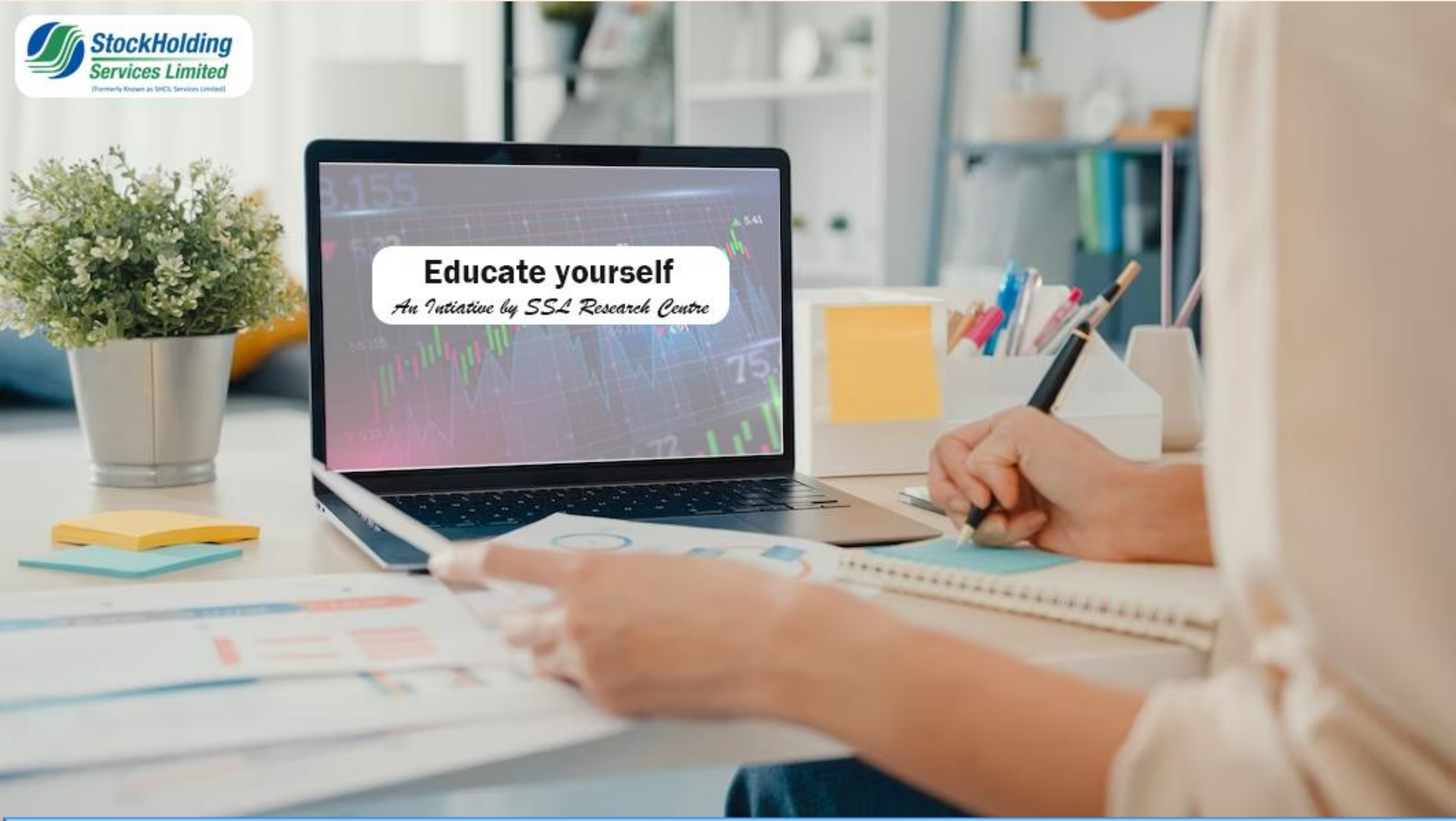

Educate yourself is an educational debate dedicated to the dissemination of stock market related terminologies in the use of fundamental and technical analysis for traders and investors. Market participants can explore self-developed skills to face the growing threats of volatility through Educate yourself.

Educate yourself is a great way to boost your knowledge in general investing lingo and helps you to trade strategically.

Title of the topic: Hedge Fund Investing

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Hedge Fund Investing

"Hello everyone hope you all are doing good", we are back with the next edition of Educate Yourself. This issue will speak upon the topic Hedge Funds Investing, what it is, how does it works, different strategies available and much more. By the end of this learning report you will have the basis knowledge of making investments in a hedge fund.

What Is a Hedge Fund?

A hedge fund is an investment vehicle that pools capital from high-net-worth investors and invests in a wide variety of assets, it is managed by professional fund managers. Hedge funds have complex portfolio-construction and risk-management techniques. Hedge fund investment is often considered a risky alternative investment choice and usually requires a high minimum investment or net worth, often targeting wealthy clients.

While reading about mutual funds, you might have come across the term 'hedge fund'. At times people confuse hedge fund as a type of mutual fund. But that is a mistake. Mutual funds and hedge funds both pool money from investors, which they invest on their behalf in different securities. That's the only similarity between the two.

How do Hedge funds work?

Hedge funds can invest capital anywhere in the market and through just about any strategy making it difficult to generalize what the "typical" hedge fund looks like. However, there are some characteristics that apply to most of them: a preference for public market investments (as opposed to private equity investments that are relatively illiquid) and a tendency to use more uncommon trading techniques such as derivatives or short selling. These funds use different types of trading techniques because of the securities and assets they invest in. They invest in equities, debt and also derivatives.

Most hedge funds buy (and/or short) publicly traded stocks, but they can also make use of alternative assets like fine art, real estate, currencies, crypto, and even patents in their money-making strategies. Different funds have different goals and employ different techniques, but all aim to produce standout returns for their clients while attempting to minimize risk.

Hedge funds' namesake comes from the way they minimize risk, many hedge funds "hedge" their bets by taking offsetting positions in assets they are long on. This could mean buying put options, selling stocks short, or even investing in assets that tend to outperform at different times in the economic cycle than their primary holdings. In doing so, they can minimize their losses to some degree should the assets they are long on fall in value.

Domestic and Offshore Hedge Fund:

Domestic Hedge Fund - Domestic hedge funds are usually organized (in USA) as limited partnerships to accommodate investors that are subject to U.S. income taxation. The fund's sponsor typically is the general partner and investment adviser. Hedge funds may also take the form of limited liability companies (LLC) or business trusts. LLPs, LLCs and business trusts are generally not separately taxed and, as a result, income is taxed only at the level of the individual investors. Each of three firms also limits investors liability; LLCs offer the additional benefit of limited liability for fund advisors (general partners).

Offshore Hedge Fund - Offshore hedge funds are typically organized as corporations in countries such as the Cayman Islands, British Virgin Islands, the Bahamas, Panama, The Netherlands Antilles or Bermuda. Offshore funds generally attract investments of US. tax exempt entities, such as pension funds, charitable trusts, foundations and endowments, as well as non-U.S. residents. U.S. tax-exempt investors favor investments in offshore hedge funds because they may be subject to taxation if they invest in domestic limited partnership hedge funds.

Hedge fund types and Strategies

Since hedge funds are private investment vehicles, they can do more or less whatever they like so long as they are upfront about their strategy to investors. (The investment strategy is normally outlined in a prospectus for investors to read before they invest.) While this degree of latitude can prove highly risky, it also affords hedge funds a huge amount of flexibility.

- ✓ Global Macro - Global Macro Strategy is an investment strategy based on the global economic outlook & ongoing trends in the economies which are expected to affect the prices of different asset classes. The manager will go long/ short on different asset classes like currencies, equities, bonds, real estate, commodities etc. based on the expectations from the economic scenarios e.g. global interest rates, economic policies etc)

- ✓ Equity - This is the largest category, with about one-third of hedge funds following this strategy. They invest in stocks globally or nationally while hedging against downturns in equity markets by shorting overvalued stocks or stock indices combining a long and short strategy, or focusing tightly on a certain sector. Equities' correlation with macroeconomic factors mean they are seen as a riskier class for investment than cash and bonds. They are highly susceptible to systematic risk factors (i.e. risks associated with the broader stock market), for example inflation, which can negatively impact future cash flows. Investors in equity strategies hedge funds also need to consider the risks associated with correlation to other equity investments held within their portfolio.

- ✓ Funds of Funds - A different kind of hedge fund is called "fund of funds". This fund also accumulates money from investors just like other hedge funds. However, the operations of this fund are not similar to other hedge funds. This is because the investing strategy of this fund is passive. This means that these funds simply give away the money to other hedge funds. Therefore, there is no active trading but instead periodic and passive monitoring of the performance given by other funds. Such funds have the opportunity to diversify their portfolio to avoid the riskiness inherent in hedge fund positions. The dangers posed by leverage are somewhat offset by this diversification.

- ✓ Market Neutral - By contrast, in market-neutral strategies, hedge funds target zero net-market exposure, which means that shorts and longs have equal market value. In such a case, the managers generate their full return from stock selection. This strategy has a lower risk than the first strategy that we discussed, but at the same time, the expected returns are also lower. For Example - A fund manager may go long in the ten biotech stocks expected to outperform and short the ten biotech stocks that may underperform. Therefore, in such a case, the gains and losses will offset each other despite how the actual market does. So even if the sector moves in any direction, the gain on the long stock is offset by a loss on the short.

- ✓ Capital structure Arbitrage Strategy - Capital structure arbitrage refers to trading strategies that take advantage of the relative mispricing across different security classes issued from the same company's capital structure. Typically, mispricing opportunities arise between equity-linked and debt-linked securities. These temporary mis-pricings arise because debt and equity markets have different participants and market structures that create different price discovery processes and speeds. For example, if a firm surprises the market and reports disappointing earnings, a company's stock may immediately fall 10 percent, but that same information may not be reflected in the company's bond price until several days later and may effect a drop in the bond's price of only 2 percent. In such a scenario, it may be possible to profit systematically from such mis-pricings and divergent intermarket dynamics.

- ✓ Quant as a strategy - A quant hedge fund is a pooled investment vehicle that uses quantitative analysis to select securities. This means that the fund relies on research, mathematical and statistical modeling to predict how an investment will perform. While investing in hedge funds is reserved only for accredited investors, anyone can work with a financial advisor to build an investment portfolio and meet their money goals.

- ✓ Event Driven - Event-driven strategies are closely related to arbitrage strategies, seeking to exploit pricing inflation and deflation that occurs in response to specific corporate events. Among these can include mergers and takeovers, reorganizations, restructuring, asset sales, spin-offs, bankruptcy, and other events creating inefficient stock pricing. Event-driven strategies require expertise in fundamental modeling and analysis of corporate events. Some examples of event-driven strategies are merger arbitrage, risk arbitrage, distressed debt, and event-based capital structure arbitrage.

- ✓ Credit Strategies - Credit strategies hedge funds invest solely or primarily in debt instruments, with the aim of profiting from inefficiencies in lending, taking long or short positions in the price of the derivative. Credit funds require significant quantitative analysis as they look to exploit specific risks related to credit instruments, such as default risk, credit spread risk, and illiquidity risk. These funds traditionally focused on corporate credit, however many funds have expanded investments into sovereign and distressed debt holdings.

- ✓ Multi-Strategy Funds - Investment managers maintain a variety of processes to arrive at an investment decision, including both quantitative and fundamental techniques. Strategies can be broadly diversified or narrowly focused on specific sectors and can range broadly in terms of levels of net exposure, leverage, holding period, concentrations of market capitalizations and valuation ranges. Various strategies are employed in a multi strategy fund. Some examples are: Convertible Bond Arbitrage; Long / Short Equity; Statistical Arbitrage; and, Merger Arbitrage.

- ✓ Alternative Risk Premia - Historically, the alternative risk premia strategy was treated as complementary to the existing core strategy utilized by a hedge fund manager, but in recent years' large institutional investors have begun to use the strategy as an investment option in its own right. Similar to a multi-strategy fund, alternative risk premia is an actively managed strategy that invests long and short across multiple asset classes, such as equities, fixed income, forex, commodities, and interest rates. The strategy aims to generate returns above the risk-free rate – the theoretical rate of return an investment can produce with zero risk – by taking on the risk of a given investment. Often systematic, trading many positions each day means that investors are provided a highly liquid offering, typically with a lower fee than more sophisticated hedge fund strategies.

Who can invest in Hedge Fund?

Only qualified or accredited investors can invest in hedge funds. They are mainly high net worth individuals (HNIs). The minimum size for investing in these funds is Rs 1 crore per investor and an entire fund needs to have a minimum corpus of Rs 20 crore.

What is the fee structure?

Hedge funds charge an asset management fee based on the fund's net assets, along with a performance-based fee. The asset management fee is generally between 1% and 2% of the fund's net assets, and is charged on a monthly or quarterly basis. The performance fee can range between 10 per cent and 15 per cent of each investor's net profits for each calendar year. The fee may go up 20%. So, if an investment of Rs 10 lakh increases to Rs 12 lakh in one year, Rs 40,000 is the fee owed to the fund.

Benefits vs risks

Benefits:

- A wide choice of investment strategies is available giving you the benefit to diversify your funds
- It gives you the potential to generate positive returns in both rising and falling equity/bond markets through its strategies
- Hedge funds help protect investors from market volatility and downturns better than other investment benchmarks.
- Public and state employee retirement plans increasingly partner with hedge funds to help provide economic security and retirement benefits to millions of workers and retirees around the world.
- It is not required that hedge funds be registered with the securities markets regulator and have no reporting requirements including regular disclosure of Net Asset Values (NAV).
- They have Access to some of the world's most talented investment managers making them a reputed investment option.

Risks:

- Dependence on the investment decisions of the fund manager
- Concentrated investment strategies can expose funds to potentially huge losses
- Typically, lower level of liquidity than mutual funds, meaning your money may be locked up for years
- They are investment funds aimed at institutions; such as companies, pension plans, and investment funds. Thus, hedge funds are not normally available to retail investors.
- Although Hedge Funds can vary widely in nature, a big portion of them are risky investments.
- Investing through an hedge fund instead of investing in financial instruments directly, generates additional costs for the client.
- The performance fee for the investment manager may encourage them to take bigger risks with your money
- There are very few government regulations overseeing hedge fund investments

Selecting a Fund

The usual approach to selecting investments does not work in the hedge fund scenario. This is because usually past returns are analyzed before making investment decisions. However, in the case of hedge funds, data relating to past returns is not available given the short life of such funds. Therefore, investors have to make their choice based on other parameters like the reputation of the fund manager, the risk control mechanisms of the fund as well as their investment philosophy.

Selecting a hedge fund is therefore a very challenging task given that there is virtually no regulation to prevent the fund from being reckless and also there is no data to support any kind of decision making,

Hedge Funds vs. Mutual Funds

While both hedge funds and mutual funds use pooled money to invest for growth, there are significant differences between the two investment vehicles.

HEDGE FUNDS	MUTUAL FUNDS
Pool money from accredited investors, which include institutional investors and high-net-worth individuals	Pool money from investors with a wide range of net worth
High minimum initial investments of Rs.1 crore	Low or no minimum initial investment requirement as less as Rs.500
Not regulated by SEBI or RBI	SEBI regulates mutual funds in India. The Reserve Bank of India (RBI) regulates mutual funds if the AMC is promoted by a bank
Limited windows for investors to invest and withdraw funds—often quarterly	Available for share purchases or redemption every day the markets are open
High fees and expenses, including as much as 20% of annual capital gains and growth	Low costs and asset management fees, particularly with no-load index funds
Use a range of investment strategies that may involve many types of assets in attempt to outperform in all types of markets	Typically adhere to a buy-and-hold securities based on a specified strategy spelled out in the prospectus
Information provided to investors only.	Annual reports are published and semi-annual disclosure of the performance of assets.

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