Morgan Stanley
INVESTMENT MANAGEMENT

Asset Class Introduction: Hedge Fund Investing

May 2026

AUTHOR

KEITH BLACK
PHD, CFA, CAIA, FDP, CDAA

Introduction

Hedge funds cannot be generalized, as they implement a wide variety of investment strategies. Investors are encouraged to understand the risk and return drivers of each strategy before allocating. On average, the risk and return of hedge funds fall between stocks and bonds, so investors should not expect hedge funds to outperform stocks in a strong bull market. Divergent hedge fund strategies can be highly diversifying, as they tend to have low drawdowns, low correlation to stocks and bonds, and outperform stocks in weak markets.

Key Takeaways

- Hedge funds can be generally categorized in one of four styles: long-equity, macro and managed futures, relative value, and event driven.
- Convergent hedge fund strategies tend to perform well in lower volatility markets, while divergent strategies tend to perform well in higher volatility markets.
- Since 2004, hedge fund indices have outperformed the bond market with lower standard deviation and drawdown risk than the 60/40 portfolio.

Defining Hedge Funds

A hedge fund is a private investment pool run by a professional manager who can use a broader set of tools than managers of traditional stock and bond funds. Traditional funds are regulated by the Investment Company Act of 1940, which prohibits asymmetric incentive fees, limits illiquid assets to 15% of the portfolio, and restricts the degree of leverage, short selling, and portfolio concentration. Hedge funds, as private funds, often trade in excess of these limits, as many strategies rely on leverage, short selling, concentration, or illiquid assets.

Each hedge fund strategy and manager is unique. On average, returns to hedge funds have been less risky than those of stock market indices, as measured by drawdown and standard deviation. Many hedge funds use short positions to reduce risks relative to the direction of underlying markets. Hedge funds typically have lower-than-market beta risk and tend to focus on generating alpha through security selection, especially in less liquid investments. However, some hedge funds cannot be classified as lower risk because they intentionally increase risk to pursue higher returns.

By taking less directional risk, hedge fund returns typically lag those of stocks in a bull market, but their defensive nature often leads to outperformance during periods of falling stock prices.

Risks of Hedge Fund Investing

The risk of hedge fund investing includes illiquidity, leverage, fees, and asymmetric returns. Hedge fund managers may require an initial lock-up period, such as one year, during which withdrawal requests will be prohibited or delayed. Liquidity constraints can benefit investors by enabling managers to invest in less liquid, mispriced assets or by delaying asset sales during periods of heightened market volatility. Hedge fund strategies that deploy leverage and short sales can magnify both gains and losses, as the strategy increases exposure beyond the client's invested assets. Hedge funds often charge both a management fee and an incentive fee, which is a percentage of both realized and unrealized profits. Because hedge fund fees are typically higher than fees on long-only actively managed funds, the manager needs to deliver meaningful value to justify and offset the additional layer of fees. Some hedge fund strategies tend to offer asymmetric returns, including those where losses tend to accelerate in markets with declining liquidity, rising volatility, and widening credit spreads.

Hedge Fund Styles

LONG-SHORT EQUITY	MACRO AND MANAGED FUTURES	RELATIVE VALUE	EVENT DRIVEN
REDUCED BETA RISK WHILE FOCUSING ON STOCK SELECTION	TRADE MACRO MARKETS TO PROFIT IN DISLOCATED MARKETS	LONG/SHORT FIXED INCOME BENEFITS FROM SECURITY SELECTION AND TIGHTENING SPREADS	FOCUS ON COMPANY-SPECIFIC ISSUES SUCH AS MERGER OR DISTRESS

Long-Short Equity Hedge Funds

Long-short equity is the most popular hedge fund strategy, whether measured by AUM or the number of funds. These managers need to have skills in buying undervalued stocks and selling short, overvalued stocks. Short selling requires substantial risk management skills, as the risk of rising stock prices can exceed the reward of declining stock prices, and managers may be forced to close short positions as prices rise.

For example, a long-short equity fund may allocate 100% of its capital to long positions expected to outperform and 50% to short positions expected to underperform. This strategy exposes 150% of client assets to the manager's stock selection skill, while reducing equity beta to just 50% of directional market moves.

Ideally, the long positions outperform the market, while the short positions underperform. A key question in the due diligence process is whether the manager has demonstrated alpha, or stock selection skills, on both the long and short sides of the portfolio. Managers with stock selection skills can maximize alpha potential in a long-short framework.

Macro and Managed Futures Funds

Macro and managed futures funds typically don't trade individual securities; instead, they focus on futures markets for equity indices, sovereign debt, currencies, and commodities such as energy, metals, and food products. These macro trades are executed on a futures exchange, which minimizes credit and counterparty risk. This is important, as the role of macro and managed futures funds is to serve as a crisis hedge in a portfolio.

Macro and managed futures strategies tend to profit in markets with strong positive or strong negative returns but offer lower returns in directionless markets. Because these strategies alternate between long and short positions, long-term returns tend to have little correlation or directional exposure to the underlying markets.

Macro funds tend to be more concentrated and discretionary. Discretionary macro managers tend to be experts in monetary and fiscal policy as well as global money flows, potentially profiting from analysis of Central Bank policies.

Managed futures funds are also known as CTAs (Commodity Trading Advisors) or trend followers. In many cases, managed futures funds are built to algorithmically exploit the 50-year history of financial and commodity futures markets to tactically allocate in the direction of market trends. The computer detects the trend, analyzes the trend, and then takes advantage of it. Managed futures funds seek to have long positions in rising markets and short positions in falling markets. In 2022, managed futures posted positive returns of 11.6% in 2008 and 21.7% in 2022.

Relative Value Hedge Funds

Relative value strategies profit from valuation convergence across related securities. Strategies include convertible bond arbitrage, fixed-income arbitrage, and mortgage-backed securities arbitrage. The typical trade is to purchase the asset with the lowest liquidity and the widest credit spread, which tends to be convertible bonds and bonds with lower credit quality.

A hedge is used to reduce equity market risk in convertible bonds and interest rate risk in corporate and emerging-market sovereign bonds. Relative value strategies can be called divergent strategies, as exposures tend to be close to market neutral when market volatility is low, and credit spreads are stable or declining, but can lose money quickly when market volatility spikes, liquidity conditions deteriorate, and credit spreads widen.

Relative value hedge funds earn returns through declines in credit spreads and leveraged exposure to positive carry trades. If the long position in a risky bond yields 6% and the short position in the duration-neutral Treasury hedge yields 4%, the unlevered strategy earns 2% income as positive carry. At three times leverage, the income increases to 6%. Returns are higher than the positive carry when credit spreads tighten, and lower than the positive carry when credit spreads widen.

Convertible bond hedge funds can profit when the volatility of the underlying stock exceeds the implied price of the embedded equity call option.

Event Driven Hedge Funds

While relative value strategies are predominantly implemented in fixed income, event-driven strategies, such as merger arbitrage and spin-offs, typically hold mostly equity securities. Event-driven strategies focus on changes in a company's capital structure. Capital structure arbitrage and distressed strategies can hold debt securities. Event driven funds can profit when the anticipated event occurs at the predicted time, but can incur losses when the event is delayed or doesn't occur at all. Because returns are driven more by company-specific events than market exposure, event driven strategies offer portfolio diversification.

Consider a proposed merger with compensation offered in the acquirer's stock. The acquirer is offering 2 shares of its $20 stock for each $36 share of the target firm's stock. A merger arbitrage fund would buy the target firm's stock for $36 and sell short 2 shares of the acquiring firm's stock for $40.   If the merger occurs within 1 year, the merger arbitrage firm earns $4, an annualized return of 11%. The key to profiting from merger arbitrage is to buy shares of target firms only when the merger is expected to be completed in a reasonable time. If the merger deal collapses, the trade would lose nearly 17% in a single day if the target's stock falls back to its pre-deal price of $30.

Recent Return Indexes of Various Hedge Fund Types

JAN 2004-DEC 2025	S&P 500	BLOOMBERG AGGREGATE BOND INDEX	60% STOCKS, 40% BONDS	EQUITY LONG-SHORT	EVENT DRIVEN MULTI STRATEGY	FIXED INCOME ARBITRAGE	MACRO
Annualized Return	10.6%	3.0%	7.7%	6.0%	6.1%	4.2%	5.1%
Standard Deviation	14.5%	4.2%	9.3%	7.0%	7.2%	5.9%	3.8%
Maximum Drawdown	-50.9%	-17.2%	-32.1%	-17.2%	-20.2%	-19.3%	-3.1%
Skewness	-0.62	-0.16	-0.61	-0.66	-1.02	-5.39	0.66

Source: Bloomberg Aggregate Bond Index, S&P 500 Index, CISDM Hedge Fund Indices. Annualized monthly data, January 2024 to December 2025.

Recent Return Indexes of Funds of Funds

JAN 2004-DEC 2025	BLOOMBERG AGGREGATE BOND INDEX	60% STOCKS, 40% BONDS	DIVERSIFIED FUNDS OF FUNDS	EQUAL WEIGHTED HEDGE FUNDS
Annualized Return	3.0%	7.7%	4.0%	6.0%
Standard Deviation	4.2%	9.3%	4.4%	6.7%
Maximum Drawdown	-17.2%	-32.1%	-17.5%	-21.7%
Skewness	-0.16	-0.61	-1.09	-0.93

Source: Bloomberg Aggregate Bond Index, S&P 500 Index, CISDM Diversified Fund of Funds Index, CISDM Equal-Weighted Hedge Fund Index. Annualized monthly data, January 2024 to December 2025.

Distressed investments are inherently illiquid, so they need to be held in a fund with long-term lock-up policies. A hedge fund may purchase defaulted debt at 40% of face value, hoping to earn a recovery value of 60% at the end of a 2-year bankruptcy process. Income is not typically earned on distressed investments, as the bankrupt firm is not paying the scheduled coupon payments on the bond. In addition to liquidity risk, distressed strategies can earn lower returns when the bankruptcy process drags on beyond the expected timing or when the recovery rate is lower than expected.

Multi-Strategy and Funds of Hedge Funds

There are four primary hedge fund strategies: long-short equity, relative value, event-driven, and macro/managed futures. While most hedge funds invest in just one of these strategies, funds of funds and multi-strategy funds diversify across all four.

A fund of hedge funds provides diversification across both strategies and the underlying hedge fund firms. This diversification tends to reduce risks, with an average equity beta of 0.15 and a correlation to bonds of 0.15.

Returns on funds of funds (FoF) tend to be lower than stand-alone hedge fund strategies. There is a double layer of fees, since the FoF charges fees in addition to those charged by the underlying manager. The return and risk of FoF are very similar to those of bonds, but with a low correlation to bond market returns.

A multi-strategy fund diversifies the risk of single hedge fund strategies but maintains the risk of a single hedge fund management team. A multi-strategy fund is offered by a very large hedge fund or a large investment bank and provides a hedge fund solution that invests across all these strategies.

Portfolio Construction with Hedge Funds

Hedge funds are considered an alternative investment with risk and return characteristics different from those of stock and bond indices. Historically, hedge funds have earned returns higher than bonds while exhibiting lower risk than a portfolio invested 60% in stocks and 40% in bonds.

Moving 10% to 20% of a portfolio from stocks and bonds into hedge funds is a diversifying strategy that has historically reduced portfolio risk. From 2004 to 2025, moving from a 60/40 portfolio to a portfolio invested 50% in stocks, 40% in bonds, and 10% in the equal-weighted hedge fund index, moved annual returns from 7.7% to 7.3%, while reducing standard deviation risk from 9.3% to 8.3% and maximum drawdown from -32.1% to -28.5%.

Investors may choose to allocate across all hedge fund strategies or focus on convergent strategies, such as equity market-neutral, merger arbitrage, global macro, and managed futures that have historically had low drawdown risk, a tendency to offer defensive returns in declining equity markets, and very low correlation to equity returns.

Convergent strategies are characterized by positive skewness in returns, with the average and largest positive

Recent Index Returns of Sample Hedge Fund Portfolios

JAN 2004-DEC 2025	60% STOCKS, 40% BONDS	50% STOCKS, 40% BONDS, 10% HEDGE FUNDS	EQUAL WEIGHTED HEDGE FUNDS	FIVE STRATEGY DIVERGENT PORTFOLIO	FOUR STRATEGY CONVERGENT PORTFOLIO
Annualized Return	7.7%	7.3%	6.0%	5.7%	5.6%
Standard Deviation	9.3%	8.3%	6.7%	5.3%	3.5%
Maximum Drawdown	-32.1%	-28.5%	-21.7%	-19.8%	-3.1%
Skewness	-0.61	-0.67	-0.93	-2.33	0.57

Source: 50%-60% S&P 500 Index, 40% Bloomberg Aggregate Bond Index, 10% CISDM Equal-weighted Hedge Fund Index. Divergent hedge fund strategies include equity long-short, convertible bond arbitrage, fixed income arbitrage, distressed securities, and event-driven multi-strategy. Convergent strategies include equity market-neutral, merger arbitrage, global macro, and CTA equal-weighted (managed futures).

returns greater in absolute value than the average and largest negative returns. Divergent strategies exhibit negative skewness, with larger losses and greater maximum drawdowns than positive returns.

Conclusion

Hedge funds can be useful as part of an alternative investment portfolio, especially when the goal is diversification and risk management. Most hedge funds are not designed to beat the market but hold short positions that offer defensive performance in declining markets. The greatest diversification is offered by strategies with the lowest correlation to stock and bond markets, especially macro and managed futures funds.

The returns presented here are based on index data, which is an average of all hedge funds reporting to the index provider. Due diligence is extraordinarily important in alternative investments, as hedge fund managers have no statutory limit on the risks they can take. Before allocating to any hedge fund, investors must carefully consider the trade-offs, as hedge funds tend to have lower liquidity, higher fees, and greater complexity and illiquidity than traditional stock and bond investments.

RO# 5453724 Exp. 05/06/2028 2504500-7200930 26Q20123 LTR