MEKETA
INVESTMENT GROUP

An Overview of Hedge Funds

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Hedge funds attract a great deal of attention and assets from investors. As of June 2022, hedge funds were estimated to be a $4 trillion industry[1] that includes a broad variety of strategies. While many institutional investors use hedge funds, their popularity has declined in recent years. This is most likely due to the disconnect between the performance of hedge funds and the (unrealistic) hype that surrounded them when they were initially adopted by many institutions.

The way the industry views hedge funds has evolved substantially over the past two decades. Though they were once considered the province of mystics and savants, most institutions now take a more skeptical and scientific look at hedge funds. This is likely due to a greater understanding of the strategies employed, the high costs of those strategies, and the returns experienced.

Despite their disappointing performance, we believe hedge funds can play a role in investors' portfolios. This paper seeks to clarify what a hedge fund is, describe the tools they may use, and provide an overview of the different hedge fund strategies. It then explores what role hedge funds typically play in an investor's portfolio, as well as considerations for implementing a hedge fund allocation.

[1] Source: Reuters

Hedge fund methods & risks

A hedge fund is a fund that can buy and sell short securities, use arbitrage, trade derivatives, and invest in almost any opportunity in any market where it foresees the potential for profit. It is important to understand that investment returns and risk vary enormously among the different hedge fund strategies.

While hedge funds are termed an "alternative investment," hedge funds are not a separate asset class but instead a portfolio construction and management method. Hedge funds represent an array of trading strategies that may or may not be directional in nature and are often granted more flexibility in what they can invest. While hedge funds will often include investments in equity, fixed income, and commodities markets, they may also invest in non-traditional securities, such as currencies, structured notes, and a variety of derivative instruments. It is how they make these investments, as well as their ability to invest in non-traditional securities, that make hedge funds unique.[2] Many hedge funds utilize complex strategies that would be difficult for non-investment professionals to understand in detail. Further, these strategies may be constantly changing.

[2] Another aspect that differentiates hedge funds from mutual funds is what the manager must disclose.

For example, most investors have a solid understanding of the risks implicit in holding common stocks or investment grade bonds. This understanding permits them to make reasonable judgments about asset allocation and manager selection. However, without a similar understanding of the complexities of various hedge funds, and the sometimes vague definitions of their strategy, investors may have limited understanding of the potential risks in their hedge fund investments. Therefore, it is imperative that investors become educated about hedge funds before making an investment.

The flexibility afforded hedge funds is often touted as a key advantage. However, like many of the other tools used by hedge funds that we outline below, complete discretion is a two-edged sword. These tools do not, in and of themselves, add value. Rather, it is their appropriate use by skilled managers that can add value. Inappropriate use of these tools can have detrimental results. Figure 1 describes some of the potential benefits and risks involved with the most commonplace of these tools.

Tool	Benefit	Risk
Short selling	Being able to profit from an asset declining in value.	Unlimited loss potential if the security price increases.
Leverage	Enables taking positions greater than the amount of capital on hand, thus amplifying gains.	Amplifies losses and introduces complexity.
Derivatives	Can cost-effectively gain exposures to various drivers of return, and it can also hedge or amplify exposures.	Adds complexity, and introduces new risks, including potentially larger losses.
Illiquid Assets	Access to assets with potentially higher returns.	Makes it harder to exit the fund in the event of needing liquidity.
Arbitrage	Can efficiently exploit price discrepancies.	May need high amounts of leverage to get meaningful return.
Limited Constraints	A broader opportunity set increases the potential for finding alpha.	Managers may lack expertise in complex markets.

FIGURE 1
Hedge Fund Tools and Their Associated Benefits & Risks

Source: Meketa Investment Goup.

Hedge fund strategies

Hedge fund strategies are often grouped into different styles, although style definitions vary. The universe of hedge fund strategies is vast, as is the range of risk/return profiles they offer. Hedge Fund Research, Inc. (HFRI) divides the universe into twenty-eight style categories, which have been consolidated into five categories in the following chart.

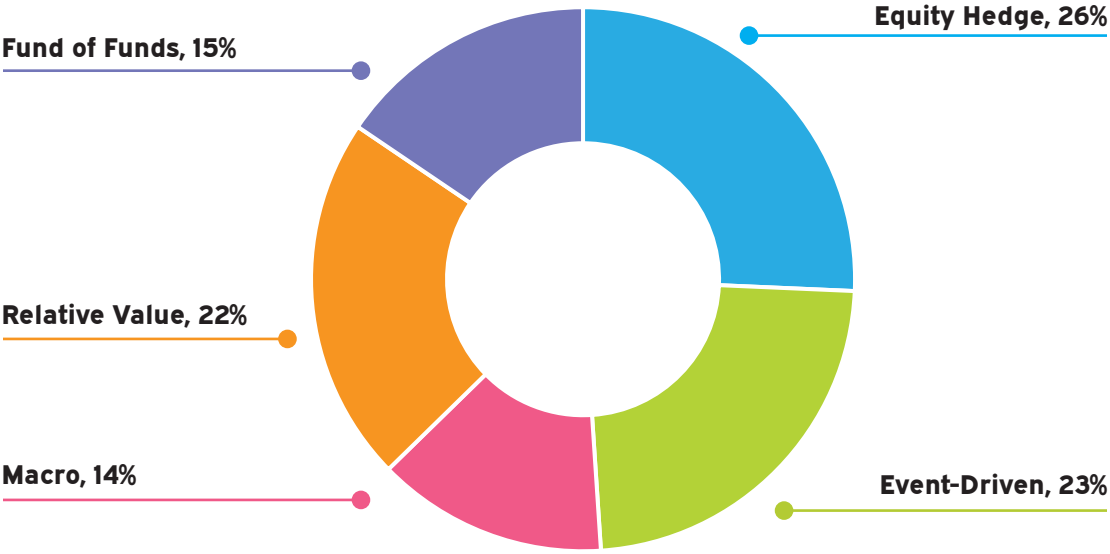

FIGURE 2
Strategy Composition of the Hedge Fund Universe

Source: HFRI as of March 2022.

Equity hedge (aka long-short equity)[3] strategies attempt to create value by going "long", or investing in, undervalued stocks and by shorting overvalued stocks. Long-short equity portfolios can range in size. Some managers may have a very concentrated portfolio of less than 10 individual stocks, while other managers may be widely diversified with hundreds of stocks. The risk and return profiles of these managers can vary quite significantly.

In **event-driven** strategies, the manager invests in the securities of companies that are expected to change in price over a short period of time due to an unusual event, such as a bankruptcy, a corporate restructuring (e.g., divestiture, merger, acquisition), or bond upgrades.

Macro strategies employ a top-down approach to investing, which starts by evaluating the overall global economic landscape, and then breaks it down by different countries, regions, and asset classes in order to develop investment ideas. This broad investment spectrum translates into a very large investable universe that, aside from liquidity restrictions, can include almost any tradable asset in the world. However, Global Macro managers have tended to gravitate toward equity indices, currencies, government bonds, interest rates, and commodities.

A sub-group of macro strategies that is worth highlighting is **trend-following** strategies, which focus on trading around a set of indicators generally having to do with price. These strategies invest based on both short-term and long-term trends and the subsequent reversals of those trends. For example, trend-following strategies based on momentum will go long an asset when the recent returns have been positive and go short when recent returns have been negative.

Relative value strategies attempt to exploit discrepancies in similar securities. The basic premise is that two securities that have similar characteristics should be priced

[3] See Meketa's Long Short Equity White paper for additional details on these types of hedge funds.

similarly. When this is not the case, an opportunity exists to short the security that is overpriced and invest in the security that is underpriced. If the manager's analysis that the securities are similar is correct, their prices should converge, in which event the manager will make money from the trades.

Arbitrage strategies, a subset of relative value, involve a manager seeking to exploit specific inefficiencies in a market by trading a hedged portfolio of offsetting long and short positions. The paired long and short securities are related in different ways, depending upon the strategy. But, in each case, the manager attempts to take advantage of pricing discrepancies and/or price volatility involving the paired securities, while maintaining minimal exposure to the overall market. Often, the profits available from these transactions are small, so most arbitrage strategies use leverage to magnify their gains.

Hedge fund of funds select a variety of individual hedge funds, usually with differing strategies, to construct a diversified portfolio. The mix of underlying strategies and funds can control returns, risk, and volatility. Funds of funds may invest in multiple (usually between 10 to 30) underlying hedge funds with the aim of seeking the best hedge funds while diversifying across managers and strategies.

Hedge funds of funds have two layers of fees, one at the portfolio fund manager level and another at the fund of fund manager level. Despite the additional fees, fund of funds offer some advantages, particularly to smaller investors, including: 1) diversification, 2) portfolio construction, 3) and due diligence.

As implied by their name, **multi-strategy funds** incorporate multiple hedge funds strategies under one money manager's umbrella. They are similar to fund of funds, except that they are tied (usually through ownership) to all of the underlying strategies. However, the manager can move money between the strategies much more quickly and there is only a single layer of fees.

As Figure 3 illustrates, the relative popularity of these respective strategies has changed considerably over the past 30+ years. The current composition is somewhat evenly balanced, with long-short equity strategies being the largest segment.

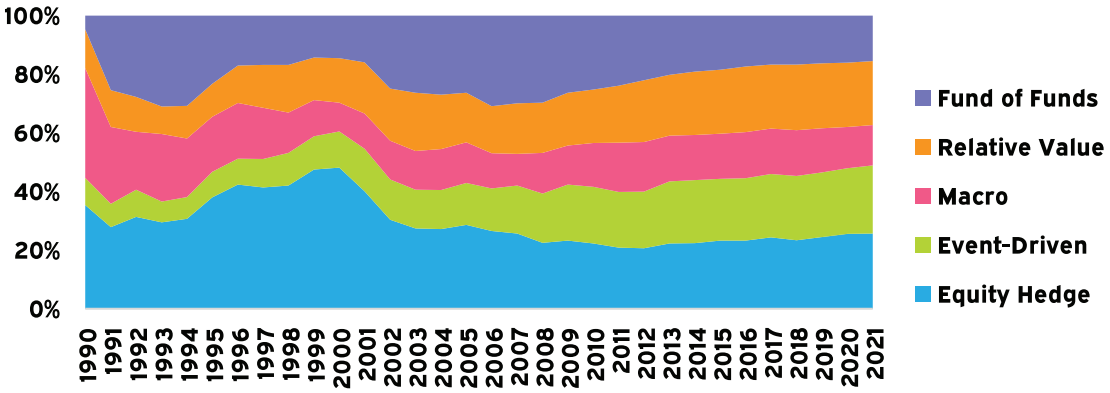

FIGURE 3
Asset Composition by Strategy Type

Source: HFRI, as of December 2021.

Performance

The performance of hedge funds undoubtedly played a major role in the industry's historical accumulation of assets. As shown in Figure 4, the returns for many of the HFRI strategy composites have outpaced the major US stock and bond indices since 1990, while exhibiting less volatility than all but the domestic bond market.

Index	Annualized Return (%)	Standard Deviation (%)
HFRI Equity Hedge	10.6	9.0
HFRI Event Driven	9.5	6.9
HFRI Macro	9.5	6.9
HFRI Relative Value	8.4	4.5
HFRI Fund Weighted Composite	9.1	6.8
Bloomberg Aggregate	4.8	5.4
MSCI ACWI	7.0	15.3

FIGURE 4
Long-Term Performance of Hedge Fund Strategies

Source: eVestment, HFRI. Data is for the period January 1990 - June 2022. Many studies have questioned the precision of published hedge fund returns, suggesting that hedge fund index returns are likely overstated because of survivorship bias, selection bias, and backfilling bias. We assume these biases exist but have diminished since the early days of the industry.

However, much of the performance that initially attracted investors to hedge funds has not persisted in recent decades. Since 2009, the performance of the average hedge fund would likely be characterized by most investors as disappointing (see Figure 5).

Index	Annualized Return (%)	Standard Deviation (%)
HFRI Equity Hedge	6.3	8.6
HFRI Event Driven	6.4	6.7
HFRI Macro	2.8	4.7
HFRI Relative Value	6.3	4.4
HFRI Fund Weighted Composite	5.6	6.1
Bloomberg Aggregate	2.8	3.4
MSCI ACWI	10.2	15.5

FIGURE 5
"Recent" Performance of Hedge Fund Strategies

Source: Bloomberg, HFRI. Data is for the period January 2009 - June 2022. Another potential problem with hedge fund data is that some returns may be smoothed, due in part to stale asset pricing. This has two consequences. First, reported volatility may be artificially dampened. Second, the reported correlations between hedge funds and publicly traded assets may likewise be artificially dampened.

This recent performance (illustrated in Figure 5) is probably more indicative of what investors can expect in the future. This is due to many reasons. First, the longer the time period, the more likely survivorship bias is present. Second, Hedge Fund Research, Inc. (HFRI) did not impose strict criteria on self-reporting until 1994, meaning that data prior to this time should be viewed with even greater skepticism. Third, the advent of the internet and the adoption of Regulation FD[4] reduced the information advantage that some hedge funds possessed. Fourth, as the hedge fund universe has grown, the strategies used by managers have become more common, resulting in portfolios more closely resembling each other and the market. Fifth, directional strategies, which tend to have the highest beta, compose a smaller percentage of the hedge fund universe than they did in the 1990s. Sixth, lower volatility numbers over the more recent period (especially for macro strategies) imply that hedge funds are taking on less risk than they used to. Finally, interest rates were extremely low from

[4] On August 15, 2000, the SEC adopted Regulation FD to address the selective disclosure of information by publicly traded companies and other issuers. Regulation FD provides that when an issuer discloses material nonpublic information to certain individuals or entities—generally, securities market professionals, such as stock analysts, or holders of the issuer's securities who may well trade on the basis of the information—the issuer must make public disclosure of that information.

the GFC until 2021, hence the cash that was being held in portfolios was providing a much lower return than it had during past, higher-rate environments.

In addition to a decline in absolute returns, the perceived "alpha" produced by hedge funds has likewise diminished. It can be difficult to define alpha for hedge funds, as many strategies do not have a comparable, investable benchmark that is universally agreed upon. Further, many sources of what had traditionally been called alpha have evolved and/or been reclassified as one or another form of beta.[5]

[5] See, for example, the myriad pieces produced by Cliff Asness and AQR on "exotic" beta.

Regardless of the cause, it appears that investors have been disappointed with the performance of hedge funds. Hedge funds have suffered from negative net asset flows since 2016 (see Figure 6), and the number of active hedge funds has also decreased since 2016.

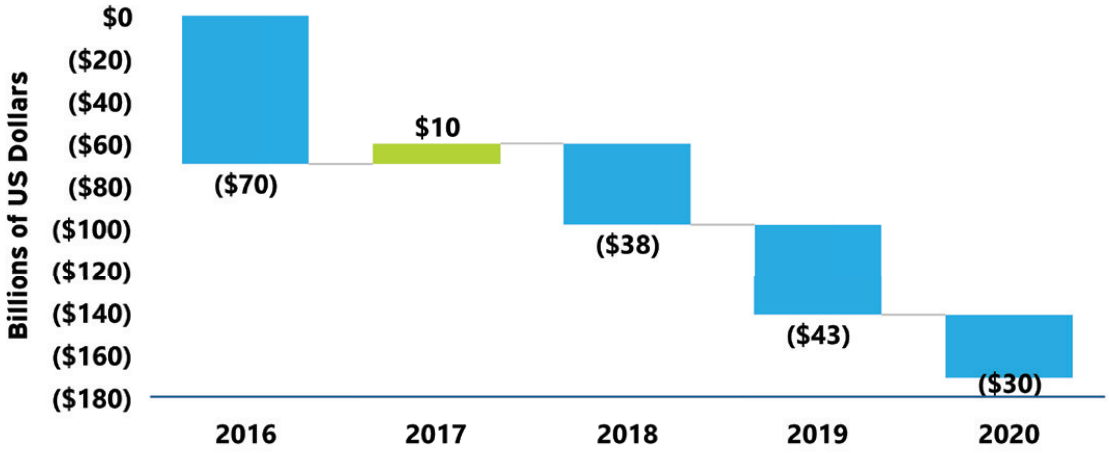

FIGURE 6
Total Hedge Fund Net Asset Flow Waterfall

Source: HFRI.

Diversification

It is typical for investors to express a desire for their hedge fund allocation to exhibit a low correlation to public stocks. Arguably, a range of 0 to 0.4 would meet the definition for the majority of investors. The average hedge fund appears to have fallen short of this objective, as illustrated in Figure 7. The correlation vs the broad equity market has averaged 0.85 and exceeded 0.7 in 88% of periods.

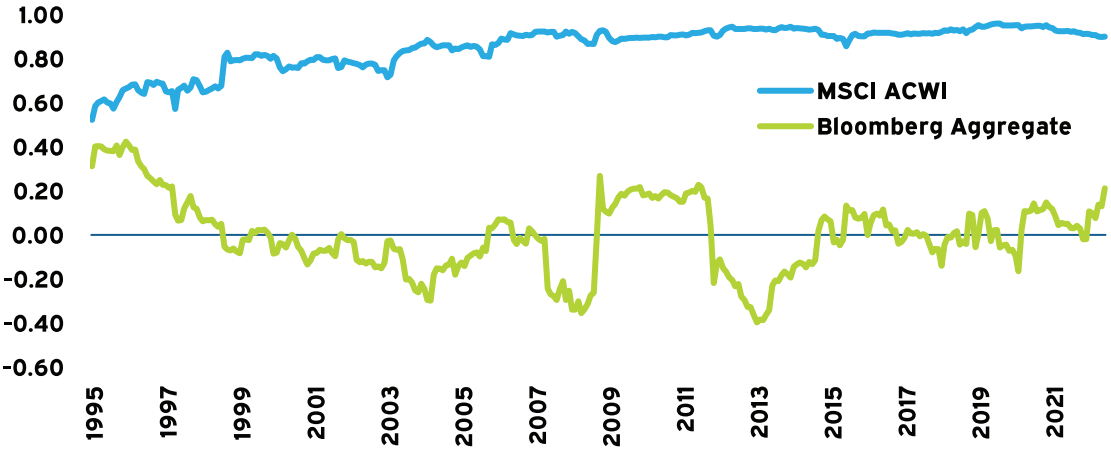

FIGURE 7
Rolling 3-year Correlation to Hedge Fund Strategies

Sources: Bloomberg, HFRI. Data is for the period January 1995 - June 2022, Represents returns for the HFRI Fund Weighted Composite versus the MSCI ACWI and Bloomberg Aggregate indices.

Though there are many different types of hedge funds, there is the potential for their returns as a group to become more highly correlated during the worst equity drawdowns (e.g., a financial crisis), a time when a low correlation is most highly prized. Because they share investors, and often invest in at least one common strategy (e.g., the carry trade), the potential for a broad disruption and significant losses are not insignificant.

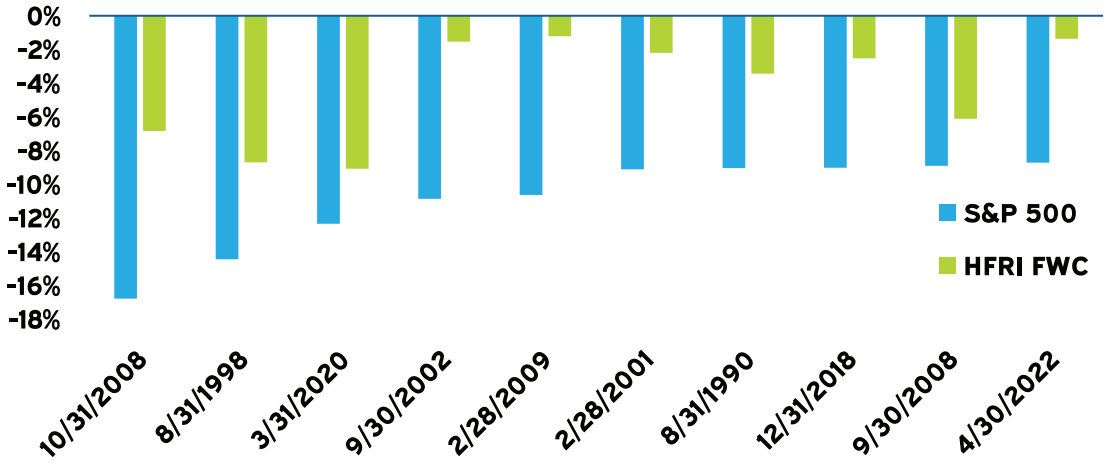

FIGURE 8
Return During the Worst 10 Months of the S&P 500

Source: eVestment. HFRI FWC is the HFRI Fund-Weighted Composite.

Persistence

Not unlike the universe of traditional managers, hedge fund managers as a whole have not shown the ability to produce consistently superior returns. Independent studies have found little evidence that hedge funds producing above-average returns will continue do so for horizons of more than one year[6], indicating that past returns are not a good indicator of future results. Still, superior hedge fund managers exist, just as superior equity and bond managers exist.

[6] Sources: Brown & Goetzmann, "Hedge Funds with Style," 2001; Agarwal & Naik, "Multi-period Performance Persistence Analysis of Hedge Funds," 2000. Kazemi, "Performance Persistence: Is It There, and Can It Be Exploited?" 2021.

Dispersion

The freedom available to hedge funds should provide skilled managers with greater opportunities to add value, but not all unconstrained managers are equally skilled. The concept of dispersion is useful when determining the extent to which a skilled manager might be able to add value. Dispersion attempts to quantify the size of the gap between the winners and losers in a market. As the marketplace expands, strategies may copy each other, but this also provides managers the opportunity to gain an informational advantage on his or her competition. If dispersion is low, manager skill offers less upside than if dispersion is high.

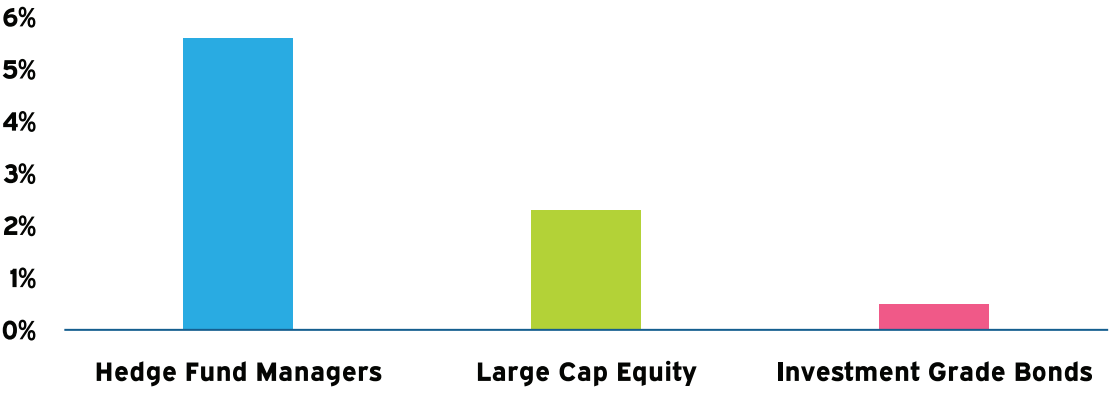

FIGURE 9
Interquartile Spreads

Source: HFRI, eVestment. Reflects 10-year interquartile return spread as of June 2022.

A good metric of manager dispersion is the interquartile spread – the difference between the returns of managers at the 25th and 75th percentiles. The spread is fairly tight for traditional public markets that are benchmark oriented, such as US equities and investment grade bonds. For hedge funds, which have a much broader opportunity set and wider toolkit, the interquartile spread is substantially larger (see Figure 9).

Portfolio concepts

Arguably, hedge funds have been mis-sold, misunderstood, and misused. Yet, several decades of experience should provide a more realistic appraisal of what these strategies can accomplish. While hedge fund performance has been disappointing, there are still reasons for investors to consider adding hedge funds to their portfolio. There are ways investors can utilize hedge funds within their portfolio to help achieve beneficial results depending on what their goals are. Rather than accepting a broad hedge fund universe to define the role within a portfolio, most institutions seek a specific role within their portfolio and then choose a sub-set of strategies to construct a program that is designed to achieve that objective.

There are essentially four ways that investors commonly use hedge funds. The first option involves treating them as a distinct asset class that is effectively market neutral. This alternative consists of "absolute return" strategies that are designed to provide returns that are *uncorrelated* with the investor's other investments and that may exhibit bond-like volatility. The second option involves incorporating a hedge fund with a net long exposure to a particular market into the investor's allocation to that asset class. Third, an investor may use a "portable alpha" strategy to overlay the returns of a hedge fund portfolio on top of the returns of a highly efficient asset class. Finally, an investor may take an approach of using hedge funds as risk mitigating strategies to offset the primary risk(s) they are taking elsewhere in their portfolio.

Absolute return

An absolute return portfolio is one that is designed to produce positive returns in most market environments. This contrasts with traditional long-only strategies, which are designed to produce returns relative to a market benchmark. From an asset allocation perspective, any strategy that produces positive returns while also being uncorrelated with the rest of the portfolio makes the overall portfolio more efficient.

To serve as a true absolute return portfolio, a hedge fund, or portfolio of hedge funds, should be close to market neutral. This applies to all markets, not just the equity market. For example, a long-short equity fund that is 40% long will have a difficult time producing a positive return when equity markets are down. Hence, the strategies typically included in such a portfolio would likely derive their primary source of returns from something other than traditional equity, credit, and interest rate markets.

Directional return provider/return generator

Many hedge fund strategies are directional in nature. That is, they derive their returns in part from the movements of an underlying asset class. These tend to have a net long bias in one or more asset classes and exhibit a positive beta. Long-short equity, event-driven, and credit strategies all fall in this category.

An investor seeking the best portfolio managers, regardless of the risks inherent to hedge funds, may wish to incorporate a hedge fund with a net long exposure to a particular market into the allocation to that asset class. For example, an investor may treat a hedge fund with a 60% net long exposure to the stock market as part of their equity allocation. However, this lower beta will serve as a headwind most of the time, and these strategies generally cannot keep up with the market over the long run. Some institutions have adjusted for this by using an equity overlay to bring the beta to 1.0 (i.e., in line with the market/benchmark).

Alpha engine/portable alpha

These are two different approaches that have a common component: financial engineering. Some institutions spend considerable resources sifting through hedge fund (and long-only) strategies to identify managers that they believe have lasting skill. They then use derivatives to hedge out any beta component(s) of these strategies, thus isolating the alpha from the beta. The resulting alpha should be uncorrelated with the rest of the portfolio.

This alpha can be overlaid on top of other return streams (again, using derivatives) to create a desired combination of alpha and beta. Most "portable alpha" strategies seek to do something similar, in terms of overlaying one return stream on top of another. The difference is that typically they are taking a portfolio of uncorrelated betas (not alphas) and putting this on top on a different beta. These betas may come from hedge fund strategies, or other alternative beta strategies. A traditional absolute return portfolio can be used as a component of a portable alpha program.

This makes economic sense, as the investor will pay very low fees for traditional market exposure, while paying higher fees for the value-added component, that is, the access for more "exotic" beta and the skill of the active manager to hopefully generate alpha. It is important that the "alpha engine" (i.e., the hedge fund) be uncorrelated with the beta component, otherwise the strategy may just represent a more leveraged version of the market exposure.

Risk Mitigating Strategies (RMS)

Risk mitigating hedge fund strategies look very different than return seeking strategies. For example, risk mitigators typically have a negative correlation to equities during major market dislocations. Long volatility, trend-following, global macro, alternative risk premia, and market neutral strategies all fall in this category. On their own, they look fairly unattractive compared to the returns on offer from riskier strategies. When combined with a portfolio of riskier (i.e., growth-oriented) strategies, their value becomes apparent.

By seeking products that perform well in bear markets, RMS allows investors to diversify to a more practical degree than assets that merely offer diversification in bull markets where they are less needed. An RMS approach allows investors to protect themselves during drawdowns against the largest risks in their portfolio.

Implementation considerations

Hiring and monitoring managers

Due diligence on hedge funds is a rigorous, time-consuming process that can be very costly. Hedge funds often utilize very complex strategies that many investors struggle to understand, and they are not always keen on revealing them. Investors in individual hedge funds must work carefully to complete a thorough and comprehensive investigation of a fund before investing, and then maintain a similarly rigorous level of diligence while monitoring the ongoing investment.

Before an investor commits to hedge funds, they must feel confident in their ability to identify superior managers. This may be more difficult than it at first appears, as the hedge funds that produced the returns that first attracted the investor may have closed their doors. Many of the most successful managers have stopped accepting new capital from investors, and the next generation is likely to do the same. Thus, it is critical to have a sound and tested due diligence process when reviewing hedge fund managers. Likewise, investors who have access to funds that may be "soft" closed (e.g., closed to new but not existing investors) may have an advantage.

Hedge funds require significantly more oversight than traditional managers, due to both the tools they use (e.g., leverage) and the instruments in which they invest (e.g., derivatives). The resources required to monitor a hedge fund are substantially greater than those needed for monitoring traditional managers. The frequent lack of (or lag in) transparency makes hedge funds more difficult to monitor and potentially riskier.

Much of the process of monitoring hedge fund managers is not dissimilar to monitoring traditional managers. Investors should check if managers are sticking to their stated strategy, by watching for changes such as style drift, inappropriate bets, or increased use of leverage. Investors should monitor if any significant changes have occurred in the firm or among investment personnel, and inquire about regulatory violations, lawsuits, or investigations.

Benchmarking

Measuring performance for hedge funds is far more challenging than for traditional managers. Long-only managers run their portfolios against a market index to which the investor can obtain passive exposure inexpensively. Unfortunately, there has not historically been a truly passive and inexpensive equivalent for hedge funds, as the only investable indices for hedge funds (e.g., the HFRX indices) are subjective and only include a sub-set of the hedge fund universe.[7]

[7] Note that in 2022, abrdn introduced the HFRI 500 Fund, which "aims to provide investors with passive exposure to hedge funds by fully replicating the HFRI 500 Fund Weighted Composite Index."

Often, investors compare hedge fund managers to the peer hedge fund strategy index. However, peer group comparisons are inherently flawed, and this can be exaggerated with hedge funds. For example, it is not rational to compare an unlevered convertible arbitrage manager against a peer group whose average manager might be levered three-to-one. Importantly, return expectations should be related to the risks taken and amount of leverage utilized.

One potential way to benchmark a hedge fund (or hedge fund portfolio) is by beta-adjusting an index. To do this an investor could take the returns of the hedge fund and that of an index, then measure the amount of beta (risk) that each held and equalize the beta. This would give a return adjusted for the level of risk. Investors who use a risk budgeting approach should appropriately align their expectations for "alpha" with those for tracking error (i.e., it is unrealistic to expect to achieve high alpha while pursuing low tracking error).

Benchmarking a hedge fund program can be as difficult as benchmarking individual hedge funds. For investors seeking a true "absolute return" or market neutral approach, a common approach is to set absolute risk and return targets. For example, an investor may seek a return of cash (e.g., T-bills) plus a premium. This will obviously present short-term challenges, as the portfolio will be inherently volatile and experience negative returns on occasion, while the benchmark will be consistently positive. Another common approach is to compare to a broad peer group that theoretically represents the opportunity set, such as the HFRI index. A more customized program can be tailored to a sub-set of the peer group.

Fees

Hedge fund managers charge fees both on the amount of assets in the fund and the amount of profit they make. The average rates hedge fund managers charged in 2021 was around a yearly fee of 1.5% of assets under management (AUM) in addition to a 17% performance fee of profits made.[8]

[8] Source: Preqin. Investors with smaller assets and/or less negotiating power are more likely to pay the traditional industry standard of "2 and 20" (i.e., 2% on AUM and 20% of profits).

The high fees charged by hedge funds present a larger hurdle for producing positive returns than investors face with traditional managers. Further, the incentive fee (i.e., the carry) is asymmetrical in its reward structure. That is, the manager may be rewarded handsomely when they outperform, but they do not share in their client's loss when they underperform. Additionally, incentive fees may encourage the manager to accept excess risk. While some hedge fund managers invest their own assets into their fund, this is neither universal nor does it fully mitigate the conflict of interest. Finally, if a manager is underperforming and the likelihood of receiving future incentive fees is small (this occurs more frequently when a fund's fee schedule includes a "high water mark"), they may simply close the fund.

It is desirable that investors pay the appropriate amount for the exposures they are receiving. Hence, investors should pay passive management fees for exposure to market risks (i.e., traditional beta), pay a slight premium for hedge fund (i.e., exotic)

betas, and pay a much larger premium for true manager skill (i.e., alpha). Investors should not pay for returns that are inflated by leverage, as they could achieve this more cheaply on their own.

Liquidity

For some hedge funds, investors face an initial "lock up" period. During this time, investors are not allowed to withdraw money from the fund, which makes the hedge fund effectively illiquid for that time. Some funds offer discounts for longer lock up periods, which can boost return but at the added risk expense. Thereafter, liquidity can vary by fund.

Vehicle

Investors looking to allocate to hedge funds also will have to determine in which vehicle they want to invest. Traditionally, investors would use a commingled fund, where a manager would own the vehicle and multiple investors would be part of that vehicle. The legal structure of these funds is usually a partnership, with the manager serving as the General Partner (GP) and the investors as the limited partners (LPs).

For large investors, separate managed accounts (SMA) have become a more prominent option. SMA's allow the investor to exert greater control, for example, over the opportunity, tools that can be used, etc.

Summary

Hedge funds are often painted with a broad brush. However, it is critical to realize that all hedge funds, and hedge fund strategies, are not the same. Much as one would not attribute the same risks to the category of mutual funds, it is important to differentiate between hedge funds. Moreover, the many varieties of funds and strategies are one of the category's most attractive attributes, as this allows an investor to choose from a much wider menu when building a portfolio.

Because each hedge fund is unique, there is no simple or direct way to assess all of the likely risks and potential returns. Before delving into hedge funds, an investor should create a long-term plan that outlines the goals and objectives of their hedge fund exposure, study the funds carefully, evaluate the skills and background of the managers, weigh alternative approaches, and rely upon the advice of experienced professionals.

A portfolio of hedge funds can be customized to produce a target level of return and risk. The role of hedge funds in institutional portfolios has evolved over time. If an institution invests in hedge funds, it needs to determine what role they should serve. Hedge funds are a tool – if misused or misunderstood, they can do harm to an investor's portfolio. However, if they are used properly, they can be very effective in helping an investor meet their goals.

Appendix | Other hedge fund risks

Limited transparency

With traditional stock and bond managers, investors are provided detailed appraisal and transaction reports listing the manager's holdings and activity. With near instantaneous access to this information, investors or their advisors can make informed judgments about the success, risk, and cost of the manager's program.

Many hedge funds lack this level of transparency. Hedge funds may provide investors with a list of positions (position-level transparency) or information about the risks associated with the hedge fund's positions (risk transparency). However, this information may only be provided in part (e.g., just the largest positions) and may be lagged by a month or more. Hence, detailed information will likely be stale by the time it is provided to the investor.

Operational risks

Hedge funds typically have more complicated operations than traditional strategies. Many hedge fund managers are not experienced with the back-office operations involved in running a large pool of money. The additional burdens and complexities of trading, accounting, pricing, and compliance are not areas in which they may be particularly skilled.

Because of this, many firms place great emphasis on the relationship with their prime broker. The prime broker often serves as a source of "one-stop shopping," acting as settlement agent, providing custody for assets, supplying financing for leverage, and preparing daily account statements. Hedge funds may also rely on the resources of their prime brokers for marketing, back-office support, technology, regulatory compliance, risk management, research, and reporting to their clients.

Headline risk

No fiduciary wants to be associated with the next incident like the meltdown of Long-Term Capital or fraud committed by Bernie Madoff. Hedge funds tend to garner a disproportionate amount of negative attention across a range of topics, such as fees, compensation, performance, strategy, etc. Hence some investors who prefer to stay out of the headlines are understandably wary about investing in hedge funds.

Appendix | Approaches to hedge funds

In 2022, Meketa reviewed publicly available investment policies and annual financial reports for a number of large pension funds and university endowments to determine what approach they were taking to investing in hedge funds. Public pensions plans tended toward absolute return and risk mitigating approaches, while large endowments tended more toward return seeking approaches.

Investor	Objective
CalSTRS	Risk mitigating
New York Common	Absolute return
Texas Teachers	Absolute return/return seeking
North Carolina	Return seeking
Michigan	Absolute return/return seeking
New Jersey	Risk mitigating
Massachusetts PRIM	Absolute return
Los Angeles County Employees	Absolute return
Pennsylvania School Employees	Absolute return
Illinois SURS	Risk mitigating
Missouri Schools	Return seeking
Utah State Retirement	Absolute return
Hawaii ERS	Risk mitigating/absolute return
Maryland SPRS	Absolute Return
Wisconsin (SWIB)	Alpha engine
Texas Employees	Absolute return
San Francisco City & County	Absolute return
Texas Municipal Retirement	Absolute return
Orange County ERS	Risk mitigating
Connecticut	Risk mitigating
South Carolina	Portable alpha
Indiana	Absolute return
Harvard endowment	Return seeking
Stanford endowment	Absolute return/return seeking
University of Michigan endowment	Absolute return
Northwestern endowment	Absolute return/return seeking
University of California endowment	Absolute return

FIGURE 10
Hedge Fund Approaches Amongst Public Pension Plans and Large Endowments

Source: Meketa Investment Group.

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