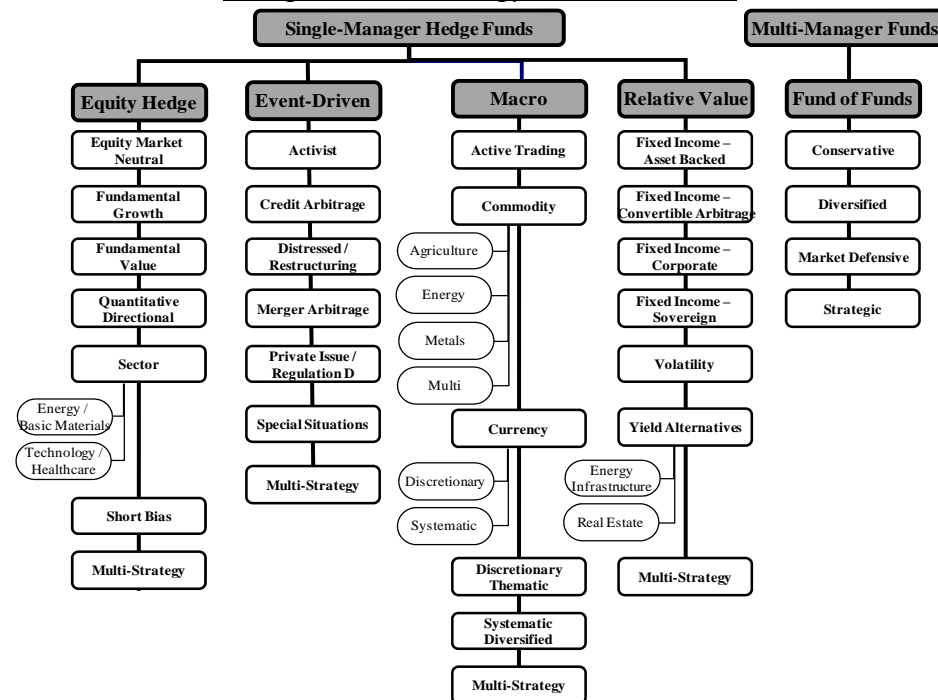


Second Quarter 2011 Knowledge College

Hedge Fund Strategies

University endowments have allocated significant assets to hedge funds over the past two decades. By 2010, the average endowment had 24 percent of its assets invested in hedge funds¹. In part due to the well publicized success of some large university endowments, smaller endowments, foundations, museums, libraries, healthcare organizations and pension funds ‘*want to be like Yale.*’ While effective hedge fund investing can help investors meet difficult investment objectives, it also brings specialized risks and challenges that must be diligently managed.

Hedge Fund Strategy Classification²



¹ Source: 2010 NACUBO-Commonfund Study of Endowments. The dollar-weighted average allocation to alternative investments was 52 percent for the 850 institutions surveyed. On average, about 46 percent of the alternative investment allocation was invested in hedge funds, which implies a 24 percent average hedge fund allocation. Hedge funds include marketable alternative strategies (i.e., hedge funds, absolute return, market neutral, long/short, 130/30, event-driven and derivatives) and distressed debt. The percentage of the alternative investments allocation was positively correlated to endowment size.

² Source: HFR Global Industry Report – Year End 2010



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The hedge fund industry has grown and evolved significantly over the past decade. By the end of 2010, Hedge Fund Research counts 9,200 total hedge funds with nearly \$2 trillion in assets. Today's hedge fund landscape is crowded with new specialized strategies sprouting up seemingly overnight. Hedge Fund Research's classification system has five broad categories: *Equity Hedge*, *Event Driven*, *Macro*, *Relative Value* and *Multi-Manager*. Each category is composed of several underlying strategies with varying sub-styles. Many of these strategies, styles and nuanced sub-styles overlap.

Equity Hedge

Equity hedge managers maintain long and short positions primarily in equity and derivative securities. Portfolio selection can be driven by either quantitative or fundamental strategies. Strategies can be broad (global) or narrow (sector specific) and have ranges of net exposures, leverage, holding periods and concentrations to various market capitalizations. The equity hedge category has several sub-strategies:

- *Market neutral* managers often use quantitative techniques to build long-short portfolios, but maintain little directional exposure to the market.
- *Quantitative directional* managers are similar to market neutral managers, but they have greater leeway to maintain directional market exposure.
- *Fundamental growth and value* managers follow stock selection processes similar to traditional growth and value managers, but can also employ leverage and short-selling.
- *Sector specialists* concentrate on specific sectors (e.g., healthcare, technology, energy, etc.), but usually maintain net positive market exposure to their sectors.
- *Short-biased* strategies are similar to traditional long-short, but typically maintain varying levels of net short exposure.
- *Multi-strategy equity hedged* managers employ multiple hedged equity strategies within a single portfolio.

Event Driven

Event driven managers take positions in companies involved in corporate transactions such as mergers, restructurings, financial distress, tender offers, shareholder buybacks, debt exchanges, security issuance or other capital structure events. Security types can range from senior to junior in the capital structure. Such managers frequently use derivatives. Their investment theses are typically fundamentally-driven. The event driven category has several sub-strategies:

- *Activist* managers seek to gain control to change management or the strategic direction of a company ostensibly to maximize shareholder value.
- *Credit arbitrage* managers seek to exploit mispricing among debt securities of an issuer.
- *Distressed* managers seek to profit from purchasing deeply discounted credit securities or instruments as a result of a company's actual or impending bankruptcy.
- *Merger arbitrage* managers seek opportunities in equity and equity related instruments of companies engaged in ownership transactions.
- *Private issue* strategies buy equity and equity related instruments that are primarily private or illiquid securities of companies.
- *Special situation* managers focus on opportunities in equity and equity related instruments of companies which are engaged in a corporate transaction, security issuance/repurchase, asset sales, division spin-off or other catalyst.
- *Multi-strategy event-driven managers* employ multiple event-driven strategies within a single portfolio.



Macro

Macro managers take an over-arching economic world view. They engage in strategies where economic change impacts equity, fixed income, currency and commodities markets. The macro category has several sub-strategies:

- *Active trading* strategies employ either discretionary or rules-based high-frequency trading in multiple asset classes.
- *Single commodity* managers trade a single commodity type (e.g. metals, energy, agriculture) using a fundamental, systematic or technical process.
- *Multi-commodity* managers include both discretionary and systematic commodity strategies. Systematic means that mathematical, algorithmic and technical models drive portfolio positioning. The systematic commodity trading strategies are often used by Commodity Trading Advisors (CTAs). Discretionary commodity strategies rely on fundamental evaluation of markets, relationships and influences as they relate to commodity markets.
- *Currency discretionary* strategies rely on fundamental evaluation of market data to trade currency markets. They generally use top-down macroeconomic analysis of variables.
- *Currency systematic* strategies are driven by mathematical, algorithmic and technical models.
- *Discretionary thematic* strategies trade in equity, interest rates, fixed income, currency and commodity markets. They rely on the evaluation of market relationships and influences and a top down analysis of macroeconomic variables.
- *Systematic diversified* strategies trade multiple asset classes and are driven by mathematical, algorithmic and technical models.
- *Multi-strategy macro* managers employ a variety of macro strategies within a single portfolio.

Relative Value

Relative Value managers seek to exploit value discrepancies between securities. They employ a variety of fundamental and quantitative techniques to develop investment theses. They trade equities, fixed income, convertible bonds, and derivatives. The relative value category has several sub-strategies:

- *Fixed income-asset backed* strategies seek to exploit mispriced spread relationships between related fixed income instruments backed by physical collateral or other financial obligations (i.e., loans, mortgages, credit cards, etc).
- *Fixed income-convertible arbitrage* strategies seek to exploit mispricing between a convertible bond and the stock of the issuer. They also may arbitrage spreads between other related instruments.
- *Fixed income-corporate* strategies seek to exploit the spread between multiple related corporate fixed income instruments. *Fixed income-corporate strategies* differ from *event-driven credit arbitrage* in that the former uses general market hedges. Event driven credit arbitrage typically has little or no net credit market exposure.
- *Fixed income - sovereign* strategies seek to exploit spreads between a sovereign fixed income instrument (foreign government bond) and some related instrument (a corporate bond or a derivative contract).
- *Volatility* strategies trade *implied volatility* as an asset class. They use derivative instruments such as options, and swaps on the volatility index (VIX) or some other measure of volatility. Volatility exposures can be long, short, neutral or variable to the direction of implied volatility.
- *Yield alternatives – energy infrastructure* strategies seek to exploit valuation discrepancies between master limited partnerships (MLPs), utilities or power generators. They typically use fundamental analysis.
- *Alternatives – Real Estate* strategies seek to exploit the valuation differences between related instruments with exposure to real estate. Strategies are typically fundamentally driven.
- *Multi-Strategy relative value* seeks to arbitrage spread relationships among any of the above.



Multi-Strategy

Multi-strategy funds allocate capital opportunistically among various hedge fund categories, strategies and styles. “Multi-strat” managers typically lever the whole portfolio. Total portfolio assets back the obligations of each specific underlying leveraged position. There is an important difference between single multi-strategy manager and multi-strategy fund of funds. Cross collateralization within a single multi-strat manager theoretically allows one errant highly levered strategy or trade to bring down the entire portfolio. A multi-strategy fund of hedge funds allocates capital to several hedge fund firms so this cross collateralization does not occur.

Multi-Manager Fund of Hedge Funds

Funds of hedge funds managers (FOHFs) invest in other hedge funds or managed account programs. A FOHF provides investors with “one-stop-shopping” to achieve strategy and manager diversification. A fund of hedge funds may also tactically weight the portfolio toward the strategies and managers they believe are best positioned for the future. The portfolio will typically diversify across a variety of investment managers, investment strategies and subcategories. However, fund of hedge funds have a double layer of fees.

Fund of Hedge Funds versus Direct Investment

Once one has made the decision to invest in hedge funds, there are a number of ways to access them. Key criteria are the investor’s size and manager evaluation acumen. One option is to invest directly and build a diversified portfolio of hedge funds. Direct investment can make sense when the investor allocates greater than \$25 million to hedge funds and has the ability to effectively evaluate and monitor hedge fund managers. It can be challenging to build a diversified portfolio of direct hedge funds with less than \$10 million regardless of the investor’s manager evaluation and due diligence capabilities. For smaller hedge fund investors, it is preferable to invest through a fund of funds (HFOF) vehicle, where an outside manager selects and diversifies among multiple hedge fund managers and strategies. For investors allocating between \$10 and \$25 million to hedge funds, a hybrid “core-satellite” model may be appropriate. This core-satellite approach has a core investment in a HFOF, but also satellite investments in direct hedge funds. This enables the core to be diversified among multiple managers and strategies, while allowing concentration in higher conviction strategies and managers.

Conclusion

Investing in hedge funds presents unique challenges and risks, but there are compelling arguments for their inclusion in a broadly diversified portfolio. However, investors should approach hedge funds with sufficient diligence and healthy skepticism.

If you would like more information about direct hedge fund investing or investing through fund of hedge funds, ask your DiMeo Schneider & Associates, L.L.C.’s investment consultant or visit our [Research & Resource Center](http://www.dimeoschneider.com) at www.dimeoschneider.com for a copy of our comprehensive paper: *Hedge Funds: Opportunities, Challenges and Market Evolution*.