CFA LEVEL 1

Alternative Investments

Hedge Funds

CHARTER DOOZY

HEDGE FUND INVESTMENT FEATURES

Distinguishing Characteristics of Hedge Fund Investments

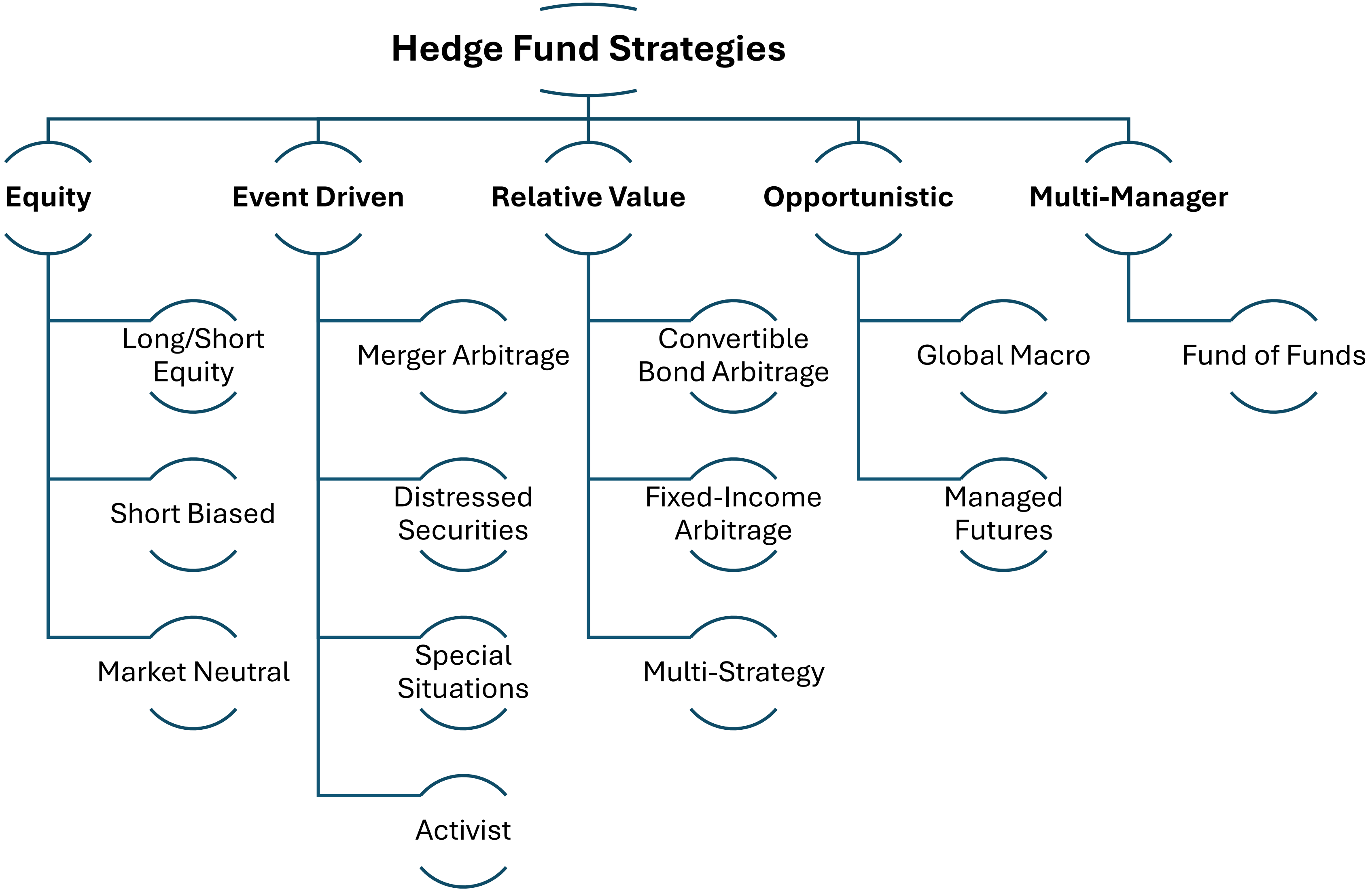
The key characteristics distinguishing hedge funds and their strategies from traditional investments include the following:

1. Less legal and regulatory constraints
2. Flexible mandates permitting the use of shorting and derivatives
3. A larger investment universe on which to focus
4. Aggressive investment styles that allow concentrated positions in securities offering exposure to credit, volatility, and liquidity risk premiums
5. Relatively liberal use of leverage
6. Liquidity constraints that include lockups and liquidity gates
7. Relatively high fee structures involving management and incentive fees

Hedge Fund Strategy Categories

CHARTER DOOZY

- Equity
- Event Driven
- Relative Value
- Opportunistic
- Multi Manager



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Multi Manager	Provide diversified hedge fund exposure with reduced manager-specific risk, at the cost of additional fees.

Long/Short Equity Strategy

CHARTER DOOZY

Takes long positions in undervalued stocks and short positions in overvalued ones to exploit pricing inefficiencies.

How It Works

- Long position: Own stocks believed to be undervalued→ e.g., Buy a regional bank trading below intrinsic value
- Short position: Borrow & sell stocks believed to be overvalued→ e.g., Short a tech stock after poor earnings
- Net exposure:
    - Market neutral (long ≈ short)
    - Net long (more long than short)
    - Net short (more short than long)

Long/Short Equity Strategy (2)

CHARTER DOOZY

Example Trades

- Pair trade: Long Coca-Cola / Short Pepsi
- Sector play: Long renewable energy / Short fossil fuels
- Style rotation: Long value stocks / Short growth stocks
- Geographic arbitrage: Long US ADR / Short local share

Key Benefits:

- Seeks alpha from security selection
- Can profit in both rising and falling markets
- Reduces exposure to broad market movements

Risks:

- Short squeeze losses
- Leverage amplifies risks
- Poor stock selection
- Timing mismatches between long and short legs

Short Biased Strategy

CHARTER DOOZY

A hedge fund strategy that seeks to profit from falling stock prices. Managers take a net short position by identifying overvalued, fraudulent, or fundamentally weak companies.

How It Works

The fund borrows and sells shares of target companies, aiming to repurchase them at lower prices. Unlike typical hedge funds that balance long and short positions, short-biased funds maintain a consistent net short exposure. Success relies on deep research into accounting red flags, inflated valuations, or sector-specific headwinds.

Short Biased Strategy (2)

CHARTER DOOZY

Equity

Event Driven

Relative Value

Opportunistic

Multi Manager

Example Trades

- Shorting a meme stock with no earnings or inflated valuation
- Targeting a company suspected of accounting fraud
- Shorting brick-and-mortar retail stocks during e-commerce expansion
- Shorting high-debt firms in a rising interest rate environment
- Shorting Russian equities during geopolitical sanctions

Key Benefits:

- Potential for strong gains during market corrections or crashes
- Acts as a hedge within broader portfolios
- Exposes corporate fraud or speculative excess
- Offers contrarian opportunities when markets are irrational

Risks:

- Markets tend to rise over time, working against shorts
- Short squeeze risk—losses can be unlimited
- Requires precise timing and deep research
- Poor risk management can lead to fund collapse in bull markets

Market Neutral Strategy

CHARTER DOOZY

A hedge fund strategy designed to eliminate market exposure (beta) by balancing long and short positions, aiming to generate returns solely from security-specific mispricings (alpha), regardless of market direction.

How It Works

The manager pairs long positions in undervalued securities with short positions in overvalued ones—typically within the same sector or factor group—to neutralize market risk. The goal is to profit from relative price movements while keeping net market exposure near zero. Some funds use quantitative models to construct factor-neutral or statistically optimized portfolios.

- Equity
- Event Driven
- Relative Value
- Opportunistic
- Multi Manager

Market Neutral Strategy (2)

CHARTER DOOZY

Example Trades

- Long Ford / Short General Motors based on valuation divergence
- Long a target company / Short the acquirer in a merger arbitrage
- Long energy stock lagging behind peers / Short energy stock that's rallied too far
- Long high-quality growth stocks / Short deteriorating value traps in the same industry

Key Benefits:

- Delivers uncorrelated returns with low volatility
- Reduces portfolio drawdowns during market turbulence
- Adds diversification to equity-heavy portfolios
- Focuses on manager skill in security selection

Risks:

- Returns may be modest, requiring leverage to enhance performance
- Assumptions around correlation and mean reversion may fail
- Short selling carries cost and execution challenges
- Underperformance during strong bull markets due to lack of beta exposure

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Merger Arbitrage Strategy

CHARTER DOOZY

Merger arbitrage is an event-driven hedge fund strategy that aims to profit from pricing inefficiencies that arise when one company announces its intention to acquire another. It involves exploiting the difference between the current trading price of the target and the acquisition offer price.

How It Works

In a cash deal, arbitrageurs buy the target company's stock after a merger announcement and aim to earn the spread if the deal closes. In a stock-for-stock deal, they go long the target and short the acquirer in the announced ratio to profit from price convergence while neutralizing market risk.

- Equity
- Event Driven
- Relative Value
- Opportunistic
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Merger Arbitrage Strategy (2)

CHARTER DOOZY

Example Trades

- **Cash merger:** Company A offers $50/share for Company B. B trades at $48. Buy B to earn the $2 spread if the deal closes.
- **Stock deal:** Company A offers 0.5 A shares per 1 B share. Buy B and short 0.5 shares of A for each B share owned. Profit when the spread converges.

Key Benefits:

- Returns are tied to deal-specific outcomes, not market direction
- Short duration trades, often 3–6 months
- Potential for attractive annualized returns
- Stock-for-stock deals allow for market hedging via shorting

Risks:

- Deal failure can lead to sharp losses
- Regulatory blocks, antitrust action, or financing problems may derail transactions
- Delays can reduce returns and tie up capital
- Hedging complexities in volatile stock-based deals

Distressed Strategy

CHARTER DOOZY

Distressed investing is an event-driven hedge fund strategy focused on buying the debt or equity of companies facing financial distress, bankruptcy, or restructuring.
The goal is to purchase these securities at deep discounts and profit as the company recovers or its assets are liquidated.

How It Works
Hedge funds identify companies undergoing serious financial trouble. They invest in senior debt, bonds, or equity trading below intrinsic value. They analyze recovery prospects—via operational turnaround, asset sales, or court-led restructuring—and aim to profit when those securities rise in value post-reorganization. Some funds actively participate in restructurings to influence outcomes.

Distressed Strategy (2)

CHARTER DOOZY

Example Trades

- Buy senior bonds of a bankrupt industrial firm trading at 40 cents on the dollar, anticipating recovery value of 70+ cents.
- Purchase loans of a distressed retailer with valuable real estate, expecting recovery through asset sales.
- Acquire defaulted debt that will convert to equity in a reorganized company.

Key Benefits:

- Potential for high returns due to deep discounts
- Exploits forced selling and market overreaction
- Opportunities to gain control or equity in reorganized firms
- Inefficiencies due to legal and market complexity

Risks:

- Company may not recover; investments can go to zero
- Legal uncertainty and drawn-out bankruptcy proceedings
- Illiquid securities can be hard to sell
- Requires deep legal and financial expertise

Special Situations Strategy

CHARTER DOOZY

A Special Situations strategy targets investments in companies undergoing unique corporate events—like spin-offs, restructurings, asset sales, or regulatory rulings—that create temporary mispricings in securities. These events are catalysts that can significantly alter the value of a company and are typically unrelated to general market movements.

How It Works
Hedge fund managers identify an upcoming event and analyze how it will impact the company's valuation or capital structure. They construct positions (long, short, or both) to profit from the anticipated outcomes. These events are often complex and under-researched, giving skilled investors an edge. The strategy may incorporate equity, credit, and derivatives across sectors and geographies.

Special Situations Strategy (2)

CHARTER DOOZY

Equity

Event Driven

Relative Value

Opportunistic

Multi Manager

Example Trades

- Buy shares of a conglomerate before a spin-off, expecting a post-event revaluation.
- Take a long position in newly issued equity after a company emerges from bankruptcy.
- Invest ahead of an FDA approval decision, based on prior trial data.
- Buy stock in a firm selling off a major division, anticipating improved balance sheet strength or a special dividend.

Key Benefits:

- Generates alpha from idiosyncratic, event-driven opportunities
- Often uncorrelated with broad market returns
- Highly flexible, allowing use of multiple asset classes and strategies
- Exploits market inefficiencies and investor uncertainty around complex events

Risks:

- The event may not occur or may have an unfavorable outcome
- Legal, regulatory, or execution delays can impact timing
- Information gaps or asymmetric access can affect outcomes
- Securities involved may be illiquid or thinly traded
- Complexity increases the potential for errors in valuation or thesis

Activist Strategy

CHARTER DOOZY

An investment approach where hedge funds acquire significant minority stakes in underperforming public companies to influence management decisions and unlock shareholder value.

Equity

Event Driven

Relative Value

Opportunistic

Multi Manager

How It Works
The fund identifies undervalued or poorly managed companies and builds a substantial stake (typically 5–10%). It then pushes for strategic, operational, or governance changes—often through direct engagement, public campaigns, or proxy battles—to improve the company's value and performance.

Activist Strategy (2)

CHARTER DOOZY

Example Trades

- Urging a company to spin off its undervalued real estate into a REIT.
- Replacing a CEO with a poor track record to restore investor confidence.
- Forcing a conglomerate breakup to focus on core business units and unlock valuation.

Key Benefits:

- Can drive significant improvements in efficiency, strategy, and valuation.
- Often leads to a positive rerating of the company's stock price.
- May create momentum for broader governance reforms.

Risks:

- High cost and complexity of campaigns.
- Potential resistance from management and lengthy proxy fights.
- No assurance of market reaction or business improvement.

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Convertible Bond Arbitrage Strategy

CHARTER DOOZY

A market-neutral hedge fund strategy that exploits pricing inefficiencies between a company's convertible bonds and its underlying stock. Convertible bonds are hybrid securities combining features of debt and equity.

How It Works
The hedge fund buys the convertible bond and simultaneously short-sells the issuer's stock to hedge the equity exposure. The goal is to profit from mispricing between the bond and the stock, collecting bond interest and benefiting from volatility while neutralizing market direction risk.

Convertible Bond Arbitrage Strategy (2)

CHARTER DOOZY

Example Trades

- Buy TechCo's convertible bond (trading at 102, convertible at $50) and short TechCo stock (trading at $45). If volatility rises or the stock moves closer to the conversion price, the convertible bond appreciates faster than the short loses value.

Key Benefits:

- Market-neutral: works in both bull and bear markets
- Long-volatility exposure: benefits from market turbulence
- Fixed income yield provides downside cushion
- Potential for equity-like upside without full equity risk

Risks:

- Credit risk: issuer downgrade or default
- Liquidity risk: bond markets can freeze in crises
- Model risk: errors in hedge ratios (delta, gamma)
- Leverage amplifies both profits and losses

Fixed-Income Arbitrage Strategy

CHARTER DOOZY

A market-neutral hedge fund strategy that seeks to exploit pricing inefficiencies between related fixed-income securities, aiming for small, consistent gains using leveraged positions.

How It Works

The strategy involves simultaneously going long and short in fixed-income instruments—such as bonds, interest rate swaps, and mortgage-backed securities—while neutralizing exposure to overall interest rate movements. Managers use quantitative models and derivatives to hedge duration and convexity risk, betting that pricing anomalies will converge over time.

Fixed-Income Arbitrage Strategy (2)

CHARTER DOOZY

Example Trades

- **Swap Spread Arbitrage**: Long 10-year Treasury, short 10-year interest rate swap.
- **Yield Curve Arbitrage**: Long 2-year and 10-year Treasuries, short 5-year Treasury to profit from curvature changes.
- **Mortgage Arbitrage**: Long agency MBS, short Treasury futures to hedge interest rate exposure.

Key Benefits:

- Potential for consistent, market-neutral returns
- Exploits short-term inefficiencies in bond markets
- Diversifies traditional equity/bond portfolios
- Uses sophisticated risk hedging and modeling techniques

Risks:

- High leverage can magnify losses
- Model and execution errors
- Liquidity risk during market stress
- Unexpected shifts in monetary policy or credit markets

Multi-Strategy Strategy

CHARTER DOOZY

A flexible hedge fund structure that allocates capital across multiple strategies—such as long/short equity, merger arbitrage, credit, and macro—within a single fund. The goal is to diversify sources of return and reduce reliance on any single market view.

How It Works

Capital is distributed among specialized teams or portfolio managers, each running a different strategy. A central investment committee or CIO oversees allocation, risk management, and portfolio construction. Allocations are dynamically adjusted based on market opportunities and relative performance. This enables the fund to capitalize on changing macro and micro conditions.

Multi-Strategy Strategy (2)

CHARTER DOOZY

Example Trades

- Long/short equity in tech vs. retail
- Merger arbitrage on pending M&A deals
- Fixed-income arbitrage using Treasuries and swaps
- Macro positions on FX or rates
- Convertible bond arbitrage paired with equity shorts

Key Benefits:

- Diversified exposure across uncorrelated strategies
- Ability to reallocate capital in real time
- Smoother return profile with reduced drawdowns
- Centralized risk oversight and capital efficiency

Risks:

- Complex to manage and assess performance attribution
- High operational and execution risks
- Key-person and organizational risks
- Potential for excessive leverage or coordination failures

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Global Macro Strategy

CHARTER DOOZY

A hedge fund strategy that seeks to profit from large-scale macroeconomic and geopolitical trends by trading across global markets and asset classes. It uses a top-down investment approach and is unconstrained by region, sector, or asset type.

How It Works
Portfolio managers develop high-conviction views on global economic conditions—such as interest rate shifts, currency movements, inflation, or geopolitical disruptions—and implement trades using instruments like futures, options, and currencies. Strategies can be discretionary (based on human judgment) or systematic (driven by quantitative models), and may be directional or relative-value.

Global Macro Strategy (2)

CHARTER DOOZY

Equity

Event Driven

Relative Value

Opportunistic

Multi Manager

Example Trades

- Long USD / Short JPY on interest rate divergence
- Short emerging market equities during currency crises
- Long gold futures amid central bank easing
- Long oil during geopolitical supply shocks
- Short German bunds vs. long U.S. Treasuries on diverging monetary policy

Key Benefits:

- Unconstrained mandate allows global, cross-asset flexibility
- Effective in volatile or crisis environments
- Diversifies portfolios due to low correlation with traditional assets
- High return potential from macro inflection points

Risks:

- Macro predictions can be wrong or mistimed
- Leverage amplifies losses if themes don't play out
- Vulnerable to policy surprises and geopolitical events
- Discretionary bias or model failure can undermine performance

Managed Futures Strategy

A hedge fund strategy that uses futures contracts—and often other derivatives—to go long or short across global asset classes, typically managed by Commodity Trading Advisors (CTAs) using systematic, trend-following models.

How It Works

The strategy identifies and exploits price trends in markets such as commodities, currencies, equity indexes, and fixed income. Most managed futures funds rely on algorithms and quantitative models to generate trading signals and rebalance portfolios dynamically. These systems may also use volatility targeting, mean reversion, or breakout indicators to adapt to market regimes.

Managed Futures Strategy (2)

CHARTER DOOZY

Example Trades

- Long crude oil futures in an extended uptrend
- Short euro futures during periods of eurozone instability
- Long U.S. Treasury bond futures as interest rates fall
- Short European equity index futures during bear markets

Key Benefits:

- Diversification: low correlation with traditional asset classes
- Crisis alpha: historically strong performance during market downturns
- Global exposure across multiple asset types
- Emotion-free, systematic investment process

Risks:

- Model risk: performance suffers if market conditions shift away from trend-based behavior
- Whipsaw risk: losses in choppy, range-bound markets
- Crowding: similar models across funds can create liquidity stress
- High turnover and transaction costs in volatile periods

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Fund of Funds Strategy

CHARTER DOOZY

A Fund of Funds (FoF) is a hedge fund that invests in a diversified portfolio of other hedge funds rather than directly in securities. This structure gives investors exposure to multiple hedge fund strategies and managers through a single investment vehicle.

How It Works

The FoF manager allocates capital across selected hedge funds with differing strategies—such as long/short equity, macro, merger arbitrage, and distressed credit. The manager conducts thorough due diligence, monitors fund performance and risk, and rebalances allocations as needed. Investors in the FoF rely on the manager's expertise for fund selection and portfolio construction.

Fund of Funds Strategy (2)

CHARTER DOOZY

Example Trades

- Allocating 25% to a long/short tech-focused hedge fund
- Allocating 15% to a macro fund shorting the yen and long U.S. treasuries
- Allocating 10% to a distressed debt fund targeting post-default Latin American corporates
- These are allocations to managers and strategies—not direct security trades.

Key Benefits:

- Instant diversification across styles and managers
- Access to top-performing or closed hedge funds
- Lower minimums compared to direct hedge fund investment
- Professional due diligence and portfolio management

Risks:

- Double layer of fees (at both FoF and underlying fund levels)Limited transparency into underlying fund positions
- Reduced liquidity, depending on redemption terms
- Manager selection risk if the FoF fails to identify strong underlying funds

Key Takeaways

CHARTER DOOZY

In summary, hedge funds:

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

Practice Question 1

CHARTER DOOZY

What distinguishes hedge funds from mutual funds?

A. Hedge funds cannot use derivatives

B. Hedge funds must match index returns

C. Hedge funds use flexible strategies and high leverage

D. Hedge funds are open to all retail investors

Practice Question 1

CHARTER DOOZY

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D. Hedge funds are open to all retail investors

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. Daily liquidity and high transparency

C. Focus on absolute return

D. Availability only to qualified investors

Practice Question 2

CHARTER DOOZY

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

A. Use of leverage and derivatives

B. Daily liquidity and high transparency

C. Focus on absolute return

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. Retail investor with $10,000

C. Pension fund

D. Family office

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CHARTER DOOZY

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A. Sovereign wealth fund

B. Retail investor with $10,000

C. Pension fund

D. Family office

Correct Answer: B

Retail investor with $10,000

Practice Question 4

CHARTER DOOZY

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

CHARTER DOOZY

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

Correct Answer: C

To neutralize market exposure via long and short positions

Up Next – Hedge Fund Investment Features

CHARTER DOOZY

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