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Hedge Funds - Return Enhancers, Risk diversifiers or Both?

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ABSTRACT

This research proposal talks about the Hedge Funds - Return Enhancers, Risk Diversifiers, or Both? According to Cambridge Dictionary, fund means money available for a specific purpose, and “Hedge” means a way of protecting, controlling, or limiting something. So basically, “Hedge Funds” means a pool of funds that is available to invest in market instruments to minimize the risk. A hedge fund is an investment fund that trades in shares, currencies, and other financial instruments to earn profit from both increasing and falling prices. One strategy is to short (borrow) shares, sell them, and then repurchase them at a lower price.

Keywords: Hedge Funds, Hedge, Funds, Return, Return Enhancer, Diversifiers, Risk Diversifiers, Alternative Investment Fund, Pool of Funds.

INTRODUCTION

The topic of this research proposal is “Hedge Funds - Return Enhancers, Risk Diversifiers or Both? "The Securities and Exchange Board of India (SEBI) states that hedge funds, including fund of funds, are unregistered private investment partnerships, funds, or pools that may invest in and trade in a variety of markets, strategies, and instruments (including securities, non-securities, and derivatives), but which are not subject to the same regulatory requirements as mutual funds. The term “Hedge Fund” was coined by Alfred Winslow Jones in 1949.

OBJECTIVES

- To understand the meaning of hedge funds.
- To measure the performance of hedge funds using appropriate methods.
- To understand the impact of return enhancers and/or risk diversifiers.

RESEARCH METHODOLOGY

The current study looks at the interplay of numerous factors that affect how behaviour of investors develops. Research is by its very nature descriptive. It is a conceptual study that is founded on an analysis of earlier studies in the field. All of the pertinent information for the research paper was gathered from secondary sources, such as online journals, newspapers, government documents, and numerous online resources.

DISCUSSIONS

Meaning of Hedge Funds: A hedge fund is a limited partnership of private investors whose capital is managed by experienced fund managers. These managers employ a range of strategies, such as borrowing money or trading in non-traditional assets, to generate returns on investments that are higher than average.

Investment in hedge funds is frequently viewed as a risky alternative investment option since it typically has a high minimum investment requirement or net worth requirement and frequently targets wealthy investors.

In other words, a hedge fund is a pool of funds that engages in both short and long positions, buys and sells stocks, engages in arbitrage, and transacts in the trading of commodities, bonds, currencies, convertible securities, convertible securities, and derivative products in order to generate returns with lower risk. By using alternative investment strategies, the fund seeks to mitigate risks to investor wealth from market volatility.

Regulatory Authority of Hedge Funds

In India, hedge funds are not required to be registered with the Securities and Exchange Board of India (SEBI).

Processing Fees to Regulate Hedge Funds

The standard expenditure fee is 2% of total assets and the standard performance fee is 20% of total returns. There isn't a set management fee in India, though. The performance fee ranges from 10% to 15%, while the expense ratio is about 2% or less. It is classified as an AIF Category III category.

Who are the investors in Hedge Funds?

High net worth individuals (HNIs) and families, endowments and pension funds, insurance firms, and banks are common types of hedge fund investors. These funds trade freely as private investment partnerships or offshore investment companies. They are exempt from the reporting requirements, such as the periodic disclosure of NAVs, and are not required to register with the securities market's authority.

Differences between Hedge Funds and Mutual Funds

Basis of Differences	**Hedge Funds**	**Mutual Funds**
1. Investors	High Net Investors come together to buy the securities.	Usually, small investors pool money.
2. Risk	The risk is high.	The risk is low as compared to hedge funds.
3. Regulations	Comparatively less regulations and compliances.	More regulations.
4. Investment Requirement	The minimum investment is Rs.1,00,00,000.	The minimum investment is Rs.500.
5. Entry and Exist	Restrictions on entry and exit.	Usually, investors enter and exit at their wish.

How to measure Hedge Fund Performance?

Why Hedge Fund Performance calculation is necessary? Hedge fund managers use a variety of performance measures and statistics when reporting hedge fund performance to current and potential investors.

The following are the methods to ascertain the performance of a hedge fund:

1. Cumulative Performance: The total percentage change in a fund's net asset value (NAV) over a specific period of time is used to calculate cumulative performance. Typically, trailing periods such as the previous three months, year, three years, or five years are used to measure cumulative performance. It is frequently measured for the full time since a fund was founded as well as for certain years, the current calendar year (YTD), and particular years.

2. Sharpe Ratio: Sharpe ratio was coined by William F. Sharpe. It's crucial to take the fund's risks into account when assessing performance. All other things being equal, a fund with the same returns as another but with significantly lower risk (as measured by standard deviation of returns) would be a better option for an investor's portfolio. This reasoning also holds true for funds that produce comparable levels of volatility but better returns than other funds.

   A fund's results in relation to its level of risk are shown by the Sharpe ratio. This is derived by dividing the excess return of the fund over the same time period, which is obtained by subtracting a predefined risk-free rate from the annualized return of the fund. The risk/reward characteristics of a fund are typically better the higher the Sharpe ratio. The fund has effectively earned more than one unit of return for each unit of risk it has taken if the Sharpe ratio is higher than 1.0.

Symbolically, Sharpe Ratio = $\frac{\text{Expected Return of Portfolio} - \text{Risk Free Return}}{\text{Standard Deviation of Portfolio}}$

3. Sortino: Sortino ratio was coined by Frank A. Sortino. The Sortino ratio only shows how well a fund has performed in relation to its amount of downside risk. It is comparable to the Sharpe ratio, but the Sharpe ratio is more vulnerable to volatility on both the upside and the downside. The Sortino ratio, in contrast, makes the assumption that investors will tolerate fluctuating returns as long as they result in gains. This is derived by dividing the fund's downside departure below the minimum acceptable return by its excess return, which is defined as the annualised return less a predetermined minimum acceptable return.

Symbolically, Sharpe Ratio = $\frac{\text{Expected Return of Portfolio} - \text{Risk Free Return}}{\text{Standard Deviation of Negative Returns of Portfolio}}$

4. Drawdown: Drawdown, which measures the biggest drop in a hedge fund's performance from high to low, is another metric used to assess its success. The gap between a fund's high-water mark and the low point that comes after this high-water mark is used to determine drawdown.

Investors frequently rely on hedge funds to provide downside protection when traditional asset classes are experiencing losses, therefore the severity and length of the downturn period is a crucial considerations when assessing hedge fund performance. Measurements of drawdown are also helpful in assisting investors in predicting future downturns. Certain funds, such as tail-risk hedge funds, will go through protracted periods of underperformance that are then followed by abrupt, noteworthy turns toward profitability.

CONCLUSIONS

Hedge funds are permitted to use strategies that are frequently regarded as 'risky,' such as using derivatives, leverage, or short selling, unlike conventional, long-only mutual funds. The goal of these techniques is to increase the risk/reward ratio of the fund's investments during bear markets.

Hedge funds were originally designed as absolute return investments, aiming for strong returns regardless of market conditions. As institutional investors have grown more knowledgeable about and utilised alternative assets throughout time, their overall position has evolved. Other alternative assets, such as private equity, are increasingly complementing these funds in their position as long-term return-enhancer. Hedge funds are also used by many investors to minimize risk in their portfolios (i.e., as a return diversifier).

By strategy, hedge funds' risk/reward profiles differ greatly. An equity market-neutral fund, for instance, will have very little exposure to market fluctuations, therefore results will mostly depend on the fund manager's ability to choose stocks. The equity market neutral fund will function more as a portfolio diversifier than a performance enhancer when compared to an equity fund with a significant long bias. Global macro funds, on the other hand, are likely to have a very different risk/reward profile, with returns determined by the fund manager's perspective on macroeconomic policy, current affairs, and currency changes.

Alternatives to the long/short equities, merger arbitrage, or global macro hedge fund strategies include litigation finance funds, cryptocurrency funds, and strategies tied to insurance. Similar to the first hedge fund structure, these funds have distinct risk exposures and display little correlation to conventional markets.

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