






Investment basics

Hedge Fund Basics

1. What are hedge funds?

Hedge funds employ non-traditional strategies including long and short positions, leveraging, arbitrage, swaps, etc. to manage risk and enhance potential return. Global estimated assets under management of the industry in 2020 sat at USD3.36 trillion.¹

A comparison between mutual funds and hedge funds

	Mutual funds	Hedge funds
 Investment objective	Aim to produce relative returns that beat the market	Aim to achieve absolute returns irrespective of market movements
 Investment strategy	Usually apply long-only strategy	Employ multiple strategies which include long and short positions, leverage, arbitrage, etc.
 Liquidity	Typically daily or weekly dealing	Typically offer monthly, quarterly or yearly liquidity. May impose lock-up period
 Minimum investment requirement	Mostly public with lower minimum investment requirements	Many are private funds with higher minimum investment requirements
 Performance fee	Some may charge performance fees	More common to charge performance fees than mutual funds. Fees are calculated in many ways such as high-water mark or hurdle rate, and can only be charged when the funds achieve specified levels of returns

¹ Source: eVestment, data as of end of 2020.

“Hedge funds have the potential to capitalise on various market conditions and provide resilience and better performance during market downturns.”

2. Key features of hedge funds



Adapt to various market conditions

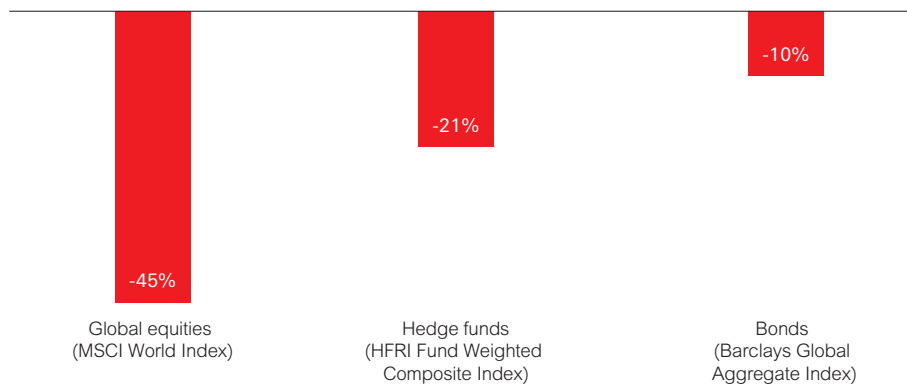
By employing long-short strategies, it is possible for hedge funds to manage the ups and downs of the market cycles and profit in rising or falling market conditions. These strategies may provide potential downside protection against market crash and demonstrate better performances during market downturns.



Diversify investment risks

Hedge funds can act as complement to traditional assets such as stocks and bonds in a portfolio and aim to achieve more steady return. With a wide range of investment tools and strategies and more flexible investment rules, hedge funds tend to have lower correlation to traditional assets and provide returns regardless of market movements, resulting in lower volatility of the overall portfolio.

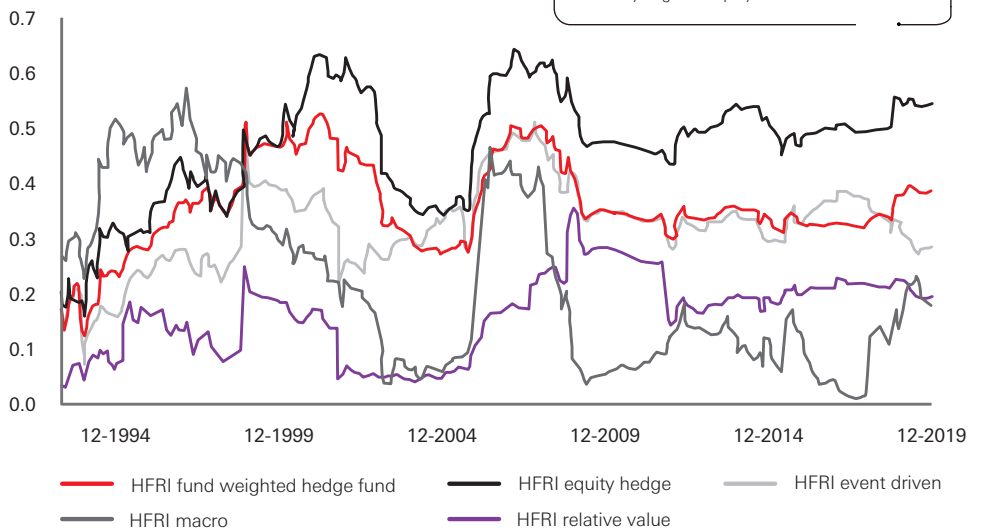
Maximum drawdown in the past 30 years*



* Maximum drawdown measures the largest drop from peak to bottom in the value of a portfolio before a new peak is attained. For illustrative purposes only.
Source: AIMA Research, data as of April 2020.

Hedge funds exhibit lower sensitivity to global equity market

Rolling 36-month beta with MSCI AC World Index



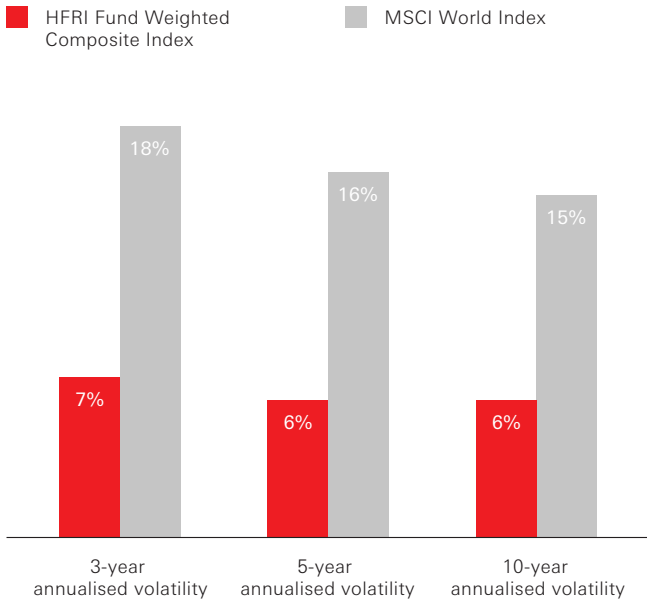
Beta of an asset represents its sensitivity in relation to the market. A beta of 0.5 means that hedge fund will change by 0.5% in response to every 1% change in the equity index. Beta of hedge fund remains at low level as shown in the chart, representing a low sensitivity to global equity market.

Source: MSCI, Hedge Fund Research, FTSE and Mercer Calculations. Beta estimated using monthly returns in excess of the risk-free rate, FTSE 3-month T-Bills as of end of 2019.

3. Three common myths about hedge funds

Myth 1: High volatility?

Truth: Hedge funds can employ different strategies (e.g. long and short positions) to contain loss during market downturn. Therefore, hedge funds are theoretically less volatile than traditional long-only funds.

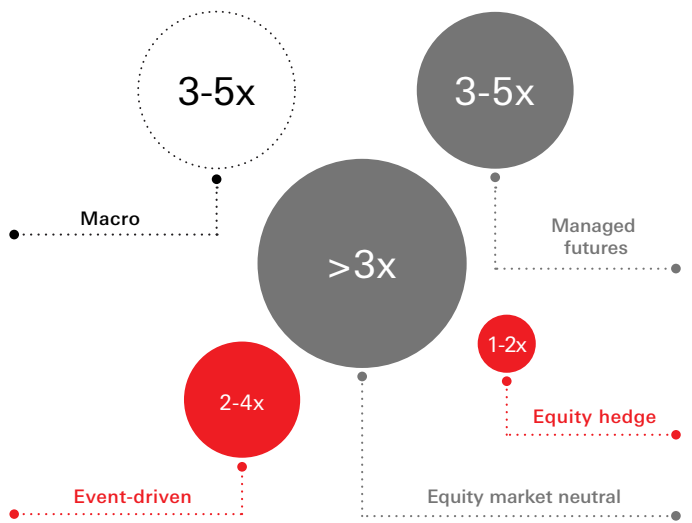


Source: AIMA Research, data as of April 2020. For illustrative purposes only.

Myth 2: High leverage?

Truth: Use of leverage is common among hedge funds with an aim to enhance potential portfolio returns. The amount of leverage used by different hedge fund strategies can vary substantially, but it is generally lower than that of broker-dealers and insurance companies.

Leverage range of hedge fund strategy

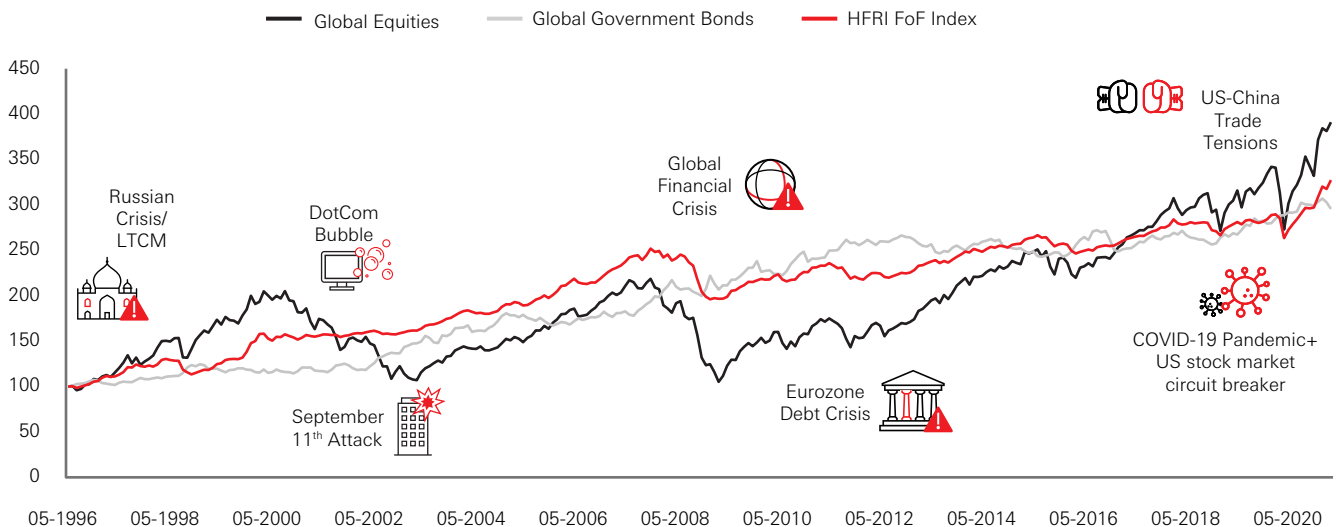


Source: AIMA Research (2016), leverage range based on various prime broker estimates over 2014 to 2016.

Myth 3: Ultra-high return?

Truth: Hedge fund is not about making ultra-high returns, but rather about achieving potential returns with lower volatility by employing various strategies in different market cycles. Historical data suggest that performance of hedge funds lay between global equities and government bonds over the long term.

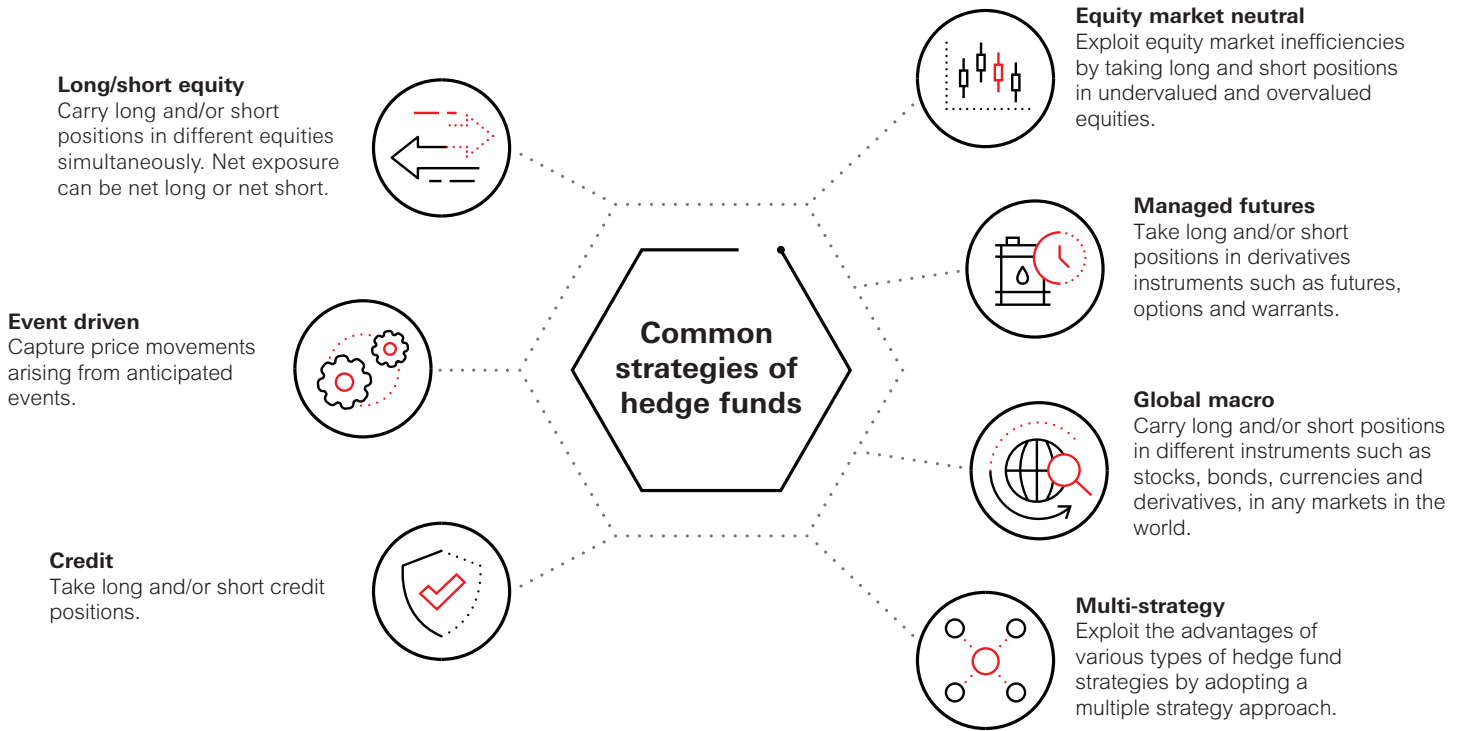
Historical performance (June 1996 – February 2021)



Source: HSBC Alternative Investments Limited, Bloomberg. Data as of February 2021.

4. Common strategies of hedge funds

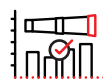
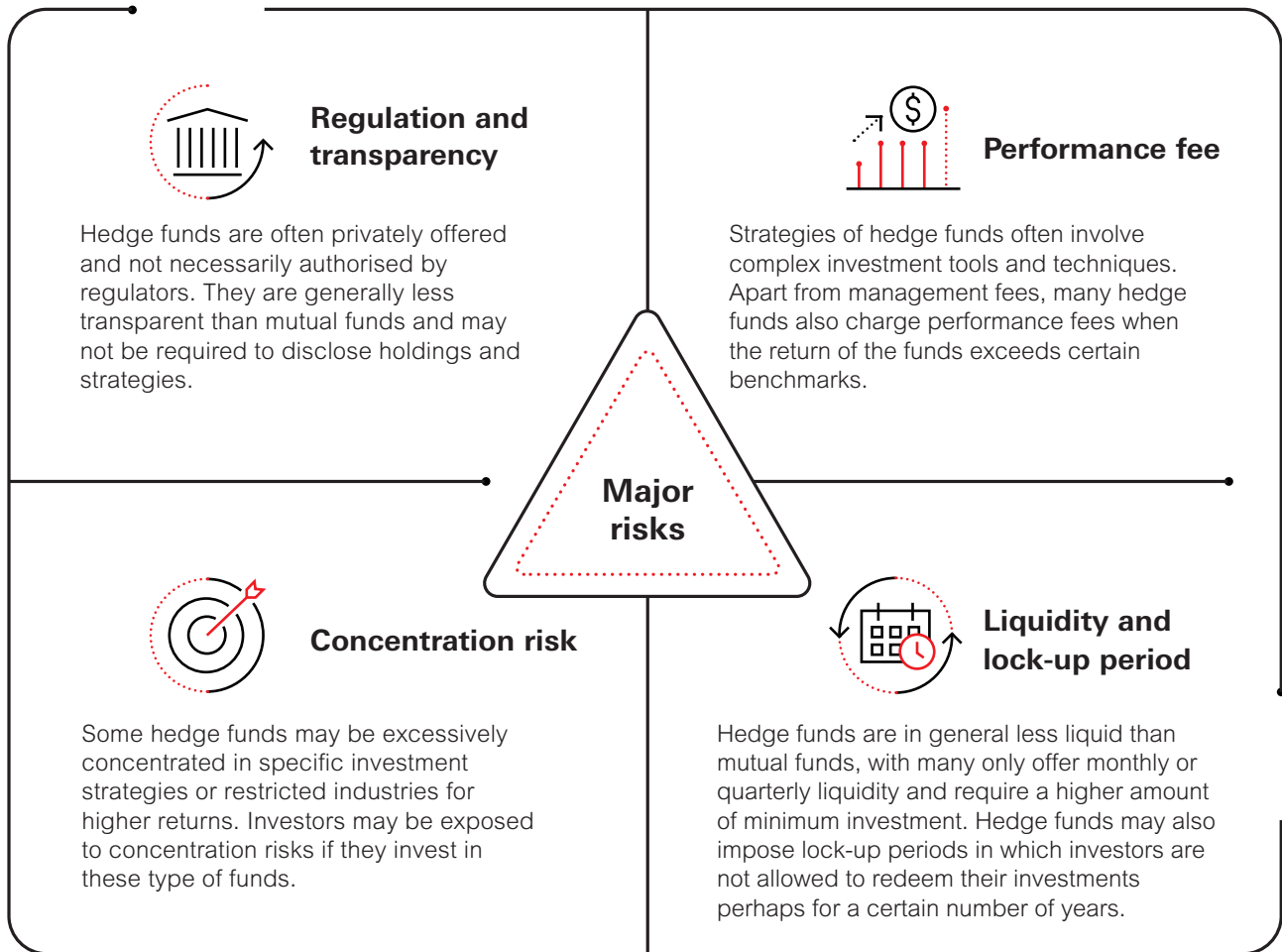
Hedge funds are fund pools that aim to achieve potential returns by employing flexible investment strategies such as:



Source: HSBC Asset Management. For illustrative purposes only.



5. Major risks of investing in hedge funds



Longer time horizon for hedge fund strategies

Some of the hedge fund strategies such as event driven and distressed debt may impose lock-up periods and restriction on redemption according to their needs, as they may invest in non-traditional assets with lower liquidity, employ higher leverage levels or invest with a more concentrated portfolio. Therefore, a longer-term investment horizon would be more suitable for hedge funds strategies.

Hedge fund strategies	Redemption notice period (Average number of days)	Redemption frequency (Average number of days)
Managed futures	12	16
Distressed debt	81	56
Event driven	48	94
Long/short equities	28	41
Macro	18	31
Multi-strategy	30	24

Source: AIMA and Chartered Alternative Investment Analyst Association (CAIA) research, 2017 data.

“Funds of hedge funds aim to achieve a long-term capital growth through strategic allocation and professional risk management.”

6. Advantages of funds of hedge funds

Hedge funds have unique advantages and risks compared to mutual funds. A fund of hedge funds is a basket of hedge funds in which investors may leverage on fund manager’s professional risk management to achieve strategic allocation and the long-term goal of capital growth.

Lower minimum investment requirement

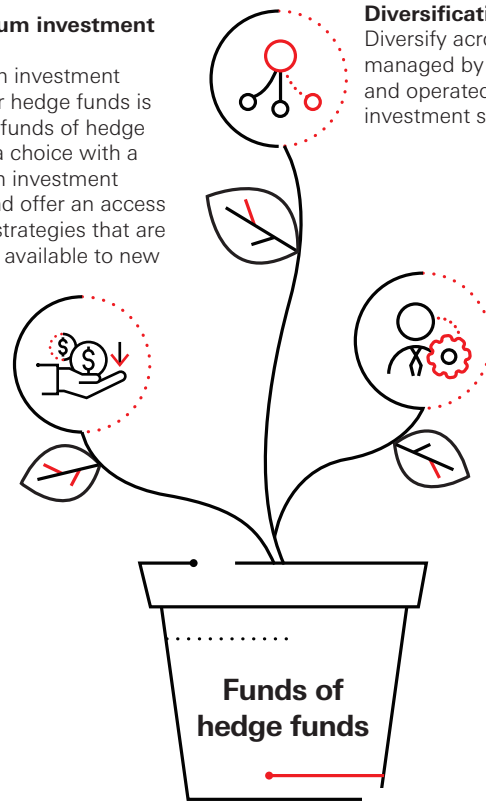
While minimum investment requirement for hedge funds is relatively high, funds of hedge funds provide a choice with a lower minimum investment requirement and offer an access to investment strategies that are sometimes not available to new investors.

Diversification

Diversify across hedge funds managed by different fund managers and operated with different investment strategies.

Professional management

Funds of hedge funds are managed by experienced professionals with a comprehensive investment process.



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