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Video Transcript

# Introduction to Hedge Funds

**Emma Cory**

As with any investment, there is risk involved. If you have any questions, please contact your Relationship Manager or Investment Counsellor.

**Emma Cory**

Hello, I'm Emma Cory, the Alternatives specialist, for HSBC Global Private Banking UK. In our latest Alternatives video, I'll be joined by Julian Romero, Head of Institutional Portfolio Management at HSBC Alternative Investments, which is part of HSBC Asset Management, to give you an introduction into hedge funds.

What are hedge funds?

Hedge funds invest in a wide range of traditional investments, such as: equities, bonds, commodities and currencies. In addition, they tend to apply sophisticated trading techniques and also use complex investments, such as derivatives and futures.

As such, the key driver of returns is not necessarily the underlying public equity or bond exposure, but the active trading techniques used by the fund manager, who will trade around specific market events or divergent market views.

**Julian Romero**

What investment strategies do hedge funds use?

We typically distinguish between six broad types of investment strategies for hedge funds: Equity Long/Short, Event Driven, Credit, Equity Market Neutral, Managed Futures and Global Macro.

In Equity Long/Short strategies, managers invest purely in equities. They benefit from rising stock prices, where they have a long position, but will benefit from falling stock prices, where they have a short position. Therefore, they can structure their portfolio so as not to rely purely on the overall market direction, but can position their investments to express a specific style, or to gain exposure to a specific sector or region.

Event Driven - As the name suggests, this type of strategy usually refers to managers trading around corporate events considered as catalyst, such as: restructurings, mergers and acquisitions, bankruptcies, spin-offs, takeovers and others. The manager attempts to take advantage of temporary stock mispricing, which can occur before or after corporate events take place.

Credit Long/Short reflects the same trading mechanism as Equity Long/Short, but investing purely in credits such as corporate credit, government bonds and associated securities and products.

Equity Market Neutral - This strategy has a similar approach to Equity Long/Short, however, it has more of an, “all-weather” focus, due to a large emphasis on eliminating or hedging market risk, thus the term, “neutral”, and focusing on idiosyncratic, meaning stock specific risk while preserving return potential.

Managed Future Strategies, which are also known as “CTAs”, today reflect primarily automated, systematic investment strategies that use statistical analysis and computer power to examine market data, identify trends and generate trades aimed to benefit from these trends.

Global Macro - This strategy takes a holistic view on the markets and bases its holdings on the general and country specific macroeconomic outlooks, political views of various countries and actions taken by the central banks.

Managers will structure trades depending on how they anticipate these elements will impact interest rates, currencies and commodities, as well as equities and futures markets.

Multi-Strategy typically invests in a range of these strategies where the fund places a strong emphasis on managing overall exposure, through a robust risk framework. Depending on the market environment, Multi-Strategy funds can dynamically shift capital away from less attractive strategies into those that present superior opportunities.

By employing uncorrelated strategies, Multi-Strategy hedge funds can improve a portfolio's risk-adjusted returns through diversification, while increasing its resiliency characteristics during times of turmoil.

**Emma Cory**
Why invest in hedge funds?
Hedge funds are typically used to complement a multi-asset class portfolio, given the low correlation to traditional asset classes. But they can also act as a standalone investment solution. They can find benefits, such as:

Attractive Return Potential - As hedge funds can benefit from both rising and falling prices through short selling. Furthermore, they can provide access to return streams inaccessible in traditional investments, such as special situations, distressed debt investing and mergers and acquisitions.

Diversification - Typically, there is a low correlation to traditional asset classes. Hedge funds provide access to a variety of different strategies that traditional investment funds cannot adopt or execute. Thus, a hedge fund can add diversification benefits to a portfolio of stocks and bonds.

Aligned Interests - As hedge fund managers generally have the majority of their own liquid wealth invested in their own funds, they're aligned with their investors to seek to deliver attractive risk adjusted returns, or, as we like to say, they have “skin in the game.” Furthermore, hedge funds provide access to some of the best-in-class alternative investment managers worldwide.

Limiting impact of market drawdowns - Hedge funds not only generally manage to capture a good portion of the upside, when markets are trending higher. They also tend to offer better protection on the downside, during market reversals. This downside protection feature is particularly important over long term, when looking at compounded returns.

In this graph, we are depicting the returns of bonds, equities, the wider hedge fund index, and a diversified portfolio of hedge funds going back almost 30 years.

If one takes a closer look, what really stands out is how smooth the return stream for a diversified portfolio of hedge funds is, in particular when compared to equities. The diversified portfolio of hedge funds resists much better drawdowns, as evidenced in the early 2000s following the bursting of the dot-com bubbles, again in 2008 during the global financial crisis, or more recently during the outbreak of COVID in early 2020, the start of the war in Ukraine, or the collapse of Silicon Valley Bank and ensuing turmoil in the financial sector. Hedge fund returns in general are less characterised by these sharp reversals and spikes in volatility, which are important features when it comes to downside protection and preservation of your capital.

**Julian Romero**
What are the challenges of investing in Hedge Funds?
The private nature of hedge funds has made direct investments a cumbersome and challenging proposition, since it often requires an understanding of sophisticated, often complex investment strategies and gives limited accessibility to hedge fund investment opportunities.

To invest successfully in hedge funds, effectively sourcing and thorough due diligence are key. The hedge fund industry has grown substantially over the years to over 7,000 funds, and there is a lack of consistency and transparency across the industry.

As with all alternative investments, the dispersion of returns between the best and the worst performing funds can be significant, and given the often complex trading nature, risk exists not only on the investment side, but also on the operational side.

How do you invest in hedge funds?
In general, one can invest either directly with a hedge fund manager or via a partner, also known as allocator. This being said, not all hedge funds are available to everyone.

A lot of the best managers either only work with a select investor base and/or can be close to new investors. You therefore need to invest with a partner who has sufficient access to these types of managers. What's more, most managers impose a minimum investment amount, some as low as $1 million, but some can ask for a minimum as much as $50 million.

Therefore, going through a partner who has this scale helps meeting this minimum. Lastly, a key consideration should be the partner’s expertise to deliver and establish investment process, and advise on an appropriate allocation across the various strategies.

Generally speaking, there are four different ways to package hedge funds investment solutions with varying degrees of involvement: Single hedge fund allocation, fund of hedge funds, discretionary mandates or advisory mandates.

Single line hedge funds - This solution allows investors to pick and choose individual funds from a pre-approved list of managers themselves.

Fund of hedge funds - The proposal here is to invest in an existing established portfolio, which is invested in a number of hedge funds across a range of strategies. A key differentiating aspect is that a fund of hedge fund provides on day one of your investment, access to a mature portfolio as well as single entry and exit points, as opposed to other solutions which are bound to the liquidity terms of the underlying managers.

Discretionary mandates - These investment solutions typically adhere to one of several established investment profiles or can be fully customised to the client's needs. But where the portfolio construction and trading decisions are made by the portfolio manager, who therefore manages the mandates on your behalf.

Advisory mandates - These are personalised solutions tailored to your specific objectives, where any addition or removal of a hedge fund holding is discussed with a dedicated hedge fund adviser.

But the ultimate decision is made by the client. As relates to investment horizon, we are of the view that hedge fund investments should be considered over the long term, and ideally at least over an entire market cycle.

The benefits of hedge funds can however be illustrated in an even shorter time frame. These two graphs illustrate the three year rolling annualised returns for equities on the right-hand side and of a diversified hedge fund's portfolio on the left-hand side. What stands out is that with equities, depending on your entry point, a position held for three years could have at best made you just over 20%, but at worst could have lost you nearly as much.

On the other hand, with a diversified hedge funds portfolio, no matter when your entry point is over the past 25 years, the worst you would have done over a three year window is to have remained flat, while still allowing you to capture a decent portion of the upside. So, this really goes to show that timing is less critical when investing in hedge funds and is a testament of the capital preservation feature of a diversified hedge fund's portfolio.

**Emma Cory**
When to invest?
For those who can tolerate, the investment and volatility risk for part of your diversified portfolio allocation, hedge funds can offer low correlation to traditional long-only assets and improve the risk return profile by lowering total portfolio volatility.

**Julian Romero**
Thanks for joining us today. If you have any questions, please contact your Relationship Manager or Investment Counsellor.