Fact sheet
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FuturePlus

Hedge funds

The addition of hedge funds to investments is believed to reduce overall portfolio risk as they are not highly correlated with traditional asset classes (i.e. Australian and international shares).

These funds use a wide range of securities, instruments and strategies to provide positive returns, regardless of the underlying security market movement. Hedge funds have been used to lower the overall volatility of a portfolio.

Types of hedge funds

- **Absolute Return -** these funds are managed like standard managed funds whilst incorporating specific strategies unique to hedge funds (such as short selling, arbitrage and global asset allocation). The overall performance of these funds is not compared to benchmarks like sharemarket indices (i.e. All Ordinaries, Dow Jones, etc.) because they are focused more on providing positive investment returns in all market conditions.
- **Positive Risk Adjusted Return -** these are funds where only the investment management activities incorporate hedge fund strategies and non-traditional asset classes. The performance of these funds is also focused on providing positive returns rather than being compared to a benchmark.

Two structures that hedge funds undertake

- **Single manager / single strategy -** where the fund relies on one investment team and specialises in one area.
- **Multi-strategy / fund of funds -** consolidates a range of specialist hedge funds to enable further diversification.

Strategies used by Absolute Return Funds

Short selling is where sellers borrow and then sell overvalued shares anticipating a decline, whereupon the shares are bought back. Arbitrage is a strategy where relative mis-pricing between related securities are identified within and across markets. Global asset allocation involves the use of research to exploit movements in different industry sectors, currencies and share markets.

Issues to consider

- A key influence on the performance of a hedge fund is the investment manager's skill and experience. Positive returns are more likely if the investment manager has made a correct judgement about the particular security. Therefore, it is important to pick the right manager. Factors such as qualifications and experience of the management team and the stability and substance of the investment team and the organisation can greatly affect the return on the investment.
- Many managers rely on short-term market mis-evaluations to generate a return and so aren't likely to release information on their processes and strategies. This makes research and evaluation more difficult.
- Valuations of hedge funds are infrequent, making it difficult to accurately value a portfolio which results in a long turnaround time for transactions.
- Given the goal of producing lower volatility, these investments have experienced less severe negative returns. However, average historical returns of hedge funds have shown that the positive returns have also been lower than standard managed funds.

Need further information?

If you have any questions about the material covered in this fact sheet, please contact FuturePlus on **1300 883 788** between 9am and 5pm on any business day.

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