HEALTH WEALTH CAREER

# HEDGE FUNDS 101

MARCH 2016

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# CONTENTS

# INTRODUCTION TO ALTERNATIVES

# Alternative investment strategies seek to achieve positive returns by pursuing investments that are outside the traditional long-only portfolios of equities and fixed income.

Many of these strategies have low correlations to traditional stock and bond asset classes, which helps improve return potential compared with traditional-only portfolios at equivalent risk levels. The popularity of alternatives has grown rapidly since the 2008 financial crisis. According to Prequin, alternative assets under management stands at $7 trillion in 2015.[1] The table below shows the broad categories and their characteristics.

## ALTERNATIVE INVESTMENT CATEGORIES AND CHARACTERISTICS

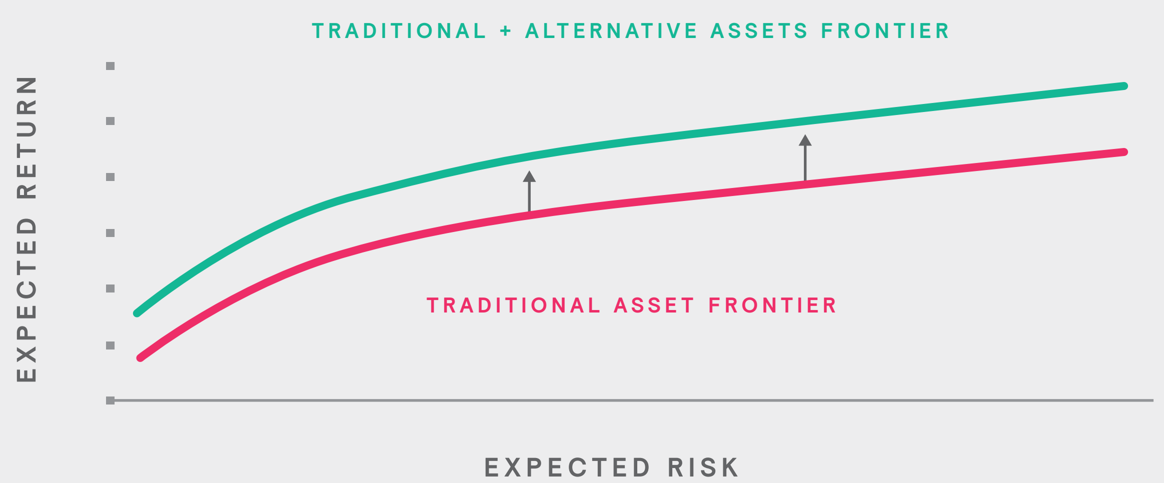
| | PRIVATE EQUITY | REAL ASSETS | HEDGE FUNDS |
|---|---|---|---|
| Composition | Venture capital, growth equity, buyouts, mezzanine debt, distressed, secondaries | Real estate, natural resources, infrastructure, commodities | Long/short equity, long/short credit, event-driven, global macro, managed futures, multi-strategy, other |
| Purpose | Improve returns relative to public equity markets, access new sources of alpha, such as illiquidity premiums | Diversify, generate income, provide some inflation-sensitive exposure | Generate alpha with less volatility than public equity markets, improve diversification, access strategies likely to assist in tail-risk hedging |

## WHY USE ALTERNATIVES?

The addition of alternatives to a traditional long equity and fixed income portfolio can improve efficiency, due to alternative strategies having lower correlations with the traditional asset classes. Effective alternative strategies can offer higher expected returns per unit of risk than traditional long equity or fixed income strategies. Alternatives can also offer additional diversification benefits, including hedging against inflation, interest rate volatility, and market risk.

[1] Preqin. *2015 Preqin Investor Network Global Alternatives Report*.

## EFFICIENT FRONTIERS: ILLUSTRATION OF FRONTIER IMPROVEMENT WITH ALTERNATIVES INCLUSION




As illustrated in the chart above, the addition of alternatives to a portfolio can improve returns over a traditional-only portfolio for any given risk level. In the following sections, this paper presents more details on some of the prevalent hedge fund strategies.

# MULTI-STRATEGY FUNDS

## Multi-strategy hedge funds invest in a variety of strategies, providing strategy diversification within a single fund.

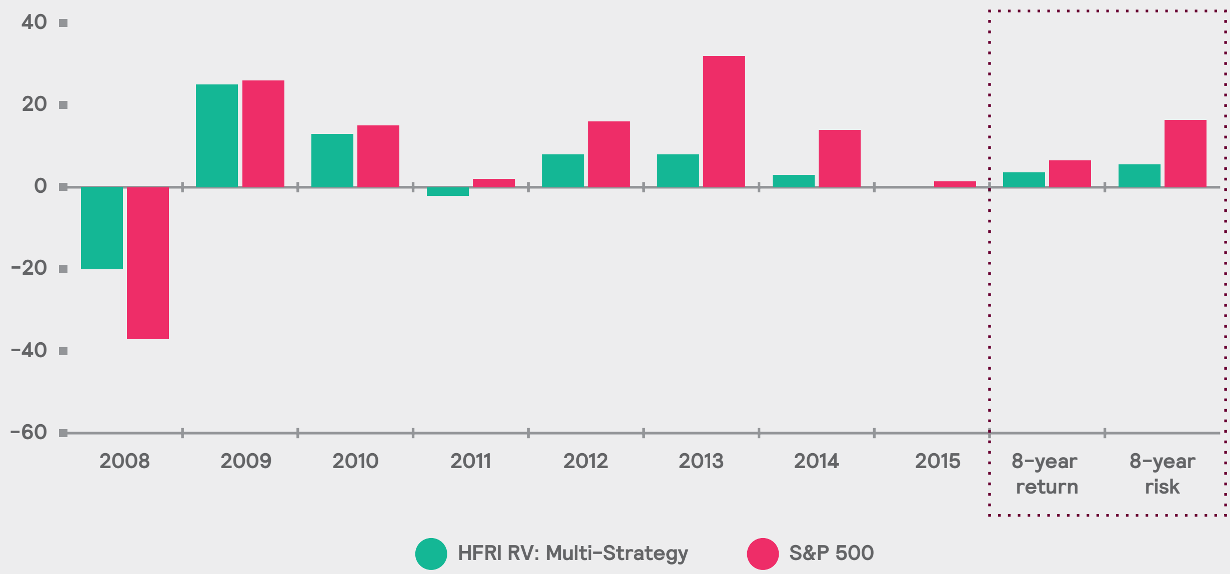
The funds typically have between three and eight underlying strategies. Some of the funds are less diversified, focusing on a particular asset class, such as credit, or a single broad strategy, such as event driven. Funds are constrained to strategies that are within the firm's expertise — however, firms with significant capital can make the investments required to bring in new high-quality strategy managers.

With multiple strategies under the purview of one firm, managers can use their market insight and risk management tools to reallocate among strategies quickly. Typically, multi-strategy funds and their general managers have a high level of control over their underlying positions because the sub-fund strategy managers share the same back office. This gives the fund's general manager insight into the overall exposures, and allows them to minimize correlations and risk factors between the underlying strategies. For investors, it means that multi-strategy funds can typically provide a high level of transparency. On the flip side, one of the main caveats of multi-strategy funds is the single-firm operational risk exposure. There have been instances where multi-strategy funds imploded and went to zero. Two examples are Amaranth (2006) and Peleton (2008). Given those risks, investment and operational due diligence is just as important for multi-strategy funds as it is for single-strategy funds.

### HOW TO USE WITHIN A HEDGE FUND PORTFOLIO

Within a core-satellite approach to hedge fund construction, diversified multi-strategy funds can be used as the core of the portfolio. The satellites around the multi-strategy fund should be selected by considering the characteristics and underlying exposures of the multi-strategy as well as the client's overall investment objectives. Although multi-strategy funds have some level of diversification, they are not recommended as a complete alternatives sleeve allocation.

## STRATEGY PERFORMANCE FROM 2008 TO 2015




Source: MercerInsight

# LONG/SHORT EQUITY AND EVENT-DRIVEN STRATEGIES

## LONG/SHORT EQUITY

Long/short equity is an investment strategy that involves buying long positions that are expected to appreciate and selling short positions that are anticipated to decrease in value. This style of investing aims to produce equity-like returns with less volatility than long-only strategies over the long run by increasing excess returns via both long and short bets and controlling the level of market risk exposure (beta).

Managers are able to control their level of market exposure (beta) by adjusting the mix of long and short positions to reflect their market outlook; leverage and derivatives are commonly used to accomplish their objectives. For instance, a manager that is bullish on the market will increase its long exposure to have a higher net exposure (long exposure minus short exposure) to the market. Conversely, a manager with a bearish outlook will increase its short positions and possibly have a negative net exposure. Therefore, the long/short manager can reduce market exposure to provide greater downside protection and lower volatility than long-only equity mandates. Although managers can and do have negative net exposures across managers and time periods long/short equity strategies tend to have a positive bias (positive net exposure) because, over time, equity market beta is generally positive.

In absolute terms, the average long/short equity strategy would perform best in a rising equity market due to its generally long equity bias. However, on a relative basis, the strategy would likely underperform the S&P 500 Index in strong market rallies due to its lower net market exposure. In flat or negative markets, particularly where returns are dispersed across equities, long/short equity strategies tend to outperform the S&P 500 Index.

## EVENT-DRIVEN

Event-driven strategies capitalize by speculating on the movement of security prices that occur in anticipation of or following a major catalyst. Typical catalysts are nonrecurring corporate events, during which market prices may not have fully adjusted — or there may be some uncertainties that create opportunities. These corporate events include, but are not limited to, mergers and acquisitions, spinoffs, bankruptcies, reorganizations, write-offs, share buybacks, special dividends, and tracking stocks. This style of investing typically includes activist hedge funds, distressed debt funds, and merger arbitrage funds. In addition, special-situation funds and multi-strategy funds are structured using a variety of event-driven strategies. Given that this type of investment strategy focuses only on company-specific events, event-driven hedge funds provide the opportunity to capture alpha while having a lower correlation to other types of investment strategies, presenting an attractive opportunity for investors looking to diversify their portfolios.

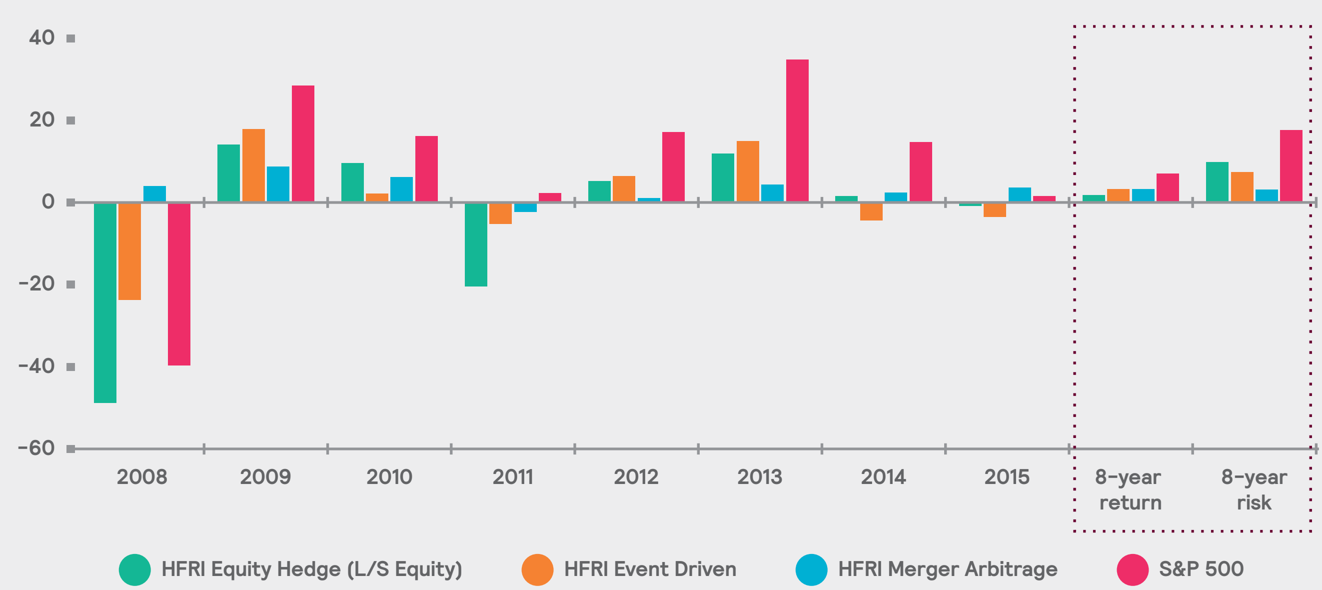
## EVENT-DRIVEN: ACTIVIST HEDGE FUNDS

Activist hedge funds seek to identify mismanaged companies and attempt to secure a majority shareholder stake so they can be actively involved in the company's management. This allows them to have an influence on driving improvements in the company's efficiency to enhance the company's prospects and valuation. Once an activist manager acquires board seats, it has the power to make changes in the form of mergers, acquisitions, or divestures. Another profitable strategy frequently used is to gain enough influence to force a share buyback or a dividend payout to benefit shareholders, including the manager, at the company's expense. Recently, in the U.S., activists have been notably succesful at inducing change at companies.

## EVENT-DRIVEN: MERGER ARBITRAGE

Merger arbitrage hedge funds seek to profit from announced mergers, typically by buying the equity of a target firm and short-selling the equity in the acquiring firm. The thesis behind this strategy is that the combined company's share price will converge in the middle. The hedge fund will typically hold the positions until the merger either goes through or fails, and ultimately profits if the events unfold as predicted.

## STRATEGY PERFORMANCE FROM 2008 TO 2015




Source: MercerInsight

# GLOBAL MACRO STRATEGIES AND MANAGED FUTURES

Global macro and managed futures strategies share many characteristics that blur the lines between them and sometimes make it difficult to determine the appropriate category. Both types of strategies can trade global bond, equity, currency, and commodity markets, and both can make directional or relative value trades — that is, whether a market will rise or fall in absolute terms or whether one market (or security) will outperform another in relative terms. In addition, both can base their decision-making on either fundamental economic or price-based indicators, have broad portfolio constraints, and can use implicit and explicit leverage. Finally, both can make use of either systematic or discretionary strategies. However, certain features tend, on average, to distinguish one style from the other.

For example, managed futures strategies (as you would expect) trade mainly markets that have futures (or similar derivative instruments) on them, whereas global macro strategies can trade a broader range of markets (including some that are less liquid) and can be more granular, sometimes trading one bond against another.

Managed futures strategies can include fundamental-based strategies, but they tend to be more price based, are predominantly directional, and are nearly always systematic. Most use past price and volume of trading as their main input to derive trading strategies based on trend following or pattern recognition, with the aim of exploiting behavioral effects of investors. Systematic, trend-following strategies seek to predict price movements from historical price data, usually over the intermediate to long term.

Pattern-recognition strategies are used to identify other market effects that can help predict price movements. This is in contrast to fundamental analysis, which takes account of economic and financial factors to identify themes and directional influences on markets.

Global macro strategies, especially the larger ones, often apply discretionary decisions. They tend to take a broad, top-down view of investing, focusing more on macroeconomic variables, but they can also include security-specific analysis. These approaches can be applied in a discretionary or systematic manner, giving rise to two main substrategies — discretionary global macro and systematic global macro.

Discretionary strategies are run by professional money managers using largely subjective research and portfolio construction. Discretionary strategies seek to add value by identifying misvaluations and trying to understand and interpret the market's psychology. Positions tend to be thematic with managers analyzing global economic fundamentals across the world.

On the other hand, systematic strategies use investment decisions based on mechanical rules devised through fundamental or price-based reasoning supported by statistical and historical analysis. Further, proprietary systems or computer trading programs may automatically make the trade order entry and exit. A significant amount of proprietary intellectual capital and quantitative research is needed for a successful systematic strategy.

Global macro and managed futures strategies offer significant benefits for a complete portfolio, starting with diversification. No inherent long or short bias results in low correlations with traditional asset classes.

| CORRELATIONS 8 YEARS ENDING DECEMBER 31, 2015 | 60% MSCI WORLD/40% CITI WGBI | (BENCHMARK) CITIGROUP WGBI | MSCI WORLD | US 3-MONTH |
|---|---|---|---|---|
| HFRI Macro (Total) | 0.32 | 0.31 | 0.27 | 0.08 |
| HFRI Systematic Macro (Mgd Futures) | 0.03 | 0.28 | -0.03 | 0.17 |

Source: MercerInsight

During times of significant equity weakness, global macro and managed futures strategies have tended to have a negative correlation to equities, mitigating a portfolio's losses during tough economic times. Examples include the Russian financial crisis and Long Term Capital Management's collapse in 1998, the tech bubble bursting in 2000 and 2003, and the most recent global financial crisis of 2007 and 2008.

Performance during down markets for managed futures funds has been strong, as the HFRI Systematic Macro and the universe median significantly outperformed global equities during 2007 and 2008. The index has lagged equities in more recent times because of the recovery leading to an equity bull market since the rebound in 2009. Ten- to 15-year performance for global macro funds was strong with low standard deviations, hence high risk-adjusted returns.

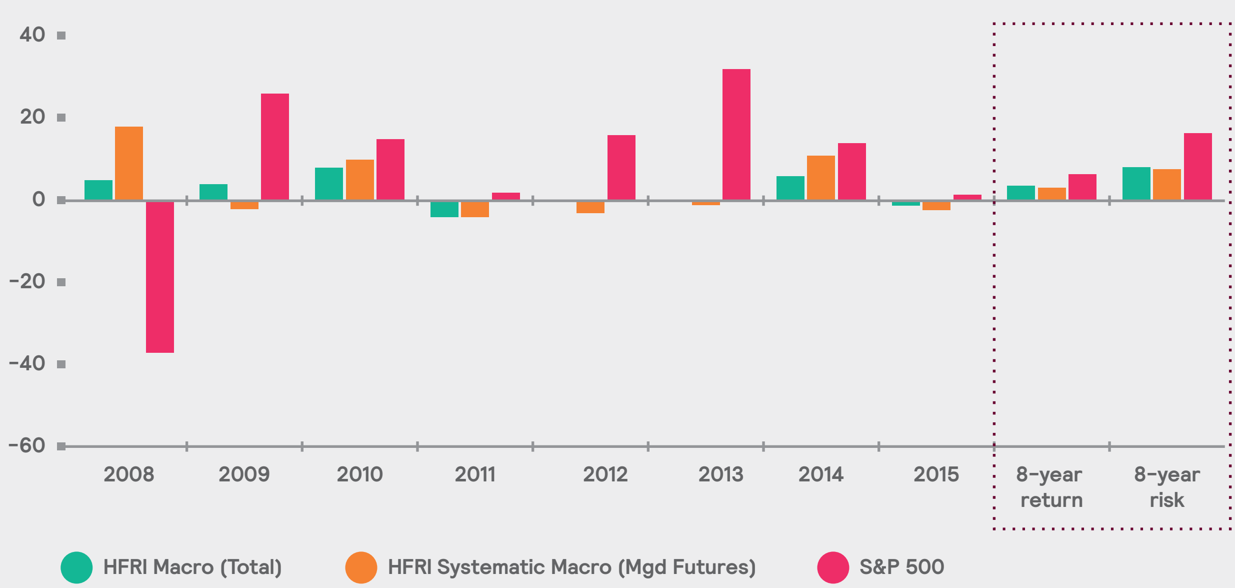
Global macro funds have historically provided significant downside protection. Over the past 20 years, when the MSCI World Index declined more than 5%, the global macro index has generally been flat to positive. Global macro funds tend to perform well when market volatility is higher and perform less well when market volatility is low, as the greater range of price movement can allow them to find opportunities and take advantage of investor irrationality. Mercer believes that the diversity of styles, breadth of assets, liquidity, and transparency of global macro strategies continue to make it an attractive approach to include in an absolute return mandate.

As with global macro funds, managed futures strategies tend to have a negative correlation to equities, mitigating a portfolio's losses during market downturns. Managed futures strategies can further diversify and lower a portfolio's volatility, as they have exhibited low correlations with traditional markets and can generate outsized returns when volatility increases, usually at the same time that traditional markets suffer setbacks.

## MANAGED FUTURES AND GLOBAL MACRO COMPARISON

| | MANAGED FUTURES | GLOBAL MACRO |
|---|---|---|
| Assets and markets | All markets with futures or forwards contracts | Any market or asset |
| Instruments | Futures. Usually forwards for currencies | Any instrument |
| Investment approach | Predominantly technical systematic approaches based on historical price patterns | Global thematic insights; systematic or discretionary |
| Best environment | In times of increasing volatility and strong trends | In regime shifts or times with limited historical precedent |

## STRATEGY PERFORMANCE FROM 2008 TO 2015




Source: MercerInsight

# DISTRESSED DEBT AND CREDIT OPPORTUNITY HEDGE FUNDS

## Distressed debt managers generally seek underperforming securities of financially troubled companies that they believe are trading below their intrinsic value.

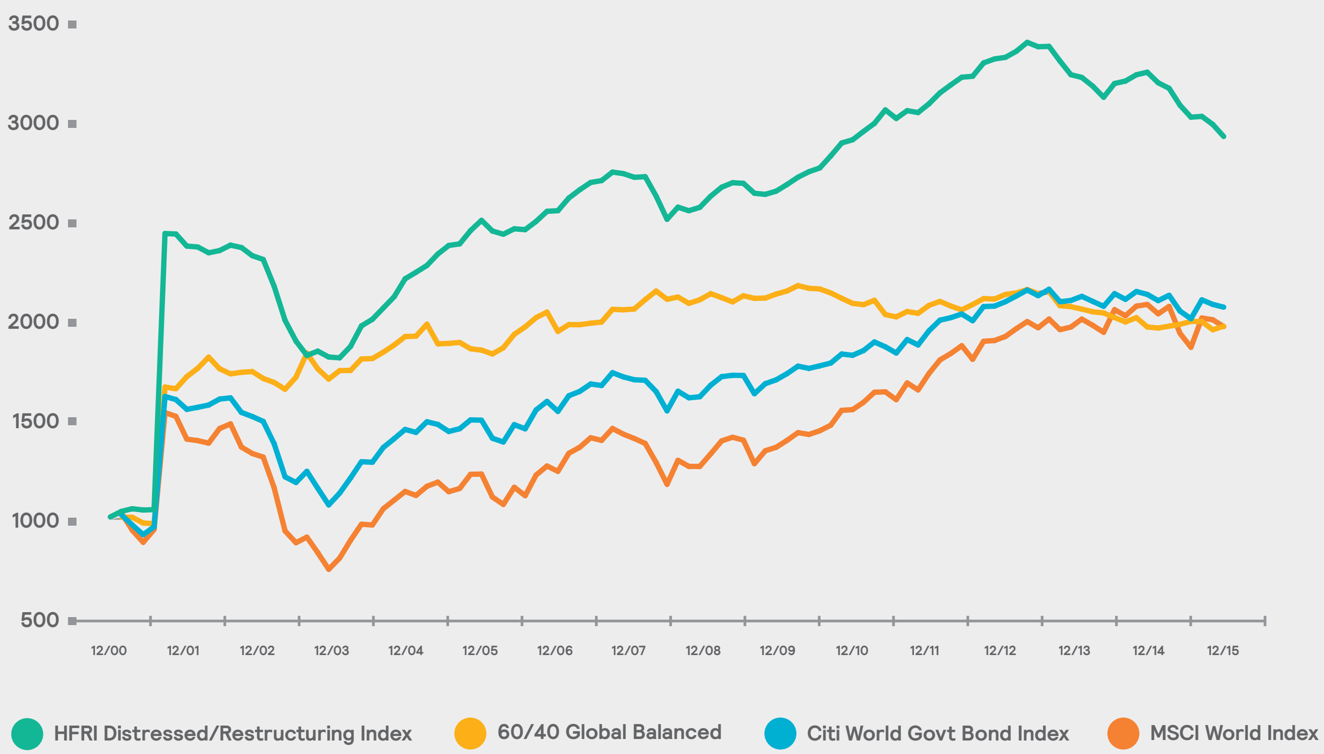
Credit opportunities managers invest across a broad opportunity set of securities, including high yield, bank debt, distressed debt, convertible securities, equities, options, and credit default swaps. The fixed income markets provide unique characteristics that allow skillful managers to add value. For instance, many institutional investors have investment policies that require the sale of fixed income securities if the securities' ratings slip below a certain level. This selling activity can create opportunities for managers to purchase credit at steep discounts.

Distressed debt managers seek primarily to invest in the securities (primarily debt) of companies that are in financial distress — meaning the company is in or is likely to enter bankruptcy. Signs of distress lead to analyst and rating agency downgrades, which further depress the value of the company's securities, as holders rush to sell securities to eliminate the risk of further loss. Once the securities have fallen in value, distressed debt funds will invest in the debt of these companies at significant discounts (often pennies on the dollar) from the par values in hopes of greater recovery during bankruptcy proceedings. When investing in debt, senior debt is often preferred in this case, as it is higher in the capital structure and carries the greatest likelihood of being repaid if the company begins liquidation.

Through the bankruptcy proceedings, many distressed managers will seek to be placed on credit steering committees and take a more activist role in their interest. The returns on distressed investing often have low correlations to the market, as the catalyst of their return is the turnaround of the individual companies, which are often not tied to broad market movements and sentiments.

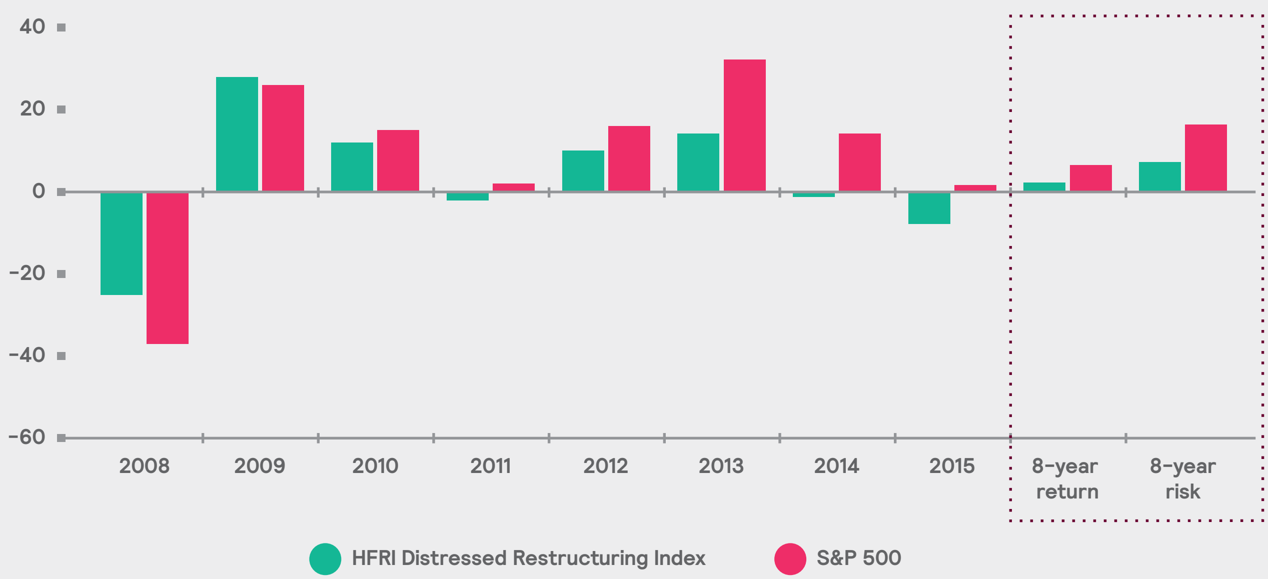
Unlike distressed managers, who primarily invest in a specific type of debt, managers who run a credit opportunities strategy largely invest in a wide range of performing and nonperforming instruments. These managers are often described as "go anywhere" and will employ a number of strategies, including distressed, long/short, market neutral, sector rotation, and relative value. Good credit opportunity managers will be able to navigate the credit cycle to overweight sectors that are in favor, and underweight sectors that are out of favor, to generate returns. Credit opportunities managers can use both fundamental and quantitative methods in an attempt to discover and exploit dislocations between companies and sectors, and across capital structures and instrument types.

Growth of $1,000 (before fees) over 15 years ending December 2015




As Illustrated in the above chart, over the past 15 years, distressed hedge funds, as measured by the HFRI ED: Distressed/ Restructuring Index, have significantly outperformed the global opportunity set of stocks and bonds, as measured by the MSCI World and Citi WGBI. Of particular note is the strength shown in recovery periods following times of financial distress, such as following the tech bubble (2001–2007) and the global financial crisis (2009–2014). During the latter period, the number of bankruptcies soared, increasing the supply of distressed paper in the market. Hedge funds swooped in to pick up the debt and benefitted strongly during the ensuing recovery. On balance, distressed debt and credit hedge funds outperformed global debt and equities on an absolute basis. In more recent periods, distressed managers have underperformed global equities but provided attractive returns, especially on a risk-adjusted basis.

## STRATEGY PERFORMANCE FROM 2008 TO 2015




Source: MercerInsight

# FUND OF FUNDS

## Hedge Funds of Funds (HFoF) are investment vehicles that invest in multiple third-party hedge fund managers.

A HFoF's manager might choose to aggregate managers of a single strategy type or can seek a diversified "multi-strategy" approach. Most HFoFs employ the multi-strategy approach.

The key advantage to the HFoFs structure is the ability to gain diversification across managers within one single fund. This is particularly advantageous for smaller investors that would otherwise be unable to meet the investment minimums to build out a fully diversified Hedge Fund program. HFoFs managers typically have 20 or more underlying managers. The HFoFs identify managers with positive expected performance and low levels of investment performance correlation. This approach maximizes the overall risk and return profile of the HFoF. The diversification of managers also reduces the risk of the "group think" that can lead to higher investment concentration and risk. For most investors, the HFoFs model provides an excellent one-stop solution for hedge fund investing. However some large institutions may desire more control over their hedge fund portfolio so as to best meet their overall investment objectives.

The HFoFs manager provides manager due diligence, operational risk assessment, and performance reporting for the underlying hedge fund managers. Additionally, HFoFs offer back-office efficiencies and are sometimes able to negotiate lower fees with underlying managers due to volume discounts.

One of the most widely publicized criticisms of HFoFs is their double layer of fees. The structure of the HFoFs fee model is a fee for the HFoFs manager as well as a pass-through of the all the underlying hedge funds. While on first glance this may seem like double dipping, investors must consider that the hedge fund of funds manager is providing manager selection and due diligence, asset allocation, and real time performance monitoring. Taken together, these functions would be prohibitively expensive for many investors seeking a diversified fund portfolio.

### HOW TO USE WITHIN A PORTFOLIO

Diversified HFoFs are intended as a complete hedge fund solution to complement traditional assets in an investor's portfolio. As such, the entire targeted hedge fund allocation should be placed with the selected Hedge Fund of Fund manager. Investment and operational due diligence remains critical for the HFoFs manager as not all HFoFs managers are created and run equally.

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