A Review of Hedge Fund Strategies in Global Financial Markets

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ABSTRACT

This paper examines the complexity of hedge fund strategies within the global economy and highlights the ongoing need to better understand their operations, particularly during periods of financial instability. Hedge funds are distinguished by their flexible investment mandates, use of advanced financial instruments, and active risk-taking approaches, which can significantly influence market dynamics. The paper discusses the classification of hedge funds based on factors such as investment style, geographic focus, and trading strategies, emphasizing the diverse nature of the industry. It also analyses key hedge fund strategies, including arbitrage, event-driven, distressed, and merger strategies, outlining their objectives and associated risks. The conclusion underscores the importance of increased transparency, stronger regulatory oversight, and improved disclosure to mitigate systemic risks. Furthermore, it calls for continued research to enhance understanding of hedge fund behaviour and their impact on global financial markets, supporting more informed investment and policy decisions.

Keywords: Hedge Funds, Classification of Hedge Funds, Hedge Fund Strategies, Investment Styles, Risk Return Profiles.

INTRODUCTION

Although the term 'hedge fund' originated from only the two, the long and short strategy employed by the managers, the new definition of hedge funds covers different strategies. There is no acceptable norm to classify hedge fund's strategies (Agrawal and Naik, 2002). Hedge funds are speculative investment vehicles which are designed to exploit superior information held by their managers (Connor & Woo, 2004). A hedge fund manager reveals full details of his strategy only after he has decided that it is no longer worth pursuing. Nonetheless, hedge fund managers are not willing to reveal their strategies usually; even if they are to explain them, they describe the general outlines of their strategies, in ways that do not reveal potential profitable trading information (Connor and Lasarte, 2004).

Hedge funds have the broadest investment horizon as they have largest capacity to take positions in any asset in any market. Hedge funds have large economic trends and take bets in whatever markets the manager feels any offer that has the highest potential rewards in. Hedge fund strategies are non- traditional which expose investors to a broad range of risks which are to be fully understood prior investing in; actually the ability of a hedge fund manager to generate consistent positive returns is often accomplished through the usage of investment strategies and securities that may expose investors to a substantial range of risks that are security or strategy special (Philipps and Surz, 2003). Therefore, it is essential to understand about the various bases of classification and their allied strategies that are usually adopted in different market conditions globally.

Objectives

- To review different basis of classifications of hedge funds.

- To review and explore various trading styles of hedge funds.
- To review different types of hedge funds strategies and techniques in different market conditions.

Classification of Hedge Funds

There was no consensus on a formal system of classifying hedge funds. Hedge Fund Research (HFR), one of the main hedge fund databases, listed 30 separate strategies with some overlap between them. Another widely used database, TASS Research, separated hedge funds into 17 strategy types (Connor and Lasarte, 2004). During implementation of hedge funds, the process of selecting managers, managing portfolios and monitoring risks is a complex task. Therefore, a variety of strategies are characterized by hedge funds (Phillips and Surz, 2003).

Historical Roots: One interesting division of hedge fund strategies was according to their historical roots. Some hedge fund strategies traced their lineage back to the original hedge fund industry, which was started by Alfred Winslow Jones in the late 1940s. Others were descendants of trading desk strategies originally practiced only within brokerage houses and investment banks. Other strategies were developed out of commodities and futures trading particularly currency trading. It was noted that any attempt to establish a formal system of classification for hedge fund strategies was limited by the fact that these strategies were continually changing. As investment opportunities shifted, hedge fund managers modified their investment plans or design new ones to take advantage of profit opportunities. To illustrate, several hedge funds began taking direct positions in leveraged buyouts previously the domain of private equity firms. The official registration started under Securities Exchange Board of India in the year 2012. There were almost thirty five registered hedge funds in India till November, 2016.

Style and Location: Hedge fund's strategy can be classified according to both style and location. Style considered to the type of positions the fund manager is taking, such as going long and short, betting on a particular type of corporate event, or maintaining market neutrality (Fung and Hsieh, 1997). Hedge fund portfolio includes long equities hedged most of the time with short sales of stocks and index options. This strategy is the largest category of hedge funds in terms of numbers and assets managed (Ballew, 2002). Location based classification considers the asset class that the hedge fund invests in, such as fixed income, equity, or currencies (Fung and Hsieh, 1997). Hedge funds are often segmented according to the asset class that they find the location of their investment in and are called as location differentiated, some of them trade solely in equities; others are specialized in fixed income or currencies (Connor and Lasarte, 2004).

Domicile: The structure and domicile of a hedge fund is primarily dependent on the tax status and residency of its prospective investors; and the investment strategy employed by the manager. Domestic hedge funds have the advantage of allowing certain categories of income, such as long term gains while distributed whereas the vast majority offshore funds are established in low or zero tax jurisdictions so that there is little or no corporate level tax for the fund. Based on domicile, hedge funds can be classified in two broad categories: onshore and offshore. Onshore funds are domiciled in US and are normally in the form of Limited Partnership, where the manager is the general partner and the investors are limited partners because the investors are not involved in the unlimited risk assumption.

In contrast, offshore funds are established in tax neutral jurisdictions like the British Virgin Islands, the Bahamas, Bermuda, the Cayman Islands, Dublin and Luxembourg allowing the investors to minimize their tax liabilities by investing outside their country. One of the more innovative offshore fund structures that allows for combining the offshore and onshore investors in the same investment vehicle is a Passive Foreign Investment Company. In such case, the offshore fund can accept both offshore and onshore investors but needs to always maintain at least a majority 50 percent of offshore investors' assets in the fund. Such a unique structure allows the manager to manage a single portfolio and not be concerned about allocating trades among offshore and onshore accounts to effectively serve both domestic and foreign investors simultaneously (Agrawal and Naik, 2002).

Trading Styles

Market Neutrality or Directional: A market- neutral strategy is a useful tool for reducing the risk of an investment while preserving return potential. It aims to generate returns that are independent of the market's swings and uncorrelated with both stocks and bonds. The skills of the portfolio managers, the direction of short-term interest rates and the degree of variation among stock returns influence the returns instead of the market dependency (Bernstein, 2012). Non directional strategies do not depend on the direction of any specific market movement and are commonly referred to as market neutral strategies. It is important to note that these strategies are neutral only to the first moment, i.e. expected returns. They are not neutral to the second moment, as in volatile periods, liquidity dries up and convergence is not always obtained and such arbitrage- based strategies can make losses. These are usually designed to exploit short-term market inefficiencies and pricing discrepancies between related securities while hedging out as much of the market exposure as possible. Due to the reduced liquidity inherent in many such situations, they frequently run smaller pools of capital than their counterparts following directional strategies. Directional strategies take directional bets and hope to benefit from broad market movements (Agrawal and Naik, 2002).

Systematic or Discretionary: Hedge funds are also classified according to whether their investment approach was systematic or discretionary. Systematic strategies are based on their trading on complex computer programs whereas discretionary funds are based on their trading decisions on the hedge fund manager's judgment. Many funds fall between these two extremes also (Connor and Lasarte, 2004).

Risk Return Diversities: Hedge funds strategies are distinguished as return enhancer strategies and risk reducer strategies. The distressed securities, event driven and macro funds are regarded as return enhancers seeking very high expected return but also increase overall portfolio volatility. Whereas, convertible arbitrage, fixed income arbitrage, long/short and short selling funds are regarded as risk reducers, offering positive excess returns along with decreasing overall portfolio volatility (Amenc et.al., 2002).

Geography: Hedge funds can also be grouped according to the geographical location of the assets they trade. For example, some funds only focus on European assets while others are limited to emerging markets. Hedge funds that have a mandate to invest in any country are labelled as global funds. Many funds are multi strategy, where the hedge fund manager changes investment strategies depending on market conditions, or allocate capital across different strategies simultaneously (Connor and Lasarte, 2004). It is also useful to divide managers by their geographic mandates. Typical mandates include U.S. and Canadian stocks only, Western Europe, Japan, Asia ex-Japan, and Emerging Markets. Global mandates are also very common (Phillips and Surz, 2003)

Single Strategy or Multi Strategy: A hedge fund that chooses a strategy and tries to hold on upon the strategy is called as single strategy based hedge fund whereas multi strategy based hedge funds keep their option open to a set of strategy that are adopted differently in different countries at different time in different asset locations that changes and focuses only on the profit earning which is only possible when the manager has great skills of switching the strategies. During a longer time period, when convertible-bond arbitrage age falls out of favour while equity long/short performs very well, multi-strategy managers may outperform convertible bond funds but underperform equity long/short managers. A well-documented example can be LTCM, which although usually were classified as a relative value fund; they also took positions in merger, takeover, events etc. (Connor and Lasarte, 2004).

Single Hedge Fund and Fund of Hedge Funds: There are two approaches regarding having investment in hedge funds. In one approach, in which the investors decide to have only one hedge fund through which they invest in. In another approach they decide to have fund of hedge funds. A fund of hedge funds may invest only in hedge funds using a particular management strategy; or, a fund of hedge funds may invest in hedge funds using many different strategies in an attempt to gain exposure to all of them. Funds of hedge funds allocate their capital by either investing in hedge funds with different strategies, or invest in many hedge funds with the same strategy. However, fund of funds were not considered as a separate hedge fund strategy, although it is considerably applied at the individual fund level (Connor and Lasarte, 2004). Fund of hedge funds delivers good returns with greater consistency when compared to various hedge funds indices and stock market benchmarks, despite the additional layer of fees. It is because the fund of hedge funds asset allocator adds alpha in selecting funds relative to nondiscretionary indices (Phillips and Surz, 2003).

Types of Hedge Fund Strategies

Arbitrage Strategies: Arbitrage strategies typically have a lower standard deviation of returns and the risk and size of the long positions are highly correlated with the risk and size of the corresponding short positions. Arbitrage based funds many a times have short volatility exposures that lead to gains in quiet markets and losses in turbulent markets. These strategies typically have annualized standard deviations of 5 to 7 percent resulting in the highest Sharpe Ratios of all hedge fund strategies. However, most of these strategies, generate money slowly but lose money quickly, which leads to unattractive negative skewness and fat tail risk i.e., large excess kurtosis in its descriptive (Black, 2009). Arbitrageurs mainly use a broad convergence-related investment theme. The base principle is that the prices of two distinctive securities will get closer over time. Managers try to remove market-related factors by focusing on the specific return objective of this price junction (Phillips ansd Surz, 2003).

Arbitrage based funds also employs different types of following strategic skills:

Treasury/Euro Dollar Arbitrage: Treasury/Euro dollar arbitrage tries to exploit differences in the yields between Treasury Bill Rates and Euro Dollar Market. The spread between the two is based on the difference in the credit worthiness of the US Government and the main international banks and is small which tends to increase during international financial shocks prevailing (Connor and Lasarte, 2004).

Convertible Arbitrage: Convertible arbitrage is a strategy where the securities of the same issuer are bought and sold seeking for obtaining low volatility returns arbitraging the mispricing of the securities (Agarwal & Naik, 2004). Convertible arbitrage takes advantage of mispricing of the embedded option value in a convertible bond. Typically, the manager buys the underlying convertible bond and sells short the corresponding equity (Phillips and Surz, 2003).

Fixed Income Arbitrage: Fixed income arbitrage has its historical roots in the fixed income trading desks of brokerage houses and investment banks. This strategy has long and short positions in government, corporate and asset backed securities through cash or derivatives. This strategy has the risk related to duration, credit exposure and the degree of leverage employed (Agrawal and Naik, 2002). Fund managers profit by exploiting pricing discrepancies between fixed income securities and their derivatives. Managers remain market neutral by hedging their exposure to interest rates. Most fixed income trades include yield- curve arbitrage, corporate vs. Treasury yield spread, municipal vs. Treasury yield spreads, cash vs. futures, and on the run vs. off the run (Ballew et. al. 2002). The strategy usually identifies mispricing among fixed income securities through mathematical models of interest rates.

Mortgage Arbitrage: Mortgage arbitrage mainly focuses on mortgage- backed securities and their related derivatives developed by financial institutions. Investors stores usually undertake a long position on a mortgage-backed security and short position on a government bond of similar maturity. Thus, the investor receives a payoff from the yield differential in spite of interest rate risks.

Long Term Capital Management (LTCM) crises in the early 1990's witnessed the success of Mortgage Arbitrage strategy (Connor and Lasarte, 2004). Mortgage-backed fixed-income arbitrage funds have relatively large spreads due to the embedded optionality and difficulty predicting prepayment speeds (Phillips and Surz, 2003).

Yield Curve Arbitrage: Yield curve arbitrage takes offsetting positions at various points of the yield curve. A parallel shift in a yield curve occurs when the yield on all maturities change by the same amount. More likely are changes in which the spread between short and long maturities increase or decrease.

Derivatives Arbitrage: Derivatives arbitrage exploits the difference in pricing between a series of options or between options, futures and the money market. Hedge funds in this strategy rely on mathematical models to exploit investment opportunities revealed and suggested by the models (Connor and Lasarte, 2004).

Stock Index Futures Arbitrage: Stock Index Futures Arbitrage is an investment strategy that attempts to profit from the differences between actual and theoretical futures prices of the same stock index. Stock index futures arbitrage takes advantage of the spread between index futures and price of underlying securities. When the futures price is lower, the manager goes to long the future contract and to short the individual component stocks and, then, unwinds the positions at a profit. The opposite arbitrage strategy is applied when the futures price is higher than the index-implied price. In such a case, when the futures price is higher, the manager goes to short the future contract and to long the individual component stocks (Connor and Lasarte, 2004). This arbitrage is done by simultaneously buying or selling a stock index future while selling or buying the stocks in that index.

ADR Arbitrage: American Depositary Receipts (ADR) arbitrage exploits the difference between the trade prices of ADRs and underlying shares which are issued and traded in a US market such as the New York Stock Exchange and priced in dollars, but backed by foreign- traded shares of a foreign domiciled company. Sometimes the currency translated price of the foreign security traded in its home market which differs from the ADR price traded on the US market in dollars. Speculators attempt to exploit these arbitrage price differentials (Connor and Lasarte, 2004). This specialist strategy is among the oldest and least well known of active arbitrage strategies. There is a high barrier to entry, because you need to act fast and have low costs to be competitive. As a result, it is mostly practiced for the proprietary accounts of large dealers and investment banks, and most hedge funds find it difficult to compete (Phillips and Surz, 2003).

Event Driven Funds: Event driven funds focuses on a single strategy, such as distressed investments or risk arbitrage (Black, 2009). These funds expect to make an impact over a relatively short period of time in the events like corporate restructuring, stock buybacks, bond upgrades, earnings surprises and spin-offs (Connor and Lasarte, 2004). These strategies try to benefit from mispricing arising in events such as merger arbitrage, restructurings, reorganization, etc. Manager takes a position in an undervalued security which is anticipated to rise in value on account of happening or not happening of such event/s. The main risk in such strategies is non-realization of the event fully or partially (Agrawal and Naik, 2002).

Distressed Funds: The distressed securities strategy buy and occasionally short securities like senior secured debt and common stock of companies under the Chapter 11 of Title 11 of the United States Bankruptcy Code and/or ones which are undergoing any kind of reorganization considering the risk of liquidation of these financially distressed company (Agrawal and Naik, 2002). Prices for distressed securities are typically volatile and illiquid. Some hedge funds focus on distressed securities which are active in the entire market; others limit themselves to more specific sectors. The market often is inefficient and illiquid because of illiquid investor irrationality, risk aversion, legal restrictions on holding sub-par securities, low coverage by analysts, and lack of research. The strategy generally takes long positions (Black, 2009).

Merger Strategy: Merger strategy based funds seek to predict the outcome of announced corporate merger transactions where they purchase the stock of the target company and sell short the stock of the acquiring company in the ratio of the stock swap transaction. The targeted return of these funds may be 5 to 10 percent earned in the initial three to eighteen months of the deal announcements. When a planned merger is cancelled, these funds experience huge losses as the stock of the target company fall 30 percent or more in a single day (Black, 2009). Merger or risk arbitrage is a hedge fund strategy that is wholly dependent on the expected price convergence of two distinct securities. Typically, following the announcement of a takeover or merger of two companies, one security, usually the target company's, will rise in price while the acquirer's stock price will fall. As a result of the offer to buy the target company's shares at specific cash or exchangeable share value, their price goes up, although usually not to the full offering price (Phillips and Surz, 2003).

Emerging Market Strategy: Emerging Market funds invest in sovereign or corporate debt and/or equity in countries considered to be emerging -- most markets other than North America, Western Europe, Japan, New Zealand, and Australia (Ballew et. al. 2002). Emerging market strategy employs a growth or value approach that invests in equities in the emerging markets with no shorting or hedging for minimizing the market risk. (Agrawal and Naik, 2002). Emerging market hedge funds are often long only because of the inability to trade in derivative securities or sell short or because they are expensive in these markets. In the event of low debt of emerging market countries in comparison to investment grade, these bonds may have risk and return characteristics similar to equity securities (Black, 2009).

Medium Volatility Hedge Fund Strategies: The medium volatility hedge fund strategies generally take long and short positions in different size and risks such as style or industry risk factors ending in a net long position in the underlying stocks. These strategies attain a volatility of 10 to 12 percent annually and these funds are considered as the largest hedge fund strategy (Black, 2009). There are different sub strategies under this type of strategy. Equity Hedge is a strategy of investing in equity or equity like instruments where the net exposure is low. The fund may be invested globally, or may have a more defined geographic, industry or capitalization focus. Equity Non Hedge is a strategy similar to equity hedge with significant net long exposure (Agrawal and Naik, 2002). Equity long or short is the same as equity market neutral except without any promise to maintain market neutrality. Therefore, there is flexibility to the manager to choose net- long or net short market exposure, while still focusing primarily on stock- selection opportunities. However, the investor is no longer clear how the hedge fund allocation affects overall portfolio risk (Connor and Lasarte, 2004).

Macro Strategy: Macro strategy funds often invest in global markets like, equity indices, currencies, commodities, and interest rate markets, selecting asset classes and countries that will benefit from the manager's market view, resulting from government actions, geopolitical issues, economic indicators, market trends and liquidity flows (Black, 2009). It is a strategy that uses leverage and derivatives as a vehicle of investment (Agrawal and Naik, 2002). The returns of macro funds are more volatile in comparison to other hedge funds because these funds usually trade in liquid instruments (Connor and Lasarte, 2004).

Managed Futures Funds Strategy: Managed futures funds are also known as Commodity Trading Advisers (CTAs). These seek profit through the quantitative prediction of market trends and invest in currencies, commodities, equity indices, and interest rate futures. They take long positions during times of rising prices and short positions during times of falling prices. They build a bottom-up portfolio of positions which get benefit from the anticipated trends in the market prices. Managed futures funds strategy offers the best hedging and diversification characteristics. Valuation risk, liquidity risk, complexity risk, and counterparty risk are very less in this type of strategies (Black, 2009). The strategies and approaches within 'managed futures' are extremely varied. The one common unifying characteristic is that these managers trade highly liquid, regulated, exchange-traded instruments and foreign exchange markets. This permits the portfolio to be marked-to-market every day. CTAs have been regulated by the Commodity Futures Trading Commission (CFTC) since 1974 and are overseen by the National Futures Association (NFA), a self regulatory organization.

Dedicated Short Bias Strategy:

Dedicated short bias strategy focuses on short side and sacrifices the market neutrality tending to be the most effective when markets decline as there are untapped profit opportunities available to investors who can short sell freely. These funds focus on the shares of companies with large market capitalizations, as they are more liquid and easier to borrow and can contribute to the informational efficiency and corporate monitoring role of capital markets (Connor and Lasarte, 2004). Dedicated short bias funds have a beta exposure close to -1.0 and their returns can add significant value, if the manager wants to display skills in predicting which stocks will underperform the relevant market index (Black, 2009).

An extensive literature review found that there are various strategies which are adopted by the different hedge funds. Apart from dedicated hedge funds, a particular fund of hedge funds and even a hedge fund may adopt a set of hedge fund strategy contributing to their main objectives. Secrecy regarding investments, returns, and strategy adoption is not disclosed or disclosed at the time when a particular hedge fund is closed or it shifts from strategy to the another strategy. But in such type of cases as well, only the old abundant strategy is disclosed. Although the institutional environment can affect the way in which hedge funds are organized, it is their return characteristics that hold the key to distinguishing between hedge fund strategies.

CONCLUSION

As far as first objective is concerned i.e. to study different basis of classifications of strategies of hedge funds, it is concluded that it is very important to delineate the differences between fund strategies and to understand the level and volatility of the resulting alpha and beta exposures. There is also need to investigate fee structures, operational risks, and the capacity of the market to absorb increased levels of hedge fund assets beyond the market risks (Black, 2009). As far as the second objective is concerned i.e. to study and explore various trading styles of hedge funds, it is concluded that hedge funds have evolutionary global history. However, there might be other strategies present for which appropriate information is lacking. The present registered number seems to be very less as compared to the age, size, and volume and market efficiency of the Indian stock market. There is less disclosure about their types, working patterns and styles. As far as the third Pat objective is concerned i.e. to describe different types of hedge funds strategies and techniques in different market conditions, there are different academic types of strategies but, which fund is focusing what strategy/ set of strategies is confidential USP. The fund manager only knows them even client investors do not know. Further it is concluded that, as far as Indian registered hedge funds are considered, there is less public information available about their parental organization or parental hedge fund, if any.

Suggestions

There is still a need of greater transparency regarding hedge funds. Regulatory control and investors interest is further reviewed. Hedge funds' operations under the impact on the market need to be further monitored at the macro level. More disclosure about fund managers profile and creditability is needed for public at large. The present registered number of hedge funds in India seems to be little less in comparison to total number of registered Alternative Investment Funds under Securities Exchange Board of India. Hence, favourable financial and legal environment needs to be strengthened. A mechanism regarding risk ascertainment of the assumed risk of the different hedge funds and the investors who are capable of assuming such level of risks be registered at a same platform, so that, the overall hedge fund sector gains popularity.

Hedge funds have a significant but mysterious role in the stock market. It is implied that the hedge funds strategies should substantially be academically and technically improvised and disclosed timely so as to gain the trust of investors. A well-structured monitoring mechanism regarding the activities of the hedge funds and hedge funds' managers may improve the functioning of the industry favouring the economy by striking a balance between secrecy and transparency. There is a need to fix the disclosure biases in trading styles of hedge funds. This will decide and channelize the appropriate return profiles of the portfolio.

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