The fun and easy way® to turbocharge your portfolio

Hedge Funds For Dummies®

Ann C. Logue, MBA
Financial Writer

A Reference for the Rest of Us!®

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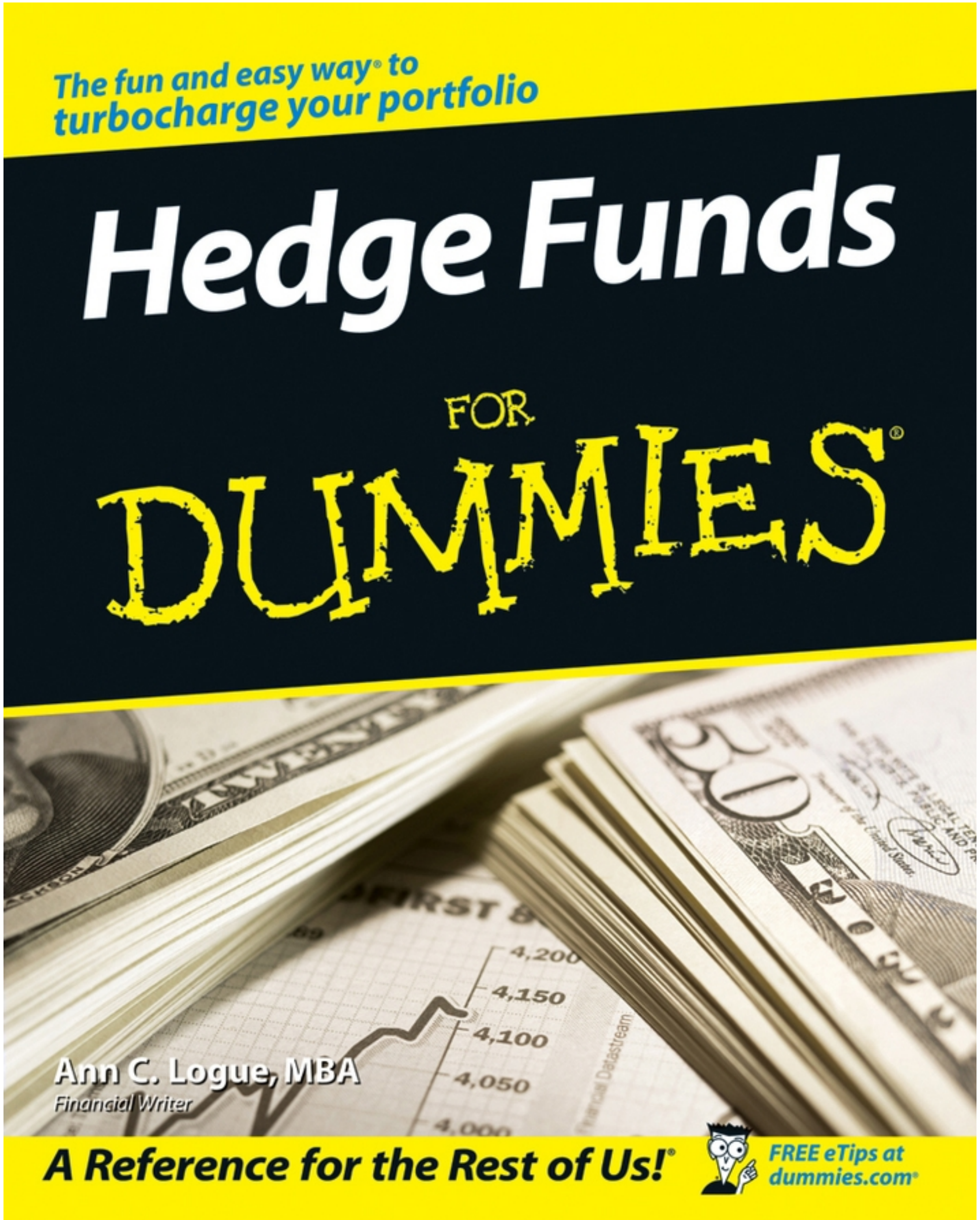
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About the Author

Ann C. Logue is a freelance writer and consulting analyst. She has written for *Barron's,* the *New York Times, Newsweek Japan, Compliance Week,* and the *International Monetary Fund.* She's a lecturer at the Liautaud Graduate School of Business at the University of Illinois at Chicago. Her current career follows 12 years of experience as an investment analyst. She has a BA from Northwestern University, an MBA from the University of Chicago, and she holds the Chartered Financial Analyst designation.

Dedication

To Rik and Andrew, for their love and support.

Author's Acknowledgments

So many wonderful people helped me with this book! I talked to many hedge fund managers and others in the investment business, including Cliff Asness, Catherine Cooper, Beth Cotner, Nancy Fallon-Houle, Marshall Greenwald, Steve Gregornik, Anil Joshi of NuFact, Russ Kuhns, Alecia Licata of the CFA Institute, Dan Orlow, Tino Sellitto, Lisa Springer, Ryan Tagal at Morningstar, Scott Takemoto, and Gary Tilkin and Kelly Quintanilla at Global Forex Trading. I also talked to a handful of other hedge fund managers who asked to remain anonymous; they know who they are, and I hope they also know how much I appreciate their help. The CFA Society of Chicago put on a great conference entitled "New Considerations in the Quest for Alpha", which took place in the middle of writing this book and gave me some valuable insights. I'm grateful to the volunteers and presenters who made the day so productive for me.

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Contents

Introduction

You've seen the headlines in the financial press. You've heard the rumors about mythical investment funds that make money no matter what happens in the market. And you want a part of that action.

I have to be upfront: Hedge funds aren't newfangled mutual funds, and they aren't for everyone. They're private partnerships that pursue high finance. If you don't mind a little risk, you can net some high returns for your portfolio. However, you have to meet strict limits put in place by the Securities and Exchange Commission — namely that you have a net worth of at least $1 million or an annual income of $200,000 ($300,000 with a spouse). Most hedge-fund investors are institutions, like pensions, foundations, and endowments; if you work for an institution, you definitely need to know about hedge funds. I also have to let you in on a little secret: Not all hedge fund mangers are performing financial alchemy. Many of the techniques they use are available to any investor who wants to increase return relative to the amount of risk taken.

Hedge Funds For Dummies tells you what you need to know, whether you want to research an investment in hedge funds for yourself or for a pension, an endowment, or a foundation. I also give you information about investment theories and practices that apply to other types of investments so you can expand your portfolio.

Even if you decide that hedge funds aren’t for you, you can increase the return and reduce the risk in your portfolio by using some of the same techniques that hedge fund managers use. After all, not everything fund managers do requires a PhD in applied finance, and not everything in the world of investing is expensive, difficult, and inaccessible.

About This Book

First, let me tell you what this book is not: It is not a textbook, and it is not a guide for professional investors. You can find several of those books on the market already, and they are fabulous in their own right. But they can be dry, and they assume that readers have plenty of underlying knowledge.

This book is designed to be simple. It assumes that you don’t know much about hedge funds, but that you’re a smart person who needs or wants to know about them. I require no calculus or statistics prerequisite; I just give you straightforward explanations of what you need to know to understand how hedge funds are structured, the different investment styles that hedge fund managers use, and how you can check out a fund before you invest.

And if you still want to read the textbooks, I list a few in the Appendix.

Conventions Used in This Book

I'll start with the basics. I put important words that I define in *italic* font. I often **bold** the key words of bulleted or numbered lists to bring the important ideas to your attention. And I place all Web addresses in `monofont` for easy access.

I've thrown some investment theory into this book. You don't need to know this information to invest in hedge funds, but I think it's helpful to know what people are thinking when they set up a portfolio. I also make an effort to introduce you to some technical terms that will come up in the investment world. I don't want you to be caught short in a meeting where a fund manager talks about generating alpha through a multifactorial arbitrage model that includes behavioral parameters. Many hedge fund managers are MBAs or even PhDs, and two notorious ones have Nobel Prizes. Folks in the business really do talk this way! (To alert you to these topics, I often place them under Technical Stuff icons; see the section "Icons Used in This Book.")

During printing of this book, some of the Web addresses may have broken across two lines of text. If you come across such an address, rest assured that I haven't put in any extra characters (such as hyphens) to indicate the break. When using a broken Web address, type in exactly what you see on the page, pretending as though the line break doesn't exist.

What You're Not to Read

I include sidebars in the book that you don't need to read in order to follow the chapter text. With that stated, though, I do encourage you to go back and read through the material when you have the time. Many of the sidebars contain practice examples that help you get a better idea of how some of the investment concepts work.

You can also skip the text marked with a Technical Stuff icon, but see the previous section for an explanation of why you may not want to skim over this material.

Foolish Assumptions

The format of this masterpiece requires me to make some assumptions about you, the reader. I assume that you're someone who needs to know a lot about hedge funds in a short period of time. You may be a staff member or director at a large pension, foundation, or endowment fund, and you may need to invest in hedge funds in order to do your job well, even if you aren't a financial person. I assume that you're someone who has plenty of money to invest (whether it's yours or not) and who could benefit from the risk-reduction strategies that many hedge funds use. Maybe you've inherited your money, earned it as an athlete or performer, gained it when you sold a company, or otherwise came into a nice portfolio without a strong investment background.

I also assume that you have some understanding of the basics of investing — that you know what mutual funds and brokerage accounts are, for example. If you don't feel comfortable with the basic information, you should check out *Investing For Dummies* or *Mutual Funds For Dummies,* both by Eric Tyson. (Calculus and statistics may not be prerequisites, but that doesn't mean I don't have any!)

No matter your situation or motives, my goal is to give you information so that you can ask smart questions, do careful research, and handle your money in order to meet *your* goals.

And if you don't have a lot of money, I want you to discover plenty of information from this book so that you'll have it at the ready someday. For now, you can structure your portfolio to minimize risk and maximize return with the tools that I provide in this book. You can find more strategies than you may know.

How This Book Is Organized

Hedge Funds For Dummies is sorted into parts so that you can find what you need to know quickly. The following sections break down the structure of this book.

Part I: What Is a Hedge Fund, Anyway?

The first part describes what hedge funds are, explains how managers structure them, and gives you a little history on their development. It also covers the nuts and bolts of SEC regulation and the process of buying into a hedge fund. Go here for the basics.

Part II: Determining Whether Hedge Funds Are Right for You

In this part, I cover many investment considerations — including your time horizon, your liquidity needs, taxes, and other special needs you may have — in order to help you figure out if you should be in a hedge fund. If you decide against it, the information here may give you some ideas on other ways you can invest your money. All investors face a list of goals for their money as well as a series of constraints that they must meet. The art of investing is balancing your investment objectives with constraints so that your money works the way you need it to.

Part III: Setting Up Your Hedge Fund Investment Strategy

Part III is the fun part — an overview of the many different ways that a hedge fund manager can generate a big return while keeping investment risk under control. Fund managers can buy and sell, take big risks, or rely on arbitrage; become shareholder activists or trade anonymously; or speculate on interest rates, currencies, or pork bellies.

This part also covers ways you can evaluate a hedge fund's risk-adjusted performance. You've probably heard of a handful of headline-grabbing hedge-fund scams, and you can find plenty of investors who have learned the hard way just how much risk their hedge funds had.