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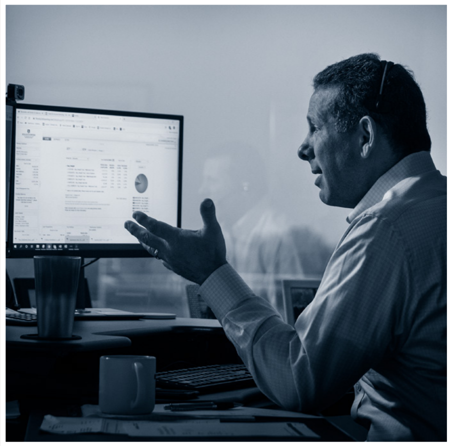

An Alternative Approach to Investing: Hedge Funds

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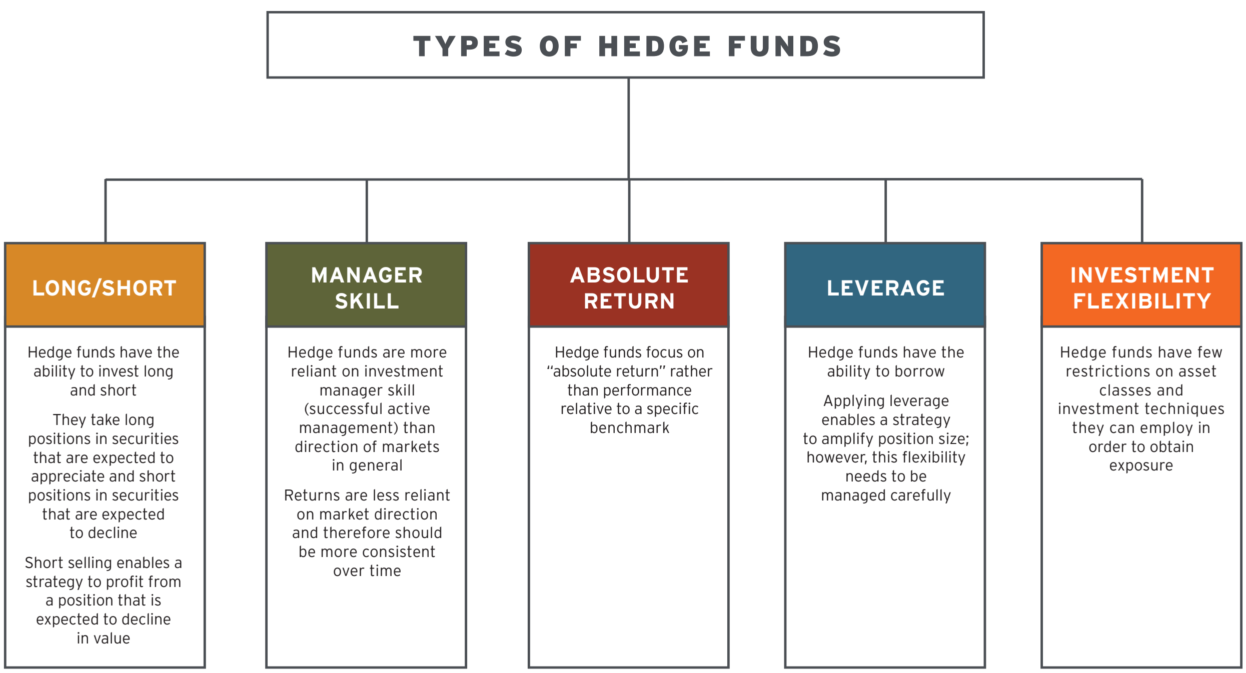
Hedge funds are able to deploy different strategies than available in the traditional mutual funds structure. Common objectives for hedge fund managers are to earn equity-like returns, while minimizing the fluctuations investors experience when being invested in the equity markets. Hedge funds can provide exposure to non-traditional return drivers and play an important role in achieving a well diversified portfolio. Hedge funds are generally unconstrained and flexible in nature, often permitting dynamic trading strategies that are intended to enhance returns by exploiting market inefficiencies.

The goal for many hedge funds is to earn positive risk-adjusted performance in all market conditions. Hedge funds are typically evaluated using an absolute return standard, such as a risk-free return plus a spread, independent of how the market or benchmarks are performing.

Types of Investments



References: Mercer, Case for Hedge Funds 2019. For illustrative and educational purposes only.

Examples of Trading Strategies Used by Hedge Funds

- Equity hedge - manager purchases positions that are expected to appreciate in value and sells positions that are anticipated to decrease in value (Long/Short)
- Relative value - manager seeks to enhance returns by exploiting pricing inefficiencies between related financial instruments such as stocks or bonds (Convertible Arbitrage)
- Event driven - manager seeks to enhance returns by capitalizing on misplaced securities associated with corporate transactions such as mergers, acquisitions, reorganizations, bankruptcies, or other corporate actions (Distressed Debt)
- Macro Trading - manager applies an opportunistic approach that aims to profit from market swings caused by political or economic events (COVID-19)

Structure

Hedge funds are generally structured as a limited partnership with a limited liability company (LLC) affiliated with the hedge fund manager being the general partners (GPs), and limited partners of the fund as the investors. The GPs usually hold total liability for the fund, while limited partners are only accountable for the amount they invest.

A hedge fund can broadly be broken down into three categories:

1. Single-strategy hedge fund - invests using one investment strategy for which the manager has aquired a deep knowledge or skill set for investing.
2. Multi-strategy hedge fund - invests in many different strategies, while still operating a single fund.
3. Fund of hedge funds - invests in a collection of different hedge funds, typically looking to diversify risk from any single manager; these investments do include an additional layer of fees.

Considerations in Allocating to Hedge Fund

Characteristics of hedge funds include:

- The ability to invest long and short positions
- Measurement of performance in absolute terms
- Usually charge a management and incentive fee
- Generally, require high minimum investments and are only available to accredited investors or qualified purchasers
- Less liquid than mutual funds and may impose lock-up periods (quarterly to three years)
- Hedge fund managers usually invest their own capital along with clients

Noteworthy Risks of Hedge Funds:

- Illiquidity
- Use of leverage
- Lack of transparency
- Strategy-specific risk

Evaluating Alternatives

What is important in evaluating alternatives to add to an individual's portfolio?

- Having a thorough and knowledgeable team that understands and can navigate investing in alternatives.
- Access to top-tier alternative investments.
- Lower and more attainable minimums for individual clients.
- Understanding how that investment is expected to perform over time and monitoring that performance.
- Understanding the fee structure.
- Understanding the illiquid and long-term commitment to the investment.

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