Since 1996, Bloomberg Press has published books for finance professionals on investing, economics, and policy affecting investors. Titles are written by leading practitioners and authorities, and have been translated into more than 20 languages.

The Bloomberg Financial Series provides both core reference knowledge and actionable information for finance professionals. The books are written by experts familiar with the work flows, challenges, and demands of investment professionals who trade the markets, manage money, and analyze investments in their capacity of growing and protecting wealth, hedging risk, and generating revenue.

Books in the series include:

*Visual Guide to ETFs* by David Abner
*Visual Guide to Chart Patterns* by Thomas N. Bulkowski
*Visual Guide to Municipal Bonds* by Robert Doty
*Visual Guide to Options* by Jared Levy
*Visual Guide to Candlestick Charting* by Michael Thomsett
*Visual Guide to Financial Markets* by David Wilson
*Visual Guide to Elliott Wave Trading* by Wayne Gorman and Jeffrey Kennedy
*Visual Guide to Hedge Funds* by Richard C. Wilson

For more information, please visit our Web site at www.wiley.com/go/bloombergpress.
Contents

How to Use This Book vii
Introduction ix

Chapter 1: Hedge Fund Daily Operations 1
Chapter 2: The Hedge Fund Life Cycle: From Startup to Titan 11
Chapter 3: Hedge Fund Investors 23
Chapter 4: Hedge Fund Capital Raising 31
Chapter 5: Long/Short Equity Strategy 41
Chapter 6: Global Macro Strategy 55
Chapter 7: Event-Driven Strategy 71
Chapter 8: Fixed-Income Strategy 77
Chapter 9: Convertible-Arbitrage Strategy 107
Chapter 10: Quantitative and Algorithmic Trading Strategies 115
Chapter 11: Managed Futures 133
Chapter 12: Credit- and Asset-Based Lending 155
Chapter 13: Multi-Strategy Hedge Funds 171
Chapter 14: Fund of Hedge Funds 179

Appendix A: Bloomberg Functionality Cheat Sheet 199
Appendix B: Answers to Test-Yourself Quizzes 201
References 205
About the Author 207
Index 209
How to Use This Book

The Visual Guide to . . . series is designed to be a comprehensive and easy-to-follow guide on today’s most relevant finance and investing topics. All charts are in full color and presented in a large format to make them easy to read and use. We’ve also included the following elements to reinforce key information and processes:

■ Definition: Terminology and technical concepts that arise in the discussion.
■ Key Point: Critical ideas and takeaways from the full text.
■ Step-by-Step: Tutorials designed to break down the steps in a multi-phase process.

■ Do It Yourself: Worksheets, formulas, and calculations.
■ Smart Investor Tip: Insights, hints, and ideas provided to help the reader better understand concepts.
■ Test Yourself: A section where readers can test their newly honed knowledge and skills
■ Bloomberg Functionality Cheat Sheet: For Bloomberg terminal users, a back-of-the-book summary of relevant functions for the topics and tools discussed.
Introduction

The goal of The Visual Guide to Hedge Funds is to provide you with the value of a $500 seminar on hedge fund investment strategies and fundamentals in exchange for your investment of time and purchase of this sub-$50 book.

This book was written for potential and current hedge fund investors, startup fund managers, hedge fund career professionals, and industry service providers such as attorneys, fund administrators, or consultants.

This book is required reading for the Certified Hedge Fund Professional (CHP) designation program, the leading self-paced training and certificate program for professionals dedicated to working and leading in the hedge fund space. (Note to CHP participants: All of the content within this book, including audio expert interviews, video modules, and whiteboard walkthroughs, may be covered on your examination.)

Many hedge fund books are written by investment consultants, portfolio managers, or analysts, and are heavy on the theory, math, and statistics. Our perspective in writing this book is made up of three parts: Direct Hedge Fund Experience, Family Office Relationships, and our 120,000 member association, the Hedge Fund Group (HFG). First, I have worked directly for many hedge fund managers ranging from startups to, more recently, multi-billion-dollar funds. Second, our team represents a few ultra-wealthy families who ask us to help them source investments; working as an extension of these families has changed our perspective on hedge funds and portfolio management. Third, through running the Hedge Fund Group association and hosting our Family Offices Group & CapitalRaising.com training workshops we have spoken with over 4,500 hedge funds, and we screen over 1,000 each
year to identify the handful that we can partner with, help directly, or may want to represent to the family office and ultra-wealthy client base that we work with. Our quarterly travel destinations and relationships span the globe including places such as New York, Singapore, Tokyo, London, the Cayman Islands, São Paulo, and Monaco, so we have tried to incorporate global considerations in this book.
Hedge funds have become a powerful force in finance. There are thousands of hedge funds operating today; an incredible expansion for an industry that was only in its infancy half a century ago. If the hedge fund industry was crawling and learning how to walk in the 1960s and 1970s, it is now fully grown, at times running circles around its more traditional peers in the investment world. In this chapter, you will learn how these alternative funds operate and how these vehicles have become ever more complex and sophisticated over the years.

As you will learn in this book, the hedge fund has evolved greatly in recent years and differs in many ways from its peers in traditional investment vehicles. Hedge funds are private investment partnerships, with only a couple exceptions where the fund is sponsored by a publicly traded investment firm. Hedge funds are actively managed, invest in a variety of securities—sometimes highly complex or exotic ones—and typically operate with greater flexibility, higher leverage, more complicated strategies, and with less regulatory oversight than a traditional investment fund.

One common misconception is that hedge funds are "just another type of mutual fund." I asked Paul Udall, Investment Director at GAM, to share how he explains what separates a hedge fund like his from a mutual fund. "Very simply, a 'hedge' fund hedges the risk in the portfolio by taking short positions to offset the long positions. The aim of this is simply to reduce the risk of general market moves." There are many other attributes that separate hedge funds as a unique alternative investment class, but the core concept to understand, as Paul explained, is that hedge funds seek to limit risk with short positions.

Hedge funds are often described along two extremes: one stereotype is of the so-called "masters of the universe," hedge fund managers who occupy lavish offices all over Manhattan and employ hundreds of traders and analysts, all earning millions in exotic and complex strategies from convertible arbitrage to quantitative-driven investments executed in the blink of an eye.
compensation on the billions that the hedge fund earns in profits. This depiction resembles Michael Douglas's famous Gordon Gekko character from the movie Wall Street. The other caricature is a lone trader, executing massive trades in his garage, reaping huge rewards while assuming equally huge risks. The truth, as is often the case, lies somewhere in the middle, and there is some truth in both extreme stereotypes.

Many hedge funds manage well over $1 billion in assets under management. These funds often occupy large Manhattan office spaces (as seen in Figure 1.1), run hugely complex trading operations, and many of these hedge fund employees will earn $1 million or more in compensation on a good year (and even on a bad year, for some funds). However, not all hedge funds are created equal and there are thousands of hedge funds that manage “mere” millions in assets under management and grind out modest gains for a small number of investors.

A sub-$1 billion dollar fund might be a startup with just $1 to $10 million under management or emerging managers who have been around a few years and have yet to hit it out of the park with returns big enough to attract institutional capital en masse. In The Big Short (Norton/Allen Lane), a terrific account of the financial crisis and the hedge funds that succeeded during that time, author Michael Lewis profiles a few managers in this low-to-middle tier of hedge funds. Michael Burry

![Image of Successful Hedge Fund Titan, Leon Cooperman, founder of Omega Advisors, Inc., Manages Billions from His New York Office](image)

*Figure 1.1 Successful Hedge Fund Titan, Leon Cooperman, founder of Omega Advisors, Inc., Manages Billions from His New York Office
Photographer: Mackenzie Stroh/Bloomberg Markets.*
is a hedge fund manager and one of the characters in Lewis’s nonfictional story. Burry managed to make a killing shorting the financial crisis and housing bubble, but for years he was just trading during the night and in his spare time. He didn’t fit the stereotype of a Wall Street titan, not with his shorts and informal style, but he possessed exceptional analytical skills.

As we explore in the next chapter, the size of a hedge fund determines the complexity and vastness of its resources and operations. Hedge funds range from the giant firms like Bridgewater Associates (which manages over $100 billion in AUM) to modest trading outfits that most investors have never heard of. The single-trader hedge fund may only have an analyst and an assistant on staff and the rest of the services, like auditing, accounting, legal, and so on, are out-sourced to industry service providers. More established, large firms will typically handle a lot of operational functions in-house and may employ dozens, even hundreds of employees. It is best to think of a hedge fund as a financial company, with all the day-to-day responsibilities and activities of a small to medium-sized business.

A hedge fund is a cohesive business with many moving parts that require numerous individuals to perform specific daily activities to allow the firm to generate returns and profit from management and performance fees. Each employee, from portfolio to risk managers, plays an important role in helping the firm operate on a daily basis. This chapter describes the roles in a hedge fund organization and how each role plays a part in the operation of a hedge fund.

**Hedge Fund Manager**

The principal of a hedge fund usually wears many hats. These include portfolio manager, asset allocation specialist, supervisor of portfolio managers, and sales representative. Each of these roles is important to the operation of a hedge fund.

Generally, when a hedge fund hangs out its shingle to start its business, the hedge fund manager is the key driver of returns. This person is usually the portfolio manager who is creating the investment strategies and the risk level associated with the fund. This portfolio manager is generally responsible for generating the hedge fund’s past returns that create the bulk of the fund’s track record. The hedge fund manager has a robust understanding of how to invest and how to manage the risks to the portfolio.

As the hedge fund expands, the fund manager’s responsibilities grow, requiring that individual to play a more versatile role within the firm. Hedge fund managers supervise and meet with the other portfolio managers on a daily basis to discuss strategy as well as their profits and losses. Risk is another issue for the hedge fund manager as he or she needs to be abreast of the potential losses his/her firm could incur if the market takes a swing that negatively affects the position.

Asset allocation is a key ingredient to generating the most efficient risk-adjusted returns. If the firm is
set up so that there is only one strategy and one manager, then asset allocation is more linear and easier to manage. For funds that have multiple managers and multiple strategies, this quantitative issue is key to performance. A hedge fund manager needs to allocate capital to the managers and strategies that are going to produce the best risk-adjusted returns. A combination of certain types of market environments and trader underperformance can create a situation where a hedge fund manager reallocates capital to a different portfolio. Some managers use qualitative allocation methods while others use quantitative methods.

Marketing and selling the services of a hedge fund is another role the hedge fund manager handles. As a hedge fund grows, the investor-relations team is formed, which removes some of the initial introductions that take place when marketing a firm. Most of the time, closing the deal is still left up to the hedge fund manager.

In summary, the principal of a hedge fund is involved in almost every aspect of the business—much like the CEO of a small business understands everything about his business. Most successful hedge fund managers that I have met were knowledgeable about every part of the firm, from the day-to-day portfolio management to how the reporting is distributed to investors by the investor relations team.

**Portfolio Managers**

Portfolio managers initiate, manage, and monitor risks associated with their portfolios. On a daily basis, managers evaluate their portfolio risk and look for additional opportunities that will allow their portfolios to generate robust returns.

The portfolio managers are responsible for generating returns and profits for a hedge fund and will meet with the hedge fund manager and fellow portfolio managers to discuss positions and potential trading ideas. Many hedge fund managers will use information gathered by their portfolio managers to initiate large positions based on the merits of the trading strategy.

On a normal business day, a portfolio manager will examine his positions and determine the risks that need to be managed. He will then calculate the profit and loss of the portfolio and compare that P&L to the one created by the controlling group.

During the course of a trading day, a portfolio manager will have conversations with analysts and other portfolio managers to gather information about current risks and potential future risks. If any trades are transacted, the portfolio manager will either enter the trades into a system that can monitor the trades and evaluate the risk, or notify an operational group of the details of the trade. Additionally, the portfolio manager will verbally confirm the details of the trade at the end of a trading day.

**Traders**

Portfolio managers work hand-in-hand with execution professionals who trade securities on regulated exchanges, as well as via over-the-counter (OTC) exchanges. Generally, the responsibilities of transacting are separated at hedge funds. Execution professionals
provide market information that includes deal flow and options flow. The information is crucial to a portfolio manager as they can garner the sentiment surrounding a security. If a portfolio manager was looking to purchase large blocks of stock, it would be difficult if investors were already bidding up a stock and were lifting offers to enter positions.

Traders also control access to numerous types of algorithms, which allows traders to enter positions at an average weighted volume. On a daily basis, traders discuss market actions with other trading professionals and execute trades throughout the day.

One might think that hedge fund trading is highly complicated (and it can be) but the act of opening and closing positions is really fairly simple. We turned again to Paul Udall of GAM to share the process he uses to execute trades in his hedge fund. Paul explains, “It really is very simple; you call or email your broker to ask him to buy the shares for your account. They will go and source them. To sell them you simply call up the broker again, and he will go and find a buyer to take them off your hands.”

Risk Management

Risk management is where individuals evaluate the risks of each trading book and the overall risk of the hedge fund on an aggregate basis; it is an independent area separate from portfolio management typically. Risk management uses a number of tools, which include evaluating the delta within each area to generate the Value at Risk of the entire hedge fund.

Value at Risk can be calculated using a number of approaches. Each methodology uses specific assumptions about return performance. Historical data is one of the more popular techniques but it assumes that history will repeat itself, and therefore historical data is presumed to be the most efficient method to test risk. Another option is to analyze the distribution of the returns and use variances and covariances across these risks. A third methodology is to use a simulation which generates a data series based on random sampling.

Every day, the risk-management group will run reports outlining the risks of the overall portfolio, as well as each trading book, and then discuss the risks with portfolio managers. The team discusses whether the risks are in line with or are above the level of risk allowed for a specific trading book. Risk management is installed within a fund to protect the hedge fund and its investors. Risk managers not only evaluate market risk, but also credit risks. A risk manager has to account not only for risks that could harm the portfolio but also such hard-to-predict events like the inability of a counterparty to pay money owed to the fund—an area of risk management that drew a lot of attention during the financial crisis when some of the largest investment banks struggled to make good on their debts and liabilities.

Chief Financial Officer

The chief financial officer (CFO) is responsible for the daily activities of capital flow throughout the hedge fund. Any money that comes in or out of a specific

### Definition: Value at Risk (VaR)

VaR is a methodology for determining the worst-case scenario given a number of assumptions made out of market and credit risks. Value at Risk started to gain popularity as a tool to measure financial risks during the mid-1990s, but its origins lie in the early developments of modern portfolio theory.

### Key Point

Not all securities are traded through well-known exchanges like the NYSE, Euronext, or London Stock Exchange. A hedge fund will often buy and sell securities through the over-the-counter market, meaning the buying and selling parties are transacting outside of the exchanges. This is where many hedge funds trade derivatives, commodities, and other securities beyond exchange-listed equities.
fund is monitored by the CFO. The hedge fund’s CFO is responsible for multiple entities and vehicles; for example, the CFO is accountable for monitoring the money that is moved in and out of domestic and off-shore funds, often with different structures, tax treatments, and other considerations. On a monthly basis, the hedge fund reports their profit and loss to their investors. The specifics need to be signed off on by the CFO and the hedge fund manager. Chief financial officers at large hedge funds have to consider a multitude of factors that could affect the financial stability of the fund, such as potential redemption requests, collateral calls, poor performance, and compliance costs. Every day, hedge funds execute substantial trades that affect the firm’s overall financial liabilities, so the CFO has to keep a constant eye on the financial picture to ensure that the fund is well capitalized and meeting all of its obligations.

**Controllers**

The controllers at a hedge fund play an accounting role and evaluate the profits and losses associated with each portfolio manager, as well as the hedge fund as a whole. Usually, the controlling group reports directly to the chief financial officer, who monitors the profit and loss statements generated by the controlling group.

Controllers will have daily interaction with portfolio managers, questioning the profits and losses created by each individual portfolio. The controllers will drill each portfolio down to specific individual trades to determine if the proper profit and loss was created, how the trades affect the portfolio’s VaR, and other factors that could come into play if the trade moves in one direction or another. At many funds, the controlling group manages and monitors a reserve created by a portfolio that sets funds aside if a trade or deal will not be realized until sometime in the future.

**Settlements**

Settlements are an operational group that evaluates each trade and determines when cash is needed to be moved in and out of a hedge fund. When trades are transacted, the settlements division is responsible for confirming each trade and making sure each party agrees to the details of a transaction. On a daily basis, the settlements team not only confirms each detail of a transaction, but assists in the process of moving capital from one firm to another. When a trade settles, it is the responsibility of the settlements group to move and receive funds to ensure that the capital accounts of each firm are current.

**Margin and Collateral**

Margin groups ensure that the amount of capital posted for margin is correct. Margin is borrowed capital that is collateralized by securities or other assets. The margin group is responsible for calculating margin on a daily basis and transferring money to and from other entities based on changes in the underlying
assets that are traded. On a daily basis, members of the margin group discuss the margin requirements with their counterparts and make daily transfers of capital based on margin agreements that are negotiated. As a hedge fund grows, margin professionals also generate new margin agreements with new counterparts.

**Legal**

The legal department at a firm is usually comprised of the general counsel along with associate lawyers and paralegals. Legal groups assist in regulatory processes and in specific types of transactions that need to be negotiated. If a hedge fund participates in over-the-counter transactions, the legal team will negotiate broader agreements, such as ISDA (International Swaps Dealers Association) agreements.

Each business day, the legal team discusses issues with outside counsel and compliance in an effort to protect the hedge fund from any regulatory issues, as well as to identify potential compliance issues on the horizon. If the hedge fund participates in nonstandard transactions, the legal team will be in constant discussions with the counterpart’s legal teams in an effort to make sure that contracts are secure prior to the initiation of any transactions.

**Compliance**

Hedge fund compliance groups work to ensure that the hedge fund is complying with all the mandatory regulations that pertain to the trading of securities by each entity associated with their hedge fund. The compliance group will work with each individual trader to make sure that they have the proper authority to trade securities based on the filing status of the hedge fund. For example, in many cases each trader will need to have a FINRA Series registration to trade on behalf of the hedge fund and its clients.

Compliance groups work hand-in-hand with the SEC (Security Exchange Commission), FINRA (Financial Industry Regulatory Authority), the CFTC (Commodity Futures Trading Commission), and the OCC (Officer of Controller of the Currency). Compliance groups work with specific exchanges, and make sure that the trading undertaken by their hedge fund meets all the regulatory requirements issued by an exchange. Hedge fund compliance has emerged as a hot issue, with insider trading, the Dodd–Frank Act, and other recent compliance-related stories dominating the news in recent years.

**Investor-Relations**

Investor relations professionals at hedge funds wear many hats and usually have experience from other organizations, which may include client services, marketing, sales, and capital introduction. Senior members of the investor relations department at a hedge fund are usually familiar with the different types of clients who will invest in a hedge fund, including pension funds, funds of funds, and other institutional investors. They often assist hedge fund managers in

---

**Smart Investor Tip**

The increase in regulation over the past few years in the United States and Europe has made the compliance department ever more important to hedge funds. Hedge funds that don’t invest in compliance groups or that try to cut corners on regulation risk being shut down by regulators, rejected by investors, and even sued by clients. Today, investors and regulators demand involved, informed, and competent compliance officers with an active role in the day-to-day operations of the fund.
Conclusion

As you learned in this chapter, hedge funds do not succeed or fail based on the trading prowess of a single manager. Hedge funds are more complex than a lone trader raking in money, and the largest hedge funds approach the complexity of investment banks. Even a medium-sized hedge fund will often have a compliance department, legal and tax issues, and carefully managed trading operations. Hedge funds can employ a chief financial officer, IT professionals, an investor-relations team, portfolio managers, and dozens of analysts and traders. I hope that this chapter demonstrates how hedge funds have evolved to become a more sophisticated and institutional industry.
Test Yourself

Answer the following questions.

1. This person or persons executes transactions for the hedge fund:
   A. Fund Manager
   B. Traders
   C. Chief Financial Officer
   D. Controllers

2. True or False: Hedge fund managers do not think about risk and delegate the risk-management task to a separate team.

3. Margin is:
   A. Capital used for a transaction.
   B. Another term for options and OTC trades.
   C. Borrowed capital that is collateralized by securities or other assets.

4. True or False: Investor-relations professionals are normally responsible for, and do not deviate from, one task.

5. True or False: On a day-to-day basis portfolio managers evaluate risk and look for new ways to generate returns.

6. Value at Risk is:
   A. A methodology for determining the worst-case scenario given a number of assumptions made out of market and credit risks.
   B. A ratio that shows the volatility within a fund.
   C. An evaluation of the percentage of funds deemed to be toxic by an auditor or governmental agency.
   D. The true cost of an investment using a risk factor determined by simulations of market tendencies.

7. True or False: A hedge fund's success is determined by the skills and success of the hedge fund manager.

8. Which group does not have regulatory oversight of hedge funds?
   a. FINRA
   b. SEC
   c. Consumer Financial Protection Bureau
   d. FEC

9. True or False: After a trade has settled, it is the responsibility of the settlement group to make sure that all legal and compliance regulations concerning the financial instrument have been met.

10. True or False: Controllers are responsible for looking into the profit and loss of a fund, often evaluating each specific trade.

Answers can be found in Appendix B.
The hedge fund industry can be an alluring place for investors and traders who eye starting their own funds and for career professionals, but most people new to the space do not understand the structure. Today, there are over 20,000 hedge funds globally, with the majority of them based in the United States and Western Europe.

In the previous chapter, we learned how hedge funds operate and the different professionals who work together to make a successful hedge fund. One important note on the staffing of a hedge fund is that the staff’s experience, size of each department, and abilities can vary significantly from fund to fund. An important determinant of a hedge fund’s operational capabilities and staff is the firm’s assets under management (AUM) and years of operation. As you will see in this chapter, there is a hedge fund life cycle, through which a hedge fund will experience growing pains (such as difficulty raising capital as a startup), pressure to stand out from the pack (and separate from other emerging managers), and finally an age of maturity (when hedge fund titans either continue to grow larger and outperform, or become satisfied at a certain size and risk level).

This chapter will provide an overview of the hedge fund startup, emerging hedge fund manager, and hedge fund titan areas, so that you are better armed with the facts on how the industry operates right now. For each area we will cover the total estimated global volume, total AUM, AUM as a share of total-industry AUM, the types of investors they typically attract, team size, and long-term trends that are affecting the health and performance returns of each size of funds.