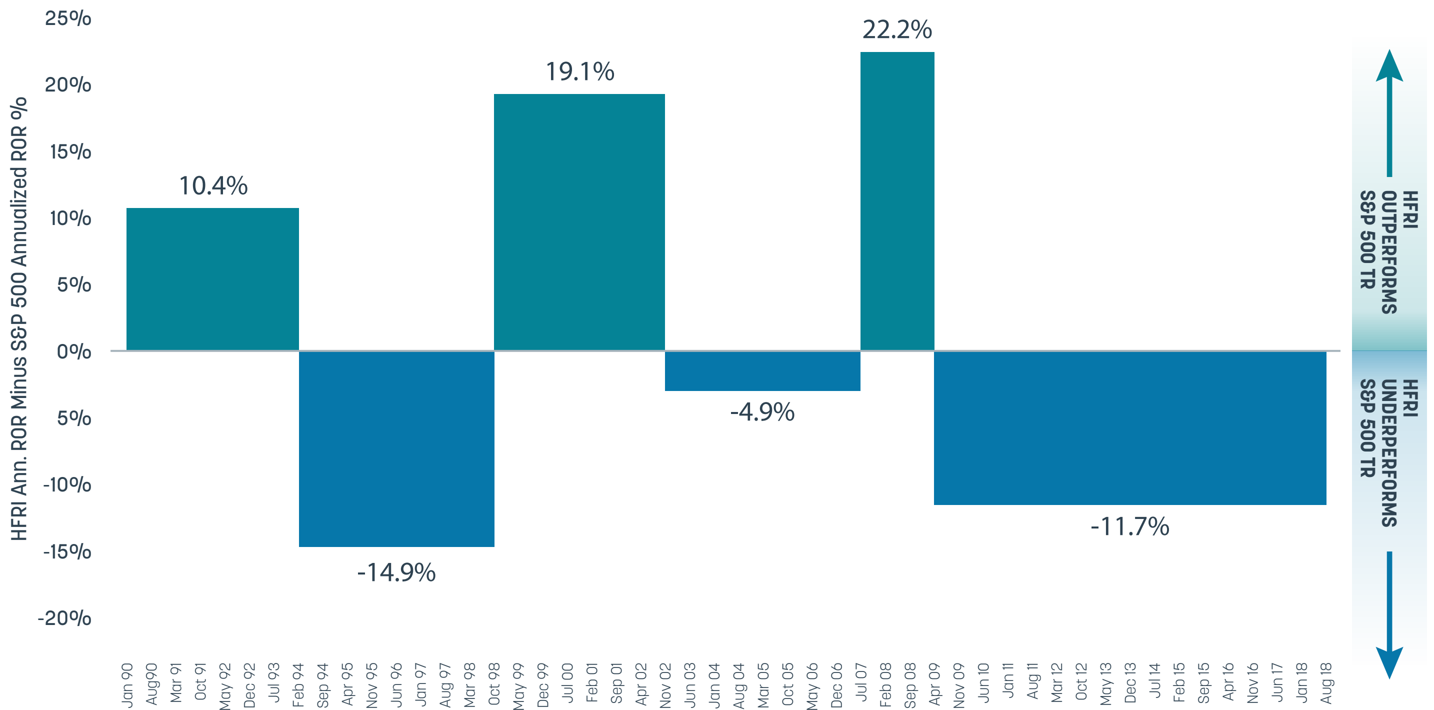
Source: HFR, Inc., as of December 31, 2018

Past performance is not necessarily indicative of future results. Diversification does not assure a profit or guarantee against a loss. Calculated using month-end data. See Glossary for definitions.

Taking a closer look, the long-term performance of hedge funds has tended to follow a cycle of ‘underperformance’ relative to stocks in rising markets, and outperformance relative to stocks in falling markets. As shown in Figure 4, stocks outperformed hedge funds during the bull markets from 1994 to 1999 and from 2002 to 2007. However, each bull market phase ended with a major bear market for stocks, during which time hedge funds outperformed. Because hedge funds typically maintain both long and short exposures, their outperformance relative to the index is not surprising.

FIGURE 4

ANNUALIZED PERFORMANCE GAP BETWEEN HFRI FUND WEIGHTED COMPOSITE INDEX AND S&P 500 TR



Source: HFR, Inc., as of December 31, 2018

Past performance is not necessarily indicative of future results. Diversification does not assure a profit or guarantee against a loss. Calculated using month-end data. See Glossary for definitions.

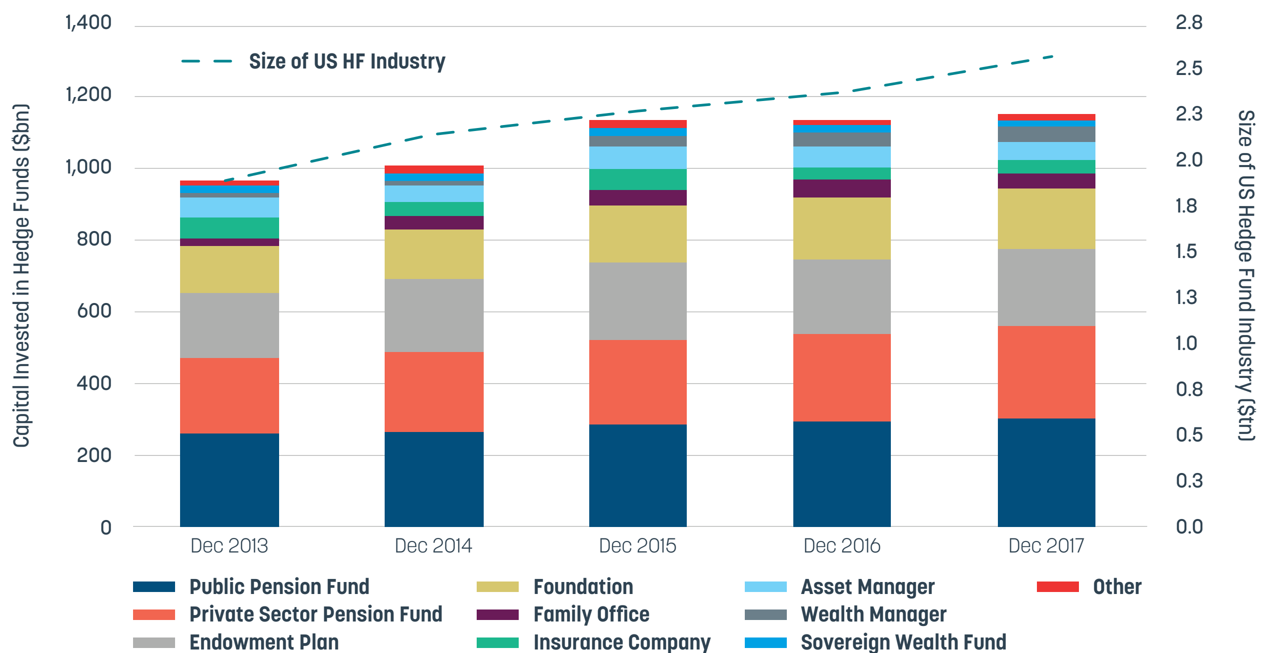
Hedge funds, as an alternative investment with unique capabilities, offer **diversification** from a traditional stock and bond portfolio. Further, there are many types of hedge funds, focused on specific sectors and approaches. This range of hedge fund investment activities reflects an additional layer of flexibility and diversification, based on strategies that exhibit various characteristics across different market environments.

As previously mentioned, most hedge funds rely on exemptions from the Securities Act of 1933 and the 1940 Act, which limits their availability to "sophisticated" investors, including institutions and high-net-worth individuals. About two-thirds of the industry's investors are institutions, with public and private pension funds contributing nearly half of all capital provided to hedge funds by U.S.-based institutions, as shown in Figure 5.[8] Individual investors are typically required to be "**accredited investors**," meaning "someone who has earned income that exceeded $200,000 (or $300,000 together with a spouse) in each of the prior two years, and reasonably expects the same for the current year, or someone who has a net worth over $1 million, either alone or together with a spouse (excluding the value of the person's primary residence).[9]

A hedge fund investor could also be a "**qualified purchaser**," which can be (i) a person with not less than $5,000,000 in investments; (ii) a company with not less than $5,000,000 in investments that is owned by close family members; (iii) a trust, not formed for the investment, with not less than $5,000,000 in investments; (iv) an investment manager with not less than $25,000,000 under management; or (v) a company with not less than $25,000,000 of investments.[10]

FIGURE 5

CAPITAL INVESTED IN HEDGE FUNDS BY US INSTITUTIONAL INVESTORS BY TYPE (EXCLUDING FUND OF FUNDS)



Source: Preqin Hedge Fund Online, as of December 2017

Investors may select from the broad array of hedge fund strategies available to meet various investment objectives. For many investors, the reason for allocating capital to hedge funds is not so much to achieve a higher absolute rate of return, but rather to improve a portfolio's risk-adjusted returns, with hedge funds acting as a diversifier to lower the volatility overall.

HEDGE FUND STRATEGIES

Hedge fund strategies extend across all markets, from equities and bonds, to commodities, currencies, credit, and derivatives. They can be guided by fundamentals or they may be driven by **quantitative** methods, which explore not only the value of individual stocks or other assets, but also make use of statistical analysis and may focus on exploiting trading patterns, sectoral trends, or the rise and fall of volatility, for example, over time.

In order to generate returns in excess of the market return, hedge fund managers have developed a wide range of investment strategies that target an equally diverse range of investment objectives, or seek to take advantage of specific market opportunities or inefficiencies. These strategies encompass market-neutral approaches, which exhibit low **correlation** to overall market performance and **directional strategies**, which seek to benefit specifically from market movements.

Security selection decisions may be directed entirely by investment professionals (**discretionary investing**), strictly based on computer models (**systematic investing**), or may entail a combination of both approaches. A hedge fund may also pursue several strategies simultaneously, reallocating its assets in a dynamic manner, as market conditions change.

For investors and advisors considering an allocation to hedge funds, it is important to develop an understanding of the most common strategies and investment styles. While there are common themes and some overlapping of categories, one can begin to segment the hedge fund universe with a general classification system. Here we will discuss six of the broadest strategy types: long/short equity, relative value, event-driven, credit, global macro, and managed futures, covering key subcategories for some of them. We will conclude this section with a comment on multi-strategy funds.

Long/Short Equity

One of the most common hedge fund types, the long/short hedge fund, comes in two basic styles, fundamental and quantitative. Fundamental fund managers conduct traditional, bottom-up analysis on a company's business prospects compared to its competitors and the current economic environment. This includes visiting with company management teams, consulting Wall Street research, and contacting customers and competitors. These hedge fund managers tend to focus their investments on specific industries or market segments where they may have deep insight or an informational 'edge,' as sector expertise can be critical to successful investment judgment.

In contrast, quantitative long/short funds (quant funds) rely less on human analysis and instead will engage in programmatic, or **algorithmic investing**, where trades are determined largely by algorithms that sift through market data to find pricing anomalies. Quant funds are generally active in a broader range of markets, collecting as much data as possible for analysis, and holding a large number of positions.

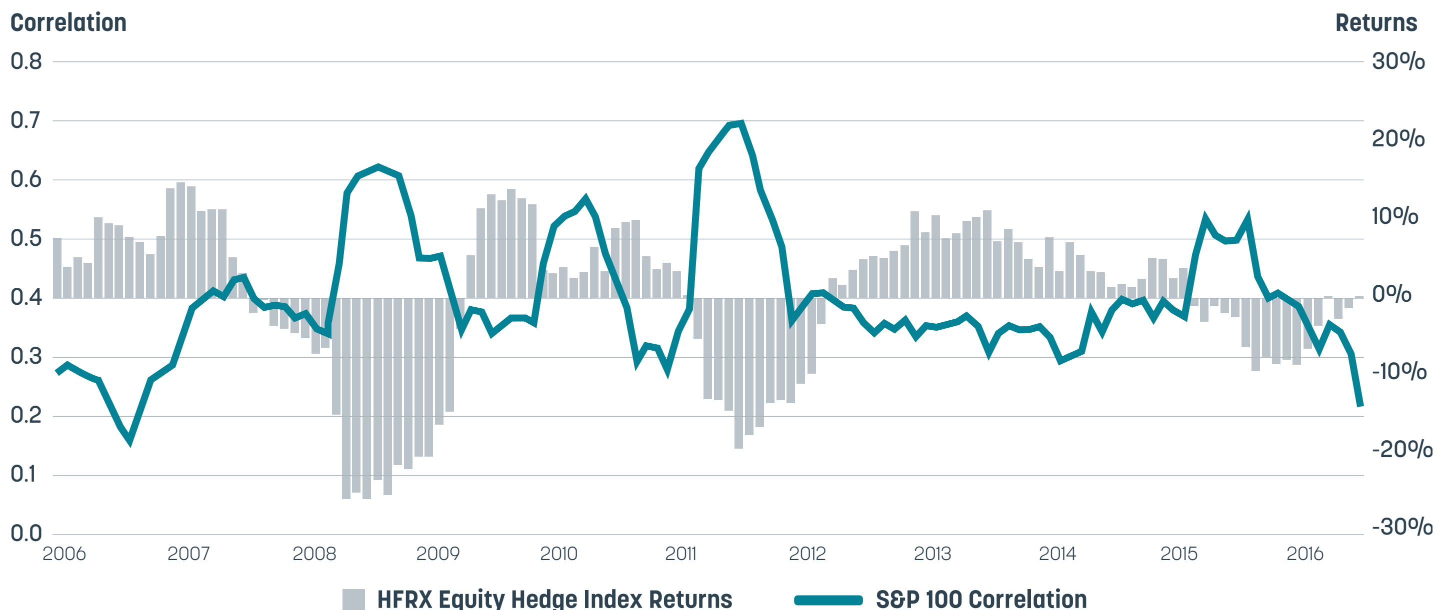
Long/short equity strategies are characterized by the ability to take both long and short positions in individual stocks. At a basic level, portfolios are constructed by combining a core group of long positions in stocks that a manager believes will increase in value, with short positions in stocks that they believe will decrease in value. Strategies can be defined by market exposure, or the proportion of long to short positions in a portfolio. Fund managers may operate with a long or short bias, or they may choose to shift their exposure opportunistically to position the portfolio in anticipation of changing market conditions. A strategy that seeks to balance the long and short exposures is said to be "market-neutral." An industry or regional focus, or the methods that fund managers use for stock selection, can further define long/short equity strategies.

Historically, the most advantageous environment for long/short strategies has been characterized by low correlations between equities, which generates greater opportunity on both the long and short sides. Figure 6 illustrates the average **pairwise correlation** for the S&P 100 versus the rolling returns of the HFRX Equity Hedge index, which broadly measures the performance of equity long/short managers. The data shows that these managers tend to outperform during periods of low correlation and to underperform when correlations are high.

SHORT SELLING may be used by managers to help hedge the risks of individual stocks, the risk of the portfolio overall, or as stand-alone source of potential return. Stand-alone short strategies tend to fall into one of three categories, each betting against the category in question: (i) fads, (ii) frauds, and (iii) struggling/failing businesses. The goal is to borrow stock and sell it high, then buy the stock back at a lower price and return it to the original owner, harvesting the difference as return.

FIGURE 6

S&P 100 AVERAGE PAIRWISE CORRELATION VS. ROLLING 12-MONTH RETURNS OF HFRX EQUITY HEDGE INDEX



Source: FactSet, Bloomberg.
Neuberger Berman, Hedge Fund Perspectives 2017

Relative Value

Relative value strategies focus on perceived mispricings between related financial instruments. This type of hedge fund uses spread trades — going long a security perceived to be undervalued, while shorting another security perceived to be overvalued — and plan to exit their positions when both securities return to their "fair value." Relative value managers profit when the spread between the two securities returns to fair value, at which point they unwind their positions. These strategies can be applied to any type of related securities, including stocks, futures, options, currencies, and commodities. Relative value is a form of arbitrage; Figure 7 illustrates examples of several common arbitrage strategies.

FIGURE 7

POPULAR FORMS OF ARBITRAGE

STRATEGY	DESCRIPTION
Fixed Income Arbitrage	Takes advantage of inefficiencies in bond prices, typically in U.S. Treasury (or other sovereign country) securities, interest-rate swaps, or asset-backed securities.
Convertible Bond Arbitrage	Focuses on situations where a company's convertible bonds are mispriced relative to the underlying credit and equity components.
Capital Structure Arbitrage	Takes long and short positions in mispriced securities within a single company's capital structure (e.g. long equity, short debt).
Equity Arbitrage	Market-neutral investments targeting discrepancies in the valuation of the equity of two similar companies, or the equity of a single company that is listed on two different stock exchanges.

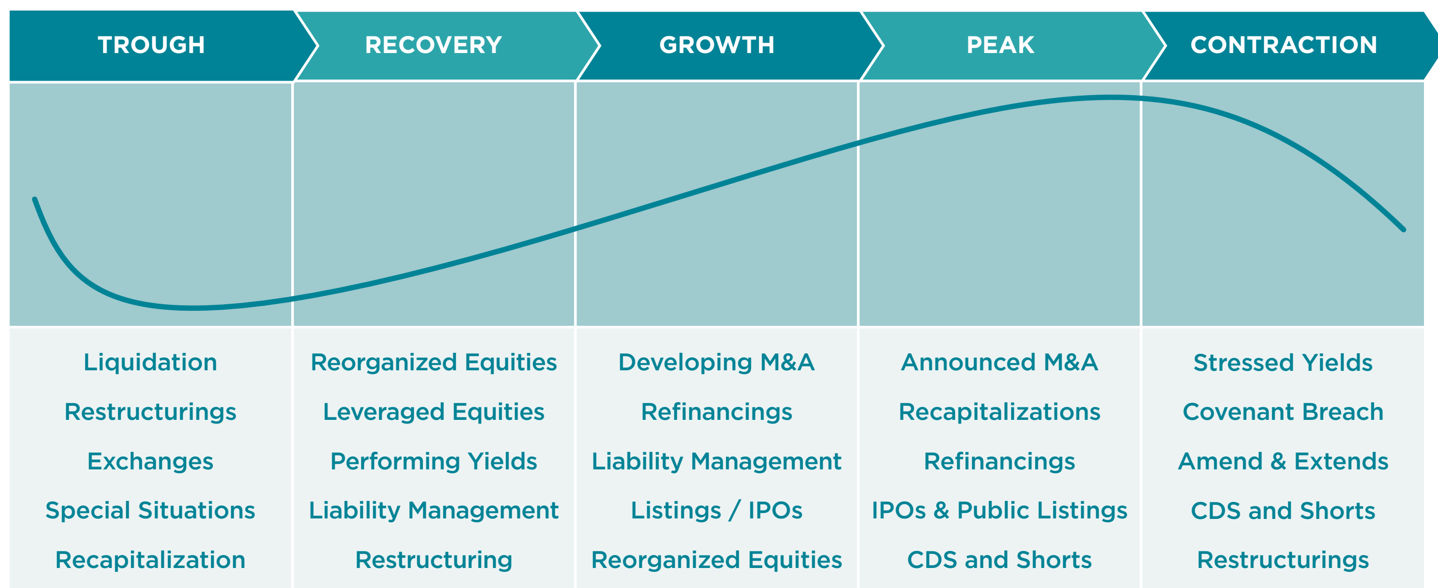
Because the price discrepancies between very similar instruments tends to be small, relative value hedge funds will commonly employ leverage to help increase returns, either through borrowing directly or by creating leverage through swaps and other derivatives. The downside of this use of leverage is that it can significantly increase risk should the value discrepancies persist or increase. To help mitigate the risk from leverage, firms often employ multiple relative value strategies. These strategies will have limited correlation with each other, allowing the firms to generate the same returns using lower leverage.

Event-Driven Strategies

Event-driven strategies are designed to take advantage of price movements in securities affected by corporate actions such as M&A deals, spin-offs, restructurings, or bankruptcies. There are numerous types of event-driven funds, typically defined by the events they focus on. Figure 8 shows sample categories and a business life-cycle that would be of interest to an event-driven hedge fund.

FIGURE 8

DIVERSITY OF EVENT-DRIVEN INVESTMENT OPPORTUNITIES OVER TIME



TROUGH	RECOVERY	GROWTH	PEAK	CONTRACTION
Liquidation	Reorganized Equities	Developing M&A	Announced M&A	Stressed Yields
Restructurings	Leveraged Equities	Refinancings	Recapitalizations	Covenant Breach
Exchanges	Performing Yields	Liability Management	Refinancings	Amend & Extends
Special Situations	Liability Management	Listings / IPOs	IPOs & Public Listings	CDS and Shorts
Recapitalization	Restructuring	Reorganized Equities	CDS and Shorts	Restructurings

Merger Arbitrage (also known as Risk Arbitrage)

Merger arbitrage is the best-known strategy within the event-driven investment category. These managers seek to take advantage of price movements in the stocks of the acquirer and target companies when a merger is announced. Until a merger is completed, there is usually a difference between the takeover bid price and the current stock price of the takeover candidate, reflecting the risk that the merger may not happen as proposed.

To form an opinion about the likely outcome of a deal, hedge funds will undertake a detailed financial analysis on the companies involved. They will supplement this research with merger analysis through computing merger multiples, assessing the purchase premium, and analyzing the overall financial merits of the deal. They will also conduct a detailed review of the merger agreement, diagnosing deal contingencies and possible regulatory issues that could affect the timing or ultimate consummation of the transaction. Networks of industry experts are often consulted as part of this due diligence process

Merger arbitrage is typically a subset of a manager's portfolio, as the volume of takeovers taking place tends to be highly cyclical and therefore the number of opportunities for merger arbitrage varies substantially. To control for risk, most merger arbitrage hedge funds will have a broadly diversified portfolio and a maximum loss limit at which they will exit a merger arbitrage position.

Spinoffs, Restructurings, Pre-Merger, and Activism

A similar approach can be applied to other corporate events occurring in the market such as spinoffs, restructurings, and potential mergers. These strategies involve entering a position either in response to, or in anticipation of potential corporate events.

Some fund managers accumulate large shareholdings in order to influence company management and encourage the desired outcome. This approach falls under the guise of "constructivism" if done behind the scenes (e.g. private conversations with management or presentations to the company board). The alternative approach, activism, is more easily recognized publicly, as it is widely reported in the press.

A typical trigger for an activist manager will come when a fund owns over 5% of the target company. At this threshold, SEC regulations require the fund to report its holding by filing either a Schedule 13G, where it commits to be a passive investor, or a Schedule13D, which indicates the investor is actively seeking to try and exert control. Activist managers will publicly advocate for changes, such as the replacement of company management or divesting a non-core division, and will often seek representation on the company's board of Directors.

Distressed

The term "distressed" securities is used broadly by hedge funds. It primarily refers to companies that are undergoing bankruptcy or restructuring, or are trading at significant discounts relative to their peers. Hedge funds executing distressed investment strategies are active in all of a company's securities, as they require the flexibility to invest across the capital structure, depending on the nature of the bankruptcy and the structure of the company's assets and liabilities.

Distressed strategies can overlap with private equity investments, as they may involve the manager taking a key debt or equity position and attempting to become part of a group that provides debtor-in-possession (DIP) financing, or owns the company outright post-restructuring. Hedge funds can also take advantage of shorter-term trading opportunities surrounding a distressed company's outstanding equity and debt securities.

Credit Strategies

Credit strategies share similar trading approaches with a number of other strategies, including, long/short equity, event-driven, and relative value, but they apply them exclusively to the broad range of instruments available in the global public and private credit markets. The underlying credit strategies include asset-based lending and leasing, long/short credit, and other specialist strategies. The instruments traded include corporate and government bonds, mortgage-backed securities, collateralized loan obligations, and other types of asset-backed securities and loans. Consequently, there are numerous trades possible under the rubric of credit strategies. A fund can take long and short positions in different credit instruments — long a corporate bond and short a high yield index, for example, to express a view that a company's credit will do better than the index. Or a fund could go long and short credit

One of the most famous examples of a successful global macro strategy involved George Soros' bet against the British pound in 1992. In 1990, the United Kingdom joined the European Exchange Rate mechanism (ERM), a precursor to the Euro in which countries agreed to maintain their national exchange rates within a predetermined band relative to the German Deutschmark, instead of "floating" their currency and letting capital markets set the rates. In 1992, Britain fell into recession. The normal response to a weak economy would be cutting interest rates, but doing so would push the pound's value below the agreed upon limit, as it was already trading at the low end of the predetermined ERM band. What kept the pound from plummeting in value was the British government's guarantee that it would keep the pound within the ERM band by buying pounds on the open market for about 2.95 Deutschemarks. Given this macroeconomic backdrop, Soros realized that the likelihood of the Bank of England successfully propping up the pound at this level over the long term was effectively zero and he built a sizable short position against the pound. On September 17, 1992, after desperately hiking interest rates twice to no effect, the British government abandoned the ERM and floated its currency on the market, causing the pound to fall 15% versus the Deutschmark and 25% versus the US Dollar. The value of the Soro's Quantum Fund increased almost instantly from $15 billion to $19 billion.

instruments of the same company with different durations — long a company's 1-year bond and short its 10-year bond — expressing a view on the company's short-term solvency as compared to its long-term creditworthiness.

Global Macro

Global macro strategies seek to benefit from observations and predictions based on broad economic activity, political outcomes, and differing macroeconomic policies employed by countries around the globe. As a result, fund managers typically have wide latitude to structure trades using virtually any trading strategy, financial instrument, and market in the world. Strategies may involve trading instruments directly influenced by interest rates and exchange rates, or indirectly by broad macroeconomic indicators such as inflation, unemployment, industrial production, foreign trade, and liquidity flows. Fund managers regularly employ leverage and may trade in established and emerging markets. Due to the immense scope of these strategies and the fund's international focus, global macro funds tend to be much larger than funds engaged in other strategies. Historically, some of the best-known funds have managed assets far in excess of $10 billion.

Managed Futures

Managed futures funds specialize in trading the global commodity and futures markets. They are most often associated with systematic trend-following strategies that employ sophisticated computer-driven trading programs to analyze, and profit from, recognized price trends in either direction (rising or falling) across asset classes and markets they trade. However, they can also be discretionary (relying primarily on human-based trade selection and execution), or a combination of systematic and discretionary, or run market-neutral strategies. Market-neutral strategies focus on spreads and arbitrage opportunities, e.g., statistical arbitrage. Hedge funds employing managed futures strategies are registered with the Commodity Futures Trading Commission (CFTC) and the National Futures Association (NFA) as Commodity Trading Advisors (CTAs) and/or Commodity Pool Operators (CPOs).

While global macro and managed futures funds display low correlation to traditional markets and to other hedge fund strategies, managed futures strategies exhibit the property of positive conditional correlation — a higher correlation with stocks in up markets, and often negative correlation in down markets. This underscores the ability of managed futures funds to preserve and even grow capital during market crises.

Multi-Strategy

Large hedge funds often employ teams of specialist portfolio managers dedicated to different investment strategies as a method of managing risk and diversifying their source of returns. This approach provides multi-strategy funds with deep insight across their range of strategies, as well as proprietary data that can be used to develop sophisticated risk management systems. Multi-strategy funds are able to allocate capital dynamically between strategies as the opportunity set changes, or to put additional capital to work for high-conviction investment ideas. When executed well, this approach is designed to generate consistent returns with low volatility, regardless of overall market conditions.

ACCESS TO HEDGE FUNDS

For those interested in investing in hedge funds, one of the first steps likely involves determining what role the allocation is intended to play in the portfolio and then assessing the best way to allocate with that objective in mind. The next step involves gaining access to managers and funds with the desired characteristics. In each case, the investor should read the fund prospectus carefully and ensure that its management, goals, strategies, and operational details are well-understood and in alignment with the investor's own goals, risk profile, and ability to support an allocation to this type of investment vehicle. The paths into hedge funds takes several forms, each with benefits, but also caveats, which pertain to the type of investor, level of sophistication, and resources that can be deployed in the effort.

Direct Access

Some investors seek direct access to funds, where they become **limited partners** (LPs) and communicate directly with the fund manager, or **general partner** (GP). For accredited or qualified investors, the challenge lies in researching and choosing the right fund or funds, and being accepted by the fund as an LP. While institutional investors, such as a pension fund, or even a large asset manager, such as a foundation or a multifamily office may only be able to effectively complete the required research, most high-net-worth individuals likely do not have the network or resources to source and conduct due diligence on high-quality hedge fund managers on their own. Or they may not have the level of assets required to diversify across several funds efficiently (i.e., investing in one hedge fund is typically not a recommended strategy). Having access to resources for evaluating and monitoring a group of individual funds is essential for success. Further, many fund managers prefer to work with experienced investors. One might have the time for research, the ability to choose appropriate funds, and even have enough money to make multiple allocations, but still not be ensured acceptance as a limited partner. Some funds, high performing funds in particular, are closed to

new investors, and other funds may not be ideal for various reasons. Specific issues include the minimum investment size, transparency into investments, and practical concerns, such as **lock-up periods** and gates. In all cases, having a trusted partner in the search for the right funds will help to mitigate the risks and support the allocation process.

Liquid Alternatives, or '40 Act Funds

Some investors will gain access to hedge funds through '40 Act funds,[11] which are part of a new wave of investment products known as "Liquid Alternatives," or "Liquid Alts." These funds are available through alternative investment vehicles structured as mutual funds. The term "'40 Act" refers to the Investment Company Act of 1940, which created provisions for such funds.

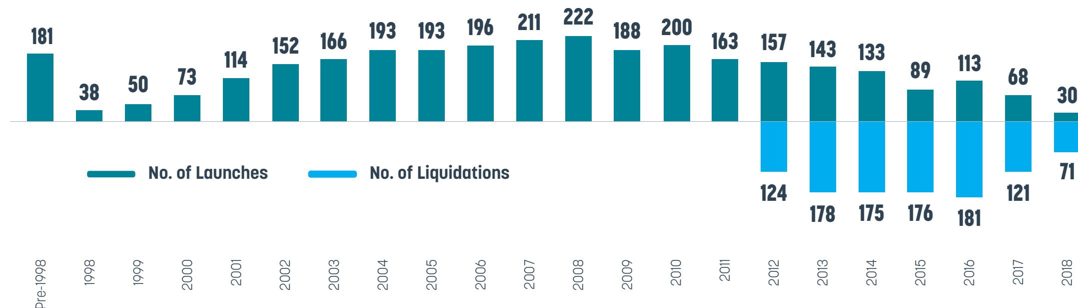
Fund-of-Funds

Another way to gain exposure to a range of strategies is to invest in a **fund-of-hedge-funds**, a vehicle that invests capital into multiple hedge funds. Fund-of-hedge-fund managers focus on sourcing and selecting individual hedge fund managers to construct multi-manager portfolios to meet a range of investment objectives. For these services, they charge investors an additional layer of management and incentive fees, which is an important consideration for investors.

FIGURE 9

FUND OF HEDGE FUND LAUNCHES AND LIQUIDATIONS BY YEAR OF INCEPTION/LIQUIDATION

PRE-1998 – 2018



Source: Preqin Hedge Fund Online
For information purposes only. Past performance does not guarantee future results.

In recent years, the fund-of-hedge-funds industry has experienced a significant drop in AUM, collectively managing $279 billion as of September 2018, compared to $1.20 trillion in AUM in June 2008. As Figure 9 shows, the trend in fund-of-hedge-fund launches tells a similar story, declining from a peak of 207 in 2007 to 65 in 2016, and showing just ten launches in the first half of 2017.[12]

These shifts are largely the result of institutional investors moving capital out of fund-of-hedge-funds in favor of investing directly with the underlying managers, thereby avoiding the additional layer of fees and retaining control over manager selection and monitoring. However, running a successful direct hedge fund investment program requires the ability to select and gain access to the best funds, as well as sufficient capital to meet individual fund minimums. Thus, fund-of-hedge-funds do have value for investors who do not have the resources to evaluate and access funds on their own. Whether investing directly or working with fund-of-hedge-funds to develop a hedge fund component to a portfolio, knowledge of the hedge fund due diligence process will be a critical component for long-term success.

HEDGE FUND DUE DILIGENCE

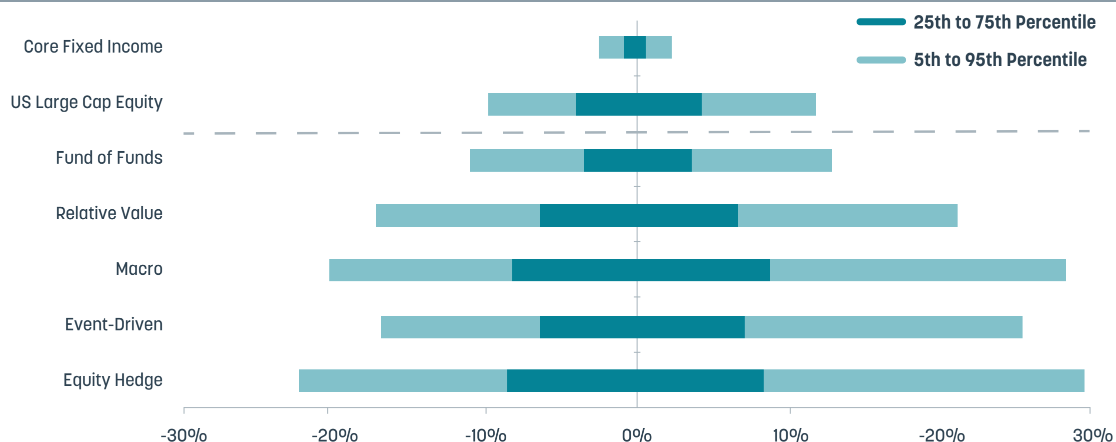
As mentioned previously, the fund prospectus outlines the fund manager's objectives, strategy, and operational details. Due diligence is the process of evaluating a fund to identify and understand the key factors and risks driving performance, prior to making an investment, and then monitoring the fund closely to ensure that those factors remain present and relevant over the life of the investment. Because hedge funds cover such a broad range of investment styles and strategies, it requires an equally broad range of resources and expertise to run an effective due diligence program.

For example, some fund managers are better at identifying and researching undervalued securities, while others excel at seeing secular trends that will impact certain industries, and still others have a well-honed understanding of how changing macroeconomic variables across the globe will impact asset prices. Investors must understand the manager's strategy and their strengths and weaknesses, as well as be able to discern how the fund may help them meet their overall investment objectives.

As shown in Figure 10, there is considerable variation in hedge fund manager performance, both within and across strategies.

FIGURE 10

ANNUAL MANAGER DISPERSION FROM MEDIAN PERFORMANCE BY STRATEGY SINCE 2000



Source: 2016 PGIM whitepaper, "Revisiting the Role of Alternatives in Asset Allocation"

With the goal of picking the right managers for the right allocations, hedge fund due diligence is structured around the following categories:

Investment Strategy & Market Opportunity

An investor will first identify a manager's investment strategy and the financial instruments, leverage, and market exposure that will be used in executing this strategy. Developing sufficient knowledge about the strategy will help an investor focus the due diligence effort on understanding the manager's strengths and weaknesses in that context. Investors should also consider whether the current environment is conducive to the chosen manager's investment strategy, or whether the investment is intended as a strategic, all-weather allocation that may not outperform over the short term, but can provide protection in a downturn, or outperformance in an upturn. An investor can then make an informed judgment about how the hedge fund will impact their portfolio.

Team

The capabilities of the team that will be sourcing, researching, structuring, monitoring, and managing the firm's investments are a critical determinant of ultimate returns. A prospective investor will investigate the backgrounds and experience of the firm's investment professionals, as well as the team's continuity and experience in working effectively together. The investor will also assess the size and quality of the current team in terms of the fund's size, the number of positions, and the turnover of those positions.

Most hedge funds trade regularly, so it is important to understand how managers make decisions to initiate and size investment positions. While the final decision may rest with the principal, the influence that different team members have over the decision process and the change in that influence over time are often major contributors to performance. Focusing on the contribution of team members, understanding the team's internal dynamics, the compensation structure, and the principal's view of the team can help an investor to identify the relative importance of the team and its individual members. This research should be supplemented by reference calls, a standard component of institutional diligence, which are useful to confirm the attribution claims of individual team members and to ensure that the professionals responsible for past successes are still with the firm.

Idea Generation and Research Process

Most investors focus their due diligence on the idea generation and research process, which is where most funds generate their added value. A prospective investor is seeking to understand how a manager generates ideas as the nature of public markets rewards those who are early in finding opportunities. The research process and its strength and repeatability are key determinants of fund performance. Here the prospective investor wants to ensure that the research process fits into the fund's investment strategy, with requisite time and depth focused on the appropriate areas. Managers with a long-term thesis on a company, for example, should focus on in-depth fundamentals, such as meeting with management, suppliers, and customers to better

comprehend the long-term prospects for the business. Managers with a trading-oriented approach will have a different process, as they will assess the key drivers of the company's fundamentals but must also understand what might move the stock price in the short term.

EMERGING MANAGERS

New, or "emerging" managers may be seen as a distinct category in the hedge fund world, owing to the potential ability to outperform their larger peers. Although they require additional due diligence, they can present attractive opportunities for investors and are typically actively seeking capital, as they build their businesses. Emerging funds have several advantages over their larger more established counterparts:

A BETTER OPPORTUNITY SET: Emerging managers, having smaller funds, are able to invest in smaller stocks, and they can also take larger positions relative to their fund size, while the potential investment's capacity may be the limiting factor for a large fund looking at the same investment.

SPECIALTY: Emerging managers will typically have a narrower focus than large funds. The founder's background and experience drives this specialty, typically in a market segment (such as small caps) or sector (such as healthcare or technology). This defined focus, combined with the founder's detailed knowledge in the domain, will lead to high conviction portfolios.

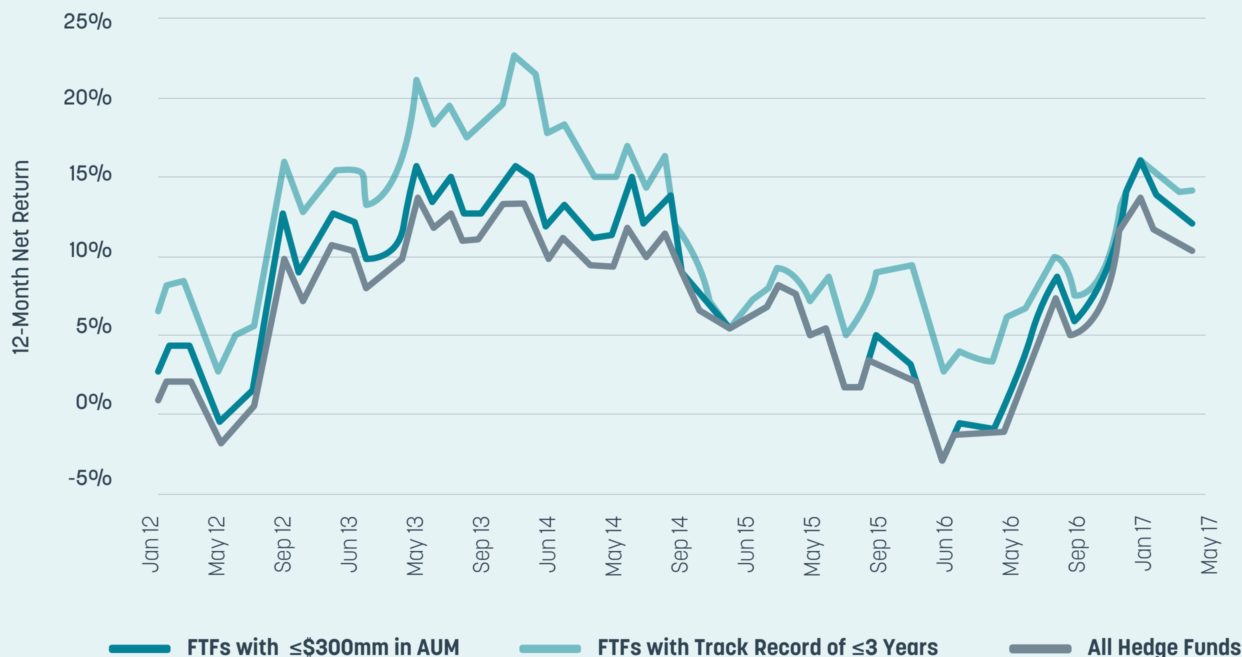
TALENT: The best managers self-select to start their own firms, having previously developed a track record and gained valuable experience at an existing firm.

MOTIVATION: Many motivational factors help drive smaller managers to focus on returns. A limited asset base will mean that the **performance fee** represents the majority of their personal profit, the entrepreneurial desire to succeed will be strong, and the small size of the team means that the founder will be more intimately involved with all aspects of the portfolio.

Figure 11 depicts the 12-month returns of first time hedge funds, as compared to their more established peers. Figure 12 shows the performance of first time hedge funds against their peers with up to a 3- year track record and then against all hedge funds.

FIGURE 11

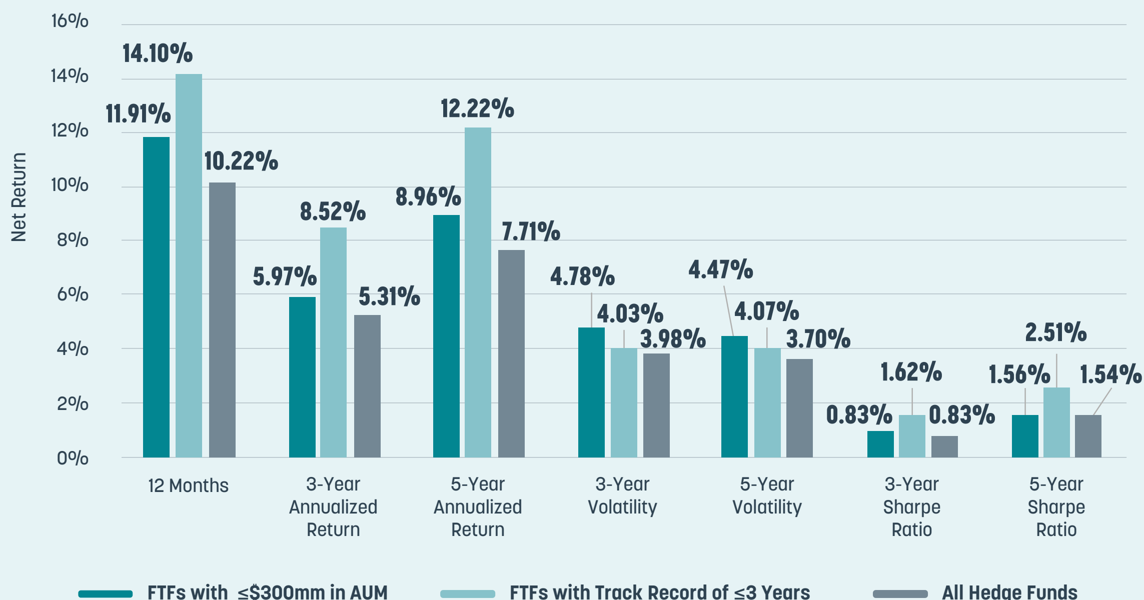
ROLLING 12-MONTH RETURNS: FIRST TIME FUNDS VS. ALL HEDGE FUNDS



Source: Preqin Hedge Fund Online, as of May 2017
For illustrative purposes only. Past performance does not guarantee future results.

FIGURE 12

PERFORMANCE OF FIRST TIME FUNDS VS. ALL HEDGE FUNDS



Source: Preqin Hedge Fund Online, as of May 2017
For illustrative purposes only. Past performance does not guarantee future results.

Position Structuring, Sizing, and Trading

A large component of investing is a manager's effectiveness at allocating capital to the best ideas and flexibility in managing and exiting positions as situations change over time. Investors should spend time understanding the work behind a hedge fund's trade structuring, position sizing, and trading strategies. The relative importance of these three facets of investment can vary depending on a manager's strategy. For global macro and credit strategies, the ability to create asymmetric risk-reward profiles is especially important. However, across strategies, the ability to size positions correctly is the skill that most often separates the best managers from the rest.

When sizing a position, managers must balance the risk-reward characteristics driven by the fundamental attractiveness of the position and the trade structure, with an understanding of what will draw others in the market to buy (or sell) the asset. An investor should understand how often the manager trades, the purpose of the trading, and how additive it has been historically. Finally, an investor should understand the circumstances that will lead the manager to exit a position, whether the decision was based on positive reasons (e.g., reaching a price target), or negative ones (e.g., hitting a stop-loss, a predefined price or loss limit). Style drift is a term used to describe when a manager strays much further than the prospectus allows. While one of the greatest advantages of a hedge fund lies in its investment flexibility, a fund is typically not completely free to chase opportunities that do not fit within that original mandate. An investor must keep abreast of portfolio changes and evaluate whether they represent a disproportionate shift in the manager's approach, or if they are indeed a natural part of a manager's dynamic investment strategies.

Portfolio Construction and Risk Management

Risk is a factor in all investments, and a hedge fund's main objective is to minimize risk while maximizing returns. An investor should understand the construction of the portfolio, including leverage, concentration, as well as the market, thematic, sector, and geographic exposures. In doing so, it will be possible to ascertain if the actual risks being taken are appropriate for the strategy and are consistent with both the manager's history and the investor's expectations.

The risk management process differs across firms: some firms embed it within the investment research process, while others view it as part of the portfolio construction process. However, all firms should have the ability to monitor risk in the portfolio and should have established a process to reduce risk should it reach predefined limits. An investor will want to know who is responsible for risk management, how they understand the biases within the portfolio, and whether they can change the portfolio's risk profile. Portfolio biases can be highlighted through factor or scenario analysis, but often correlations or themes across the portfolio are not caught by backward-looking data. However, through a combination of understanding the portfolio, the firm's risk processes and limits, and talking with key people, an investor can develop an informed view on a fund's risk. Finally, in order to monitor the portfolio on a systematic basis, an investor should ensure that the fund will provide suitable transparency on its holdings and relevant changes that are taking place in the market that may shape those holdings.

Track Record

The principal reason to analyze a fund's historical track record is to understand the key factors that have driven performance and ensure that they are consistent with the fund's strategy and investment process going forward. An investor should analyze the fund's performance from a quantitative standpoint, checking to see how returns compare to those of suitable **benchmarks** and the level of risk that was taken to achieve those returns. Hedge funds are typically benchmarked to peers that employ similar strategies, although funds whose primary objective is return enhancement may be compared to traditional public equity indices.

Operational Due Diligence

After an investor has completed their investment due diligence and is satisfied with the robustness of the manager's investment process and approach to risk, it is important to ensure that the manager's operations meet certain standards. This operational due diligence should focus on three primary areas: the manager, the fund, and the firm's overall controls.

Manager operational due diligence involves checks on the management company, their regulatory compliance processes, and their information technology. The goal of due diligence research on the management company is to understand the structure of the business and the role of any affiliate firms, and to ensure that the team is aligned with investors through ownership, remuneration, and investment in the fund. One aspect of this research is to understand who the essential personnel are in managing the fund: Are the key employees in place and actively engaged with the fund for the foreseeable future?

A common way to address this question contractually comes in the form of a "key man provision," which is a clause in the contract that allows limited partners to exit this fund — normally without restrictions — if one or more named "key" principals (with essential knowledge and expertise) are absent or fail to devote a specific amount of time to the partnership and its investment activities.

Investors should always confirm a manager's regulatory oversight and legal history, in case there are any claims, actions, or conflicts that would preclude investment. This should be supplemented by identifying the manager's compliance infrastructure and policies. Finally, given the importance of technology and the rise of cybercrime, investors should be aware of a manager's controls in these areas, including a disaster recovery plan.

Operational analysis of the fund itself is more straightforward, as it involves reviewing the legal and financial documents of the fund to confirm structure and other key details. These elements include the investment strategy, assets under management, service providers, corporate governance, investment terms, fees, and expenses. It is recommended that investors reach out to service providers directly to confirm their roles.

Hedge funds invest across multiple asset classes, instruments, and geographies; trade regularly; and can employ leverage. Each of these aspects of a hedge fund's activities affects the manager's internal operations, and

hence understanding the asset controls, trading controls, valuation controls, and reporting controls that are in place is important. Asset controls entail understanding the manager's brokerage and counterparty relationships, and the process by which assets can be transferred, with the goal of preventing unauthorized transfers. Trading controls look at the way a manager accounts for and settles trades on a timely basis in order to minimize errors. Valuation controls ensure that assets are marked fairly, utilizing independent third-party pricing where possible, and maintaining a defined process for any internally marked assets. Finally, reporting controls confirm that the numbers presented to investors are accurate and will not require future restatement.

GETTING STARTED

Before making an investment in a hedge fund, investors should consider **four key questions:**

Question	
1 What is the role for hedge funds within my portfolio?	Investors allocate to hedge funds for many different reasons, e.g., return enhancement, diversification, or capital preservation. When creating a new portfolio allocation dubbed "Risk Mitigating Strategies" in 2016, CIO of the California State Teachers' Retirement System (CalSTRS) Christopher Ailman stated, "We have a very large bias to growth in GDP in our portfolio. We want to hedge that. We actually want the hedge fund strategies not for extra return, we are doing the opposite. We think that they actually can be a defensive strategy." Understanding the specific objectives for the portfolio will help investors better align their hedge fund allocations to their overall investment goals.
2 Am I comfortable with the manager's process and risk/return profile?	It is important to understand how an individual hedge fund has historically generated returns and what the plans for the future may be. Within each strategy, different managers take on different amounts of risk to achieve their individual return targets, leading to a wide range of prospective risk/return profiles. Investors should understand a manager's investment process and structure, and the underlying drivers of the fund's returns. This includes potential drawdowns and how the strategy would be expected to perform under various market conditions.
3 Am I comfortable with the liquidity of my investment?	Hedge funds are less liquid than ETFs and mutual funds, but more liquid that private equity or venture capital investments. Redemption terms vary from fund to fund — some managers offer monthly or quarterly redemptions, while others may require investments for a multi-year period. Investors must determine if the redemption terms suit the manager's strategy — funds that run more concentrated strategies, or invest in more illiquid markets, for example, tend to be less liquid. But investors must also determine if these terms suit their own liquidity needs, ensuring they have sufficient cash available for other near-term obligations.
4 Am I comfortable with my operational due diligence?	Investment due diligence is only half of the equation. Hedge funds are more complex than mutual funds or other publicly traded investment types, and they engage with a variety of third-party service providers in the execution of their investment strategy. Operational due diligence is a continual process of evaluating the operational aspects of a hedge fund and verifying what is conveyed in a fund's legal documents, audited financials, and reference checks before and during the investment period. Investors are looking for 'red flags' or anything that would indicate an unnecessary risk. If a hedge fund does not pass operational due diligence checks, an investor should not invest or, if already invested, seek to either resolve the issue or to withdraw from the fund.

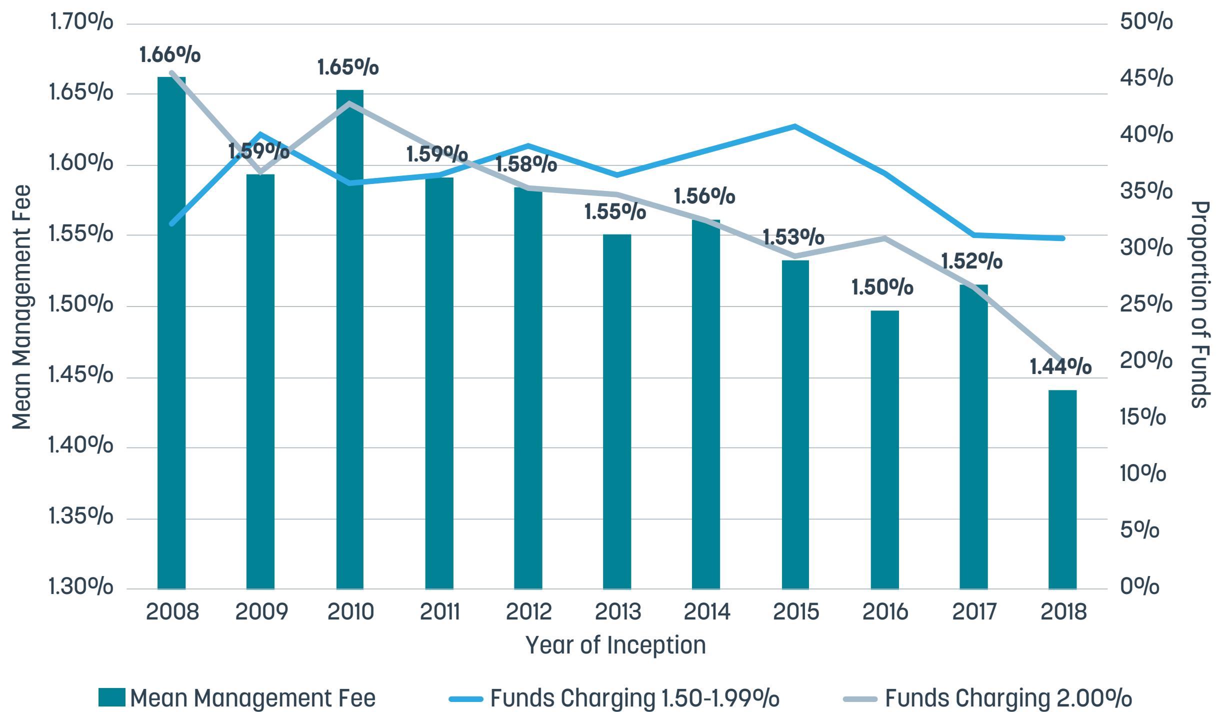
HEDGE FUND FEES & INVESTMENT MECHANICS

Management Fee

Hedge funds charge management fees to cover their operating costs, including staff salaries, investment infrastructure, and trading. Historically, the management fee has been set at 2% of assets under management, with newer or lower performing funds sometimes charging less, and high performing, high demand funds occasionally charging more. Hedge fund management fees have come under pressure in recent years, with the average management fee across the industry standing at 1.56% as of June 30, 2017.[13] Since 2007, the average management fee of hedge funds launched each year has gradually decreased from 1.66% to 1.51% in 2016, as shown in Figure 13.

FIGURE 13

MEAN MANAGEMENT FEE AND FEE DISTRIBUTION BY YEAR OF INCEPTION



Source: Preqin Hedge Fund Online

Incentive (or Performance) Fee

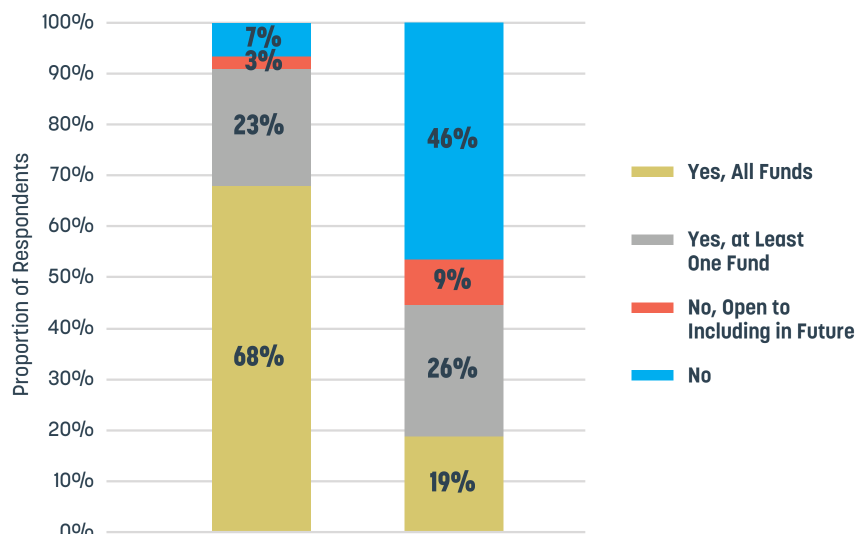
In addition to the management fee, hedge fund managers typically charge an incentive, or performance fee, which works to align their interests with those of investors. The standard hedge fund incentive fee has traditionally been 20% of fund profits, although like management fees, hedge fund managers may charge more or less, depending on the level of demand for their funds. The purpose of the incentive fee is to motivate the hedge fund manager to generate profits for investors and to increase the fund's net asset value (NAV) continually. Incentive fees are charged on "net capital appreciation," or the growth of the fund's NAV.

While the fee structure is unique and may seem onerous, there are several common protections for investors. High water marks stipulate that incentive fees can only be charged for any performance above an investor's highest net asset value in the fund (the "high water mark"). In other words, high water mark ensures that a fund manager does not receive incentive fees for gains that merely recover previous losses.

An additional protection sometimes offered in relation to the incentive fee is a hurdle rate, or a minimum level of return that must be generated in a certain period before any performance fee can be taken. Hurdle rates are much less common than high water marks, as shown in Figure 14, although funds with a hurdle rate also typically have a high water mark.

FIGURE 14

FEE PROVISIONS PROVIDED BY HEDGE FUND MANAGERS



Source: Preqin Hedge Fund Manager Survey, November 2018

Hedge fund performance should always be assessed net of fees, and hedge fund fees generally should be viewed in relation to the level and quality of money management that is being provided. While average hedge fund fees are declining, the dispersion in fees charged by different managers has actually grown in recent years, sometimes in excess of the historical 2/20 standard. This is because investors remain willing to pay for consistently profitable strategies and those that offer unique risk/reward characteristics, but they have other, less expensive options for strategies that trade well-known risk premia.

Investment Mechanics

The minimum investment required by most hedge funds is $1 million, although this threshold may be substantially higher for funds with a consistent track record of outperformance. In contrast to mutual funds, which calculate their per-share price each day and allow investor to sell their shares daily, hedge funds offer a variety of liquidity options, with the norm being quarterly redemption rights. Investors must also give written notice of their intention to redeem, with notice periods typically ranging from 30 to 90 days in advance, allowing the manager to position the hedge fund's portfolio to finance the redemption request.

In addition, most hedge funds have "lock-up periods," a length of time typically starting on the date of the initial investment, during which the investor cannot redeem, even upon request. The length of the lock-up period is typically one-year, but will vary by fund. In some cases, there may be a "hard lock," with no redemption possible, while in other cases the investor may be able to withdraw funds early after paying a penalty.

Even after a lock-up has expired, withdrawals may be subject to a "gate" or **"redemption limit"** that constrains the amount of investor capital withdrawn from the fund at any one time. The main purpose of gates is to prevent large scale or very sudden withdrawals that could require the fund to liquidate large amounts of securities at fire-sale prices. Gates also help to align the fund's liquidity with the characteristics of the underlying asset and/or trading strategy. Most limited partnership or operating agreements specify gates, but these may not be enforced in practice, depending on the circumstances.

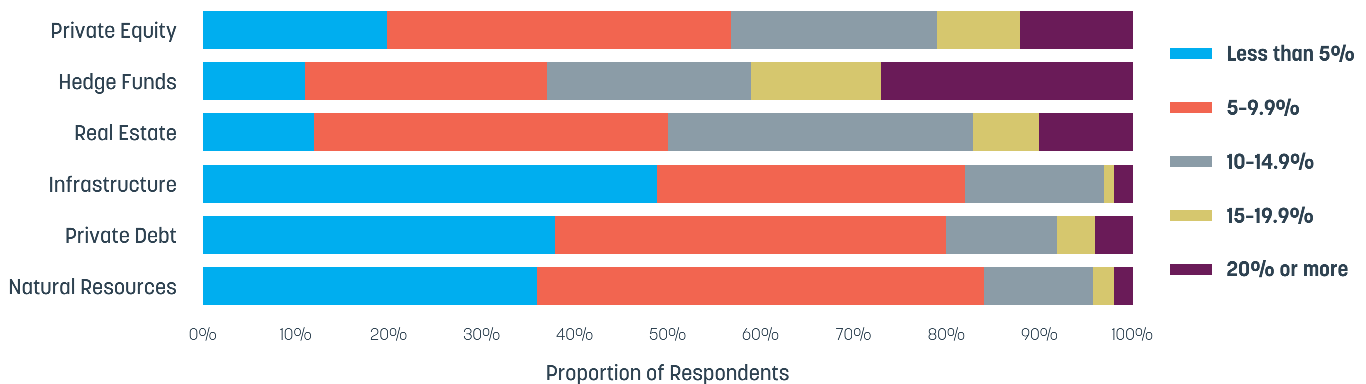
For investors considering an allocation to hedge funds, fees, redemption rights, and lock-up periods are important considerations. If these elements of hedge fund investing can be accommodated, the next questions are: how much to allocate and what kind of performance can the investor expect?

ASSET ALLOCATION AND HEDGE FUND PERFORMANCE

As shown in Figures 15 and 16, there is significant variability in institutional allocations to hedge funds, even relative to other types of alternative investments, such as private equity and real estate. However, endowments tend to maintain hedge fund allocations of about 20% as a proportion of the total assets under management.

FIGURE 15

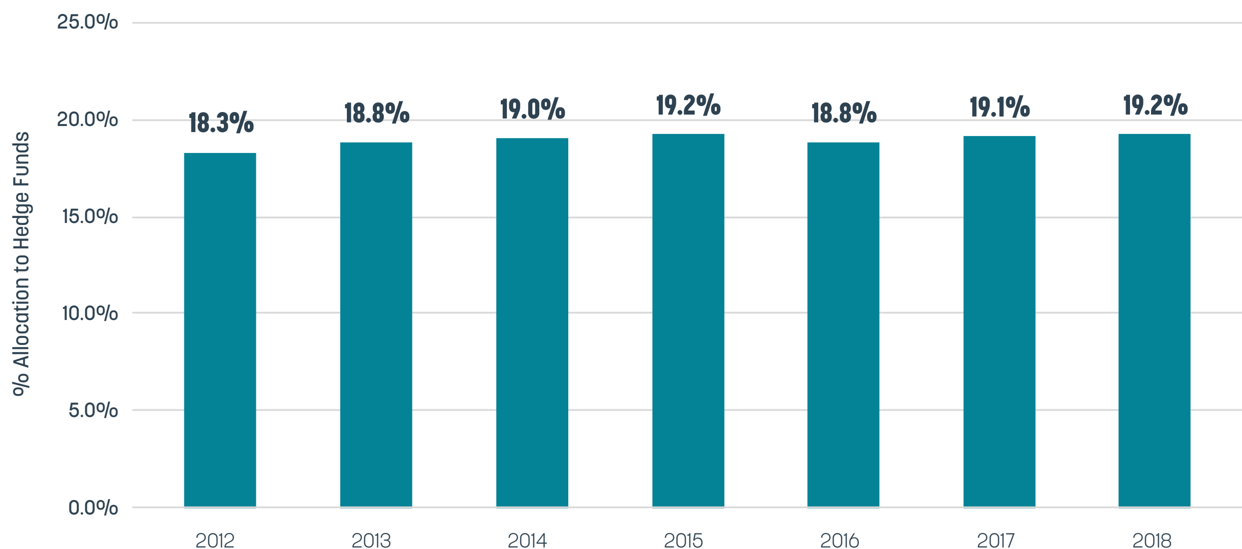
INSTITUTIONAL INVESTORS IN ALTERNATIVE ASSETS BY TARGET ALLOCATION TO EACH ASSET CLASS (% OF AUM)



Source: Preqin Hedge Fund Online, as of June 2016
Past allocations are for illustrative purposes and subject to change.

FIGURE 16

AVERAGE CURRENT ALLOCATION OF ENDOWMENT PLANS TO HEDGE FUNDS (% OF AUM)



Source: Preqin
Past allocations are for illustrative purposes and subject to change. Diversification does not assure profit or guarantee against a loss.
See Glossary for definitions.

The hedge fund performance characteristics described previously, namely the ability to help maintain overall portfolio returns while mitigating risk, is largely accomplished via diversification — using hedge fund strategies that carry a minimal or negative correlation to traditional markets. Because these strategies tend to be lowly correlated or uncorrelated with the rest of the market as a result of hedging and other specialized investment techniques, they can be sources of positive performance during difficult markets and also improve the portfolio's ability to withstand a drawdown. Figure 17 show hedge fund performance by strategy from 2014 to 2017; the variability of each strategy's performance under different market conditions is evident.

FIGURE 17

HEDGE FUND HISTORICAL PERFORMANCE BY STRATEGY

2014	2015	2016	2017	2018
Credit Strategies **5.98%**	Relative Value Strategies **5.53%**	Event Driven Strategies **12.82%**	Equity Strategies **15.13%**	Credit Strategies **2.10%**
Equity Strategies **5.44%**	Macro Strategies **4.35%**	Credit Strategies **8.92%**	Event Driven Strategies **9.80%**	Macro Strategies **0.97%**
Multi-Strategy **5.15%**	Multi-Strategy **3.53%**	Macro Strategies **7.59%**	Multi-Strategy **9.38%**	Relative Value Strategies **0.82%**
Relative Value Strategies **4.87%**	Credit Strategies **2.36%**	Equity Strategies **7.40%**	Credit Strategies **8.11%**	Multi-Strategy **-2.10%**
Macro Strategies **4.70%**	Equity Strategies **1.22%**	Multi-Strategy **6.16%**	Macro Strategies **4.72%**	Event Driven Strategies **-4.06%**
Event Driven Strategies **2.65%**	Event Driven Strategies **(0.67)%**	Relative Value Strategies **3.45%**	Relative Value Strategies **6.60%**	Equity Strategies **-5.40%**

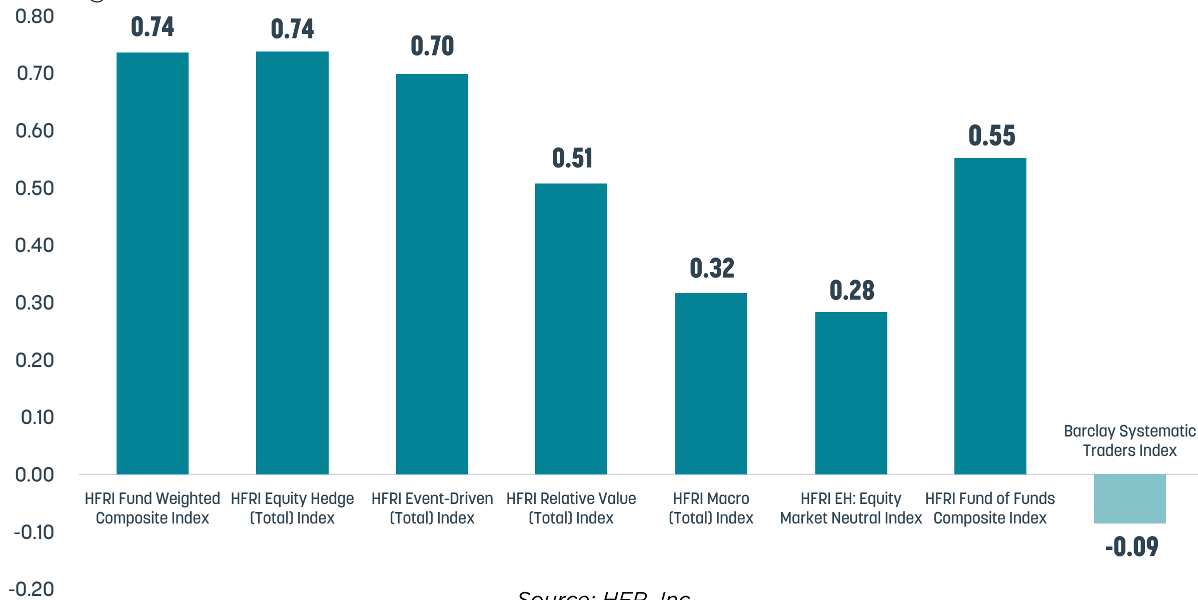
Source: Preqin, data through December 31st, 2018. For illustrative purposes only. Past performance does not guarantee future results.

As Figures 18 and 19 indicate (on the following page), global macro and systematic trading/managed futures strategies have consistently shown the least correlation to traditional markets. Equity and credit long/short strategies generally feature some correlation to traditional equity and/or fixed income markets, as most long/short funds run a net long bias over time. Note, however, that true market-neutral funds, which completely offset sensitivity to market direction through their hedging features, exhibit relatively low correlation to traditional public markets.

FIGURE 18

HEDGE FUND STRATEGY INDEX CORRELATIONS TO S&P 500 TR

Jan 1990 – Aug 2018



Source: HFR, Inc.

Past performance is not necessarily indicative of future results. Diversification does not assure a profit or guarantee against a loss. Calculated using month-end data. See Glossary for definitions.

FIGURE 19

3-YEAR ROLLING CORRELATIONS OF HEDGE FUNDS[15] TO THE S&P 500 TR

HFRI Fund Weighted Composite Index
HFRI Equity Hedge (Total) Index
HFRI Event-Driven (Total) Index
HFRI Relative Value (Total) Index
HFRI Macro (Total) Index
HFRI EH: Equity Market Neutral Index
HFRI Fund of Funds Composite Index
Barclay Systematic Traders Index

Source: HFR, Inc., as of December 31, 2018

Most institutional investors use hedge funds to dampen volatility and balance the risk/return profile of their overall portfolios; this is an approach that often relies on larger, well-established funds that trade in numerous markets and can dynamically deploy capital across multiple strategies. In addition, some hedge fund allocations also target consistent alpha generation.[14] This objective tends to be best served by smaller and/or niche strategies focused on a narrow opportunity set, where the manager has a competitive advantage such as deep sector knowledge or analytical skill. However, because they are designed to offer higher returns, these strategies can be more concentrated and, correspondingly, they may feature higher mark-to-market volatility. Investors should consider all aspects of hedge fund dynamics carefully and align their expectations with the nuances of hedge fund investing in mind.

CONCLUSIONS

This introduction to Hedge Fund Essentials is intended to assist advisors, managers, and individuals with the basic terms and principles of investing in hedge funds. Like other forms of alternative investment, an allocation to hedge funds will help to ensure sufficient diversification and downside protection in an ever-changing market. For all investors, from large pension funds, to family offices, to high-net-worth individuals, the analytical and decision making processes are of central importance and should be conducted carefully, with the goal of developing a solid, practical foundation in the strategies and objectives of hedge funds.

As technology has advanced and globalization continues, many investment choices are available across asset classes in markets around the world. In the search for yield and diversification, hedge funds offer an opportunity to pursue excess returns and engage in investments with low correlation and substantial geographical, sectoral, and strategic variation. These features enhance the manager's ability to navigate a wide range of market conditions and pursue performance beyond the market average.

Clearly, the hedge fund world is complex, with special features that fall outside of the traditional stock and bond world. Therefore, making a commitment to in-depth education is critical for advisors and investors, as they explore the unique offerings. In support of such education, this paper, which is the first of a series by iCapital Network, has offered a perspective on understanding and accessing this evolving form of alternative investment.

Aref Jessani
Senior Vice President, Research and Diligence

GLOSSARY

Accredited Investor	In the U.S., this term is used by the Securities and Exchange Commission (SEC) under Regulation D to refer to investors who are financially sophisticated. This can include high net worth individuals (HNWI), banks, insurance companies, brokers and trusts. *To be an accredited investor, an individual must have an annual income exceeding $200,000, or $300,000 for joint income, for the last two years with expectation of earning the same or higher income in the current year. An individual is also considered an accredited investor if they have a net worth exceeding $1 million, either individually or jointly with their spouse. Also, if a person can demonstrate sufficient education or job experience showing their professional knowledge of unregistered securities, they too can qualify to be an accredited investor. In order to invest in most PE offerings a client needs to be an Accredited Investors and Qualified Purchaser (defined below).*
Algorithmic (or Program) Investing	This is a type of investing done using computers that follow a defined set of instructions and mathematical models. These computers are typically able to place trades more quickly and more often than human traders.
Alternative Investments	These encompass investments that are not one of the conventional investments (bonds, stocks and cash). Alternative investments are typically held by institutions or accredited high net worth investors due to regulations limiting their sale to the broader public. *The most common alternative investments are in private equity, real estate, hedge funds, commodities, etc. Alternatives tend to behave differently than typical stock and bond investments, so adding them to a portfolio may provide broader diversification, reduce risk, and/or enhance returns.*
Barclays Systematic Traders Index	*An equal weighted composite of managed programs whose approach is at least 95% systematic. In 2019 there are 394 systematic programs included in the index. To qualify for inclusion in the Barclay Systematic Traders Index, an advisor must have twelve months of prior performance history. The index is rebalanced annually.*
Benchmark	A previously agreed upon point of reference. In the case of performance, a benchmark would be the index or indices chosen. *Benchmarks are used to show a fund’s relative performance compared to similar peers or an index (e.g. S&P 500 TR) over a given period of time.*
Correlation	This measures the degree to which two securities move in relation to one another. *In hedge funds, it is often used to compare the similarity in movement of a fund and an index.*
Directional Strategies	These are investment strategies that have a meaningful amount of exposure to the broad market. *Directional hedge funds tend to operate with lower leverage and less hedging, with most of the returns generated on the long-side through owning stocks, bonds and other instruments.*

GLOSSARY

Discretionary Investing	This is when the decisions to buy/sell assets are being made based on the judgment of the investment manager.
Diversification	This is a method of risk management where an investor reduces the risk and volatility of its portfolio through holding a wide array of different assets that have limited correlation to each other.
Drawdown	This represents the peak-to-trough decline of an investment fund; it is normally measured in %-terms.
Due Diligence	This is the research performed by an investor on a potential investment, in order to determine its merits and uncover potential risks. *The due diligence process should uncover the strengths and weaknesses that could potentially affect performance. The key areas that are typically analyzed include the past performance and the factors that drove it, the team members and their experience, the strategy, how ideas are generated and diligence, how positions are sized and traded, and risk management. A separate part of the due diligence process is operational due diligence which analyzes the management firm's operational procedures and compliance/regulatory adherence.*
Fund-of-Hedge-Funds	A fund that takes limited partner positions in a number of hedge funds. *The purpose of these vehicles is to give the investor in the fund-of-funds more opportunity and diversity in the underlying hedge fund investments.*
Fund	An investment fund is the pooled capital of investors that enables the fund manager make investment decisions on their behalf. *The commingled fund is managed by a General Partner (or investment manager), and investors are known as Limited Partners.*
Gate	This is a provision in an investment fund's offering documents that allows the investment manager to restrict redemptions and identifies the circumstances when such restrictions can be applied. *Gates typically come in 2 forms; share-class level gates and fund-level, which reflect how the gate is measured and applied. A manager may apply a share-class level gate when total redemptions in a share-class exceed a prescribed limit, typically 25%, on a redemption date. The share-class level gate is only applied to that share class. The fund-level gate is applied when the redemptions exceed the prescribed limit for the entire fund and is applied to all redemptions in the fund. Gates can either be applied on a pro-rata (i.e. all redemption requests are treated the same) or a first-come first-served basis (i.e. those who submitted redemptions for prior quarters, and may have been gated, are given priority over new redemptions).*
General Partner ("GP"), or Investment Manager	These two terms are used interchangeably for the manager of a hedge fund. The GP, or investment manager, is given authority to make the fund's investments and trades.

GLOSSARY

Gross Exposure	Gross exposure refers to the absolute total of a fund's investments and indicates the Fund's total exposure to financial markets. It is calculated by adding the absolute value of Fund's long and short positions. *A higher gross exposure indicates increased leverage and provides an insight into amount of risk that is being taken.*
Hedge Fund	This is an investment partnership. The name derives from the use of trading techniques that the partnership can utilize, most importantly to "hedge" against perceived risks by taking offsetting positions.
High Water Mark, or "Loss Carryforward"	This represents the peak net asset value that an investor's holding in an investment fund has reached. A high water mark is used to help determine the amount of performance-based compensation that a manager can earn; if the net asset value of the fund falls in one investment period (typically annual), the manager can only begin to charge a performance fee again once the investment has recouped those losses and the net asset value has exceeded the high water mark.
Hurdle Rate	This represents the minimum return that a hedge fund must earn before it can begin to charge a performance fee.
Incentive (or Performance) Fee	This is a payment made to an investment manager for generating positive performance returns. The performance fee is typically calculated as a percentage of the profits, both realized and unrealized, over the course of a year.
Leverage	This is the use of borrowed money or securities that are used by an investment manager to increase the potential return of a fund. *Hedge fund leverage can be looked at in two ways, gross leverage and accounting leverage. The gross leverage is the same as a fund's gross exposure and reflects the ratio of the total invested capital on both the long and short sides of the portfolio divided by the fund's net asset value. The accounting leverage reflects the invested capital on the long side divided by the fund's net asset value.*
Limited Partner ("LP"), or investor	A limited partner is a business partner whose liability is limited to the amount of their investment in the company.
Lock-Up Period	This represents the window of time when investors in a hedge fund are not allowed to redeem (sell) their holding. There are two types of lock-ups; hard lock-ups and soft lock-ups. Investors are forbidden from redeeming during a hard lock-up under any circumstances. In a soft-lock up period, investors can redeem but must pay a penalty (typically 1-5% of the investors net asset value) in order to do so. The penalty is typically paid to the fund, and so benefits the other investors in the fund. *Lock-ups were created to prevent investors from trading into and out of hedge funds, with the aim of providing the GP with a more stable base of capital and allowing it to take longer-term positions.*

GLOSSARY

Management Fee	A management fee is a charge levied by an investment manager for managing an investment fund. The management fee is intended to compensate the managers for their time and expertise for selecting investments and managing the portfolio. *Investors (LPs) in a fund pay this fee, normally 1.0% to 2.0% of net asset value per annum, to the fund manager in return for them managing the fund. This fee is typically paid either monthly or quarterly and is not contingent on any kind of performance.*
Pairwise Correlation	This is a process of analyzing assets, normally the components in an index, in pairs to ascertain their correlation. The correlations of each of the underlying pairs are combined to provide an indication of how tied the components of an index are to each other.
Qualified Purchaser	To be a Qualified Purchase, an individual must own $5 million or more in investments or invest at least $25 million, either for their own accounts or on others' behalf (e.g. a professional investment manager) *The qualifications to be a Qualified Purchaser are significantly more stringent than that of an Accredited Investor. Most private market funds (e.g. private equity funds) require their investors to be Qualified Purchasers.*
Quantitative (or Systematic) Investing	This is a form of investing that uses computer algorithms and models to sort through data – normally financial, but increasingly other types – in order to identify predictable patterns. The investment decisions are made by the computer within a predetermined set of investment constraints.
Redemption Limit	This is a limit on the size of an investor's redemption at each redemption date. *The redemption limits are stated in the offering memorandum for the fund. The most prevalent is a 25% quarterly redemption limit, which limits the investor to withdrawing 25% of its capital each quarter. This means that it would take a year to fully exit the investment.*
Sharpe Ratio	This is a measure of performance adjusted by the associated risks. It is calculated by taking a fund's annualized return, removing the risk-free rate (typically the 3-month Treasury rate), and dividing this "excess return" by the fund's standard deviation.
Short Selling	This is the sale of a security that is not owned by the seller. The security is typically borrowed, and short sellers benefit from a fall in price that allows them to buy back the security at a lower price. *Short-selling is a common hedge fund practice that is used to help reduce a fund's exposure to markets, or hedge out a specific risk.*
Special Situations	Special situation investment opportunities can take many forms and involve multiple asset classes. Typical special situations can arise from spinoffs, tender offers, mergers and acquisitions, bankruptcy or distress, litigation, capital structure dislocations, activism, or just complexity that the market does not understand. *Special situations are typically investments into companies that have an element of distress, dislocation or dysfunction and are perceived to be undervalued.*

GLOSSARY

Standard Deviation	This is a measure of volatility, which is often used as a proxy for risk. It measures the degree to which a fund's individual monthly performances differs from its average monthly performance. Funds that have a high standard deviation are less predictable and therefore viewed as riskier.

MARKET INDICES

Global 60/40 Index	An index comprising of 60% allocated to the MSCI World Net Daily Total Return Index and 40% to the Bloomberg Barclays Global Aggregate Index, which is rebalanced on a quarterly basis. Please see below for further details on the underlying indices.
Bloomberg Barclays US Aggregate Bond Index	A broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS (agency and non-agency).
Bloomberg Barclays Global Aggregate Bond Index	A flagship measure of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers.
Cliffwater Direct Lending Index	Seeks to measure the unlevered, gross of fee performance of U.S. middle market corporate loans, as represented by the asset-weighted performance of the underlying assets of Business Development Companies (BDCs), including both exchange-traded and unlisted BDCs, subject to certain eligibility requirements.
ICE BofA ML US High Yield Index	Tracks the performance of below investment grade, but not in default, US Dollar-denominated corporate bonds publicly issued in the US domestic market, and includes issues with a credit rating of BBB or below, as rated by Moody's and S&P.
MSCI World Index	The index captures large and mid cap representation across 23 Developed Markets (DM) countries. With 1,633 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. The MSCI World used herein specifically reflects the MSCI World Net Daily Total Return Index, which approximates the minimum possible reinvestment of the regular cash distributions.
Nasdaq Composite Index	The market capitalization-weighted index of over 3,300 common equities listed on the Nasdaq stock exchange. The types of securities in the index include American depositary receipts, common stocks, real estate investment trusts (REITs) and tracking stocks, as well as limited partnership interests. The index includes all Nasdaq-listed stocks that are not derivatives, preferred shares, funds, exchange-traded funds (ETFs) or debenture securities.
Russell 2000 Index	An index measuring the performance of approximately 2,000 small-cap companies in the Russell 3000 Index, which is made up of 3,000 of the biggest U.S. stocks. The Russell 2000 serves as a benchmark for small-cap stocks in the United States.

MARKET INDICES

S&P 500 Total Return Index	An index of 500 stocks issued by 500 large companies with market capitalizations of over $5 billion. The Total Return reflects the impact of dividends being reinvested in the S&P 500 Index.
S&P 600	An index of 600 small-cap stocks that tracks a broad range of small-sized companies that meet specific liquidity and stability requirements.
S&P/LSTA Leveraged Loan Index	Provides an overview of the Senior Secured, Floating Rate Leveraged Loan market as well as an expansive review of the S&P Leveraged Loan Index (LLI) and sub-indexes including daily pricing on the S&P/LSTA LLI 100.
West Texas Intermediate ("WTI")	Also known as 'Texas light sweet', WTI is a grade of crude oil used as a benchmark in oil pricing. This grade is described as a Medium crude oil because of its relatively low density, and sweet because of its low sulfur content. It is the underlying commodity of New York Mercantile Exchange's oil futures contracts.
VIX or VIX Index	A calculation designed to produce a measure of constant, 30-day expected volatility of the U.S. stock market, derived from real-time, mid-quote prices of S&P 500 Index call and put options. On a global basis, it is one of the most recognized measures of volatility — widely reported by financial media and closely followed by a variety of market participants as a daily market indicator.

HEDGE FUND INDICES

HFRI Equity Hedge: Equity Market Neutral Index	Equity Market Neutral strategies employ sophisticated quantitative techniques of analyzing price data to ascertain information about future price movement and relationships between securities, select securities for purchase and sale. These can include both Factor-based and Statistical Arbitrage/Trading strategies. Factor-based investment strategies include strategies in which the investment thesis is predicated on the systematic analysis of common relationships between securities. In many but not all cases, portfolios are constructed to be neutral to one or multiple variables, such as broader equity markets in dollar or beta terms, and leverage is frequently employed to enhance the return profile of the positions identified. Statistical Arbitrage/Trading strategies consist of strategies in which the investment thesis is predicated on exploiting pricing anomalies which may occur as a function of expected mean reversion inherent in security prices; high frequency techniques may be employed and trading strategies may also be employed on the basis on technical analysis or opportunistically to exploit new information the investment manager believes has not been fully, completely or accurately discounted into current security prices. Equity Market Neutral Strategies typically maintain characteristic net equity market exposure no greater than 10% long or short.

HEDGE FUND INDICES

HFRI Equity Hedge (Total) Index: Equity Hedge	Investment Managers who maintain positions both long and short in primarily equity and equity derivative securities. A wide variety of investment processes can be employed to arrive at an investment decision, including both quantitative and fundamental techniques; strategies can be broadly diversified or narrowly focused on specific sectors and can range broadly in terms of levels of net exposure, leverage employed, holding period, concentrations of market capitalizations and valuation ranges of typical portfolios. EH managers would typically maintain at least 50% exposure to, and may in some cases be entirely invested in, equities, both long and short.
HFRI Equity Hedge: Sector – Healthcare Index	Sector - Healthcare strategies employ investment processes designed to identify opportunities in securities in specific niche areas of the market in which the Manager maintain a level of expertise which exceeds that of a market generalist in identifying opportunities in companies engaged in all development, production and application of pharmaceuticals, biotechnology, and healthcare products and services. Sector - Healthcare strategies typically maintain a primary focus in this area or expect to maintain in excess of 50% of portfolio exposure to these sectors over a various market cycles.
HFRI Equity Hedge: Sector – Technology Index	Sector - Technology strategies employ investment processes designed to identify opportunities in securities in specific niche areas of the market in which the Manager maintain a level of expertise which exceeds that of a market generalist in identifying opportunities in information technology companies. Sector - Technology strategies typically maintain a primary focus in this area or expect to maintain in excess of 50% of portfolio exposure to these sectors over a various market cycles.
HFRI Event Driven (Total) Index: Event-Driven	Investment Managers who maintain positions in companies currently or prospectively involved in corporate transactions of a wide variety including but not limited to mergers, restructurings, financial distress, tender offers, shareholder buybacks, debt exchanges, security issuance or other capital structure adjustments. Security types can range from most senior in the capital structure to most junior or subordinated, and frequently involve additional derivative securities. Event Driven exposure includes a combination of sensitivities to equity markets, credit markets and idiosyncratic, company specific developments. Investment theses are typically predicated on fundamental characteristics (as opposed to quantitative), with the realization of the thesis predicated on a specific development exogenous to the existing capital structure.

HEDGE FUND INDICES

HFRI Event Driven: Distressed/Restructuring Index	Distressed/Restructuring strategies which employ an investment process focused on corporate fixed income instruments, primarily on corporate credit instruments of companies trading at significant discounts to their value at issuance or obliged (par value) at maturity as a result of either formal bankruptcy proceeding or financial market perception of near term proceedings. Managers are typically actively involved with the management of these companies, frequently involved on creditors' committees in negotiating the exchange of securities for alternative obligations, either swaps of debt, equity or hybrid securities. Managers employ fundamental credit processes focused on valuation and asset coverage of securities of distressed firms; in most cases portfolio exposures are concentrated in instruments which are publicly traded, in some cases actively and in others under reduced liquidity but in general for which a reasonable public market exists. In contrast to Special Situations, Distressed Strategies employ primarily debt (greater than 60%) but also may maintain related equity exposure.
HFRI Fund of Funds Composite Index	Fund of Funds invest with multiple managers through funds or managed accounts. The strategy designs a diversified portfolio of managers with the objective of significantly lowering the risk (volatility) of investing with an individual manager. The Fund of Funds manager has discretion in choosing which strategies to invest in for the portfolio. A manager may allocate funds to numerous managers within a single strategy, or with numerous managers in multiple strategies. The minimum investment in a Fund of Funds may be lower than an investment in an individual hedge fund or managed account. The investor has the advantage of diversification among managers and styles with significantly less capital than investing with separate managers. PLEASE NOTE: The HFRI Fund of Funds Index is not included in the HFRI Fund Weighted Composite Index.
HFRI Macro (Total) Index	Macro: Investment Managers which trade a broad range of strategies in which the investment process is predicated on movements in underlying economic variables and the impact these have on equity, fixed income, hard currency and commodity markets. Managers employ a variety of techniques, both discretionary and systematic analysis, combinations of top down and bottom up theses, quantitative and fundamental approaches and long and short term holding periods. Although some strategies employ RV techniques, Macro strategies are distinct from RV strategies in that the primary investment thesis is predicated on predicted or future movements in the underlying instruments, rather than realization of a valuation discrepancy between securities. In a similar way, while both Macro and equity hedge managers may hold equity securities, the overriding investment thesis is predicated on the impact movements in underlying macroeconomic variables may have on security prices, as opposes to EH, in which the fundamental characteristics on the company are the most significant are integral to investment thesis.

HEDGE FUND INDICES

HFRI Relative Value (Total) Index	Investment Managers who maintain positions in which the investment thesis is predicated on realization of a valuation discrepancy in the relationship between multiple securities. Managers employ a variety of fundamental and quantitative techniques to establish investment theses, and security types range broadly across equity, fixed income, derivative or other security types. Fixed income strategies are typically quantitatively driven to measure the existing relationship between instruments and, in some cases, identify attractive positions in which the risk adjusted spread between these instruments represents an attractive opportunity for the investment manager. RV position may be involved in corporate transactions also, but as opposed to ED exposures, the investment thesis is predicated on realization of a pricing discrepancy between related securities, as opposed to the outcome of the corporate transaction.
HFRI RV Fixed Income - Asset Backed Index	Fixed Income: Asset Backed includes strategies in which the investment thesis is predicated on realization of a spread between related instruments in which one or multiple components of the spread is a fixed income instrument backed physical collateral or other financial obligations (loans, credit cards) other than those of a specific corporation. Strategies employ an investment process designed to isolate attractive opportunities between a variety of fixed income instruments specifically securitized by collateral commitments which frequently include loans, pools and portfolios of loans, receivables, real estate, machinery or other tangible financial commitments. Investment thesis may be predicated on an attractive spread given the nature and quality of the collateral, the liquidity characteristics of the underlying instruments and on issuance and trends in collateralized fixed income instruments, broadly speaking. In many cases, investment managers hedge, limit or offset interest rate exposure in the interest of isolating the risk of the position to strictly the yield disparity of the instrument relative to the lower risk instruments.
HFRI Relative Value: Multi-Strategy Index	Multi-Strategies employ an investment thesis is predicated on realization of a spread between related yield instruments in which one or multiple components of the spread contains a fixed income, derivative, equity, real estate, MLP or combination of these or other instruments. Strategies are typically quantitatively driven to measure the existing relationship between instruments and, in some cases, identify attractive positions in which the risk adjusted spread between these instruments represents an attractive opportunity for the investment manager. In many cases these strategies may exist as distinct strategies across which a vehicle which allocates directly, or may exist as related strategies over which a single individual or decision making process manages. Multi-strategy is not intended to provide broadest-based mass market investors appeal, but are most frequently distinguished from others arbitrage strategies in that they expect to maintain >30% of portfolio exposure in 2 or more strategies meaningfully distinct from each other that are expected to respond to diverse market influences.
HFRI Fund Weighted Composite Index	The index is a global, equal-weighted index of over 1,500 single-manager funds that report to HFR Database. Constituent funds report monthly net of all fees performance in US Dollar and have a minimum of $50 Million under management or a twelve (12) month track record of active performance. The HFRI Fund Weighted Composite Index does not include Funds of Hedge Funds.

HEDGE FUND INDICES

Barclay CTA Index	A leading industry benchmark of representative performance of commodity trading advisors. There are currently 510 programs included in the calculation of the Barclay CTA Index for 2019. The Index is equally weighted and rebalanced at the beginning of each year.
S&P 600	An index of 600 small-cap stocks that tracks a broad range of small-sized companies that meet specific liquidity and stability requirements.
S&P/LSTA Leveraged Loan Index	Provides an overview of the Senior Secured, Floating Rate Leveraged Loan market as well as an expansive review of the S&P Leveraged Loan Index (LLI) and sub-indexes including daily pricing on the S&P/LSTA LLI 100.

END NOTES

1 https://www.valuewalk.com/alfred-winslow-jones/
2 Ibid.
3 See https://www.managedfunds.org/wp-content/uploads/2016/06/MFA_HFRegulated_Timeline_infographic.pdf for brief details.
4 https://blogs.cfainstitute.org/investor/2017/03/06/the-golden-age-of-hedge-funds/.
5 https://www.hedgefundresearch.com and https://www.bloomberg.com/news/articles/2017-01-23/hedge-fund-assets-pass-3-trillion-in-2016-for-first-time-chart.
6 https://www.hedgefundresearch.com and http://www.marketwatch.com/story/hedge-funds-closed-down-last-year-at-a-pace-unseen-since-2008-2017-03-17.
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8 http://hedgefundamentals.org/the-basics/ and https://www.preqin.com/docs/reports/Preqin-Special-Report-Hedge-Funds-in-the-US-October-2016.pdf.
9 https://www.investor.gov/additional-resources/news-alerts/alerts-bulletins/updated-investor-bulletin-accredited-investors
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11 Liquid alts are often called '40 Act funds because the provisions governing them were created by the U.S. Congress in the Investment Company Act of 1940.
12 http://hedgenordic.com/2017/11/funds-of-hedge-funds-consolidate-in-fight-for-survival/.
13 Preqin Special Report: HF Manager Outlook H1 2017.
14 Investing in Hedge Funds: All About Returns? The Real Drivers for Institutional Investor Allocation, Preqin, June 2014. The results of this study are based on a Preqin survey of over 100 investors, with these investors comprising more than $13tn in assets under management. The investors were located globally and represented a broad spectrum of investor types from the largest pension funds to family offices and other private wealth institutions. Additional data was taken from Preqin's Hedge Fund Online service, which maintains data on over 4,600 investors in hedge funds, 16,500 hedge funds, and 6,700 fund managers.
15 **HFRI Fund Weighted Composite Index:** The HFRI Fund Weighted Composite Index is a global, equal-weighted index of over 1,400 single-manager funds that report to HFR Database. Constituent funds report monthly net of all fees performance in US Dollar and have a minimum of $50 Million under management or a twelve (12) month track record of active performance. The HFRI Fund Weighted Composite Index does not include Funds of Hedge Funds.

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HFRI Equity Hedge (Total) Index: Equity Hedge: Investment Managers who maintain positions both long and short in primarily equity and equity derivative securities. A wide variety of investment processes can be employed to arrive at an investment decision, including both quantitative and fundamental techniques; strategies can be broadly diversified or narrowly focused on specific sectors and can range broadly in terms of levels of net exposure, leverage employed, holding period, concentrations of market capitalizations and valuation ranges of typical portfolios. EH managers would typically maintain at least 50% exposure to, and may in some cases be entirely invested in, equities, both long and short.

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HFRI EH: Equity Market Neutral Index: Equity Market Neutral strategies employ sophisticated quantitative techniques of analyzing price data to ascertain information about future price movement and relationships between securities, select securities for purchase and sale. These can include both Factor-based and Statistical Arbitrage/Trading strategies. Factor-based investment strategies include strategies in which the investment thesis is predicated on the systematic analysis of common relationships between securities. In many but not all cases, portfolios are constructed to be neutral to one or multiple variables, such as broader equity markets in dollar or beta terms, and leverage is frequently employed to enhance the return profile of the positions identified. Statistical Arbitrage/Trading strategies consist of strategies in which the investment thesis is predicated on exploiting pricing anomalies which may occur as a function of expected mean reversion inherent in security prices; high frequency techniques may be employed and trading strategies may also be employed on the basis on technical analysis or opportunistically to exploit new information the investment manager believes has not been fully, completely or accurately discounted into current security prices. Equity Market Neutral Strategies typically maintain characteristic net equity market exposure no greater than 10% long or short.

Barclay Systematic Traders Index: An equal weighted composite of managed programs whose approach is at least 95% systematic. In 2018 there are 400 systematic programs included in the index. To qualify for inclusion in the Barclay Systematic Traders Index, an advisor must have twelve months of prior performance history. The index is rebalanced annually.

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