PacificCPE

COURSE
82151A

Hedge Funds Basics: Foundations, Registration, and Entry

Get grounded in the essentials of hedge funds before diving into more complex strategies. This opening module covers what makes hedge funds an alternative asset class, how to make sense of SEC registration requirements, and what the process of investing in a hedge fund actually looks like. Whether you're advising clients who already hold hedge fund positions or exploring this space for the first time, this course gives you the foundational knowledge you need to engage confidently with the topic.

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LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Recall the types of fees associated with hedge funds.
- Recall the characteristics of an accredited investor.
- Identify how hedge funds are priced.

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Publication Date: August 2026

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Chapter 1: HEDGE FUNDS: ALTERNATIVE ASSETS AND ALTERNATIVE STRATEGIES

Chapter Objective

After completing this chapter, you should be able to:

- Recall the types of fees associated with hedge funds.

You see hedge funds in the news all the time, but it's hard to know exactly what they are. That's because, at its essence, a hedge fund is a bit of a mystery. A *hedge fund* is a lightly regulated investment partnership that invests in a range of securities as the managers attempt to increase expected return while reducing risk.

Hedge funds are part of a growing class of *alternative investments*. These are funds that look to upend traditional relationships between risk and return, offering investors better expected returns for a given level of risk. This doesn't mean that they are necessarily safer or better performing, by the way. There's much mystique surrounding hedge funds and alternatives that make them seem special, but they are not. They're just different.

Over the years, most hedge fund managers have concentrated on their investment strategies rather than the structure of the fund. The investment styles they use have come to be known as alternative strategies, and they're now available in a range of investments, including exchange-traded funds and other formats that are accessible to just about anyone with money to invest.

Hedge fund and alternative managers today take on the roles of risk managers, investment bankers, venture capitalists, and currency speculators, and they affect discussions in boardrooms at brokerage firms, corporations, and central banks all over the world.

In this chapter, I cover the basic vocabulary of alternative investing. Having this knowledge helps you understand the purpose of these funds. Then you can get into the details of the structure. Also, I clarify what a hedge fund is and what it isn't, which is important because you come across a lot of myth and misinformation out there. The information you find here serves as a springboard for the topics I introduce throughout the rest of the course, so get ready to dive in.

DEFINING HEDGE FUNDS

Here's the first thing you should know about hedge funds: They have no clear identity or definition. In the investment world, "I run a hedge fund" has the same meaning as "I am a consultant" in the rest of the business world. The speaker may be managing money for other people and making

millions (or billions), or they may be looking for a socially acceptable reason for not having a real job. The money manager may be investing conservatively or taking aggressive risks, beating the market and then some or barely breaking even.

The term does have meaning. Here's the short answer:

A hedge fund is an investment partnership that uses a range of assets and strategies to generate a high level of return relative to the amount of risk taken.

Of course, if it were that simple, there wouldn't be enough material for an entire book. Consider the pages that come after this to be the long answer.

DEFINING ALTERNATIVE STRATEGIES

Traditional money management involves buying such real money assets as stocks and bonds, then selling them to take advantage of better opportunities or return money to the account owners. The money can be invested, meaning that the assets are held for a long period of time, or they can be traded, meaning that they're bought and sold frequently to take advantage of short-term changes in market prices. The risk and return of these investments are closely tied to the risk and return of the entire market.

Alternative strategies involve assets and investment techniques that have risk-and-return profiles that are different from those of the stock and bond markets. They fall into two main categories: absolute-return funds and directional funds. I look at the differences between the two in the following sections.

Absolute-return strategies

Sometimes called a "nondirectional fund," an absolute-return fund is designed to generate a steady return no matter what the market is doing. The very first hedge fund had an absolute-return objective using a long-short strategy (see Chapter 1 of course 82155B), and that approach stuck.

Although absolute-return funds are close to the true spirit of that original hedge fund, some consultants and fund managers prefer to stick with the label "absolute-return fund" rather than "hedge fund." The thought is that hedge funds are too aggressive and alternative funds are too wild, while absolute-return funds are designed to be slow and steady. In truth, the label is just a matter of personal preference.

Tip

An absolute-return strategy is most appropriate for a conservative investor who wants low risk and is willing to give up some return in exchange. (See Chapter 2 of course 82154B for more information on structuring your portfolio.) Portfolio managers can use many different investment tools within an absolute-return strategy, a few of which I present in Part 3 of this course.

Technical Stuff

Some say that absolute-return funds generate a bond-like return, because like bonds, absolute-return funds have relatively steady but relatively low returns. The return target on an absolute-return fund is usually higher than the long-term rate of return on bonds, though. A typical absolute-return fund target is 6 percent to 8 percent, which is above the long-term rate of return on bonds and below the long-term rate of return on stock.

Directional strategies

Directional funds are alternative funds that don't hedge — at least not fully (see the section "Hedging is at the heart of it" for more on hedging). Managers of directional funds maintain some exposure to the market, but they try to get higher than expected returns for the risk that they take. Because directional funds maintain some exposure to the stock market, they're said to have a stock-like return. A fund's returns may not be steady from year to year, but they're likely to be higher over the long run than the returns on an absolute-return fund.

Directional funds are the glamorous funds that grab headlines for posting double or triple returns compared to those of the stock market. The fund managers may not do much hedging, but they have the numbers that get potential investors excited about hedge funds.

Tip

A directional strategy is most appropriate for aggressive investors willing to take some risk in exchange for potentially higher returns. (See Chapter 2 of course 82154B for more information on structuring your portfolio.

INTRODUCING SOME BASIC CONCEPTS

This is a book, not a blog post, giving me plenty of room to cover the background of the investment business. It's an industry with a lot of smart, creative people who spend time thinking about new

ways to help businesses raise money while helping investors manage risk. They come up with new tools for speculation and for protection, and they try to stay a step ahead of the competition.

All of this creative energy builds on the basics.

Alternative, to what?

The traditional asset classes are stocks, bonds, and cash. Stocks represent ownership in companies, bonds are a form of loan, and cash is, well, king. These assets form the market and the key metrics, like interest rates, exchange rates, and of course the market indexes.

Alternative assets are all of the things that investors can put their money into that are neither stocks, bonds, nor cash. This includes everything from real estate to bitcoin to the amount of carbon in the atmosphere.

Alternative strategies is a broader concept, but it represents ways that money managers work to get an investment return that is different from that of stocks, bonds, or cash. Increasingly, managers look at ways to engineer returns rather than identify assets for investment. Sometimes, it works quite well.

Generating alpha

Hedge fund managers all talk about alpha. Their goal is to generate alpha, because alpha is what makes them special. But what the heck is it? Unfortunately, alpha is one of those things that everyone in the business talks about but no one really explains.

Alpha is a term in the Markowitz Portfolio Theory (MPT), which I explain in Chapter 1 of course 82153B. The theory is a way of explaining how an investment generates its return. The equation used to describe the theory contains four terms:

- The risk-free rate of return
- The premium over the risk-free rate that you get for investing in the market
- Beta
- Alpha

Beta is the sensitivity of an investment to the market, and alpha is the return over and above the market rate that results from the manager's skill or other factors. If a hedge fund hedges out all its market risk, its return comes entirely from alpha.

Tip

People aren't always thinking of the Markowitz Portfolio Theory when they use alpha. Instead, many people use it as shorthand for whatever a fund does that's special. In basic terms, alpha is the value that the hedge fund manager adds.

Warning

In theory, alpha doesn't exist, and if it does exist, it's as likely to be negative (where the fund manager's lack of skill hurts the fund's return) as positive. In practice, some people can generate returns over and above what's expected by the risk that they take, but it isn't that common, and it isn't easy to do.

Hedging is at the heart of it

Hedging means reducing risk, which is what many hedge funds are designed to do. Maybe you've hedged a risky bet with a friend before by making a conservative bet on the side. But a hedge fund manager doesn't reduce risk by investing in conservative assets. Although risk is usually a function of return (the higher the risk, the higher the possible return), hedge fund managers have ways to reduce risk without cutting into investment income. They can look for ways to get rid of some risks while taking on others with an expected good return, often by using sophisticated techniques. For example, a fund manager can take stock market risk out of the fund's portfolio by selling stock index futures (see Chapter 1 of course 82154B). Or she can increase her return from a relatively low-risk investment by borrowing money, known as *leveraging* (also in Chapter 1 of course 82154B). If you're interested in investing in hedge funds, you need to know how the fund managers are making money.

Risk remains, no matter the hedge fund strategy, however. Some hedge funds generate extraordinary returns for their investors, but some don't. In 2021, the Backstop BarclayHedge Hedge Fund Index — a leading measure of hedge fund performance (www.barclayhedge.com/) — reported that the average hedge fund return for the year was 10.22 percent. The NASDAQ Composite Index (www.nasdaq. com/market-activity/index/comp) returned 21.4 percent for the same period, and the Morgan Stanley Capital International World Index (www.msci.com) was up 22.35 percent. Of course, U.S. Treasury bonds lost 4.4 percent that year.

Hedge funds do not always beat the market. In fact, their investors often don't want them to beat the market. Instead, they're looking for a steady return or for a risk-and-return combination that fits with other assets in their portfolios.