LM06 · HEDGE FUNDS · LOS A, B, C

Hedge Funds

CFA Level I · 2025 Curriculum · Alternative Investments

What Are Hedge Funds?

Private investment vehicles that pool money from **institutions and high-net-worth individuals** (accredited investors). They are NOT an asset class — they are a **collection of investment vehicles** driven by diverse strategies.

HEDGE FUND VS. MUTUAL FUND — CAPABILITY MAP

HF Hedge Fund	MF Mutual Fund
✓ Short selling allowed	✗ Long-only (generally)
✓ Heavy use of leverage	✗ Regulated leverage limits
✓ Derivatives, OTC, illiquid assets	✓ Plain vanilla equities & bonds
✓ Absolute-return mandate	✓ Benchmark-relative mandate
✓ Accredited investors only	✓ Open to retail investors
✓ Lockups + gates + notice periods	✓ Daily liquidity at NAV
✓ Management + incentive fees	✓ Management fee only (no incentive)

Learning Outcomes

- **a** Explain investment features of hedge funds and contrast with other asset classes
- **b** Describe investment forms and vehicles used in hedge fund investments
- **c** Analyze sources of risk, return, and diversification among hedge fund investments

Key Terminology

TERM	DEFINITION

GP / LP	General Partner (fund manager, unlimited liability) / Limited Partners (investors, limited liability)
Lockup Period	Minimum time investors must keep capital in the fund before redemption
Notice Period	30–90 day advance notice required before redemptions
Gate	Limit or restriction on redemptions for a period
High-Water Mark	Highest NAV net of fees — incentive fees only earned above this level
"2 and 20"	Classic fee: 2% management fee on AUM + 20% of profits
"1 or 30"	Newer: greater of 1% management fee OR 30% incentive fee above a mutually agreed-on hurdle rate
Alpha	Manager-specific return from security selection (idiosyncratic)
Fund of Funds	Diversified portfolio of hedge funds — accessible to smaller investors
SMA	Separately Managed Account — "fund of one" for large investors

Regulation · Leverage · Absolute Return · Accredited Investors · Alpha-Seeking · Lockups · High-Water Mark

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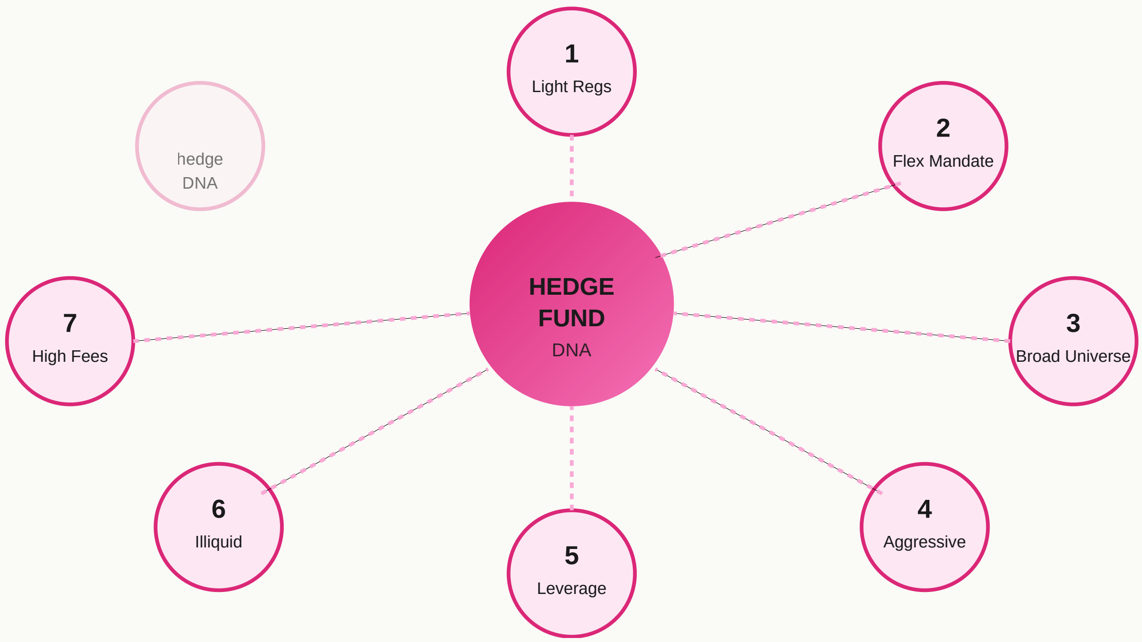
Seven Distinguishing Characteristics

These seven features set hedge funds apart from traditional investments (mutual funds, ETFs). **Memorize all seven** — they appear frequently on the exam.

THE 7 HF DNA FEATURES — RADIAL INFOGRAPHIC



#	CHARACTERISTIC	DETAIL
1	**Fewer legal/regulatory constraints**	Lightly regulated; accessible only to accredited investors
2	**Flexible mandates**	Can use shorting and derivatives — mutual funds typically cannot
3	**Larger investment universe**	Can invest across asset classes, regions, and strategies
4	**Aggressive investment styles**	Concentrated positions; credit, volatility, and liquidity risk premiums
5	**Liberal use of leverage**	Short selling, borrowing, derivatives — sometimes all three
6	**Liquidity constraints**	Lockups, notice periods (30–90 days), gates

7	**High fee structures**	Management fee + incentive/performance fee ("2 and 20")

Modern Hedge Fund Characteristics

- ✓ Aggressively managed portfolios across asset classes and regions
- ✓ Generate absolute returns or outperform benchmarks with minimal restrictions
- ✓ Organized as private limited partnerships
- ✓ Managers often invest materially in their own funds (skin in the game)
- ✓ Invest anywhere with high return opportunity — restrictions are minimal

□ **Exam Tip:** The seven distinguishing characteristics are a classic list question. If the exam asks "which is NOT a characteristic," look for something like "guaranteed returns," "daily liquidity," or "highly regulated."

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Hedge Fund Strategies — The Five Categories

Equity Hedge Strategies (Bottom-Up)

SUB-STRATEGY	HOW IT WORKS	NET BIAS
Fundamental Long/Short	Long undervalued + short overvalued securities	Net long
Fundamental Growth	Long positions in high-growth companies	Net long
Fundamental Value	Long positions in undervalued/unloved companies	Net long
Short Biased	Short overvalued equities; limited or no longs	Net short
Market Neutral	Equal $ long undervalued + short overvalued	$\beta \approx 0$

Event-Driven Strategies (Short-Term, Bottom-Up)

SUB-STRATEGY	HOW IT WORKS
Merger Arbitrage	Long target company + short acquirer. Profit when discount to deal price narrows. Risk: deal may not close.
Distressed/Restructuring	Buy fixed-income securities (including fulcrum security) of bankrupt/near-bankrupt companies at a deep discount. Profit at settlement (liquidation or equity conversion).
Activist	Buy significant equity stake in mismanaged company → influence policies (restructure, divestitures, strategy changes).
Special Situations	Buy equity of companies in restructuring other than merger/bankruptcy — security issuance, spin-offs, rescue finance.

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Strategies — Relative Value & Opportunistic

Relative Value Strategies

SUB-STRATEGY	HOW IT WORKS
Convertible Bond Arbitrage	Exploit mispricing between convertible bond and issuer's stock. Long convertible + short stock. Use puts/CDS to mitigate bankruptcy risk.
FI Asset-Backed	Exploit mispricing of asset-backed and mortgage-backed securities. Seek secure coupon return + relative quality mispricing.
FI General	Long/short trades between corporate issuers, between corporate and government, or within same issuer's capital structure.
Multi-Strategy	Allocates across multiple strategies within one fund group, seeking consistent absolute positive returns across opportunities.

Opportunistic Strategies (Top-Down)

Global Macro

Top-down approach. Trade across asset classes based on expected changes in economic policies globally. Focus on currency, fixed income, or interest rate changes.

Managed Futures (CTAs)

Actively managed directional investments in futures markets. Use technical and fundamental strategies, trend and momentum models. Historically focused on commodity futures.

Multi-Strategy vs. Fund of Funds

Multi-Strategy: Multiple strategies executed *within one fund group*, pursuing opportunities across strategies.

Fund of Funds: Invests in *separate hedge funds*. Charges an additional management fee and incentive fee on top of the underlying fund fees.

⚙ "2 AND 20" FEE CALCULATOR — INTERACTIVE

Drag the sliders. See in real-time how management fee, incentive fee, hurdle rate, and HWM split a hedge fund's gross return between the investor and the manager.

AUM ($M)	$100M
Mgmt Fee	2.00%
Incentive Fee	20%
Hurdle Rate	0.0%
Gross Return	15%
Prior HWM Gap	0.0%

Gross P&L	$15.00M
Management fee (2.00% × AUM)	− $2.00M
Incentive base (above 0.0% threshold)	$15.00M
Incentive fee (20%)	− $3.00M
Investor net return	**$10.00M (10.00%)**

Investor net

Incentive fee

Mgmt fee

□ **Exam Tip:** Classic exam trick: if gross return is **below the hurdle rate** OR **below the high-water mark**, the incentive fee is ZERO. Management fee is charged regardless. Move the "Prior HWM Gap" slider above the "Gross Return" and watch the incentive disappear.

□ **Exam Tip:** The exam loves to test: "Which strategy is MOST likely bottom-up?" (Equity hedge, event-driven) vs. "Which is top-down?" (Macro). Also know that market neutral = beta ≈ 0.

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Quiz 1 · Features & Strategies

QUIZ CHECKPOINT

Q1. Which hedge fund strategy maintains a portfolio beta approximately equal to zero?

Q2. A hedge fund that takes a significant equity stake in a public company to influence its management and policies is BEST classified as:

Q3. Global macro strategies are BEST described as:

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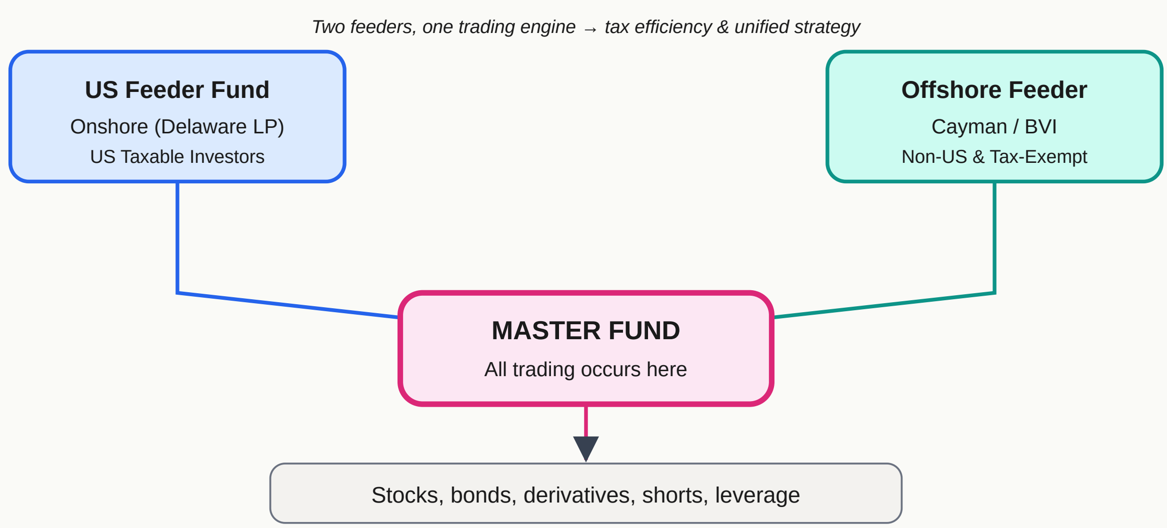
Hedge Fund Investment Forms

Direct Investment Forms

FORM	DESCRIPTION	FOR WHOM
Limited Partnership / LLC	GP = fund manager; LPs = investors. Governed by offering documents + possible side letters.	Standard accredited investors
Master-Feeder Structure	Onshore + offshore funds feed into a master fund. Tax-efficient structure.	Mixed domestic/international investors
Separately Managed Account (SMA)	"Fund of one." Assets held in investor's name; day-to-day managed by HF manager. Customizable mandates, better transparency, greater control, lower fees.	Large institutional investors

MASTER-FEEDER STRUCTURE — HOW ONSHORE/OFFSHORE CAPITAL FLOWS



Fee Structures

2 & 20

CLASSIC: 2% MGMT + 20% PROFITS

1 or 30

GREATER OF 1% MGMT OR 30% INCENTIVE ABOVE A MUTUALLY AGREED-ON HURDLE RATE

Side letters: Separate agreements for specific investors with different legal, regulatory, tax, operational, or reporting requirements.

Indirect Investment Forms

Fund of Hedge Funds

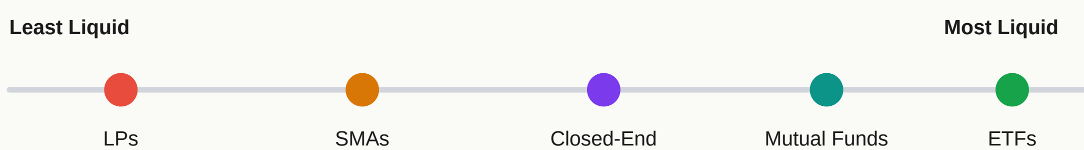
Pools investor capital across a portfolio of HFs. Lower minimums, reduced lockups, due-diligence expertise, geographic/strategy diversification.

⚠ **Double fee layer:** additional "1 and 10" fees on top of the underlying HF fees → significantly reduces net returns.

Replication ETFs

Mimic HF strategies using liquid assets. Lower fees but typically inferior returns.

LIQUIDITY SPECTRUM OF HF INVESTMENT ALTERNATIVES



□ **Exam Tip:** SMA = "fund of one" for large investors — assets held in investor's name, HF manager handles day-to-day. Fund of funds = double fees = key disadvantage.

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Redemptions, Fees & the High-Water Mark

Investor Redemption Controls

MECHANISM	PURPOSE
Redemption fees	Discourage redemptions; cover transaction costs of unwinding positions
Notice periods (30–90 days)	Allow managers to liquidate positions in an orderly manner
Lockup periods	Prevent withdrawals shortly after investment → gives managers time to implement strategies
Gates	Limit or restrict total redemptions for a period — protects remaining investors from forced liquidation at unfavorable prices

A HF's ability to demand long lockups depends on the **reputation of the firm/manager**. Redemptions during poor performance can force liquidations at unfavorable prices and magnify losses.

Custom Fee Arrangements

ARRANGEMENT	DETAILS
Liquidity/size discounts	Longer lockups → lower fees; larger investors → better terms
Founders shares	Lower fees for early investors in startup funds (e.g., "1.5 and 10" instead of "2 and 20")
Either/or fees	Lower management fee (1%) OR higher incentive fee (30%), whichever is greater
High-water mark	Incentive fees only earned above the highest previous NAV (net of fees). Different LPs may have different HWMs based on entry date.

Key insight: Because the HWM resets only when the fund hits a new peak NAV (net of fees), the manager must recover past losses before earning incentive fees again — preventing double-charging for the same gains.

SOURCES OF RETURN — HF VS. TRADITIONAL

Traditional	Hedge Fund
Alpha (small)	**Alpha (PRIMARY focus)**
Sector / Style	Sector / Style (Diversify)
Market Beta (Broad Market)	Market Beta (Mitigate)

HFs emphasize idiosyncratic risk → alpha from manager skill & market inefficiencies

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Quiz 2 · Forms & Fees

QUIZ CHECKPOINT

Q4. The primary disadvantage of investing through a fund of hedge funds is:

Q5. A separately managed account (SMA) structure is MOST beneficial for:

Q6. A high-water mark provision protects investors by ensuring that:

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Risk, Return & Diversification

Sources of HF Performance

SOURCE	DESCRIPTION
Market beta	Broad market return — replicable with index funds/ETFs. HFs seek to *minimize* this.
Strategy beta	Return attributed to the specific investment strategy applied across the market.
Alpha	Manager-specific return from selection of specific positions. The **primary focus** of HFs — driven by market inefficiencies and manager skill.

Index Biases — Why HF Returns Are Overstated

All three biases push reported index returns **above** actual investor experience.

BIAS	WHAT HAPPENS
Selection bias	Index inclusion depends on voluntary (self-reported) data — typically from better-performing funds
Survivorship bias	Funds that close or stop reporting are removed from the index
Backfill bias	When a new fund starts reporting, its prior performance is retroactively added

Most HF indexes are also **non-investable** and face reporting delays.

Historical Performance

1990–2014: HFs delivered higher returns than stocks or bonds with low correlation to traditional assets.

In recent years, HF returns have declined and correlations with global equities have increased.

Diversification Benefits — With a Catch

HFs use market-neutral, relative-value, and event-driven strategies to achieve diversification and outperform on a risk-adjusted basis. Less-than-perfect correlation with stocks provides benefit.

⚠ **Caveat:** During financial crises, HF correlations with stock markets **increase** — exactly when diversification is needed most. Post-2008, institutional investors demanded greater transparency, control, and due diligence.

Performance Appraisal Challenges

- ! Sharpe ratio requires normally distributed returns — HF returns are asymmetric and skewed
- ! Standard deviation is not a good measure of dispersion for HFs
- ! Flexible strategies and minimal disclosures make benchmarking difficult
- ! Illiquid holdings complicate performance attribution
- ! Higher fees lower net returns to investors

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Strategy Explorer & Fee-Drag Comparator

Click a strategy cell to drill into mechanics, typical return profile, and risk profile.

EQUITY · BOTTOM-UP **Long/Short**	EQUITY · BOTTOM-UP **Market Neutral**	EQUITY · BOTTOM-UP **Short Biased**	EVENT · SHORT-TERM **Merger Arb**
EVENT · SHORT-TERM **Distressed**	EVENT · SHORT-TERM **Activist**	EVENT · SHORT-TERM **Special Situations**	RELATIVE VALUE **Convertible Arb**
RELATIVE VALUE **FI Arbitrage**	RELATIVE VALUE **Multi-Strategy**	OPPORTUNISTIC · TOP-DOWN **Global Macro**	OPPORTUNISTIC · TOP-DOWN **Managed Futures**
MULTI-MANAGER **Fund of Funds**			

EQUITY · BOTTOM-UP

Market Neutral

Equal $ long undervalued + short overvalued. Portfolio beta ≈ 0. Profit from security selection, not market direction. Leverage often used because gross exposure is 2× net capital.

Approach: Long an underpriced security and short an overpriced security in the same sector — equal dollar amounts.

Vol: LOW · β: ~0 · Liquidity: Med · Leverage: Med

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Quiz 3 · Risk, Return & Biases

QUIZ CHECKPOINT

Q7. Which bias results from retroactively adding a new fund's stellar past performance to a hedge fund index?

Q8. The PRIMARY source of hedge fund excess return is:

Q9. The Sharpe ratio is a POOR measure of hedge fund risk-adjusted return because:

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Final Quiz — Comprehensive

FINAL ASSESSMENT

Q10. A convertible bond arbitrage strategy involves:

Q11. A multi-strategy hedge fund is BEST described as one that:

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Scorecard & Chapter Summary

Your Score

0 / 11

Answer all quizzes to see your result.

Key Takeaways

1. HFs are private investment vehicles for accredited investors — NOT an asset class but a collection of strategies. Seven distinguishing characteristics set them apart from traditional investments.

2. Five strategy categories: Equity (bottom-up), Event-Driven (bottom-up, short-term), Relative Value (mispricing), Opportunistic (top-down macro/CTA), Multi-Manager (FoF).

3. Market neutral = beta ≈ 0. Long/short = typically net long. Short biased = net short. Know each sub-strategy's mechanics.

4. Forms: LP (standard), SMA (large investors, "fund of one"), FoF (small investors, double fees). Fee structures: "2 and 20" classic; "1 or 30" newer.

5. HFs focus on alpha (manager skill + market inefficiencies), NOT beta. Three index biases overstate returns: selection, survivorship, backfill.

6. HFs provide diversification through low correlation with traditional assets. BUT correlations increase during financial crises. Post-2008: greater demand for transparency, control, and due diligence.

7. Sharpe ratio is a poor HF measure — returns are asymmetric/skewed. Lockups, gates, and notice periods control redemption risk.

□ **Exam Tip:** For exam day: memorize the 5-category strategy grid with sub-strategies, the 7 distinguishing characteristics, the 3 index biases (selection, survivorship, backfill), and the distinction between multi-strategy (one fund group) vs. fund of funds (separate funds with an additional fee layer).

Step 1 of 13