Hedge Fund Strategies: Key Risks and the Benefits of Investing in a Fund of Funds Structure Through a Mutual Fund

Inappropriate Use of Leverage, Illiquidity, Lack of Transparency, and Manager Selection are the “Big Four,” According to Palmer Square

In the unending quest to increase return without a commensurate increase in risk, many investors find themselves drawn to hedge funds. And, in our opinion, for good reason. Alfred Jones brought hedge fund strategies to prominence in 1942 and they have been an important tool ever since, because – when properly managed – they have the potential to reduce risk and produce more consistent risk-adjusted returns. But there is no free lunch when it comes to hedge fund managers. Market movement aside, there are other risks at play. While many investors, such as endowments and family offices, have experienced high risk-adjusted returns over time by using alternatives, other investors have suffered direct losses from certain hedge fund strategies that did not fare so well. To reap the portfolio benefits that alternatives offer, it is important to understand the risks of hedge fund investing – and how to help investors avoid them.

While every investment includes myriad risks, Palmer Square has found that the four most significant risks to hedge fund investing are:

1. Over-leverage
2. Illiquidity
3. Lack of transparency, and
4. Manager selection

Historically, investors have primarily accessed hedge fund strategies and managers through private placement limited partnership vehicles or fund of funds limited partnership vehicles. Those vehicles have only been available to accredited investors and/or qualified purchasers. Today, alternative mutual funds are available as investment options for all investors. As alternative investing options continue to increase, we believe it has become more important than ever to pay attention to the risks highlighted above (especially manager selection, as described later in this paper).

In the mutual fund world (as opposed to the private placement space), the Investment Company Act of 1940 (1940 Act) regulations limit the use of over-leverage and illiquidity, and they require that managers provide transparency. As a result, investors new and old to hedge fund strategies have less exposure to three of the four most significant risks simply by investing through an open-end mutual fund structure. We believe the last of the Big Four risks, manager selection risk, can be mitigated by performing the required investment and operational due diligence, gaining exposure to institutional level hedge fund managers and using a diverse set of strategies. Let’s take a closer look now at each of the Big Four risks:
In simplest terms, leverage is the use of borrowed capital to pursue an investment opportunity. A hedge fund manager would take your dollar of equity and then ‘leverage’ it by adding borrowed money typically provided by one of the major Wall Street investment banks (i.e., prime brokers). Amplifying an investment with debt can prove to be advantageous or, in some cases, disastrous. Many of the best known hedge fund failures stem from an excessive use of leverage such as Long-Term Capital Management.

Within the private placement world of investing in hedge funds, leverage is open-ended and managers can use as much borrowed money from prime brokers as they deem appropriate for their strategy. In contrast, leverage is strictly limited to 1.33x total assets in the mutual fund space. In essence, managers can leverage long positions up to 1.5x, but they are required to have enough cash set aside to cover their short positions. Given the daily liquidity requirement of an open-end mutual fund structure, many managers have historically been cautious about closely approaching the 1940 Act limit. As a result, these restrictions may reduce the additional risk that leverage can pose to the average mutual fund investor’s investment portfolio.

Illiquidity
Many managers advertise to clients that they have a liquid portfolio. What does that mean? Typically, it means that securities can be sold quickly with minimal impact to the portfolio. Securities that trade frequently on exchanges or trade over the counter with significant daily trading volume usually fit into this category. Managers will often cite statistics to demonstrate liquidity such as days trading volume to liquidate a portfolio.

Why does illiquidity present a risk to typical hedge fund investing? Illiquidity stifles a manager’s ability to be opportunistic and tactical with the portfolio—a major reason many investors choose hedge funds in their portfolio. Hedge fund managers add value to portfolios in many cases by being uncorrelated to traditional stock and bond markets through precise security selection (both long and short) and by being able to shift gears when opportunities present themselves. Today, markets tend to move up and down with incredible velocity, and managers that can sell assets, increase their shorts or longs, move quickly from debt to equity or move to cash have potential advantage.

Illiquid assets are limited in the mutual fund world to 15% of total assets and are defined as assets that may not be sold or disposed of in the ordinary course of business within seven days, at approximately the value at which the mutual fund has valued the investment on its books. Given investors’ ability to buy and sell mutual funds daily, many investment managers strive to avoid illiquidity, thereby reducing this key risk to hedge fund investing. Finally, sticking to liquid investments allows clients to redeem their shares whenever they deem it appropriate.

Lack of Transparency
Transparency is another buzzword that is commonly used in the hedge fund space. At its core, transparency describes how much information a hedge fund manager shares with their investors. Across the hedge fund landscape, transparency varies widely for private partnership managers. Some managers will provide position-level transparency while others will only discuss their top 10 long positions. Reduced transparency has been commonplace for years, because hedge fund managers typically want to protect the confidentiality of their best long and short ideas. Alerting their investors to positions may decrease their perceived edge. Such worries are often particularly true for short-biased firms. In the case of the short-biased manager, market knowledge of their positions could result in a short squeeze if others take long positions to artificially drive up a stock’s price.
In recent years, transparency has increased rather dramatically across the industry; however, position level transparency is still rare. Without transparency, investors may become concerned about the possibility of fraud, given their inability to clearly see how and where money is being managed. Ultimately, without the benefit of transparency, investors must rely heavily on their due diligence process or a fund manager's due diligence to evaluate not only the investment strategy, but also the operational and compliance infrastructure.

In the mutual fund world, investors have the benefit of increased transparency. Mutual funds are investment companies that must register with the U.S. Securities and Exchange Commission (SEC). In addition, mutual funds must have directors who are responsible for extensive oversight of the fund's policies and procedures. Mutual funds are required to report their holdings through filings with the SEC quarterly on the Fund's fiscal calendar and they must stay within the investment parameters set forth in their prospectus.

Transparency provides investors with the ability to better understand where their capital is being invested.

**Manager Selection Risk**

Selecting a hedge fund manager or strategy can be a difficult task for many investors. Performing the necessary due diligence on hedge fund-type strategies requires time, resources, expertise, data and access to institutional knowledge that many investors don’t have. Further complicating matters is the fact that there may be a large disparity among hedge fund manager performance from one year to the next. As a result, manager selection risk can be significant, and obviously there are no 1940 Act rules and regulations in place to mitigate this risk. However, the risk can be reduced by investing through a fund of funds or manager of managers that can perform the required due diligence and provide access to institutional-level hedge fund managers and a diverse set of strategies.

Typically, fund of fund managers are specialists in the hedge fund arena, which can be especially helpful to institutional and retail investors who don’t feel equipped to spend the time and resources required to perform the due diligence on their own. It is Palmer Square's belief that a fund of funds strategy mitigates manager selection risk by providing diversification and risk management benefits that minimize the effect of one manager’s potential underperformance and can lead to higher risk-adjusted returns.

**Palmer Square Capital Management**

To learn more about Palmer Square and our funds, please visit our website at www.palmersquarecap.com or call our Sales Desk at 888-870-3088.
Notes:

1 **Correlation** - the extent to which the returns of different types of investments move in tandem with one another in response to changing economic and market conditions. Correlation is measured on a scale of -1 (negatively correlated) to +1 (completely correlated). Low correlation or negative correlation to traditional stocks and bonds may help reduce risk in a portfolio and provide downside protection.

2 **Beta** - describes an investment's volatility in relation to that of the stock or bond market as a whole. For example, the S&P 500 is typically considered to be 'the equity market' and it has a beta of 1.0. A stock that exhibits more volatility than the S&P 500 is said to have a beta of greater than 1.0 while a stock that exhibits less volatile than the S&P 500 is said to have a beta of less than 1.0.

You should consider the funds’ investment objectives, risks, charges and expenses carefully before investing. For a prospectus, or summary prospectus, that contains this and other information about the Funds, call 1-866-933-9033 or visit our website at www.palmersquarecap.com. Please read the prospectus, or summary prospectus carefully before investing.

Past performance does not guarantee future results. Absolute return funds are not designed to outperform stocks and bonds in strong markets. Techniques used are intended to reduce risk and volatility, seeking to provide protection in a down market. Asset allocation decisions may not always be correct and may adversely affect Fund performance.

Derivatives can be highly volatile and may have the potential for unlimited loss. The use of leverage may magnify losses. A security which was liquid when purchased may subsequently become illiquid. Credit default swaps and related instruments are derivatives used for hedging against a credit default and may involve greater risks than if the Fund invested in the referenced obligation directly. Short sales may be considered speculative and it may be difficult to purchase securities to meet delivery obligations. Distressed securities are typically unrated, lower-rated, in default or close to default and the prices may be extremely volatile, more likely to become worthless and the Fund may lose all of its investment. Event-driven strategies are speculative, which may result in a new less valuable security (or derivative) and are subject to the risk of complete loss of value. Foreign investments present additional risk due to currency fluctuations, economic and political factors, government regulations, differences in accounting standards and other factors. Investments in emerging markets involve even greater risks. Small, mid and large cap stocks are subject to substantial risks such as market, business, size volatility, management experience, product diversification, financial resource, competitive strength, liquidity, and potential to fall out of favor that may cause their prices to fluctuate over time, sometimes rapidly and unpredictably. Debt securities have interest rate, inflation and credit risks and are subject to prepayment and default risk. High yield and junk securities involve greater risk and tend to be more sensitive to economic conditions and credit risk.

The Fund may have a high portfolio turnover which could result in greater transaction costs, lower Fund performance and higher tax liability for shareholders. It may be more expensive to invest in an ETF or mutual fund rather than owning the portfolio securities of these investment vehicles directly and may involve duplication of advisory fees and certain other expenses. Diversification does not ensure increased returns or decreased risk. The Fund is new, with no operating history.

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