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## Hedge Fund Primer

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### Executive Summary

- A hedge fund (HF) is an alternative investment that pools assets from multiple investors.
  - As of fourth quarter 2017, about 9,007 HFs were registered with the U.S. Security and Exchange Commission (SEC).
  - SEC-registered HFs reported gross assets of \$13.2 trillion as of fourth quarter 2017, up from \$11.6 trillion in fourth quarter 2016.
- HFs are illiquid investments that may experience increased market value risk given the strategy and use of leverage.
- Hedge Fund Research (HFR), a hedge fund industry data provider, groups HFs into seven strategy types: equity hedge; event-driven; fund of funds; macro; relative value; risk parity; and blockchain.

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### What is a Hedge Fund?

The name “hedge fund” originated from the hedging techniques used by the first of these funds, where the manager held cash assets expected to appreciate in price while also shorting assets expected to depreciate in price. Over time, the types and nature of hedging concepts expanded, as did the different types of investment vehicles.

HFs are distinct from mutual funds, as their use of leverage is not capped by regulators. HFs do not make a public offering or market themselves (i.e., through widely distributed media). Instead, a private offering is made via a private placement memorandum (PPM). The PPM includes information similar to that found in a mutual fund prospectus, including a description of the investment, risks and associated fees.

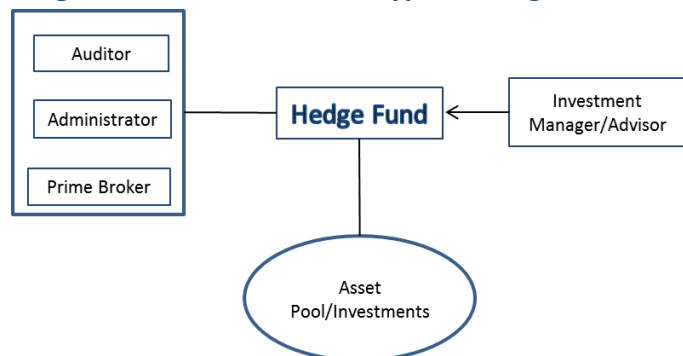
HFs with at least \$150 million in assets under management (AUM) must register with the SEC and report various activities and operations on Form PF. As of fourth quarter 2017, about 9,007 SEC-registered HFs filed a Form PF, up from 8,927 at fourth quarter 2016. The HFs also reported gross assets of \$13.2 trillion as of fourth quarter 2017, up from \$11.6 trillion in fourth quarter 2016.

The majority (51.3%) of HFs filing a Form PF was domiciled in Cayman Islands, while the majority (88.5%) of investment advisors was domiciled in the U.S. as of fourth quarter 2017.

### Structure of Hedge Funds

HFs are often structured as a limited partnership, limited liability company (LLC) or similar vehicle. HFs consist of a general partner (GP) and limited partners (LPs) that are investors in the fund. The GP is also generally the sponsor of the fund, responsible for undertaking the legal organization of the fund and fundraising. The GP is also often the party responsible for making investment decisions on behalf of the HF, and so has a fiduciary responsibility and, therefore, can be legally liable for the actions of the fund. Other participants include third-party service providers, such as auditors, administrators and prime brokers (see Diagram 1.)

**Diagram 1: Illustration of a Typical Hedge Fund Structure**



### Hedge Fund Management Fees and Incentives

For its services, the GP earns a management fee. The management fee, usually 1%–2% of AUM (per annum), is typically paid to the GP on a monthly or quarterly basis. In addition, the GP has a stake in the performance of the HF, which is often structured as a percentage of returns (typically about 20%).

Some HFs require the GP to achieve a certain level of return (a hurdle rate), either as a fixed percentage or a benchmark rate (such as London Interbank Offered Rate (LIBOR) or the Standard and Poor’s (S&P) 500 Index) before the GP is entitled to receive performance compensation. Hurdle rates can be either a “hard hurdle” or a “soft hurdle.”

A hard hurdle means that the manager only receives performance compensation that exceeds the hurdle rate. A soft hurdle means that no performance compensation is received if performance falls short of the soft hurdle rate, but once the soft hurdle rate is exceeded, the manager is entitled to the entire performance compensation.

To prevent a GP from receiving duplicate performance compensation following periods of volatility, most HFs require LPs to recoup prior losses before the GP is entitled to receive additional performance compensation. To do so, a “high water mark” is established immediately following the allocation of incentive compensation. A high water mark is the highest value that an HF ever reached. Under the “loss carry forward” terms, the GP is entitled to be compensated for performance that exceeds the prior “high water mark.”

### ***Minimum Initial Contributions***

HF offering documents typically contain minimum investment thresholds as a condition to investment. Generally, the investment minimum amounts are set via the discretion of the GP. Note, however, that HFs organized under Cayman Islands laws require a statutory minimum initial investor contribution of \$100,000.

### ***Restrictions on Redemption***

HF shares may only be redeemed on a periodic basis, typically quarterly or annually. Prior to redemption, most HFs require a redemption notice from the redeeming LP. Typically, an LP must notify the GP of the intent to redeem shares no later than 30 days prior to the redemption period. So, for an HF with quarterly redemption, for example, liquidation of LP shares can take up to four months.

The restrictions on redemption limit the liquidity of HFs. But there is no established secondary trading market. A gray market facilitates secondary trading of HFs, but it is most often at a discount to net asset value. As a result, redemption, though limited, is often the best (and only) means of exiting an HF.

A GP may suspend redemptions for a period of time for a variety reasons, including stopping mass redemptions triggered by market fears.

### ***Hedge Fund Regulation***

Any HF with at least \$10 million in AUM and more than 500 investors are subject to periodic reporting under the federal Securities Exchange Act of 1934 (34-Act). For that reason, GPs generally limit the number of investors in a given HF to 100 investors. The 100-investor limit also exempts the HF from the financial condition and investment policy disclosures required under the federal Investment Company Act of 1940 (40-Act). HFs are also prohibited by the 40-

Act from making public offerings. However, they are subject to the antifraud provisions included in the federal Securities Act of 1933 (33-Act) and the 34-Act.

Recent legislation under Title IV (Regulation of Advisers to Hedge Funds and Others) of the federal Dodd-Frank Wall Street Reform and Consumer Protection Act mandates funds with between \$25 million and \$150 million in AUM to register with the state in which they operate, while those with more than \$150 million in AUM must register with the SEC.

Registered funds must report to the SEC using Form PF their use of leverage and sources of financing; use of derivatives; fund strategies and risk; largest positions; type of investors; and third-party service providers. Funds with AUM of \$500 million to \$1.5 billion must file annually, while those with AUM greater than \$1.5 billion must file quarterly.

Many HFs operating in the U.S. are also regulated by the Commodity Futures Trading Commission (CFTC), including advisers registered as commodity pool operators (CPOs) and commodity trading advisors (CTAs).

## **Hedge Fund Strategies**

While HF strategies vary, they are all intended to focus on a specific aspect of market volatility. HF strategy definitions are not absolute; that is, there may be some overlap and some judgement involved, whereby funds may be characterized under more than one strategy type. HFR categorizes hedge funds into seven strategy types: equity hedge; event-driven; fund of funds; macro; relative value; risk parity; and blockchain (relatively new category comprised of cryptocurrency and infrastructure sub-strategies).

### **Equity Strategies**

Equity strategies account for about 33% of all assets managed by HFs, the most of any other strategy. The major strategies in this group include long/short equity, market-neutral, short-biased and sector.

**Long/short equity** strategies involve holding long positions in securities that are expected to increase in value, while also holding short positions in securities expected to decline in value. HFs using a long/short equity strategy employ a wide range of fundamental and quantitative techniques to make investment decisions. Long/short HFs tend to invest primarily in publicly traded equity and their derivatives, and they tend to be long-biased.

**Market-neutral** strategy is designed to have low correlations to the equity market. Market-neutral HFs typically hold equal dollar amounts of long and short positions. Alternatively, some HFs hold the beta equivalent of the long and short positions instead of a dollar equivalent position. Beta is a measure of the volatility of a security's price relative to the overall market.

Market-neutral strategies also largely underperform the equity market because finding stock-specific anomalies is difficult given the availability of market information.

***Short-biased*** strategies allow HFs to take short positions in equity that they believe to be overvalued and are expected to fall in value more than the overall market. In a rising market, short-biased strategies can be high risk, as the value of the shorted equity may rise to an unknown limit.

***Sector*** investing is a strategy of investing in the securities of companies focused on a specific segment of the economy, such as technology or health care.

### **Event-Driven Strategies**

Corporate transactions—such as mergers and acquisitions, consolidations, recapitalization, liquidations and bankruptcy—are the basis for event-driven strategies. Merger arbitrage funds, for example, may hold long positions in an acquired company and short positions in the acquiring company, with a goal of capturing the spread between each company’s current share price and the share price once the merger is complete.

***Distressed Securities*** or ***Special Situations*** are an event-driven strategy where the securities of a nonperforming company (for example) are purchased (usually at a discount) with expectations of increasing value from performance improvements.

***Capital Structure Arbitrage*** is an event-driven strategy whereby an HF takes long and short positions in a company’s equity and other securities to exploit a perceived mispricing between the securities.

### **Hedge Fund of Funds**

A fund of funds is an HF that holds LP interest in other HFs.

### **Macro Strategy**

Macro refers to the general investment strategy based on broad political and economic outlooks of various countries. Macro strategy involves both directional analysis, which seeks to predict the rise or decline of a country’s economy, as well as relative analysis, which evaluates economic trends relative to each other.

Macro HFs are not confined to any specific investment vehicle or asset class, and can include investment in equity, debt, commodities, futures, currencies, real estate and other assets in various countries. Currency traders rely heavily on macro strategies to forecast relative currency values. Likewise, interest rate portfolio managers, which trade instruments that are keyed into sovereign debt interest rates, are heavily involved with macro fundamental analysis.

## **Arbitrage Strategies**

Arbitrage strategies seek to exploit observable price differences between closely related investments by simultaneously purchasing and selling them. When properly used, arbitrage strategies produce consistent returns with low risk. However, because price inefficiencies between investments tend to be slight, arbitrage funds must rely heavily on leverage to obtain significant returns. Due to heavy use of leverage, some arbitrage firms have suffered extreme losses when pricing differences unexpectedly shifted.

**Fixed income arbitrage** seeks to exploit pricing differences in fixed-income securities, most commonly by taking various opposing positions in inefficiently priced bonds or their derivatives, with the expectation that prices will revert to their true value over time. Common fixed-income arbitrage strategies include swap-spread arbitrage, yield curve arbitrage and capital structure arbitrage.

**Convertible arbitrage** seeks to profit from price inefficiencies of a company's convertible securities relative to its stock by taking long positions in the convertible securities while simultaneously taking a short position in the common stock (or vice versa). The increased popularity of convertible arbitrage has had the effect of diminishing available price inefficiencies, making it difficult to achieve significant returns without using leverage.

**Relative value arbitrage**, or "pairs trading," involves taking advantage of perceived price discrepancies between highly correlated investments, including stocks, options, commodities and currencies.

## **Risk Parity Strategy**

A risk parity strategy defines "risk budget" as the amount of risk a portfolio manager is willing to take on in order to pursue a target return. Volatility is an important input in determining the risk of an asset.

Risk parity diversification focuses on risk allocation, whereas traditional diversification focuses on dollar allocation. As a result, under risk parity, a portfolio may appear more diversified given the aim of equal risk across asset class.

## **Statement of Statutory Accounting Principles**

For accounting treatment of HFs, U.S. insurers' other long-term invested assets are subject to the *Statement of Statutory Accounting Principles (SSAP) No. 48—Joint Ventures, Partnerships and Limited Liability Companies*, which requires an equity method for all such investments regardless of whether it is considered to be controlled by or affiliated with the reporting entity. Under the equity method, investments wholly owned by an LLC that is directly and wholly

owned by the insurer, and that do not meet the criteria of *SSAP No. 40R—Real Estate Investments*, are initially valued at cost with periodic adjustments for gains and losses. Other long-term investments in Schedule BA that do not meet the SSAP No. 48 requirement must follow *SSAP No. 21R—Other Admitted Assets*.

## **Key Terminology**

### **Commodity Pool Operator (CPO)**

The GP of a commodity pool is typically registered as a CPO with the Commodities Futures Trading Commission (CFTC) and the National Futures Association (NFA).

### **Commodity Trading Adviser (CTA)**

Manager hired by a CPO to manage a commodity pool.

### **Drawdown**

The percentage loss from a fund's highest value to its lowest, over a particular time frame. A fund's maximum drawdown and worst historical drawdown is a measure of potential risk.

### **Form ADV**

The SEC's uniform application for investment adviser registration. Form ADV contains basic information about a registered investment adviser, including AUM and contact information.

### **Gates**

To prevent forced untimely liquidation of investment positions to satisfy large redemption requests, most hedge funds limit the percentage of the portfolio that can be withdrawn in any given redemption period. Gates are mainly instituted during periods of extreme market volatility, such as 2008 and 2009, when a large number of funds invoked gate provisions to prevent untimely liquidations.

### **Lock-up Period**

Time period that an initial investment cannot be redeemed from an HF. It is typical for an HF to require an initial lock-up period of one year or more, with quarterly or semiannual redemption allowed thereafter.

### **Master-feeder Fund**

Typical HF structure whereby a master trading fund is domiciled offshore. The master fund has two investors: another offshore fund; and a U.S. limited partnership (i.e., the feeder funds). Investors invest in the feeder funds, which, in turn, invest in the master fund.

### **Redemption Notice Period**

Required notification period for an intended redemption request. Notification is typically required in writing.



**Side Letters**

Negotiated terms that are not applicable to other investors. Often the special arrangement involves better economic terms, such as reduced management or performance fee, or more convenient withdrawal terms.