CFA LEVEL 1

Alternative Investments

Hedge Funds

CHARTER DOOZY

INTRODUCTION

The Evolution

Citadel

•Founded by **Ken Griffin** in 1990 (Griffin started trading convertible bonds from his Harvard dorm room)

•**Assets Under Management (AUM):** ~$63 billion (2024).

•**Investment Style:** Multi-strategy — trades across equities, fixed income, commodities, credit, and quant strategies.

•Operates **multiple autonomous investment teams** under one firm.

•Known for **fast, aggressive** trading and risk management.

•Runs **Citadel Securities**, one of the largest market makers globally.

The Evolution

Bridgewater Associates

•Founded by **Ray Dalio** in 1975 (Dalio's book *Principles* lays out his philosophy)

•**Assets Under Management (AUM):** ~$125 billion (2024).

•**Investment Style:** Macro-focused — bets on economic trends across countries and asset classes.

•Famous for the **Pure Alpha** strategy (active alpha-seeking) and **All Weather** portfolio (diversified risk parity approach).

•Deep culture of **radical transparency** and **principled decision-making**.

•Publishes influential white papers and economic research.

The Evolution

Renaissance Technologies

- Founded by **Jim Simons** in 1982 (a former codebreaker for the NSA and a mathematics professor)
- **Assets Under Management (AUM):** $130 billion (2024), though internal Medallion Fund size is capped ($10 billion).
- **Investment Style:** Quantitative — uses mathematical models, statistics, and machine learning to find trading opportunities.
- **Medallion Fund** is legendary for ~66% annual returns (before fees) over 30+ years.
- Only insiders (employees) are allowed to invest in the Medallion Fund today.
- Staffed mainly by **mathematicians, physicists, computer scientists**, not traditional finance people.

What Are Hedge Funds?

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Private, actively managed pooled investment vehicles that use non-traditional strategies to pursue absolute returns.

Access is restricted.
Strategies are wide open.

Key Characteristics of Hedge Funds

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- Lightly regulated
- Active management focus
- Flexible mandates & diverse strategies
- Use of leverage & derivatives
- Open only to accredited investors
- High fee structures (often 2% + 20%)

Where the “Hedge” Came From

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Originally

Equity long/short strategy to hedge market risk

Today

Anything goes - directional bets, global macro, statistical arbitrage

The name stuck,
but the strategies evolved.

Hedge Funds vs. Traditional Funds

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Feature	Hedge Funds	Mutual Funds / ETFs
Strategy	Flexible, unconstrained	Long-only, benchmarked
Regulation	Light	Heavy
Access	Accredited investors only	Open to public
Fees	High (2/20)	Low (0.5–1%)
Transparency	Low	High

Why Do Hedge Funds Matter?

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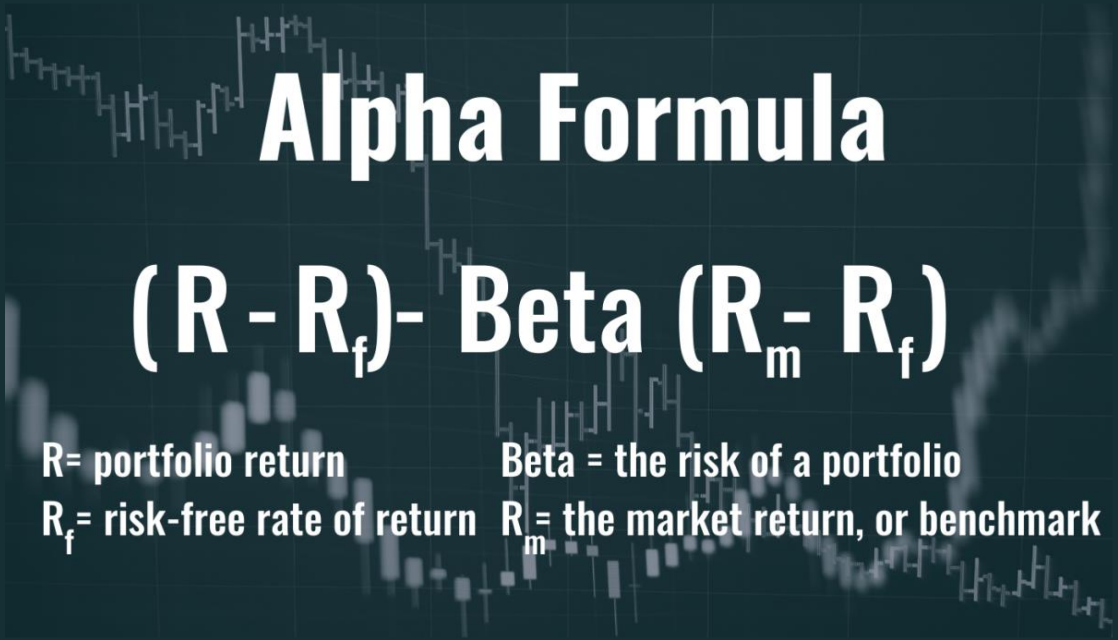
- Access to alpha
- Low correlation with traditional assets
- Portfolio diversification
- Opportunistic & nimble

Alpha is the excess returns earned on investment above the benchmark return.



Who Invests in Hedge Funds?

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- Pension funds
- Endowments & foundations
- Sovereign wealth funds
- High-net-worth individuals
- Family offices

Retail investors are excluded due to complexity and risk.

Common Hedge Fund Strategies

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- Misnomer: Not always “hedged”
- Originally equity long/short
- Today: Multi-asset, multi-strategy
- Goal: Absolute returns, not benchmark-relative

Common Investment Strategies Include:

- Long/Short Equity
- Event-Driven
- Relative Value
- Global Macro
- Multi-Strategy
- Convertible Arbitrage

Deep dive in next video

The Hedge Fund Industry

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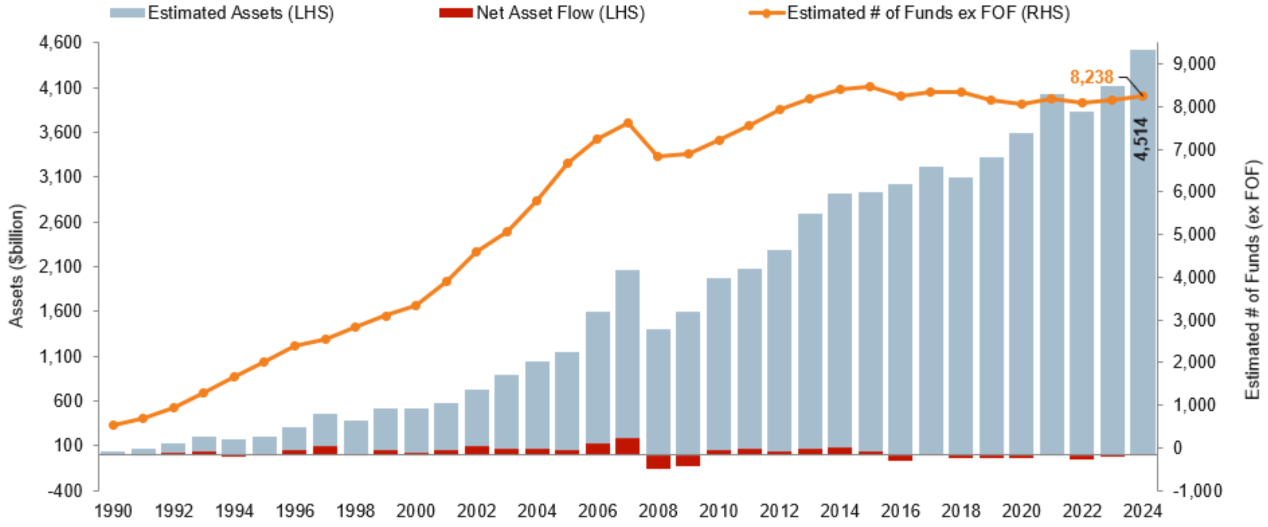
- 1950s: Birth of first hedge fund
- 1990s–2000s: Rapid growth, rise of institutional capital
- $4+ trillion AUM globally today
- Hundreds of new funds launched each year

Alfred Winslow Jones

Growth of Hedge Fund Assets and Number of Funds



Source: HFR Global Hedge Fund Industry Report – Fourth Quarter 2024 (www.hedgefundresearch.com)

Key Takeaways

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- Hedge funds are **private**, **flexible**, and **alpha-focused**
- Their strategies are often **unconventional** and **complex**
- Access is **exclusive**, with high fees and high potential reward
- The CFA exam expects **conceptual understanding**, not just definitions

Practice Question 1

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What distinguishes hedge funds from mutual funds?

A. Hedge funds cannot use derivatives
B. B. Hedge funds must match index returns
C. C. Hedge funds use flexible strategies and high leverage
D. D. Hedge funds are open to all retail investors

Practice Question 1

CHARTER DOOZY

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Correct Answer: C

Hedge funds use flexible strategies and high leverage

Practice Question 2

CHARTER DOOZY

Which of the following is not a defining characteristic of hedge funds?

A. Use of leverage and derivatives

B. B. Daily liquidity and high transparency

C. C. Focus on absolute return

D. D. Availability only to qualified investors

Practice Question 2

CHARTER DOOZY

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A. Use of leverage and derivatives

B. B. Daily liquidity and high transparency

C. C. Focus on absolute return

D. D. Availability only to qualified investors

Correct Answer: B

Daily liquidity and high transparency

Practice Question 3

CHARTER DOOZY

Which investor is least likely to invest in a hedge fund?

A. Sovereign wealth fund

B. B. Retail investor with $10,000

C. C. Pension fund

D. D. Family office

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Correct Answer: B

Retail investor with $10,000

Practice Question 4

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What is the original purpose of a hedge fund?

A. To replicate index performance

B. To offer high liquidity

C. To neutralize market exposure via long and short positions

D. To limit investment to government bonds

Practice Question 4

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Correct Answer: C

To neutralize market exposure via long and short positions

Up Next – Hedge Fund Investment Features

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Now that we know **what hedge funds are**, let's explore **how they operate**.

- Legal structures
- Fee models (including 2/20)
- Manager–investor relationships
- Operational frameworks
- Side letters and LP-GP contracts

"The difference between winning and losing is most often not quitting."— Walt Disney