

Overview of Hedge Fund Strategies

The use of derivatives in hedge funds has always been an appealing yet controversial topic of discussion ever since the collapse of LTCM was blamed on the extensive use of leverage (among other factors). And because of this reason, we felt that it would be worthy to consider hedge funds as part of the Global Derivatives website as a topical aspect. Here, we consider in a broad sense, the various types of hedge fund strategies which exist today in one of the most mystifying and dynamic industries within the investments field. Although there are various different classifications of trading styles and strategies, we aim to highlight all the major methods used in industry today.

"It is always better to make little money most of the time than to make a lot of money once in a lifetime"

Market Neutral Strategies

These strategies are known as market neutral due to several key characteristics. Market neutral funds tend to take positions which offset each other through both a long and a short position simultaneously, in order to minimize their net position / exposure with respects to risk and return.

Long – Short:

Popular in times of uncertainty, a long-short methodology attempts to reduce market risk by taking both long and short positions in the market. This can be done by longing undervalued assets and shorting overvalued ones. If we consider what happens when the market goes up, the undervalued assets' increase in value will likely offset the correction in overvalued assets. Hedge funds will hope that the spread between the gains and losses will be positive, i.e. the undervalued assets will see an increase in value greater than any losses incurred from the overvalued assets, or vice versa.

Convertible Arbitrage:

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A seemingly complex strategy involving convertible securities (securities which can be exchanged for a predefined number of another) such as that of convertible bonds which convert into normal shares or bonds which is undertaken in order to take advantage of any price discrepancies between the convertible security and that of the exchangeable underlying. A position can be taken by longing the convertible security and shorting the underlying asset to which the convertible can be converted into in the hope that upon the conversion, there is a profit to be realized from the difference in prices.

Event Driven / Special Situations Strategies

As the strategy name suggests, event driven funds aim to profit on events related to particular companies. It is often said that these funds take a bet on direction rather than magnitude of move and play the game that something in the future will happen which will affect the company in a way which their assets move formidably. Although not limited to reorganizing firms and M & A participants, these are the primary strategies of event driven funds.

Distressed Securities:

An example of an event driven strategy is investing in distressed securities. These securities would include debt and equity of companies undergoing reorganization under Chapter 11 (in the USA), or are next to bankruptcy in the hope that the company will emerge from their positions and experience an increase in value. These securities often cost next to nothing and often give the hedge funds a position in the management of the company during the restructuring process; making them somewhat comparable to certain latter stage venture capitalists or even corporate vultures in certain respects.

Merger/Risk Arbitrage:

These funds tend to analyze companies which are potential takeover or merger targets by taking two positions. An example of this type of arbitrage would be buying a company's stock which is a target for an acquisition as the value tends to increase upon the acquisition taking place and at the same time, short the acquiring company's stock as the price of the acquirer will tend to fall in the even of an acquisition.

Long & Short

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This category of strategies involves either buying or selling a particular security based on views of the market or the company. Often, a hedge fund will leverage their position to maximize any potential gains which may be realized.

Short Selling:

To profit from short selling, one would expect or hope that the price of a particular stock will fall at a future date. Hedge funds which utilize this particular strategy will often borrow stock to sell at market prices (shorting) and if the price falls, they will buy the lot back from the market at a lower price than they purchased it for and returning the borrowed stock to realize a profit.

Long:

A widely used strategy in hedge funds; this is merely an extension to standard equity-based investment funds in longing equities or other fixed income instruments in order to profit from a rise in the price of the held asset. The main difference is that whereas investment funds cannot take on leveraged positions, a hedge fund will often utilize leveraged positions to maximize returns.

Growth Fund:

Similar to long funds, these hedge funds aim to invest in growth stocks. This strategy seeks capital appreciation as its goal. Many of these portfolios are hedged by short selling and options.

Global Macro

Global Macro:

An economics based strategy, hedge funds utilizing this type of investment strategy aims to profit from shifts in global economic conditions such as inflation, interest rates, currencies and other macro-economic factors. Interest rate derivatives and currency derivatives are commonly employed for speculative purposes and are used to profit from economic movements in particular within particular countries.

Sector and Country

Sector Funds:

Hedge funds which have particular expertise within certain industries may focus on specific sector funds which invests in a particular sector such as technology, pharmaceuticals, utilities or any other market sector. These investments usually consist of long or short positions in the stock, debt or even derivatives on the sector stocks.

Emerging Markets:

These are funds focusing on emerging markets with less-developed economies and aim to profit from market growth or economic conditions which positively affect particular securities in the emerging market. Hedge funds which use this strategy will purchase securities in the emerging market such as sovereign debt or corporate securities in the belief that their value will appreciate with economic growth.

Dynamic Strategies

Market Timing:

As the name of the strategy suggests, this involves the appropriate timing of the markets. This type of strategy often aims to profit on the correct timing of investments across markets by moving between various asset classes depending on the managers' view on the market environment.

Opportunistic:

Instead of merely switching across asset classes, these funds tend to make use of a combination of the aforementioned strategies depending on the managers' outlook on the economy. The switching between strategies is an attempt to utilize the strategies which will give way to the most profitable opportunities.

Funds of Funds

Funds of Funds:

These funds invest in other hedge funds and can be seen as being a more diversified version of the normal hedge funds with the opportunity to take on hedge fund exposure, albeit not

directly. These funds essentially analyses hedge fund manager performance and ability, rather than the actual investments within the individual hedge funds.

Funds of Funds of Funds:

A new concept developed by a New Jersey based hedge fund, funds of funds of funds (or F3s) aims to take on hedge fund exposure in terms of investable instruments whilst reducing the volatility of the fund itself. These F3s may allow investors with lower risk tolerances to take positions in the vastly mystifying hedge fund industry.

CTAs:

Otherwise known as Commodity Trading Advisors, these types of funds invest in financial and commodity futures markets. These funds are analogous to a standard mutual fund investing in equities, where instead of equities; the fund now invests in futures in an attempt to diversify futures positions to maximize the risk-reward profile. Traditionally, individual futures traders were exposed to significant risks when taking positions in futures contracts because of their low diversification and high transaction costs – CTAs are the result of the need for diversification into markets which an individual investor would otherwise find difficult to.