

Part 1: Why is there so much interest in hedge funds?

Private and institutional investors have traditionally used long-only funds that invest in equities, bonds and/or cash as the foundations of a balanced investment portfolio. However, they are increasingly turning to hedge funds for new sources of return, to diversify a portfolio or to smooth returns.

Most recently, the credit crunch has prompted investors to reassess their portfolios. The increase in market volatility, rising inflation, fears for global economic growth and poor stock market performance in many regions have led many to consider alternative investments, including hedge funds, real estate and private equity.

The appeal of hedge funds lies in four broad areas

1. The first of which is their ability to use the most suitable financial instrument for the task in hand. Flexible use of tools including derivatives, short selling and gearing, in addition to traditional long positions, help create more opportunities to generate alpha than those available to a traditional long-only fund. Furthermore, these tools can also be used to reduce potential risks.
2. Secondly, investing in hedge funds could help increase portfolio diversification. Their lack of correlation to bond and stock markets is particularly enticing for more traditionally structured portfolios, and many also specialise in a certain sector, niche area or investment technique within an asset class. This means that a well constructed hedge fund portfolio can hopefully provide low correlation between themselves as well as other asset classes.
3. Absolute returns are another attractive characteristic. A diversified hedge fund portfolio that invests in a number of managers with different risk factors can strive to produce positive annual returns in different market environments – a more intuitive measure than comparing fund performance to a benchmark index. After all, a traditional fund may outperform its benchmark but still have produced negative returns.
4. A fourth desirable feature of hedge funds is potential downside protection. As they can hold long and short positions and use derivatives for hedging purposes, they are often less volatile than long-only funds and may be better protected in declining markets.

Adding hedge funds to your investment portfolio

The combination of these desirable factors is increasingly attracting institutional investors, as a way to diversify portfolios and enhance their risk-adjusted return. The explosion in hedge fund popularity is also related to the variety available, with over 10,000 in existence¹ (Source: Hedge Funds Research). These differ widely by ethos and culture, and the regions, sectors and asset classes that they participate in, as well as the financial instruments and investment methods that they employ. Returns, risks and volatility can differ enormously by strategy, but a diversified hedge fund portfolio can be constructed to aim to deliver good consistent returns, which are often less volatile than traditional equity funds, through the use of flexible, unconstrained investment techniques.

Despite these benefits, many institutional investors are reluctant to invest in hedge funds due to the perceived risks and a lack of in-house resources or expertise to confidently select a fund. Their greater flexibility could engender a higher risk profile and investors should be comfortable with the risk/return profile and fund manager before investing. Once investors have selected a fund, they are reliant on the fund manager's skill and expertise.

Why is there so much interest in hedge funds?

For this reason, a popular way to gain exposure to hedge funds is through fund of funds. These blend exposure to several different hedge funds, and their associated investment strategies and assets classes, to produce a portfolio with more stable long-term returns than a single fund. Combining several hedge funds also reduces the risk of a fund blow-up or poor performance, making fund of funds particularly appealing to investors for whom capital preservation is important. Furthermore, the underlying funds are selected and monitored by specialist experts.

Hedge funds offer investors greater choice than ever before and there should be a fund or fund of funds to match an investor's preferred risk reward profile, asset class and other variables. However, even when all selection criteria have been met, the final consideration must be the choice of fund manager or hedge fund of fund manager, who should have the experience, skill and access to resources to maximise returns and minimise risks.

For more information contact your usual JPMorgan Asset Management representative
www.jpmorganassetmanagement.co.uk/institutional

The information in this document is based on our understanding of law and regulation at the time of publication. The value of investments and the income from them may fall as well as rise and investors may not get back the full amount invested. Hedge Funds may not be tax efficient, and have higher fees than traditional investments. They may also be highly leveraged and engaged in speculative investment techniques, which can magnify the potential for investment loss or gain. Issued by JPMorgan Asset Management Marketing limited, authorised and regulated by the Financial Services Authority. Investment is subject to documentation (Prospectus, Simplified Prospectus and Terms and Conditions), copies of which can be obtained free of charge from JPMorgan Asset Management Marketing Limited, Registered in England No. 288553, 125 London Wall, London EC2Y 5AJ.

LV – JPM2333

09/08