

Bailey Jung

# Demystifying Hedge Funds

**M**ost people have read about or heard passing references to investment vehicles known as hedge funds.

Despite the growth of this market segment in recent years, there remains an aura of uncertainty and mystique surrounding these products.

This article provides an overview of what hedge funds are, how they are different from mutual funds, and why they might be a suitable investment for a portion of an investor's portfolio.

The number of hedge funds launched in Canada since 2000 has grown dramatically. A few years ago, there were perhaps 25 to 30 hedge funds. Today there are approximately 180 in Canada. In the US, they number around 6000.

Many of the traditional, big mutual-fund companies in Canada now offer hedge funds or are in the process of offering them. Some fund companies that currently have hedge funds in their line-up include: AGF, Sprott, Mackenzie Financial, and Dynamic Mutual Funds.

**Some argue they are very risky investments, while others maintain they actually reduce risk.**

## What are Hedge Funds?

Most investors don't understand what hedge funds are and how they work. Some argue they are very risky investments, while others maintain they actually reduce risk. Here's the confusing part—they're both right.

First, let's address the notion that they are risky investments.

Hedge fund managers use a wide range of complex and sometimes risky strategies to make money in all market conditions, good or bad. Some of these complex strategies include short-selling, hedging, leveraging, arbitrage, and the use of various derivatives instruments. Because these methods are not generally well understood by the average investor and, if used incorrectly, can lead to huge losses, they are considered risky by some investors.

Many of the specific strategies used by hedge fund managers are kept a secret. Because of this lack of disclosure and lack of transparency, there may be more risk attached to investing in hedge funds.



Last, hedge funds are not as tightly regulated as mutual funds. This means, for example, that hedge fund managers have much greater freedom and flexibility to adopt various trading strategies. Again, if done incorrectly, this can lead to significant losses.

Now let's look at how hedge funds reduce risk.

With traditional equity mutual funds, when the market moves up, the value of equity mutual funds also moves up. When the market drops, the value of equity mutual funds also drops. In other words, equity mutual funds are highly correlated to the general market.

One of the main reasons hedge funds can reduce the risk of a portfolio is because of the behaviour of these funds. Hedge fund returns, by and large, are not correlated to the general market's return. One of the objectives of hedge funds is to provide positive returns regardless of market direction. They do not have a benchmark to compare their returns, as mutual funds do. Put another way, hedge funds focus on absolute returns, while mutual funds focus on relative returns.

To give you an example, if the S&P/TSX index loses 12 percent and your mutual fund loses only 10 percent, a mutual fund manager would get a pat on

the back for beating the benchmark index by 2 percent. With absolute returns, the only thing that counts is whether the fund generated positive returns. It doesn't care how much the benchmark index rises or falls; its only goal is to make money.

Further evidence of the risk reduction characteristics of hedge funds is the increasing acceptance of hedge funds by pension funds, foundations, endowments, and other institutional investors in using hedge funds to enhance portfolio returns and reduce overall risk.

Although there are a number of different hedge-fund styles, one of the most common and easy to understand is the Long/Short Equity Hedge.

With this style, a manager would short the stocks he dislikes and believes will fall and buy or go long on stocks he likes. When a stock is shorted, an investor borrows the stock and then sells it. He actually sells it before he buys it, hoping to be able to buy it back later at a lower price. With this strategy, which I've actually simplified, long/short managers have the

ability to make money in good markets or bad, whereas traditional products like mutual funds provide profits or losses directly related to the market.

For the most part, hedge funds are bought and sold just like regular mutual funds, with a few notable exceptions. Because hedge funds were traditionally the domain of sophisticated investors, many hedge funds are still only available to "accredited investors."

**For the most part,  
hedge funds are bought  
and sold just like regular  
mutual funds...**

This means an investor must have:

- more than \$1,000,000 in financial assets;
- an income of greater than \$200,000 in each of the previous two years; or
- an income greater than \$300,000 in combined family income in each of the previous two years.

Investors who do not qualify as "accredited investors" are still permitted to invest in hedge funds, provided they invest a minimum of \$150,000. In BC, that amount is \$97,000.

A few hedge funds are now available for smaller retail investors. Hedge fund investors are also required to give notice to the fund company if they want to sell their hedge fund units. This notice can range from a couple of weeks to a month.

To summarize, here are some of the key differences between mutual funds and hedge funds.

- Mutual funds are measured on relative performance, compared to some kind of benchmark. Hedge funds seek superior risk-adjusted returns, on an absolute basis.
- Mutual funds are tightly regulated. Hedge funds are less regulated.
- Mutual fund managers cannot invest more than 10 percent of the fund's assets in a single company. There are no such restrictions on hedge funds.

- Mutual fund managers can only go long on a stock . . . in other words, buy and wait for it to go up in value. Hedge fund managers can use a wide range of strategies.
- Mutual funds make money only when the market goes up. Hedge funds can make money when the market goes up or down.
- Mutual funds are highly correlated to the overall market. Hedge funds have low correlation to the overall market.

### **Summary**

Hedge funds, as you can see, are both risky on one hand and can actually reduce portfolio risk on the other. Choosing a good hedge fund requires more research and due diligence than traditional mutual funds. Because of the sometimes complex strategies involved, investors would be wise to do their homework and understand the risk-reward characteristics of each fund.

Investors should not invest all of their money in hedge funds. A 5 percent minimum or 20 percent maximum is generally recommended, depending on the investor's risk tolerance and return objectives. ▲

*RBC Dominion Securities Inc. is a member company under RBC Investments. RBC Dominion Securities Inc.\* and Royal Bank of Canada are separate corporate entities, which are affiliated.*

*\*Member of CIFP*

*The views and opinions of this article are those of the author and not necessarily those of RBC Dominion Securities Inc. Any opinion or advice contained in this article should not be construed as offering professional advice. Readers are advised to consult their own professional advisors regarding their own situations.*

**Bailey Jung** is an Investment Advisor with RBC Dominion Securities Inc. He provides wealth management solutions and financial planning services to his clients.

Voice: 604 665-0673

[bailey.jung@rbc.com](mailto:bailey.jung@rbc.com)

[www.rbcinvestments.com/bailey.jung](http://www.rbcinvestments.com/bailey.jung)