The Morningstar Hedge Fund Categories

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Introduction

The Morningstar Hedge Fund Categories were introduced in 2005 to help investors understand the different types of investment strategies used by hedge funds around the world. Hedge fund managers typically focus on specific areas of the market and/or specific trading strategies. For example, some hedge funds buy stocks based on broad economic trends, while others search for arbitrage profits by pairing long and short positions in related securities. The Morningstar categories divide the universe of hedge funds based on these different approaches.

Morningstar supports 15 hedge fund categories, which map into five broad asset classes (Equity Focus, Arbitrage, Corporate Life Cycle, Macroeconomic Trends, and Combinations). These categories and broad asset classes can help investors make meaningful comparisons between hedge funds. Investors can use these peer groups to identify top-performing funds, evaluate a fund's performance against its peers, and find similar funds. For example, if an investor wanted to evaluate how well a fixed-income arbitrage fund performed, they could compare its performance to that of the fixed-income arbitrage category and the arbitrage broad asset class.

Morningstar assigns a category to each hedge fund based on the hedge fund memorandum document, conversations with portfolio managers, and regression techniques. Currently, Morningstar does not have access to portfolio holdings for hedge funds and must instead rely on information provided by the asset managers.

We regularly review the category structure and the hedge funds within each category to ensure that the system meets the needs of investors. The driving principles behind the classification system are as follows:

- Individual funds within a category use similar strategies and techniques to create value.
- Individual funds within a category can, in general, be expected to behave more similarly to one another than to funds outside the category.
- Categories have enough constituents to form the basis for reasonable peer group comparisons. (Small categories are permitted when a subset of funds is substantially different than other categories.)
- The distinctions between categories are meaningful to investors and assist in their pursuit of investing goals.

Equity Focus

Funds in the equity-focus broad asset class primarily invest in stocks and may take long or short positions. Managers may also use options to lever their position or to hedge. Hedge funds with more short positions are more likely to behave differently than traditional long-only funds or indexes. Most managers assemble portfolios via fundamental equity research, although some managers may use top-down strategies.

Equity Net Long

These funds maintain a core holding of long stock positions and usually hedge the portfolio slightly with smaller short positions in stocks or indexes. These short positions can be a safety net if the broad market declines and the long positions falter. These managers may focus on a specific sector, style, size or geographic area, based on their expertise and the available opportunities in the market. Short positions typically account for about 15-40% of fund assets.

Equity Net Neutral

These funds, which are also known as market neutral funds, divide their exposure equally between long and short stock positions. They buy attractive stocks and short weaker stocks. If the broad market is fairly flat, they aim to profit from both the long and short holdings. If the broad market is rising or falling, the gains and losses from the long and short positions should approximately cancel each other out. These funds typically hold a diverse selection of equities in order to limit their exposure to any one stock, and they rebalance their holdings frequently. These funds normally design their strategies based on broad groups of securities, rather than specific pairs. Short positions typically account for about 40-60% of fund assets.

Equity Net Short

These funds dedicate most of their portfolio to short stock positions, in an attempt to take advantage of anticipated market or stock declines. Some managers invest the proceeds from their short positions in low-risk assets, while others dedicate a portion to long stock positions in order to hedge against broad market rallies. In the event of a broad market rally, these funds will lose money on their short positions but will experience a gain on their long positions. The number of hedge funds pursuing this strategy is fairly small. Short positions typically account for 60-85% of fund assets, although some managers may be 100% short.

Equity Focus (continued)

Equity Variable

These funds use both long and short positions in stocks in different combinations over time. These funds do not hold their long/short exposure fixed, and the net exposure for these funds will vary widely at any given point in time. An equity-variable fund could be predominately long, predominately short, or somewhere in between, given the manager's overall equity market sentiment. These funds are more dependent on a manager's ability to predict whether the market will rise or fall.

Arbitrage

Funds in the arbitrage broad asset class study the pricing relationship between pairs of related securities. Managers take a long position in the security that appears to be under-priced and a short position in the security that appears to be over-priced. The manager will hold the positions until the pricing discrepancy disappears. These strategies are usually market neutral. Because markets are generally efficient, pricing discrepancies are typically very small and short-lived. Therefore, these funds tend to be highly leveraged, using borrowed money to increase the size of possible gains.

Relative Value Arbitrage

These funds take long and short positions in pairs or sets of related securities in order to profit from perceived pricing discrepancies. These funds use numerous different arbitrage strategies, including convertible arbitrage (convertible bond vs. the issuing stock), fixed-income arbitrage (e.g. long-term vs. short-term bonds), capital structure arbitrage (senior debt vs. junior debt vs. preferred stock vs. common stock), statistical arbitrage (mathematical pricing models vs. market prices), or pairs trading (one stock vs. its industry peer, e.g. Coca-Cola vs. Pepsi). These funds are usually highly leveraged.

Convertible Arbitrage

These funds study the relationship between a company's stock and its convertible bonds. Convertible bonds contain an option that allows the bondholder to trade in the bond for common stock at a certain price and under certain conditions. Usually, the bond trades for less than the stock so managers buy the bond and short the stock. These funds craft strategies to manage their exposure to interest rate risk, default risk, and illiquidity in the convertible bond market, and pricing volatility in both the stock and bond markets. Because the pricing discrepancies are usually very small, many of these funds employ leverage to maximize return.

Fixed Income Arbitrage

These funds specialize in arbitrage opportunities in the fixed-income market. Portfolio managers study whether spreads (the differences between bonds' yields) are reasonable between short-term, long-term, corporate, mortgage-backed, municipal, and government bonds. For example, if a manager thought that the yields on long-term bonds were too high relative to their expected risk, he might buy those bonds in the hopes that the yields would fall and the bond prices would rise. These managers take offsetting positions to neutralize their exposure to other factors, and they are often highly leveraged.

Corporate Life Cycle

Funds in the corporate life-cycle broad asset class attempt to profit when stock or bond prices change in response to certain corporate events, such as bankruptcy, mergers, or acquisitions. Managers will typically use short positions or derivatives to hedge their market exposure. These positions help the fund capture the price change related to the event itself and insulate the fund from broad market changes.

Corporate Event Driven
These funds attempt to profit from price changes related to a variety of corporate events, including bankruptcy, emergence from bankruptcy, mergers, acquisitions, divestitures, stock buybacks, dividend issuance, major shifts in corporate strategy and other atypical events. Most strategies involve purchasing or shorting elements of a company's capital structure and could involve senior debt, junior debt, convertible bonds, preferred stock, or common stock.

Distressed Companies
These funds specialize in financially troubled companies that may face bankruptcies, distressed sales, corporate restructurings or financial reorganizations. A fund might take long positions only in the company stock or debt, or it might exploit pricing discrepancies between different parts of the company's capital structure, e.g. buying senior debt and shorting preferred stock. The hedge fund may try to accumulate a controlling stake in the company in order to influence the outcome. During bankruptcy proceedings, debtholders often exchange their debt for an equity stake in the post-bankrupt entity.

Merger Arbitrage
These funds specialize in companies that are or may be involved in corporate mergers and acquisitions. These funds typically purchase shares in the company about to be acquired (e.g. Gillette) while selling shares in the buyer (e.g. Procter & Gamble). This tactic is popular because the stock of the company about to be acquired will usually rise and the buyer's stock will typically fall when the acquisition is announced or completed. These funds bear the risk that the deal may be stalled or may fall through. Many of these funds use derivatives to hedge against market risk or as an alternative to buying or selling the stock directly.

Macroeconomic Trends

Funds in the macroeconomic-trends broad asset class study broad-based changes and prices in global markets. Often, these funds make tactical decisions about an optimal global asset allocation mix, and they use equities, bonds, currencies, derivatives, and commodities in their portfolios. Many managers look for emerging trends in countries, industries, and geopolitical institutions. Some managers will also attempt to profit from general market volatility during times of uncertainty.

Global Macro

These portfolio managers take a top-down, broad view of the world. They look for investment opportunities by studying the global economy, government policies, interest rates, inflation, and market trends. These managers study which asset classes look most attractive and promising. For example, a manager might decide that European stocks look over-valued while Asian debt looks under-valued. These funds invest in equities, bonds, currencies, derivatives, and commodities.

Emerging Markets

These funds specialize in securities issued by corporations and governments in developing nations. These managers study current events, history, and the investing climate in each country. Most of these securities are exposed to political, economic, currency, and government risks, and the managers seek the best return for any given level of risk. These funds invest in both equity and fixed-income securities. Some funds focus on a specific area of the world, while others invest in emerging markets around the world.

Managed Futures

These funds invest in a variety of futures contracts, including currencies, interest rates, stocks, stock market indexes, derivatives, and commodities. These funds build quantitative models to price futures and then take long and short positions in the futures. For example, a hedge fund might have long positions in weather futures and short positions in gold futures. These funds often prosper when there is a lot of uncertainty about futures prices.

Combinations

The combinations broad asset class contains the hedge funds that merge multiple techniques into one single fund. Multi-strategy funds tend to manage all the assets in-house, while fund of funds purchase stakes in other hedge funds.

Multi Strategy

These funds offer investors exposure to several different hedge fund investment tactics. In most of these cases, all of the assets are managed in-house at the hedge fund, but the assets may be divided between multiple portfolio managers, each of whom focus on a different strategy. An investor's exposure to different tactics may change slightly over time in response to market movements.

Fund of Funds

A fund of funds invests in a sampling of other hedge funds. The fund of funds offers investors exposure to several different investment tactics, which it outsources from different hedge fund asset managers. The advisor for a fund of funds does due diligence on different asset managers and selects the appropriate managers and asset weights for different parts of the portfolio.