

Demystifying hedge funds

CATALYST | 25
FUND MANAGERS YEARS

Why the simple ideas are sometimes the best ideas

Simplicity is the ultimate sophistication.

Leonardo da Vinci

Marcus Erlank

Director and Hedge Fund Portfolio Manager

Demystifying hedge funds

The toolkit available to a hedge fund manager is unusually broad. Long and short positions, derivatives, corporate actions, index events, and leverage can all play a role. Popular culture has added to the sense of complexity: films such as *The Big Short* and series such as *Billions* often portray hedge fund returns as the product of one clever insight expressed through an exotic trade. That makes for good television, but it is not how an absolute return mandate is typically delivered through a full market cycle.

This is not an argument against using sophisticated tools. Hedge funds should use the flexibility available to them where it can improve risk-adjusted returns. But it is useful to

distinguish between the strategies that can add incremental alpha and the disciplines that do most of the heavy lifting over time. Stock selection, exposure management and the ability to act quickly are the foundations; derivatives and special situations can then add another layer of return.

The distinction becomes clearer by looking first at three examples of the more specialised tools available to a hedge fund. The examples below are illustrative rather than descriptions of any particular fund or transaction.

The incremental layer: adding alpha around the edges

01

Derivative strategies

Consider a manager who sees value in a listed sector but already has meaningful exposure through physical holdings. Rather than committing more capital to the shares, the manager could use a bull fence across a small number of liquid stocks. A bull fence combines options to create a defined range of outcomes and can, depending on market pricing, be established at little or no net premium cost. The trade does not create the investment idea; it provides a different and potentially more capital-efficient way to express an existing view, while exchanging some upside for downside protection.

02

Index reconstitutions

When a stock is expected to enter a widely followed index, benchmark-aware investors may need to buy it, which can create technical demand and improve institutional relevance. A hedge fund may therefore choose to increase an existing position ahead of an index review. The sequencing matters: the fundamental investment case should come first, with the anticipated index event influencing position size rather than creating the position. Otherwise, the fund is effectively relying on a forecast of an index committee decision.

03

Accelerated book builds

Listed companies periodically raise equity, often at a discount to the prevailing share price, to fund acquisitions or other growth opportunities. A fund with available liquidity and an existing view on the company may be able to acquire shares at a more attractive price than is available in the open market. The discount alone is not enough: the quality of the assets being acquired, the price paid and the likely return on the new capital still determine whether the transaction creates value.

These strategies can add meaningful incremental alpha and are an important part of the hedge fund toolkit. But they are episodic: the opportunity has to present itself. Over a full cycle,

the larger contribution tends to come from the repeatable disciplines applied across the whole portfolio.

The cornerstones: the foundational steps

01

Selecting the right securities

A fundamental, bottom-up process seeks to hold larger positions in securities assessed as undervalued and smaller or short positions in those assessed as overvalued. The principle is simple; executing it consistently is not. It depends on a repeatable valuation framework and a deep understanding of the underlying fundamentals. In a hedge fund, this stock-selection skill can be expressed more freely because the portfolio is not necessarily anchored to benchmark weights. Conviction, rather than index composition, can drive position size.

02

Managing net and gross exposure

Among the most powerful instruments available to a hedge fund is the discretion to hold cash during periods of heightened volatility or where the market appears expensive, and conversely to increase exposure where a significant opportunity set exists. Where a manager balances market exposure well, the benefit tends to be twofold: lower realised volatility, and a superior return through the cycle. Neither outcome is guaranteed, and the discipline is demanding precisely because exposure decisions are most consequential at the points where conviction is hardest to sustain.

03

Nimbleness in execution

Macroeconomic headlines can cause public market prices to move much faster than underlying company fundamentals. In these periods, opportunities may last only days or even hours. A manager can only respond effectively if the groundwork has already been done: the securities are well researched, liquidity is available and the decision-making process is able to move quickly. The edge is not simply speed; it is being prepared to act when price and value temporarily diverge.

THE ARITHMETIC OF COMPOUNDING

The arithmetic of compounding is unsentimental, and capital preserved through a drawdown does not need to be earned back.

Why the distinction matters

Why the distinction matters

The difference between these two groups of tools is largely one of repeatability. Special situations are episodic and event dependent: an options trade requires suitable pricing and liquidity; an index trade requires a pending reconstitution; and a book build requires a company to raise capital at a time when the fund wants, and is able, to participate. The manager

controls the response, but not when the opportunity appears. These trades can also be capacity-constrained, limiting how much they can contribute as a fund grows.

Stock selection and exposure management are different. They can be applied continuously, affect the whole portfolio and compound over time. That is why they tend to determine a much larger share of the absolute return outcome.

THE INCREMENTAL LAYER	THE CORNERSTONES
Episodic and event dependent	Applied continuously
Needs the opportunity to present itself: suitable option pricing, a pending index review, a company raising capital	Available in every market, in every position, on every day the portfolio is managed
Affects a small number of positions at a time	Affects the whole portfolio
Often capacity-constrained, so the contribution shrinks as a fund grows	Scales with the portfolio and compounds over time
Diversifies the sources of return	Determines the larger share of the absolute return outcome
The central lesson is simple. Hedge fund returns do not have to depend on complexity. Over time, the foundations remain	selecting the right securities, managing how much market risk to take and being prepared to act when opportunities emerge.

THE BOTTOM LINE

Special situations enhance the foundation and diversify the sources of return, but they are the cherry on top. The cake still has to be baked.

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