PacificCPE

COURSE
82156A

Alternative Investments: Performance Evaluation, Liquidity, and Tax Considerations

Before recommending or reviewing a hedge fund investment, you need to know how to assess whether it's actually delivering results. This course covers performance evaluation methods, the often-overlooked role of liquidity and time horizons in hedge fund investing, and the tax and transparency considerations that matter most to accountants and advisors. If you work with clients who hold alternative investments, this module addresses the questions you're most likely to encounter around reporting, compliance, and investment suitability.

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

Start Course ↓ | Final Exam Copy ↓

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 characteristics of the various methods used to evaluate hedge fund performance.
- Recognize the features of permanent funds.
- Recall the tax treatment of capital gains.

Copyright Notice

© 2026 Pacific CPE, LP. All rights reserved.

This course and test have been adapted from supplemental materials and uses the materials entitled Hedge Fund for Dummies, 2nd Edition © 2023 by Ann C. Logue. Displayed by permission of the publisher, John Wiley & Sons, Inc., Hoboken, New Jersey. All rights reserved.

The materials in this course — including the text, illustrations, exhibits, examples, exam questions, and review questions — are the copyrighted property of Pacific CPE, LP. No portion of this course may be reproduced, stored in a retrieval system, distributed, or transmitted in any form or by any means (electronic, mechanical, photocopying, recording, or otherwise) without the prior written permission of Pacific CPE, LP, except for the personal, non-commercial use of the registered learner.

Pacific CPE, LP grants the registered learner a single-seat, non-transferable license to access this course for the purpose of completing the associated continuing professional education credit. Account credentials may not be shared.

This course is provided "as is" for educational purposes. While Pacific CPE, LP makes a reasonable effort to ensure the content is current and accurate, the materials should not be relied upon as a substitute for professional advice. Pacific CPE, LP disclaims all liability for any error, omission, or loss arising from the use of, or reliance on, the course content.

Publication Date: August 2026

TABLE OF CONTENTS

CHAPTER 01

But Will You Make Money? Evaluating Hedge Fund Performance 6

1.01 Measuring A Hedge Fund's Risk And Return 6

1.02 Benchmarks For Evaluating A Fund's Risk And Return 15

1.03 Putting Risk And Return Into Context With Academic Measures 20

1.04 Serving Yourself With A Reality Check On Hedge Fund Returns 23

1.05 Hiring A Reporting Service To Track Hedge Fund Performance 25

Test Your Knowledge 27

CHAPTER 02

You Want Your Money When? Balancing Time And Liquidity 30

2.01 Considering Your Cash Needs 30

2.02 Like Dollars Through The Hourglass: Determining Your Time Horizon. 31

2.03 Poring Over Your Principal Needs 35

2.04 Handling Liquidity After You Make Your Initial Investment 37

Test Your Knowledge 42

CHAPTER 03

Taxes, Responsibilities, Transparency, And Other Investment Considerations 44

3.01 Taxing You, The Hedge Fund Investor (Hey, It's Better Than Death!) . 44

3.02 Figuring Out Your Fiduciary Responsibility 51

3.03 Transparency In Hedge Funds: Rare But There 55

Test Your Knowledge 61

Glossary 63

Index 65

Final Exam Copy 77

Chapter 1: BUT WILL YOU MAKE MONEY? EVALUATING HEDGE FUND PERFORMANCE

Chapter Objective

After completing this chapter, you should be able to:

- Recall the characteristics of the various methods used to evaluate hedge fund performance.

Calculating investment performance seems easy: You take your balance at the end of the year, divide it by your balance at the start of the year, subtract 1, and voila! For example, $1,100,000 ÷ $1,000,000 – 1 = 10 percent. But what if you add to your investment in the middle of the year in order to net a bigger return? What if your hedge fund manager had to cash out other shareholders? Quickly, you're left with algebra unlike any you've seen since high school. Because of all the possible complications, many researchers in the investment industry are trying to standardize calculations, and others are asking pointed questions to make solid comparisons.

This chapter looks at how a hedge fund measures and evaluates its performance, as well as what questions you need to ask your prospective fund partners about performance calculation. Evaluating a hedge fund's performance helps you determine if the fund is the right fit for your investment objectives. It also tells you if the hedge fund manager is doing well relative to the risk taken, which is why you invest in the fund in the first place.

MEASURING A HEDGE FUND'S RISK AND RETURN

Risk and return are measures of how a hedge fund performs. In general, less risk is preferable to more, and more return is preferable to less. Some people invest in hedge funds to reduce risk, preferring *nondirectional* or *absolute-return funds* (see Chapter 1 of course 82151B); other investors aim to increase return regardless of risk by investing in *directional funds*. These funds maintain exposure to the market rate of return, and you have no guarantee that the direction of the return will be up. (In Chapter 1 of course 82153B, you find a big discussion of how risk and return affect the assets that a hedge fund selects for its portfolio; the other chapters of Part 3 cover different strategies that hedge funds can use to manage risk and return.)

Remember

No type of hedge fund is better than another, as long as the fund that you invest in suits your investment objectives. (You know what your objectives are, don't you? If not, head to Chapter 2 of course 82153B, Chapter 1 of course 82154B, Chapter 2 of course 82154B for a crash course.)

The following sections give you the methods used to measure return and risk within a hedge fund. I present the different forms of return and factor in fees, and I explain how risk factors into performance.

Warning

Unlike mutual funds, hedge funds don't have to publish their performance numbers. And even if they do, they don't have to follow a set methodology. You have to ask questions about the numbers that you see.

Reviewing the return

Return is an estimate that investors can manipulate. The price of a security tonight won't be the price you'll get if you sell in the morning, but it may be the best you get. Return is a measure of past performance, not a predictor of future results. It doesn't matter what a hedge fund did last year; this year is an entirely different ballgame. Whether you're a current or a prospective investor, past return numbers are only rough indicators of what you can expect.

However, I can't say that return figures are worthless. If you're already in a fund, return measures tell you how you did over a time period, which is important information. You may get a different return when you cash out of the fund, but the fund manager still posted a set of investment gains or losses over a specific time period. You can compare that number to your expectations and your needs.

What muddies the picture is that a hedge fund manager may have been lucky or unlucky, or may have an investment style that does very well in some market conditions and not so well in others. That's why return is only one piece in the evaluation of a portfolio's performance.

Without further ado, the following list gives you the steps taken to calculate investment return:

1. **Valuing the assets**. A hedge fund has to know what it holds and what its holdings are worth. The best method is to use market value — what the security would sell for on the market today — but some funds use their initial costs instead (especially for assets, like real estate, that don't trade easily; see Chapter 2 of course 82152B). Sometimes, a hedge fund will estimate the value

of an illiquid asset (see Chapter 1 of course 82152B). The estimate may be close to reality, or the fund may use it to make itself look good.

Remember

Many securities pay off some income. Certain bonds make regular interest payments, and some stocks pay dividends. Funds should value securities that pay income with an accrual for any upcoming payments.

2. **Choosing the dates.** A year has 365 days (366 in leap year) and ends on December 31. It has 12 months of 28, 29, 30, or 31 days. At least, that's how a year runs on a regular calendar. In an accounting calendar, years may be a little different. A year may be 360 days long and have 12 months of 30 days each. Each month could end on the last day on the calendar (the 28th, 29th, 30th, or 31st), or a month may end on the last business day or the last Friday.

Tip

It doesn't matter how a hedge fund's manager sets the fund's time periods as long as he or she discloses the beginning and ending dates and applies the method consistently. Just make sure when you're doing comparisons that you compare numbers for the same time periods. A shady fund manager may change the ending date for a quarter in order to avoid a big market decline on the last calendar day, for example (see Chapter 3 of course 82157B for more on due diligence).

3. **Calculation methodology.** Give someone with a numerical bent a list of numbers and a calculator and he or she can come up with several different relationships between numbers. After investors determine the asset values for certain time periods, they can calculate rates of return. But how? And over how long a time period? The process gets a little more complicated at this stage. Even though the fund may hand over the work to accountants or even actuaries, you should still understand the differences in the methods.

The following sections take you inside this third step by giving you different calculation options. I also show you how fees enter the scene — about as anticipated as a trip to the dentist (unless you're the fund manager).

Time-weighted returns

The most common way to calculate investment returns is to use a *time-weighted average* — also called the *Compound Average Growth Rate* (CAGR). For one time period, the calculation produces a simple percentage:

$$\frac{EOY - BOY}{BOY}$$

EOY stands for "end of year asset value," and *BOY* is "beginning of year value." The result is the percentage return for one year. Simple arithmetic!

Remember

Now, if you want to look at your return over a period of several years, you need to look at the compound return rather than the simple return for each year, because the compound return shows you how your investment is growing. You're getting returns on top of returns, which is a good thing, but the math gets a little complicated because now you have to use the root function on your calculator. The equation looks like this:

$$\sqrt[N]{\frac{EOP - BOP}{BOP}}$$

EOP stands for "end of the total time period," *BOP* stands for "beginning of the total time period," and N is the number of years that you're looking at.

Table 13-1 shows a time-weighted return over a four-year period.

TABLE 13-1 CALCULATING A TIME-WEIGHTED RETURN

	Year 1	Year 2	Year 3	Year 4
Beginning-of-Year Asset Value	$100,000	$123,456	$156,030	$145,683
End-of-Year Asset Value	$123,456	$156,030	$145,683	$158,966
Annual Percentage Return	23%	26%	–7%	9%
Four-Year Time Weighted Return	1			5%
	Year 1	Year 2	Year 3	Year 4

Dollar-weighted returns

The *dollar-weighted return* — also called the *internal rate of return (*IRR) — is the rate that makes the net present value of a stream of numbers equal to zero. You find the number through an iteration that almost always has to be done on a calculator or a computer. You use the IRR to determine the return for a stream of numbers over time; it's also widely used to value bonds and calculate venture capital returns.

Table 13-2 shows a comparison of year-by-year dollar weighted returns with a cumulative dollar-weighted return over a five-year time period.

TABLE 13-2 A DOLLAR-WEIGHTED RETURN EXAMPLE

	Year 1	Year 2	Year 3	Year 4	Year 5
Beginning-of-Year Asset Value	$100,000	$123,456	$156,030	$145,683	$185,966
End-of-Year Asset Value	$123,456	$156,030	$145,683	$158,966	$175,620
Incremental Gain	$23,456	$32,574	$(10,347)	$13,283	$16,654
One-Year Dollar-Weighted Return	23%	26%	-7%	9%	10%
Five-Year Cumulative Dollar-Weighted Return					16%

Technical Stuff

I'm convinced that this method became popular in the 1970s, when Hewlett-Packard introduced its HP12C financial calculator, the first of its kind that could find internal rate of return easily. The calculator was also relatively expensive when it came out, making it a big status symbol. Many financial types started using internal rate of return so they could show off their fancy calculators. Even today, IRR requires more computing power than most calculators have because it's the result of a series of calculations, not the solution to a single equation.

The calculation for IRR simply doesn't work well for everything. The dollar-weighted method can overstate returns, and it can occasionally show nonsensical results if too many negative returns appear in a series. (As much as investors don't like it, a long-running hedge fund may have a year or two of losses and still be a good investment.)