GETTING STARTED WITH HEDGE FUNDS

If you are thinking of investing in hedge funds, you're likely spending a fair amount of time concentrating on understanding the different investment strategies and associated risk/return characteristics. That is essential information in your decision-making process. But equally important, is understanding the operations and underlying economics of a fund—for example, what are the associated fees and expenses charged by the fund, the fund manager, and any third-party service providers, or how often can subscriptions or redemptions be made. These considerations can seriously impact whether an investment is appropriate for your risk profile or makes sense given your current investment objectives or portfolio's asset mix. There's a lot to take into consideration.

Ready to invest? Let's recap four key questions you should be able to answer before you do.

1. What is the role of this fund in my portfolio?

Investors allocate to hedge funds for many different reasons, e.g., return enhancement, risk mitigation, or capital preservation. For instance, 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." It sounds obvious but understanding your objectives will help you better align your hedge fund allocation to your overall investment goals.

2. Am I comfortable with the manager's investment process and risk/return profile?

It is critical 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 scenarios.

3. Am I comfortable with the fund's liquidity?

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—for example, funds that run more concentrated strategies, or invest in more illiquid markets, tend to be less liquid. But they must also determine if these terms suit their liquidity needs—for example, ensuring they have sufficient cash available for other near-term needs.

4. Am I comfortable with the fund's operations and third-party service providers?

Investment due diligence is only half of the equation. Hedge funds are much 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 while, invested. Investors are looking for any '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 resolve the issue or withdrawal from the fund.

END NOTES

[1]Hedge Funds May See Up To $8.7 Billion Windfall From Calstrs, Bloomberg, Klaus Wille, September 14, 2016, http://www.bloomberg.com/news/articles/2016-09-14/hedge-funds-may-see-up-to-8-7-billion-windfall-from-calstrs

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