HEDGE FUND INVESTING

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Hedge funds have been sold on the basis of their ability to provide absolute returns in all market environments. Will the industry succeed over the long term to generate absolute returns? Which strategies and vehicles have the best chance for success? These are the questions that we will explore in this article.

The hedge fund universe is one of the fastest growing phenomena in the financial markets today. Estimates for the total USD amount of hedge fund assets deployed today range from USD 700 billion to USD 1,000 billion, compared to a total of only several hundred million USDs some 15 years ago. Where did this explosive growth come from and what is fueling it? Simply put, in a world of ever-growing uncertainty, ever-increasing volatility and ever-decreasing interest rates, investors have developed an insatiable appetite for above-average, stable, "absolute" returns, irrespective of the direction and vagaries of the financial markets.

HEDGE FUND STRATEGIES

With demand for absolute returns increasing exponentially, a host of hedge fund strategies have been developed -- some simple and some excruciatingly complicated. What are these hedge fund strategies and how well should you be sleeping as a hedge fund investor, given their underlying risks? Hedge fund strategies can be grouped into four main categories:

1. Relative Value: this category is characterized by the attempt to arbitrage differences in mis-pricings among loosely or closely related securities. Hedge Fund managers invest by buying the undervalued security and selling the overvalued security, in the hope that the "spread" between the two securities will narrow. Relative value strategies include, among others: fixed income arbitrage, convertible arbitrage, volatility arbitrage, and equity market neutral.

2. Event Driven: hedge fund managers attempt to benefit from the impact of events, such as mergers, acquisitions, spin-offs and reorganizations on a whole host of securities, ranging from equities to high yield debt to bank loans. The strategies broadly fall into two sub-categories: merger arbitrage and distressed securities investing.

3. Opportunistic Strategies: the hedge fund manager attempts to make money on any variable that is moving in a "momentum" fashion. Variables include interest rates, exchange rates, commodities, general market indices, and industry sectors. Two of the main opportunistic strategies are Macro hedge funds and CTAs (Commodity Trading Advisors)

4. Long/Short Equity Strategies: This strategy relies on securities analysis to develop a portfolio of long stocks and short stocks. In the classic approach, a minimum of 40% of the portfolio is dedicated to the short side in every market environment, while the size of the long portfolio varies according to market conditions and opportunities. Occasionally, the managers will enhance their short portfolios with put options and/or index-related shorts. In general, this strategy, as opposed to the three previous approaches, does not rely on leverage to generate above average returns. Unlike the other hedge fund investment strategies, the

long/short equity strategy does not purport to achieve absolute returns. The strategy is clearly correlated to the equity markets. However, over the years it has proven to be one of the most reliable avenues for achieving above-average risk-adjusted returns. It is a very simple strategy that is quite close to the traditional equity investment strategy and can easily be explained: Instead of just focusing on finding good, undervalued companies and business models to invest in, the long/short manager also finds bad, overvalued companies and business models to short. In terms of basic risk control, the long/short equity strategy has some major advantages: low leverage, high liquidity, wide diversification and transparency.

FUND-OF-HEDGE FUNDS

The challenge facing hedge fund investors lies in finding those individual hedge funds, which have the best chance for generating above average returns with a low risk exposure. This hurdle can be overcome by leaving the fund selection to the hedge fund advisory professionals, which construct a diversified hedge fund portfolio in the form of a Fund-of-Hedge Funds (FOHF). A successful selection process is dependent on a rigorous quantitative and qualitative analysis of the hedge fund universe. While the fee structure is more expensive in these investment vehicles, the individual risks of each hedge fund strategy are mitigated and the overall portfolio volatility is dramatically reduced.

Based on their 55 years of investing experience, the authors of this article favor the long/short strategy. Absolute returns are nice in theory and work wonders on the cocktail party circuit, but they do not actually exist in the real world! An approach that participates well in up-markets and conserves capital in down-markets is a much more realistic and achievable goal, both in theory and in practice.

FAIRWAY INVESTMENT PARTNERS

Fairway Investment Partners provides global investment counseling services to wealthy individuals, families and institutions. The firm is based in New York and in Zurich. It was formed in January of 1992 by Francesco Andina and Charles E. Abrecht. Our investment process is disciplined, totally objective and personalized. The firm primarily focuses on determining the optimal investment structure and asset allocation for its clients' portfolios and on carefully selecting a group of specialized portfolio managers with outstanding performance records.

As the accompanying chart demonstrates, Fairway has implemented the global long/short FOHF strategy with impressive results since 1993. Our Stafford Fund, launched in April of 1993, has averaged a return of approximately 13% per annum, compared to 6% for the MSCI World Equity Index. We are investors rather than marketers, and we "eat our own cooking". By focusing exclusively on the long/short equity strategy, we have created a unique expertise and track record in the hedge fund world.

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