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## KEY HEDGE FUND TERMS

Every Beginner Should Know

Hedge fund management has its own distinct vocabulary. Listed below are frequently used terms that you should know, if you are new to this field.



### ABSOLUTE RETURN

Return that an asset achieves over a certain period of time. The goal is to have a positive return, regardless of market direction.



### ACCREDITED INVESTOR

SEC terminology to refer to an investor who makes \$200,000 a year, or one who has net worth of \$1 million or an entity with \$5 million in invested assets. Individuals, banks, insurance companies, employee benefit plans and trusts can all be considered accredited investors.



### ALPHA

The return to a portfolio over and above that of an appropriate benchmark portfolio.



### ASSET MIX

The classification of all assets within a fund or portfolio. They are assigned to one of the core asset classes: equities, fixed income, cash and real estate. Other categories are commodities, international investments, hedge funds and limited partnership interests.



### ARBITRAGE

Any strategy that invests long in an asset and short in a related asset, hoping to profit from a temporary pricing discrepancy.



### ATTRIBUTION

The process of "attributing" returns to their sources, like stock selection, industry/sector over- or under-weighting or factor weighting.

$$P = \frac{1}{100}$$

### BASIS POINT

Investment returns are measured in basis points. One basis point equals 1/100 of a percent. For example, 75 basis points (bps) equals 0.75%.



### BETA

Measure of systematic - non-diversifiable risk. The goal is to quantify how much systematic risk is being taken by the fund manager vis-à-vis different risk factors, so that one can estimate the alpha on a risk-adjusted basis. If XYZ has a beta of 1.5, it will supposedly move 1.5 percent for every 1 percent move in the market.

### BUSTED CONVERTIBLES

Convertible bonds trading well below par value, at or near their investment value.



### CONVERTIBLE BONDS

Bonds that can be converted into a fixed number of shares. These are hybrid securities with features of both bonds and stocks. Therefore, their valuations reflect both types of instruments.



### CORRELATION

Measure of how strategy returns move with one another, in a range of -1 to +1. A correlation of -1 implies that the strategies move in opposite directions, while a +1 implies parallel movement.



### DIRECTIONAL EXPOSURE

The amount of risk an unhedged position faces in the market, as compared to the net exposure of positions involving long and short hedged relationships.



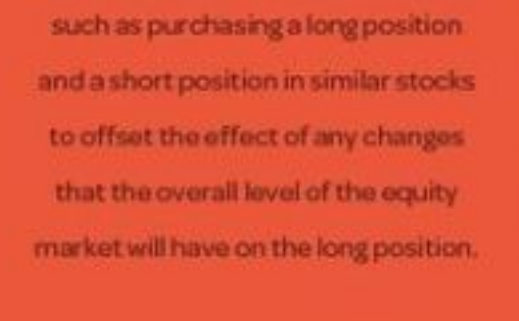
### DURATION

A measure of how sensitive a bond's price is to a shift in interest rates. In general terms: Duration = (Change in price) / Price Change in interest rates



### DRAWDOWN

The percentage loss from a fund's highest value to its lowest, over a particular time frame. A fund's "maximum drawdown" is often looked at as a measure of potential risk.



### HEDGING

Any investment that is taken in conjunction with another position in order to reduce directional exposure, such as purchasing a long position and a short position in similar stocks to offset the effect of any changes that the overall level of the equity market will have on the long position.



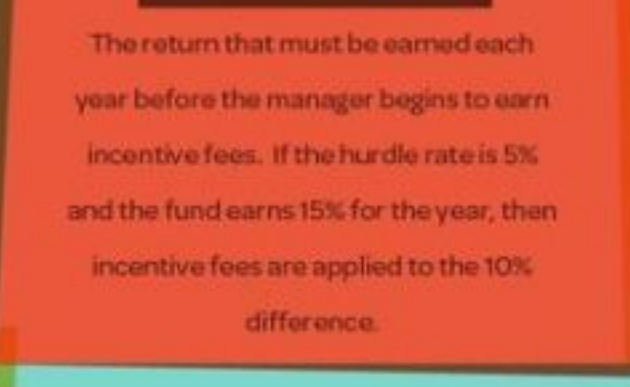
### FUND-OF-FUNDS

By making a single investment in a fund-of-funds, investors obtain access to a number of different hedge funds in which, because of the high minimum investment required by each, they normally could not invest in as an individual.



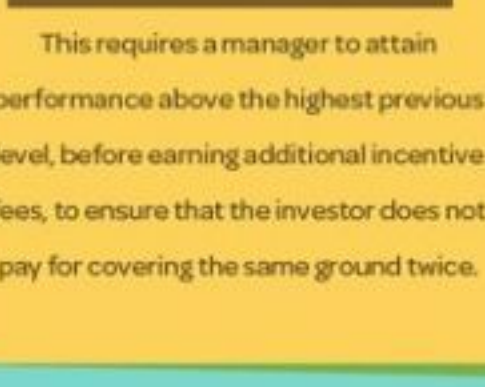
### HEDGE RATIO

The number of shares of common stock that a manager sells short out of the total number possible.



### HURDLE RATE

The return that must be earned each year before the manager begins to earn incentive fees. If the hurdle rate is 5% and the fund earns 15% for the year, then incentive fees are applied to the 10% difference.



### HIGH WATER MARK

This requires a manager to attain performance above the highest previous level, before earning additional incentive fees, to ensure that the investor does not pay for covering the same ground twice.



### INCENTIVE/ PERFORMANCE FEE

The hedge fund manager's share in the fund's profits. Typically, 20% is charged each year, in addition to a standard management fee.



### LEVERAGE

The practice of borrowing to increase a position in a security. If one uses leverage and makes good investment decisions, leverage can magnify the gain. However, it can also magnify a loss.



### LIQUIDITY

It refers to the periods during which investors can redeem their investments and have their money returned from the fund (monthly, quarterly, etc.).



### LOCK-UP PERIOD

The time an investor must remain invested in the portfolio before his or her investment can be redeemed.



### NET MARKET EXPOSURE

The percentage of the portfolio exposed to market fluctuations because long positions are not matched by equal dollar amounts of short positions.



### MARKET NEUTRAL PORTFOLIOS

They consist of approximately equal dollar amounts of offsetting long and short equity positions, so total net exposure is close to zero.



### NEUTRAL HEDGE

A hedge ratio that does not add exposure to up or down markets.



### OPTION ADJUSTED SPREAD

The spread relative to Treasuries that equates the present value of a series of uncertain cash flows of an instrument to its current market price. It is often used with mortgage-backed securities.



### OPPORTUNISTIC

A term that describes an aggressive strategy with a goal of making money, as opposed to holding onto the money one already has.



### PORTFOLIO SIMULATION

Involves testing an investment strategy by "simulating" it with a database and analytic software. The simulated returns of the strategy are compared to the benchmark to see if it can beat that benchmark.



### RISK ARBITRAGE

Strategy to generate profits by taking a long position in the stock of a target company and optionally combining it with a short position in stock of an acquiring company to create a hedge.



### RUN ON THE FUND

This is when a hedge fund faces a growing amount of redemption requests.



### QUALIFIED PURCHASER

Is an individual or family company holding at least \$5 million in investments or an entity that owns and invests on a discretionary basis at least \$25 million in investments.



### SHORT EQUITY

Refers to an equity position sold short, or "short stock."



### R-SQUARED

Measure of how closely a portfolio's performance varies with the performance of a benchmark, and thus a measure of what portion of its performance can be explained by the performance of the overall market or index.



### SHORT INTEREST REBATE

If you borrow stock and then sell it short, you have cash in your account. The short rebate is the interest earned on that cash.



### SHORT SELLING

The practice of borrowing a stock on collateral and immediately selling it on the market with the intention of buying it back later at a lower price after the market corrects itself.



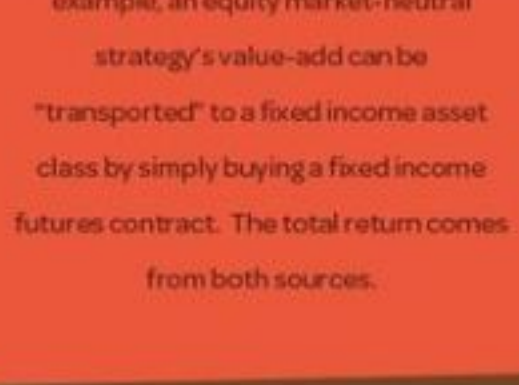
### SPREAD

The difference between the yields of two comparable or related securities. Spreads are measured in basis points. The more risky the security, the larger the spread.



### SIGNIFICANT CORPORATE EVENTS

Major public events, such as mergers, bankruptcies and spin-offs, that have the potential to dramatically change a company's makeup and, as a result, the valuation of its debt and equity instruments.



### TRANSPORTABLE ALPHA

The alpha of one active strategy can be combined with another asset class. For example, an equity market-neutral strategy's value-add can be "transported" to a fixed income asset class by simply buying a fixed income futures contract. The total return comes from both sources.



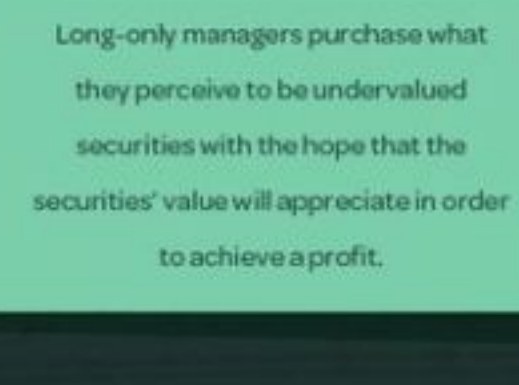
### STANDARD DEVIATION

The measure of average deviation from an expected result. The larger the variation, the riskier the investment.



### SHARPE RATIO

A measure of risk-adjusted return, computed by dividing a fund's return over the risk-free rate by the standard deviation of returns. The idea is to understand how much risk was undertaken to generate the alpha.



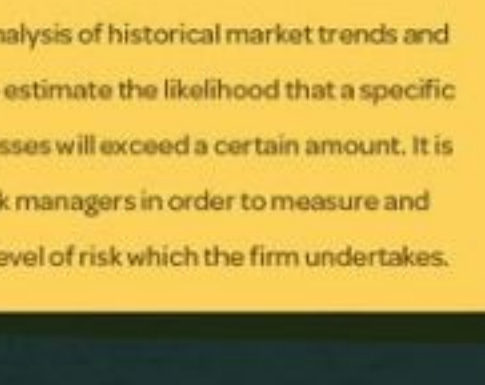
### TRADITIONAL, OR LONG-ONLY, INVESTING

Long-only managers purchase what they perceive to be undervalued securities with the hope that the securities' value will appreciate in order to achieve a profit.



### TRANSPARENCY

The ability to review the underlying instruments and positions within a manager's portfolio.



### VALUE AT RISK

Statistical analysis of historical market trends and volatilities to estimate the likelihood that a specific portfolio's losses will exceed a certain amount. It is used by risk managers in order to measure and control the level of risk which the firm undertakes.