Part 2: What should potential hedge fund investors consider when making their selection?

Once investors have made the decision to add hedge fund exposure to their investment portfolio, they face a dazzling array of choice. With around 10,000 individual hedge funds to choose from, selecting the most appropriate investment for their needs can be daunting.

This is one reason behind the popularity of hedge fund of funds, which blend exposure to several hedge funds. Managed by experts who select and monitor each underlying fund, they usually combine multiple investment strategies, asset classes and region or sector specialisations. Spreading exposure by manager, strategy and style helps to deliver smoother returns and reduces risk, which is particularly attractive when capital preservation is important.

Hedge fund investment strategies can be divided into two broad styles: arbitrage and directional, which may be combined within fund of funds or multi-strategy portfolios. Within these styles there are numerous classifications, of which we will just touch on the most common.

Arbitrage strategies

Arbitrage strategies aim to profit from pricing anomalies based on the assumption that prices trend towards a historical norm. They often use mathematical models to identify market inefficiencies which cause prices to divert from their fair value. Relative value is one of the most common arbitrage strategies, involving the simultaneous purchase and sale of similar securities to exploit pricing differentials. Many of the funds using this strategy focus on one asset class, such as convertibles, fixed income, equity market neutral or statistical arbitrage.

Merger or event driven arbitrage funds are also relatively common within the hedge fund universe. These focus on the securities of companies that are involved, or may become involved, in mergers or other special situations that could alter their financial structure or operating strategy. These strategies aim to profit from the uncertainty over whether takeover bids will be successful and capitalise on the disparity between the current and proposed bid share prices.

Directional strategies

Within directional strategies, which tend to have more market exposure, equity long/short funds invest in undervalued securities and sell short overvalued securities, aiming to maximise absolute returns in falling as well as rising markets. Meanwhile, distressed securities funds buy equity or debt in struggling companies and seek out companies that are facing bankruptcy or are about to restructure, to profit from mispricings of often deeply discounted securities.

Opportunistic or global macro funds, also directional in style, use a variety of instruments and strategies to exploit changes in an economic or financial environment. For example, they may calculate the impact of government policy on interest rates, stock, bond, currency or commodity markets and implement trades designed to profit from this. Directional funds may also specialise in one sector, region or theme, for example emerging markets.

Adding hedge funds to your investment portfolio

Different investment strategies have their own advantages and disadvantages, which the investor must consider. For many, the best solution may be hedge fund of funds for access, diversification and oversight by a team of investment, risk management and operation specialists. However, even after deciding what type of fund to invest in, potential investors must choose a manager that they are comfortable with and meets their specific needs. Here the quality of manager is crucial.

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Although many investors believe they can assess a manager in a similar way to long only managers, for example track record, absolute performance and level of experience are all important, that is not enough. Investors must also review the strategy, operations, risk management, financing and other aspects of the business both prior to and after investment. Hedge fund of funds, which perform this investigative work for their clients in addition to the other benefits that they provide, are therefore the optimal solution for many investors.

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