PacificCPE

COURSE
82152A

Hedge Funds Basics: Applying Strategies and Research Methods

Not every client has access to a hedge fund, but many of the underlying strategies are more accessible than you might think. This course explores how to apply hedge fund-style thinking without direct fund investment, and examines how rigorous research and smart asset selection serve as their own form of risk management. Ideal for CPAs and financial advisors looking to broaden their strategic toolkit and offer more sophisticated guidance to clients navigating complex investment decisions.

CREDIT HOURS 2 | FIELD OF STUDY BUSINESS | EXAM QUESTIONS 10

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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 various types of options that are available to investors.
- Recognize examples of alternative investments.

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Chapter 1: USING HEDGE-FUND STRATEGIES WITHOUT THE HEDGE FUNDS

Chapter Objective

After completing this chapter, you should be able to:

- Recall the various types of options that are available to investors.

A full-fledged hedge fund may not be appropriate for you for a variety of reasons. You may not be an accredited investor (see Chapter 2 of course 82151B). You may not be able to lock up your money for long periods of time (see Chapter 2 of course 82153B). Or you may not be able to buy into a fund that seems suitable for you. However, these obstacles don't prevent you from taking advantage of hedge-fund strategies to protect your other investments in all types of market conditions. Democratic alternatives — strategies available through ETFs and mutual funds — represent one of the fastest-growing sectors of the investment market.

Investors of all shapes and sizes can (and should) use diversification to reduce risk and increase return — a staple of the hedge-fund strategy. Some investors may also want to try their hands at more aggressive techniques, like leverage (investing with borrowed money; see Chapter 1 of course 82155B), short-selling (selling borrowed shares of stocks expected to fall in price; see Chapter 1 of course 82155B), and using derivatives (options, futures, and so on; see Chapter 2). You can diversify your investments to take advantage of natural hedges, which are offsetting risk and return relationships between asset classes. And, you can enter mutual funds that follow certain hedge-fund investment styles without the accredited-investor requirements. This chapter shows you how to make these hedge-fund strategies and more work for you.

A DIVERSIFIED PORTFOLIO IS A HEDGED PORTFOLIO

You have a choice of different investment assets: stocks, bonds, cash, real estate, and precious metals, to name a few. These assets all perform differently at different times over an economic or business cycle, which is why long-term investors usually hold a mix of assets, figuring that some years will bring fruitful returns and others will be down years. The process of mixing the assets that investors hold is known as *diversification*.

Because different assets have different risk-and-return profiles, they offset each other to generate smoother long-term performance. Some years, bonds will be great performers but stocks will be disappointing. Other years, bonds will be not-so-hot and stocks will be burning up the charts. That's why investors should buy some of each. Some people work with a mutual fund or investment

manager who promises a diversified portfolio, and others simply buy a mix of assets to create diversification on their own.

Diversification is a long-run strategy, although it can have short-term benefits. Over the long run, the performance of the different asset classes, working together, should lead to a solid long-run total return. In the short term, you'll have a little exposure to everything, meaning that you won't miss out when one asset class shows spectacular performance.

Warning

Many investors think that instead of diversifying, they should simply move around their assets so that they're always invested in the top-performing asset. This strategy, however, requires clairvoyance, something that few people have, even with the help of designer tarot cards. I've never met someone who enjoyed success with this strategy, although that could be because they're living in their beachfront houses on Maui rather than making mortgage payments in the Midwest. But beware: Following this strategy means you run the risk of constantly selling at the bottom and buying at the top, a sure-fire way to lose money (see Chapter 1 of course 82155B for info on buying low and selling high).

A slow-and-steady strategy works over the long run ...

A diversified portfolio may not have stellar performance in any one year, but in exchange, you get consistent performance over the long run. Not convinced? Here's an example: Say that you had $2,000 to invest at the beginning of 2012. You put $1,000 in the S&P 500 (an index prepared by the Standard and Poor's Corporation that tracks the performance of 500 large American companies) and another $1,000 in an absolute-return investment (see Chapter 1 of course 82151B) designed to generate an 18-percent return, year in and year out. Table 4-1 shows what would've happened to your investments.

TABLE 4-1 COMPARING THE TOTAL RETURN ON THE S&P 500 WITH A STEADY 18-PERCENT RETURN

Date	S&P 500 Total Return	Value of Investment in the S&P 500	Absolute-Return Investment Total Return	Value of the Absolute-Return Investment
Initial Investment		$1,000		$1,000
12/31/2012	16.00%	$1,160	18%	$1,180
12/31/2013	32.39%	$1,536	18%	$1,392
12/31/2014	13.69%	$1,746	18%	$1,643
12/31/2015	1.38%	$1,770	18%	$1,939
12/31/2016	11.96%	$1,982	18%	$2,288
12/31/2017	21.83%	$2,414	18%	$2,700
12/31/2018	4.38%	$2,520	18%	$3,185
12/31/2019	31.49%	$3,314	18%	$3,759
12/31/2020	18.40%	$3,923	18%	$4,435
12/31/2021	28.71%	$5,050	18%	$5,234

At the end of the 10 years, you would've been better off in the absolute-return investment, but you would've sat with an investment that underperformed in the early years. Many investors would've thrown their hands up in 2013 and moved their money out of the absolute-return fund and into the S&P 500, just in time for a big move up — followed by a long slide down.

A diversified portfolio requires some patience, just as any long-run investment strategy does. Diversification eliminates the problem of predicting which assets will do best in which years, but it means that your portfolio won't do as well in years when a single asset class shows unprecedented, high rates of return. When thinking about what investment style is right for you, you have to decide if you'd rather have a steady return and give up the excitement of the up years, or if you'd rather ride the roller coaster and end up in the same place.

... But some investors want to hit a home run NOW

Remember

Many investors — professional and amateur alike — claim to invest for the long run, but the reality is that they track the prices of their investments daily. When you follow your investments like your fantasy sports teams, it can be painful to sit with a portfolio designed for long-run, steady return during a period when less-diversified portfolios are showing fabulous growth.

And maybe you don't want to be in hedge funds to get a steady, low-risk 8-percent or 10-percent return. Maybe you want to double your money this year. Well, don't we all? If doubling your money were easy, we would all move to Las Vegas.

Some hedge funds have had long stretches of abnormally strong performance, so such success is possible. Can you do it by yourself, on occasion? Maybe. Here are two strategies that can help:

- Take on more risk by reducing the amount of diversification in your portfolio.
- Continue diversifying by adding riskier assets than those already in your portfolio.

The following sections explore these two approaches in more detail.

Reducing your diversification

If you're after return, and you can live with some risk, a solution for you may be to concentrate your investments into riskier assets. Investors often take undiversified bets in one asset class (see Chapter 2 for more on asset classes). Young investors tend to buy more stock than older investors because they can accept more risk. Entrepreneurs may have almost all their assets in their businesses, but they can live with that risk because they believe in what they're doing. You may not be hedging, technically, but remember: Not many of what people call "hedge funds" are hedging, either.

Suppose you just barely have enough money to invest in a hedge fund, but you still want to invest in one. So, you decide to sell all your stock and some of your bonds and put all that money into a macro fund that invests in currencies and commodities outside the United States (see Chapter 1 of course 82156B for more information on macro funds). In effect, you've reduced the amount of diversification in your portfolio by taking a large bet in one sector.

Diversification into riskier assets

Ah, you say, you've read ahead in the course and noticed that I discuss how diversification can actually increase return while reducing risk. So how do you do that?

Well, you diversify into riskier assets! Here are some examples of this strategy:

- If you hold mostly cash, you can buy bonds.
- If you hold cash and bonds, you can buy stock.

• If you hold mostly U.S. assets, you can buy in markets outside the United States.

Tip

These assets you diversify with may have the same or greater risk on a stand-alone basis as the assets you already have, but if the new assets don't correlate with the old assets — in other words, if they don't move up and down in the same direction at the same time — you can improve your overall return while reducing risk.

Diversification into riskier assets is the reason that big institutional investors like pensions and endowments put money in risky, directional hedge funds (see Chapter 1 of course 82151B). Their small positions in aggressive commodities-trading funds or highly leveraged global macro funds not only increase returns in the years that those strategies do well, but also offset the risk in other parts of the portfolios.

Technical Stuff

To a finance professor, risk is the likelihood of getting any return other than the return you expect to get. In these terms, if your investment does better than expected, you took on risk. In the real world, most investors don't see getting more money than expected to be a risky proposition, which is why you need to think about downside risk, not total risk. See Chapter 1 of course 82153B for more information.

EXPLORING YOUR EXPANDING ASSET UNIVERSE

Hedge fund managers invest in a huge range of assets. If you look through most of the chapters in Part 3, you discover the many ways that a hedge fund manager can make money. Currency. Commodities. Private equity. Common stock. Options. Warrants. Convertibles. Plain-vanilla bonds. Selling ice cream on eBay. (Just wanted to make sure that you're still paying attention.) The list is long, and that's the point: The easiest way for you to hedge risk is to diversify holdings among your different assets with different risk and return characteristics. You can do that without a net worth of a million dollars and without paying a hedge fund manager a 15-percent performance fee.

After you develop a core portfolio of stocks, bonds, and cash, you can think about adding positions in other assets. This section explores the asset alternatives that you can explore, at least until you get that million dollars (and even long after).

Remember

Individual investors should keep an emergency fund of cash equal to about six months' worth of expenses. Pension funds and endowments keep some of their holdings in cash to meet their obligations, and so should you.

Rounding up the usual asset alternatives

If you're interested in hedge-fund strategies and want to be involved with a fund at some point, you're probably familiar with stocks, bonds, and cash as asset classes. However, at this stage in your investment career, you may not be as familiar with some alternative investments that could help you round out your investment portfolio. I dive into some alternatives in the pages that follow.

International stock

The U.S. economy has a direct effect on the U.S. stock market. Other stock markets don't feel the same effect, or at least not to the same extent, which is why one way to diversify your portfolio is to add international stock. You can buy stock directly or through mutual funds — some of which buy shares in companies all over the world, and some of which concentrate on certain markets. Which strategy is right for you depends in large part on what risks you want to manage and what other assets you hold in your portfolio.

Table 4-2 shows what happens to an investor's portfolio if he puts half the money he allocates to U.S. equities into an international fund with a lower beta but the same expected total return (you can find out about beta in Chapter 1 of course 82153B). The result? The same performance with less risk.

Remember

Now, you may be thinking, why not just put all the money in the international fund? After all, it has a lower risk for the same return. You need to remember that beta is calculated relative to the U.S. stock market. You choose the international fund because it has less correlation with the U.S. market, not necessarily less total risk.