Hedge funds are investment vehicles that seek positive absolute returns, regardless of the direction of the market. Hedge funds tend to be more popular in bear markets, because they hedge what they own. In a bull market, hedge funds may not perform as well.

The appeal of these hedging strategies is the possibility of receiving stock market returns with lower volatility. Hedging investments also provide a way to diversify your portfolio, since these funds tend to offer return patterns different from many other investments.

More Available Now
Until recently, very few individual investors could take advantage of hedge funds investment strategies. Now, there are more than 40 mutual fund products that offer individuals access to hedge fund strategies, and the list of available hedge mutual funds is growing each month.

Most private hedge funds have very restrictive access requirements issued by the Securities and Exchange Commission (SEC). Hedge funds are only open to “accredited” investors—those whose net worth exceeds $1 million or whose annual income is at least $200,000 for individuals or $300,000 for married couples.

Each private hedge fund usually requires a minimum investment of $1 million. Fees are very high—often 1%-2% for the annual management fees—and 20% of the profits go to the hedge fund manager.

Mutual Fund Advantages
Hedge mutual funds have lower minimum investments and lower fees. Mutual funds also are more highly regulated than private hedge funds.

Hedge mutual funds allow you to have daily liquidity, where private hedge funds have an investment lock-up period during which your funds are unavailable for use. Tax reporting is improved by using a hedge mutual fund versus delayed tax reporting that results from K-1 filings for a private hedge fund.

It’s helpful to know the language used when talking about hedge funds. “Long” investing is when you own a stock you hope will appreciate from the investment. Being “short” is a stock you believe will lose some value. The ability to “go short” is important because it can reduce your net exposure to the stock market. If the market encounters a difficult period, your short positions will gain and offset some of the losses in your long positions.

Hedging Strategies
Most financial planners will limit their exposure to these hedging strategies to about 5%-20% of an overall portfolio. Consider the following hedging strategies now available through mutual funds:

- Market neutral funds try to balance long positions with short positions in a way that gives them a net market exposure close to zero. The goal of market neutral funds is to make money whether the market is rising or falling. They strive to provide absolute returns regardless of the market direction.
- Long/short funds involve managers buying securities they believe will go up in value and selling short securities they believe will go down in price. This strategy looks to take advantage of under- and over-priced securities and provide better returns in a variety of market conditions.
- Merger arbitrage invests in publicly announced company mergers where the company being acquired is purchased and the acquiring company is sold short. In 2006, the number of announced mergers is at a very high level, and this type of hedging strategy has been doing well.
- Convertible arbitrage involves purchasing a portfolio of convertible securities and hedging a portion of the equity risk by selling short the underlying common stock. Historically, convertible arbitrage has been a low risk hedging strategy.

Conclusion
Conventional wisdom and history tell us markets do not go straight up. By having some exposure to hedging strategies, you can reduce the overall amount of volatility in your portfolio.
The mission of the Wisconsin Medical Journal is to provide a vehicle for professional communication and continuing education of Wisconsin physicians.

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