

Hedge Funds

Introduction

The term “hedge fund” today covers an increasingly wide berth, but essentially refers to an investment pool with the ability to execute a broad range of investment strategies through virtually any type of asset. A hedge fund manager is generally allowed the freedom to operate in a nearly unconstrained environment, and the key driver of their performance is the manager’s skill at navigating both positive and negative markets. Some managers strive to deliver significantly outsized returns with the caveat of increased risks, while others target modest returns with a focus on risk mitigation. Laird Norton Tyee (LNTyee) approaches hedge fund investing through fund of funds (FOF) in order to provide our clients a core, well-diversified allocation to hedge funds that incorporates managers across this spectrum. We believe this approach offers diversification benefits and downside protection to a comprehensive portfolio with the expectation of attractive risk-adjusted returns.

What is a hedge fund?

A hedge fund is a portfolio of managed investments that, unlike traditional investment vehicles, often employs advanced investment strategies that are either unavailable or prohibited in traditional funds. Not beholden to any particular benchmark, a hedge fund manager has a much broader selection of investment opportunities available to them. While traditional managers generally stick with buy and hold strategies and only use a limited number of security types, hedge fund managers can use any variety of trading strategies, like leverage, or any type of securities, like derivatives. Different hedge fund managers approach the market in distinct ways, but their intention is to gain exposure to risks that are well understood and have a favorable risk to reward trade-off, while avoiding or hedging other risk exposures. Although the universe of hedge fund managers is highly differentiated, it can be broken down into two general segments; absolute return and directional, which is based on the primary approach and/or objective of the manager.

Absolute Return – Absolute return-oriented (or low volatility) strategies look to compare the value of similar assets to one another in search of arbitrage opportunities. This hedge fund category is more conservative and offers strong diversification benefits. In fact, there are managers that have demonstrated bond-like volatility since the inception of their funds, in addition to exhibiting low correlations to other traditional asset classes. Because of this, LNTyee typically uses absolute return strategies either as a complement to or in place of a fixed income allocation.

Directional – Compared to absolute return managers, these managers tend to have greater exposures to equity or commodities markets and are inclined to have higher volatility. Although directional funds offer some diversification benefits, they can also provide greater return enhancement opportunities when compared to absolute return strategies. As opposed to the bond-like attributes of absolute return strategies, LNTyee views directional funds as more equity-like in asset allocation considerations.

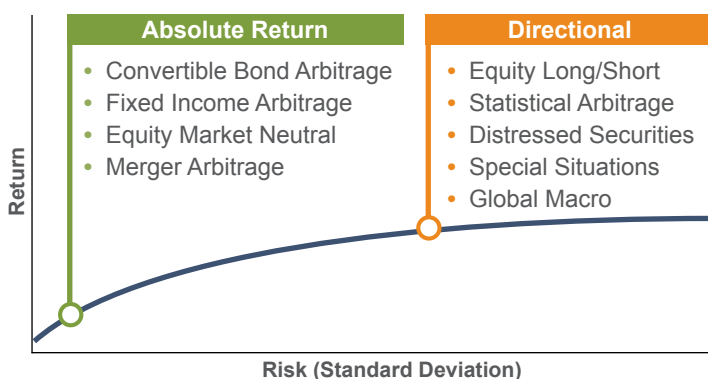
Historically, hedge funds were only available to sophisticated investors with high levels of wealth via limited partnerships (LPs). The markets have evolved, however, and a growing number of mutual fund options now exist which provide daily liquidity and lower investment minimums.

Why invest in hedge funds?

A hedge fund is a portfolio of managed investments that often employs advanced investment strategies that are either unavailable to or prohibited in traditional funds. This offers hedge fund managers a much broader selection of investment opportunities when compared to traditional fund managers. While traditional managers generally stick to buy and hold strategies and only use a limited number of security types, hedge fund managers can invest in a diverse range of assets including stocks, bonds, currencies and commodities. In addition, hedge fund managers use any variety of trading strategies like leverage, or investing through the use of derivatives such as options or futures contracts. The value of hedge funds comes from the manager’s ability to seek returns from nearly anywhere, so managers are largely unconstrained in the strategy or security types they can employ. This dexterity creates returns that are often uncorrelated to traditional markets, and managers can often prove accretive in both positive and negative environments.

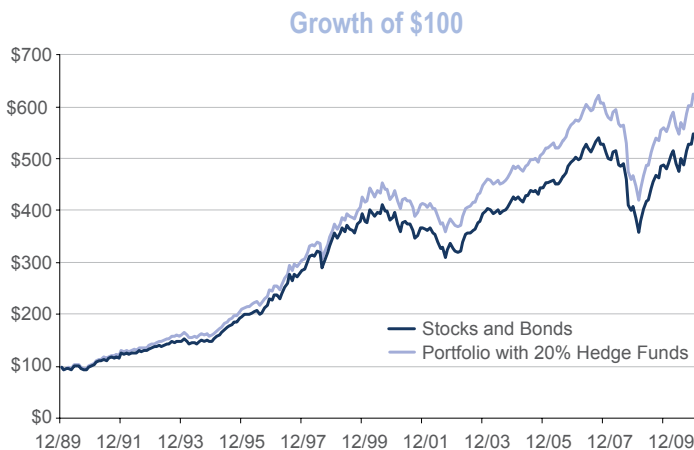
The result of this is that hedge funds can offer equity-like returns with significantly less volatility. They also provide considerable diversification benefits to a comprehensive portfolio, as hedge funds are only modestly correlated to the equity markets and

Risk and Return by Strategy



Hedge Funds

are virtually uncorrelated to bond markets. Given their ability to navigate both positive and negative markets, hedge funds also tend to offer considerable downside protection as well. Thus, as can be seen from the charts below, adding hedge funds to a portfolio of traditional assets has historically increased the portfolio's return, while reducing risk (as defined by Standard Deviation).



	Return (%)	Std Dev (%)	Sharpe Ratio
Stocks and Bonds	8.4	10.0	0.47
Portfolio with 20% Hedge Funds	9.1	9.1	0.59

*Stock and Bond portfolio: 65% S&P 500, 35% Barclays Aggregate.

**Portfolio with 20% Hedge Funds: 52% S&P 500, 28% Barclays Aggregate, 13% HFRI Equity Hedge, 7% HFRI FOF Conservative.

Source: S&P 500, Barclays Aggregate and HFRI

Risks of investing in hedge funds

When comparing the risks associated with hedge funds to those of traditional assets, hedge funds often exhibit high degrees of leverage, lower liquidity, limited transparency into fund holdings, and higher concentrations in a single security, sector or region. With the exception of hedge funds structured as mutual funds, many hedge funds are not regulated by the SEC or any other regulatory agency. Hedge funds also tend to have higher fees, which can erode the investment return. Some funds may charge a performance-based fee, which entitles the manager to a share of the profits earned by the fund. While mutual funds are prohibited from charging fees on performance, this is often standard practice with LP structures and can incentivize managers to take additional risk. Another type of risk to consider is counterparty risk, which is the risk to each party of a financial contract that the other party (or counterparty) will not live up to its contractual obligation. Such financial contracts are frequently utilized in hedge fund strategies.

It is also important to understand that there are unique risks associated with each individual fund, which are outlined in their offering documents.

Investing in hedge funds

The wide dispersion of hedge fund returns suggests that it is imperative for investors to gain ample diversification to a number of strategies and managers within their hedge fund allocations. Most investors find that this is best achieved through FOFs. FOFs not only aggregate many styles and strategies into a single investment, but also incorporate sophisticated risk management techniques in structuring each manager within the portfolio. Most LPs have large minimums making it difficult for individuals to access the best managers and diversify their positions. Alternatively, FOFs offer access, diversification and administrative ease with a single, more manageable minimum. While FOFs do charge an additional layer of fees, the benefits of greater diversification, improved manager access, enhanced risk management, and reduced administrative burden warrant the additional expense.

Investors should consider their liquidity needs when selecting hedge funds. LPs can impose liquidity terms ranging anywhere from monthly to yearly, and can restrict new investors from redeeming for a period of time. However, there are mutual fund options which can be traded daily. Therefore, when allocating to hedge funds, investors should evaluate which structure, or combination of the structures, is most appropriate to meet their liquidity needs

It is important to have a thorough understanding of this complex investment vehicle before investing. If you are considering adding hedge funds to your portfolio, we encourage you to read our more in-depth White Paper on alternative assets.

Disclaimer:

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