THE ADAPTIVE INVESTOR

This article is part of a series written by Michael Kerris at BrightView Capital Management with the goal of educating investors about investing in a more sophisticated risk-averse way.

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Hedge Fund Investing Overview

What are hedge funds? How do they work? Why invest in one? Hedge funds are a mystery to some and once thought of as an investment vehicle exclusively for the rich and famous. Hedge funds are in fact the choice of many sophisticated investors, especially those that have lived through and understand the consequences of major stock market corrections.

The word "hedge," meaning a line of bushes around a field, and has long been used as a metaphor for the placing of limits on risk. Early hedge funds sought to hedge specific investments against general market fluctuations by shorting the market, hence the name. Nowadays, however, many different investment strategies are used, some of which do not hedge.

A hedge fund is similar to a mutual fund or ETF (exchange traded fund) in that it is a pooled investment vehicle managed by professional management that can invest in among other things the stocks of publicly traded companies.

Hedge funds differ from mutual funds and ETFS in that hedge funds are not necessarily required to register with the SEC. Hedge funds are generally not permitted to advertise, nor can they be offered or sold to the general public. Participation takes place via private placement. All of this makes hedge funds less familiar to individual investors who are generally only able to gain access to hedge funds through existing personal relationships and introductions. Unlike the general financial markets, which are open to any and all investors, only about 7% of American households qualify to invest in hedge funds and furthermore the manager determines who is allowed into the fund. Hedge funds are still subject to the same anti-fraud measures as other publicly offered investments and their managers have the same fiduciary duty as other investment advisors.

While hedge funds have existed for many decades, they have become increasingly popular in recent years, growing to be one of the world's major investment vehicles. The global hedge fund industry is comprised of approximately 10,000 hedge funds

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managing a combined $2 trillion dollars, and has come to represent a huge share of trading in financial markets. And hedge funds are likely to continue attracting disproportionate amounts of capital based on the potential for attractive risk-adjusted returns.

Although past performance does not guarantee future performance, there are plenty of benefits that hedge funds offer versus other asset classes. These benefits include:

- Flexibility: Hedge funds are able to approach the markets in ways that mutual funds and ETFs cannot including being able to go long stocks (benefit when prices climb), to go short stocks (benefit when prices fall), use leverage and derivatives, concentrate positions, and to go to cash or hedge to protect capital.

- Skill-based strategies: Returns of hedge funds are derived mostly from the skill of the hedge fund manager in executing their chosen strategy rather than exclusively relying on asset appreciation in rising markets.

- Absolute Returns: Hedge funds are focused on generating absolute returns, which means they try to make money in both bull and bear markets. And even if they are not able to achieve absolute returns, hedge funds often do a better job at protecting capital in down markets.

- Diversification: Adding hedge funds to an investment portfolio generally provides diversification not otherwise available in traditional investing.

- Lower Volatility: Hedge funds have historically had one-third lower volatility than equity markets. Reducing the volatility in one's portfolio can lead to higher compounded returns over time with less stress.

- Higher Returns: Some hedge fund strategies offer the possibility of enhanced returns.

- Alignment of Interest: Hedge fund managers generally have a strong alignment of interest with their investors because a majority of their personal wealth is also invested alongside the investors in their funds. Thus hedge fund managers have a strong vested interest in making money for their clients.

From a performance perspective, hedge funds (as measured by the HFRI Composite Index) have generated net annualized return of 10.19% compared to 9.19% for the S&P 500 since January 1990. And they have outperformed with lower volatility. $100,000 invested in the S&P 500 in 1990 would be worth approximately $900,000 today; while $100,000 invested in hedge funds in 1990 would be worth approximately $1,130,000 today. You can see the power of even just 1% annualized return over time. Beyond the averages, there are some truly outstanding performers.

All hedge funds are not the same. Hedge funds can follow a number of strategies, each having its own investment return and volatility. The strategies tend to be more niche-like in their approach. The variety of hedge fund strategies far exceeds anything offered by a traditional mutual fund or ETFs. Knowing and understanding the characteristics of a fund's strategy is essential.

Many hedge funds have enjoyed exclusivity generally catering to institutional investors like pensions, insurance companies, endowments and the super wealthy. But some hedge funds have lower investment minimums making it more accessible for individual investors to participate in them. While institutions have been investing in hedge funds for decades and generally have a representative allocation to them, individual investors that qualify to invest in hedge funds generally still do not have any exposure to them. This is often because they are less aware of them, and don't know where to even begin a conversation.

We believe that there is an important place for hedge funds in everyone's portfolio to hedge against risk and volatility and to also potentially make a positive absolute return during the next bear market. Investors should also consider the possible additional gains from long term compounding at higher rates of return. It is important to take the time to evaluate hedge funds and find one that matches your investment objectives with a strategy and manager you believe in.

We welcome your feedback as we strive to make hedge fund investing more accessible.

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