CFA LEVEL 1

Alternative Investments

Hedge Funds

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HEDGE FUND INVESTMENT RISK, RETURN, AND DIVERSIFICATION

Big Picture Overview

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- Hedge funds **focus on alpha** — seeking unique, manager-driven returns.
- **Diversification benefits**: hedge funds can stabilize portfolios against market shocks.
- Performance is influenced by **market beta**, **strategy beta**, and **true alpha**.
- Hedge fund benchmarks suffer from **biases** that can distort reported returns.
- Investors must evaluate **risk, return, and diversification impact** carefully.

Sources of Hedge Fund Returns

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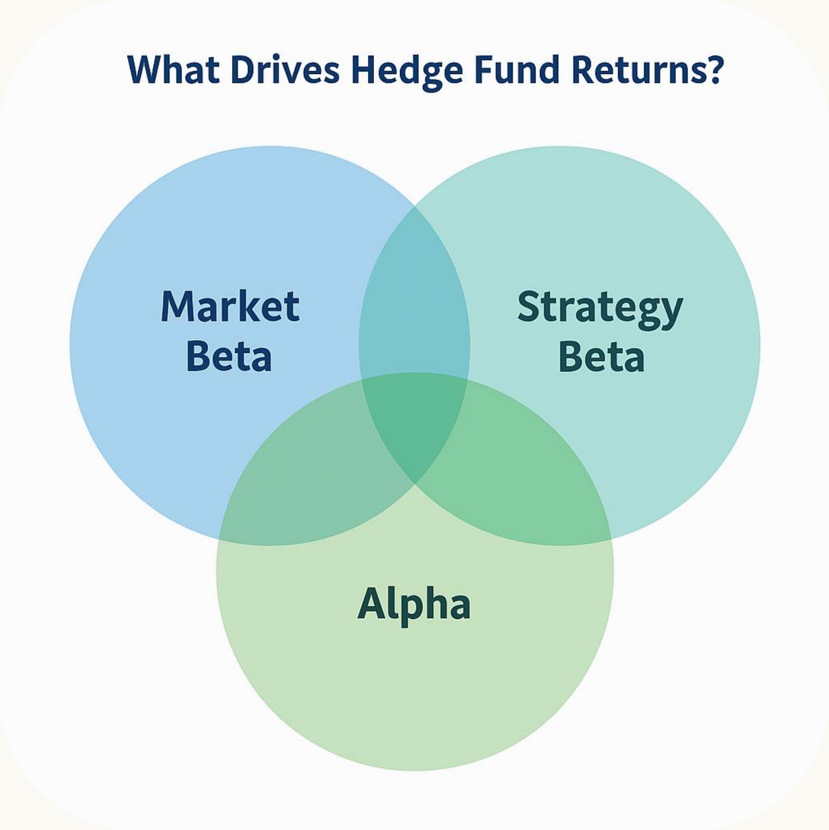
What Drives Hedge Fund Returns?

•**Market Beta:** Exposure to broad market trends (e.g., stock indexes).

•**Strategy Beta:** Return characteristics tied to the fund's chosen strategy.

•**Alpha:** Manager skill—identifying mispricing, exploiting inefficiencies.



Hedge Fund Fee Structures

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Fee Models: "Two and Twenty" and Beyond

•Traditional: **2% management fee + 20% performance fee**.

•Newer trend: **1% management fee or 30% incentive on alpha**.

•Fee pressure driven by institutional investor demands.

•Fee terms can **dramatically impact net returns** to investors.

Hedge Fund vs Traditional Funds

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Hedge Funds Play a Different Game

•Traditional funds = **Market beta** + diversification.

•Hedge funds = **Idiosyncratic returns** + alternative risks.

•Hedge funds use leverage, short selling, and alternative instruments.

•**Benchmarking** hedge funds is more complicated and less transparent.

Traditional Investing	Hedge Fund Investing
Beta-heavy	Alpha-seeking
Market-dependent	Manager-skill-dependent
Ride waves	Find hidden gems

The Hidden Biases in Hedge Fund Indexes

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Why Hedge Fund Performance Looks Better Than It Is

- **Selection bias**: Only strong-performing funds choose to report.
- **Survivorship bias**: Failed funds drop out, boosting averages.
- **Backfill bias**: Newly added funds backfill past good results.
- **Non-investable indexes**: Many hedge fund indexes can’t be directly invested in.

Hedge Fund Risks (Beyond Returns)

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Hidden Risks in Hedge Fund Investing

•**Liquidity risk:** Lockups, redemption gates delay access to cash.

•**Operational risk:** Less transparency and governance oversight.

•**Fee drag:** High management and incentive fees erode returns.

•**Fraud risk:** Lower regulatory scrutiny can open the door to abuse.

Hedge Fund Historical Returns

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What the Data Tells Us (1990–2019)

•Hedge funds had **higher returns** than bonds, **lower volatility** than stocks (1990–2014).

•In recent years (2015–2019), returns **dropped** and correlation to stocks **increased**.

•Hedge funds can still play a diversification role but **selectivity** is critical.

•Hedge fund strategies have widely varying risk/return characteristics.

Diversification Benefits

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Why Hedge Funds Still Matter

- Hedge funds historically offer **low correlation** with bonds and moderate with stocks.
- Can **stabilize** traditional 60/40 portfolios.
- Ideal for **risk diversification**, not necessarily for massive outperformance.

Key Takeaways

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- Hedge funds focus on generating **alpha**, not just riding the market.
- Hedge fund returns involve hidden biases — interpret results carefully.
- Hedge funds remain a **diversification tool**, but recent returns require **realistic expectations**.
- Liquidity constraints and high fees **must be considered**.

Practice Question 1

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Which of the following is the **primary source of alpha** in hedge fund returns?

A) Investing heavily in broad market indexes

B) Reducing leverage and trading less

C) Manager skill in exploiting inefficiencies

D) Buying government bonds during crises

Practice Question 1

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Which of the following is the **primary source of alpha** in hedge fund returns?

A) Investing heavily in broad market indexes

B) Reducing leverage and trading less

C) Manager skill in exploiting inefficiencies

D) Buying government bonds during crises

Correct Answer: D

Alpha represents excess returns driven by manager skill, not market-wide movements.

Practice Question 2

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Which type of bias is caused when only successful funds are newly added and their past returns are included?

A) Selection bias

B) Survivorship bias

C) Backfill bias

D) Liquidity bias

Practice Question 2

CHARTER DOOZY

Which type of bias is caused when only successful funds are newly added and their past returns are included?

A) Selection bias

B) Survivorship bias

C) Backfill bias

D) Liquidity bias

Correct Answer: C

Backfill bias happens when historical strong performance is added retroactively to an index.

Practice Question 3

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Hedge funds primarily aim to:

A) Outperform via market beta exposure

B) Minimize fees through passive strategies

C) Generate absolute returns independent of market trends

D) Track traditional indexes

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C) Generate absolute returns independent of market trends

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Correct Answer: C

Hedge funds strive for absolute returns using flexible strategies, regardless of broad market moves.

Practice Question 4

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Which of the following risks is **most unique** to hedge fund structures compared to mutual funds?

A) Credit risk

B) Operational risk

C) Equity risk

D) Interest rate risk

Practice Question 4

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Which of the following risks is **most unique** to hedge fund structures compared to mutual funds?

A) Credit risk

B) Operational risk

C) Equity risk

D) Interest rate risk

Correct Answer: B

Hedge funds have more operational risk due to lighter regulation and lower transparency..

You Mastered

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- Sources of hedge fund returns: beta and alpha
- Biases in hedge fund index reporting
- Risks beyond performance — liquidity, fees, and operational risk
- Diversification benefits and realistic role in portfolios

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