PacificCPE

COURSE
82154A

Alternative Hedge Fund Strategies: Equity, Corporate Events, and Macro Funds

Dive into the active side of hedge fund investing with a look at short-selling, leverage, and equity rebalancing strategies. This course also explores how hedge funds identify profit opportunities across the corporate life cycle, from mergers to bankruptcies, and examines macro funds that seek returns by tracking global economic trends. For CPAs and advisors working with sophisticated investors or institutional clients, understanding these strategies adds important context when reviewing fund holdings or evaluating investment risk.

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

- Recognize the characteristics of large cap funds.
- Recall the least risky stage of venture capital.
- Recognize how the Federal Reserve Bank works.

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TABLE OF CONTENTS

CHAPTER 01

Short-Selling, Leveraging, And Other Equity Strategies 6

1.01 Short-Selling Versus Leveraging: A Brief Overview 7

1.02 Strutting In The Equity Style Show 8

1.03 Market Neutrality: Taking The Market Out Of Hedge Fund Performance 11

1.04 Rebalancing A Portfolio 15

1.05 Long-Short Funds 19

1.06 Making Market Calls 21

Test Your Knowledge 27

CHAPTER 02

Observing How Hedge Funds Profit From The Corporate Life Cycle 30

2.01 Examining The Corporate Structure (And How Hedge Funds Enter The Picture) 30

2.02 From Ventures To Vultures: Participating In Corporate Life Cycles 33

Test Your Knowledge 43

CHAPTER 03

Macro Funds: Looking For Global Trends 46

3.01 Fathoming Macroeconomics 47

3.02 Taking Special Issues For Macro Funds Into Consideration 50

3.03 Widening Or Narrowing Your Macro Scope 51

Test Your Knowledge 62

Glossary 64
Index 66
Final Exam Copy 78

Chapter 1: SHORT-SELLING, LEVERAGING, AND OTHER EQUITY STRATEGIES

Chapter Objective

After completing this chapter, you should be able to:

- Recognize the characteristics of large cap funds.

Equity-based hedge funds, which are hedge funds that invest in equities, start with the same investment strategies as mutual funds, brokerage accounts, or other types of investment portfolios that invest in equities. However, equity hedge funds use two unique strategies — short-selling and leveraging — to change the risk profiles of their investments in stocks. Depending on your hedge fund's strategy and market expectations, it may have greater or less risk than the market, in part because of the use of these strategies (see Chapter 1 of course 82153B for more on risk and return). And you can assume that most hedge funds are using some leverage and some short-selling to reach their risk and return objectives.

You can find out about the basics of equities and other types of investment assets in Chapter 2 of course 82152B. In this chapter, I show you how hedge funds invest in equities. They rarely buy and hold stocks in the way that traditional investors do (although they will if they see the right opportunities). Instead, hedge funds use techniques like short-selling and leveraging to reduce the risk of their portfolios while increasing return — or so you hope! In this way, hedge funds feature a different way of thinking about stock investing. If you're investigating hedge funds, you'll likely come across these types of funds. The more you know about them, the better equipped you'll be to make good decisions with your money.

Remember

Here's one other thing to note about hedge funds: Fund managers can mess around with the risk-and-return profiles of their portfolios by using a wide range of strategies. Unlike mutual funds, hedge funds have no hard and fast rules about what type of investment strategy is best for any given type of investor. When researching hedge funds, you need to know more than just whether the fund manager prefers large cap stocks or small cap stocks and whether he or she prefers to manage risk through short-selling or through derivatives. You also need to know what his or her risk-and-return targets are and whether they make sense for your investment objectives. (You can discover more about setting investment objectives in Chapter 1 of course 82155B, Chapter 2 of course 82156B, Chapter 3 of course 82156B.)

SHORT-SELLING VERSUS LEVERAGING: A BRIEF OVERVIEW

Short-selling and leveraging, two investing strategies, are fundamental to the operations of a hedge fund. They're widely associated with equity trading, although they can be used with other types of securities and derivatives. In fact, almost all hedge funds use some short-selling and leverage in order to increase return for a given level of risk. Therefore, if you're interested in hedge funds, you should find out as much as you can about short-selling and leverage so that you have a better understanding of what hedge funds do. The following list introduces these topics to begin your learning process:

- **Short-selling**: Borrowing an asset (like a stock or bond), selling it, and then buying it back to repay the loaned asset. If the asset goes down in price, the hedge fund makes the difference between the price where it sold the asset and the price where it repurchased the asset. Of course, if the asset appreciates in price, the hedge fund loses money. The opposite of short is long, so an investor who is *long* is an investor who owns the asset.

Tip

If much of your portfolio sits in an S&P 500 index fund — a fund that invests in all the securities in the S&P 500 in the same proportion as the index in order to generate the same return — you have significant exposure to the stock market, which means you have market risk. One way to reduce that risk without giving up your expected return is to seek out equities with a different risk profile. Short-selling gives you more places to look.

- **Leverage**: Borrowing money to invest, often from brokerage firms. Leverage increases your potential return, but also increases your risk. Hedge funds use leverage, but so do other types of accounts, and many individual investors use it, too.

You can find more coverage on leverage and short-selling in Chapter 1.

STRUTTING IN THE EQUITY STYLE SHOW

In this section, I talk about some different investment styles used by long equity managers, or those equity investors who don't short stocks (and thus are rarely hedge fund managers, although a small number of hedge fund managers are long-only). With this information, you'll have a sense of how a hedge fund manager may start the hedging process; at the least, you'll understand how some hedge fund strategies are different from the strategies used by other types of investment accounts.

Long equity managers fall into several broad categories and employ several styles, often called style boxes. Fund managers use these categories to guide their choices for the long portions of their portfolios (the securities that they own, not those that they short) or to determine the risk that they can reduce with hedging strategies. At a minimum, you want to recognize the terms I cover in this section when they come up in conversation.

Remember

Few hedge funds use the strategies in this section exclusively. Hedge fund managers are in the business of using exotic investment techniques in order to beat the market — and to justify their high fees.

Trying on a large cap

A *large cap fund*, which may be a hedge fund, a mutual fund, or another type of investment portfolio, invests in companies with a market capitalization (shares outstanding multiplied by current price) of $10 billion or more. These companies tend to be multinational behemoths with steady performance and fortunes tied to the global economy. You can find these companies in the S&P 500, the Fortune 500, and on every other 500 list, save the Indy 500.

Warning

Many large cap managers engage in a strategy called *closet indexing*: They buy shares in the largest companies in the S&P 500 in more or less the same proportion as the S&P index. The result is that the portion of the portfolio containing the large cap shares has almost identical risk and return as the index but for the higher fee that an active manager receives. Hedge fund managers who do closet indexing aren't hedging, so they aren't doing what you pay them to.

Fitting for a small cap

A *small cap stock* is a share of a company with a market capitalization of under $2 billion. These companies tend to be growing faster than the market as a whole, and they aren't as closely covered by investment analysts as larger companies, so their shares may not be as expensive as those in similar but better-known companies.

Some fund managers concentrate on investing in company stocks with a market cap of under $100 million, believing that's where the real money-making opportunities lie because these stocks are even less covered than small cap stocks, so the managers may be getting in on the ground floor. This style of investing, known as *micro cap*, is similar to venture capital and requires that the fund manager do careful research, because other investors may be showing little interest in the company.

Remember

What's in between $10 billion and $2 billion? Mid cap investments, which have characteristics of both large cap and small cap stocks. Easy, huh? Some small and mid cap companies will grow and graduate to the next level. However, some mid cap companies used to be large cap companies before they ran into trouble, and some small caps are former mid caps whose growing days are over.

Note that the industry has no standard cutoff for small, mid, and large cap stocks. Different analysts and money-management firms set their own parameters, and the parameters tend to go up when the market goes up and come down a little bit when the market comes down. So if you come across hedge fund managers who define companies with a capitalization of $2 billion as small cap stocks, they aren't doing anything wrong; they're just using a cutoff that works with what they see in the market at that point.

Tip

If a hedge fund manager mentions capitalization as a style, you should certainly ask about how the fund defines the cutoffs.

Investing according to growth and GARP

A *growth fund* looks to buy stock in companies that are growing their revenue and earnings faster than the market as a whole. Hedge funds expect these equities to appreciate more than the market and to have some life to them, making them longer-term holdings.

Because markets are structured to be reasonably efficient, growth stocks tend to be more expensive than stocks in companies that are growing at a normal rate. For this reason, many fund managers try to find cheap growth stocks, following a strategy called *Growth at the Right Price* (or *Growth at a*

Reasonable Price [GARP]). The fund manager attempts to combine growth with low price-to-earnings ratios in order to earn a greater-than-market return for a market rate of risk.

So what's cheap and what's expensive? Professional investors look at the stock price relative to a company's earnings and assets, not the absolute stock price, to determine the value of a stock. A stock priced at $5 per share may be expensive if the company is losing money, and a stock priced at $350 per share may be a bargain if the company has $400 per share in real estate that other investors are overlooking. You can certainly ask a hedge fund manager about the fund's valuation methods used to determine whether a stock is cheap.

Swooping in on lowly equities with value investing

Value investors are the most traditional of equity investors. Guided by the classic text *Security Analysis* (McGraw-Hill), written by Benjamin Graham and David Dodd in 1934 and updated frequently since then, hedge fund managers who consider themselves value investors look for stocks that are cheap based on accounting earnings or asset values. They shoot for companies that have solid assets, plenty of cash, and inferiority complexes because the market doesn't recognize them. Value investors care more about what a business would look like dead, with the assets sold and the proceeds distributed to *shareholders*, than what it would look like if it grew in the future.

Sometimes, when a stock takes a hit on a bit of bad news, a hedge fund manager will swoop in and buy shares from panicking sellers. Even if the stock never recovers its old high-flying price, it may recover slightly after investors digest the news, allowing the value manager to make a quick profit. On the other hand, value investors sometimes fall into value traps when stocks keep getting cheaper and cheaper. They buy all the way down until the companies end up in bankruptcy and the investments are worthless.

Technical Stuff

Alpha is a rate of return over and above the market rate of return, but for the same amount of risk. Hedge fund managers are on an endless search for *alpha*, and many think that buying into unappreciated or unrecognized companies may be one way to capture their elusive quarry (see Chapter 1 of course 82153B for more on the topic).

Keeping options open for special-style situations

Many hedge fund managers avoid certain style boxes for their portfolios. They may label themselves *special-situations investors* or say that they like to take an opportunistic approach. Sharp managers may want to keep their options open, especially at a larger firm that can afford investment analysts and traders who have their own investment niches. Other managers may want flexibility to move between styles whenever the current en vogue style isn't working out. A cynic may say that this is