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Research on Chinese Hedge Fund Strategies

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Abstract: With the rise of the hedge fund industry in China, more and more hedge fund firms and products are becoming known to the market. Hedge funds have a wide variety of investment strategies, which are far more diverse than those of public funds. Common hedge fund strategies include equity strategies, bond strategies, quantitative strategies, and so on. In this paper, I will introduce and analyze the common hedge fund strategies.

1. Concept of Hedge Funds

Hedge funds, also known as hedge funds, originated in the United States in the early 1950s and hedge risk by buying and selling short, options futures and other financial instruments to achieve higher returns while avoiding risk. the world's first limited partnership hedge fund, Jones Hedge Fund, emerged in 1949. It achieved high returns by buying shares of undervalued companies while selling shares of overvalued companies, coupled with the use of leveraged trading. To date, global hedge funds have more than $1 trillion under management.

In the U.S., because hedge funds are loosely regulated, investors in hedge funds are required to have sufficient capital to qualify to participate in them. We also refer to such investors as qualified investors. In China, hedge funds, i.e. private equity funds, also require investors to be high net worth individuals or institutional investors, and investment shares must start at RMB 1 million.

Hedge funds have some characteristics of their own. Unlike public funds, they are often privately directed. This can effectively circumvent regulation. Fund managers also often invest their own funds into the hedge funds they manage. This aligns the interests of the fund manager with those of the investors. In addition to a basic management fee of 1% to 2%, hedge funds also charge a performance fee of 10% to 20%. This commission provides sufficient incentive for fund managers. Hedge funds are also very flexible in their investment tools, and can use a wide range of financial derivatives or a combination of them.

2. The Development of Hedge funds in China

The real development of the hedge fund industry in China started with the establishment of the China Securities Investment Fund Association (CSIFA) in 2012. The China Association of

Securities Investment Funds (CASIF) began to regulate hedge funds in China. Hedge fund management companies in China need to apply for a private equity manager license from the association to start their own investment management of funds. In China, hedge funds are called private equity funds. The association requires that private equity fund investors must have an investment amount of at least RMB 1 million. Private equity funds must raise funds in a private, non-public manner.

Most hedge funds in China apply for a securities-based private equity manager license and invest in a variety of securities products such as stocks, futures, and bonds. Today, there are more than 10,000 private equity managers, with funds under management ranging from tens of millions to over ten billion dollars. Some of the more well-known private equity funds in China with assets under management of more than 10 billion include Jinglin Investment, Valeant Investments, Linyuan Investment, etc.

Hedge funds in China have a simple organizational structure and a high degree of flexibility in day-to-day management and investment. Hedge funds are very flexible in their investment approach, and can exercise a variety of Chinese securities market investment tools, multiple investment techniques, leveraged operations, etc. Compared to public funds, which have many restrictions, hedge funds can give full play to the investment ability of fund managers.

3. Hedge Fund Strategies

3.1 Fund of funds strategy

Fund-of-funds strategy (FOF strategy) is a way to diversify risk and increase returns by investing in multiple high-quality eligible hedge funds. The selected funds inherently have their own investment style, historical performance, and risk range. The funds exist in different proportions to each other and interact with each other in terms of strategy, return, and risk to achieve the optimal fit for the overall portfolio composition. On the one hand, the fund of funds strategy can obtain the advantages and performance of the invested funds in the portfolio. On the other hand, because the funds in the portfolio have different investment targets, investment practices and investment styles, their performance is not necessarily correlated with each other, thus also achieving a risk diversification effect. The overall risk resistance of the FOF portfolio is greatly enhanced. This results in a portfolio fund that is more optimal than individual funds.

3.2 Equity Strategy

The equity investment strategy gains from changes in stock prices by holding stocks. The fund can hold stocks that are undervalued, stocks with high future growth, or stocks with advantages in a certain industry, buy stocks at relatively low prices, and sell them when prices are high to gain income. The returns of the equity strategy depend on the rise and fall of stock prices. Different stocks in the fund have different movements, which have a mutually constraining effect on the returns and volatility of the overall portfolio. The investment managers of the equity strategy generally have in-depth research and analysis skills on individual stocks, and select stocks and timing for buying and selling stocks through fundamental analysis, technical analysis, industry analysis, trend analysis and other analysis methods. At the same time, they have a strong ability to control stock risk. When stocks fall sharply or perform unsatisfactorily, they will reduce their positions or liquidate them, and only the best performing stocks will appear in the portfolio.

3.3 Alpha Strategy

Investors are exposed to both systematic risk (Beta risk) and unsystematic risk (Alpha risk) in the market. Alpha strategies achieve excess absolute returns by measuring and shifting systematic risk. This return does not vary with the systematic risk and exists outside the systematic risk. Alpha strategies are used in a wide range of applications, in the stock market, bond market, and commodity market. The returns achieved by the alpha strategy do not vary with the market fluctuations, obtaining a pure return independent of the market. Even when the overall market is declining, alpha strategies can achieve good positive returns. One of the world's largest hedge funds, Bridgewater Hedge Fund, is a user of the alpha strategy.

3.4 Quantitative Fund Strategies

Quantitative strategy is to find investment opportunities and targets through quantitative statistical analysis with the help of quantitative models. Quantitative investment in the investment decision-making process by human influence is very small, mainly through data analysis to reach conclusions, and thus relatively objective. The more famous quantitative funds in China, such as the Grand Prix Fund managed by James Simmons, have achieved excellent investment performance. There are also several quantitative funds in China with a management scale of more than 10 billion. The use of quantitative strategies is often accompanied by the application of computer programs, commonly used quantitative programming languages such as Python, C++, etc. Fund managers using quantitative strategies not only need to know financial knowledge and be familiar with various financial products such as stocks, but also need to have in-depth understanding and application ability of quantitative models and computer programs.

3.5 Macro Strategy

Macro strategy refers to the study of domestic and global macroeconomic conditions in order to judge the buying and selling behavior of stocks, futures, bonds and other investment products. It tries to use the basic principles of macroeconomics to identify the future trend and mispricing of various financial assets. Macro strategy is mainly based on subjective analysis and judgment. The Global Macro strategy (Global Macro) is one of the most popular hedge fund strategies, which is able to invest in various commodities on a global scale. Its strategy is very variable, sometimes long, sometimes short, and it can do both diversified investment and higher risk concentrated investment. In China, the macro strategy is still in its early stage, on the one hand, there are still relatively few domestic hedge fund companies using the strategy, and on the other hand, there are still relatively few varieties of macro strategy available for domestic investment.

3.6 Event-driven

Event-driven strategy is to arbitrage by analyzing the occurrence of major events with different impact on the underlying investment. Through the analysis of the probability of the occurrence of major events and the judgment of the impact on individual stocks, investors can choose to trade stocks or other financial products. These events include corporate spin-offs, mergers and acquisitions, asset restructuring, stock buybacks, etc. The price of a stock is inherently affected by various events, from macro events, to major industry events, to corporate related events, and so on. By analyzing and judging these events, fund managers can gain arbitrage opportunities. For

example, the successful development of a new product in a listed company may lead to future increases in share prices. The acquisition of an important business unit of another listed company may lead to a future decline in the share price.

3.7 Relative Value Strategy

Relative value strategies are strategies that take advantage of pricing errors between correlated assets to establish a position to hedge the return of a normalized price spread. Common relative value strategies include equity market neutral, index arbitrage, asset securitization product arbitrage, etc. Relative value strategies focus on the change in the value of the underlying asset and are less correlated with the market. Relative value strategies simultaneously design two highly correlated assets or the same asset in different markets, and when the price difference between these two assets is large enough, buy the lower-priced asset and sell the higher-priced asset, thus obtaining the price difference between them. The relative value strategy does not make market directional choices, so it does not fluctuate with the market and the risk can be effectively controlled.

3.8 Bond strategy

Bond investment strategies are divided into passive investment strategies and active investment strategies. Passive investment refers to holding a certain number of bonds in the portfolio for a long time without trading frequently to obtain high returns. Active investment strategy for bonds means that investors use investment in bonds to gain excess returns. On the one hand, it can borrow the effect of interest rates on bond prices to buy and sell bonds for a gain. On the other hand, it can look for mispriced bonds in the market and gain investment income. Since the subject of investment is a bond, its pricing and price fluctuations have their own characteristics. The price movements of bonds are often influenced by changes in interest rates and related events.

3.9 Futures Strategy

Futures strategy is a trading method to gain income by managing and trading futures. Futures are divided into commodity futures, stock index futures, etc. Futures are commonly referred to as buying a contract to buy and sell commodities in the future with money from the present. It is not investing in the present commodity, but in the future commodity. Since futures are generally traded on margin, they carry a large amount of leverage. Trading futures generally requires good risk control and management skills. If you do not manage risk well, you will be prone to a short position in futures.

3.10 Statistical Arbitrage Strategy

A statistical arbitrage strategy is the use of mathematical models to capture investment opportunities arising from transient market failures. It gains returns by winning more and losing less in a statistical sense and accumulating more. Statistical arbitrage is an ultra-short-term investment strategy that does not focus on the intrinsic value of an asset, but rather on the volatility and deviation of the asset price. Statistical arbitrage first originated from pair trading, in which securities were paired according to various characteristics, and then long one that was currently undervalued in the market and short one that was overvalued in the market, thus reducing risk and gaining return. Modern statistical arbitrage strategies cannot be separated from cutting-edge

statistical models and algorithms, including the selection of investment targets, the judgment of trading signals, the number of transactions, etc. are all the results of large-scale statistical calculations.

3.11 Fixed Income Strategy

Fixed income strategy is a kind of investment strategy to invest in listed companies to issue additional shares. A fixed issue is a non-public offering of shares by a listed company to a small number of qualified and specific investors. Investors in a fixed issue generally purchase shares at a discount to the market price and can sell their shares after a certain lock-up period. The investment strategy of the fixed issue strategy is already the shares of the listed company, which are free to move after the lock-up period. Therefore, the profit of the fixed income strategy mainly comes from two aspects: one is the discount below the stock market price when purchasing the fixed income shares. Rather, it is the possible future upside of the stock price.

4. Reasons for the Emergence of Multiple Hedge Fund Strategies

4.1 Loose Regulation

The regulators are loosely regulating hedge funds and are not as strict as public funds. As a result, various investment strategies and approaches are allowed. Many high-risk, highly leveraged investment methods are also more common in the hedge fund space. Hedge fund managers use a variety of investment techniques and thus a variety of investment strategies in order to generate higher performance. All of these are permitted by law. Because of the loose regulation, hedge funds can only be invested by qualified investors, usually very wealthy high net worth individuals and institutions.

4.2 Pursuit of high returns

Hedge funds are profit-seeking and seek absolute high returns on their investments. Hedge fund managers have developed a variety of investment strategies to make money in order to achieve such high returns. As long as the financial market gives such a possibility, hedge fund managers will try to obtain high returns from financial investments through various methods, thus also generating a variety of investment strategies.

4.3 Diversity of Financial Instruments

The financial markets have produced many financial instruments that have led to the easy implementation of many investment strategies. For example, the creation of financial derivatives such as forwards, futures, swaps, and options has facilitated the trading of hedge funds to better control risk and obtain returns. The trading of various financial instruments together with the existing investment in stocks and other assets has greatly enriched the variety of hedge fund investment strategies.

5. Characteristics of Hedge Fund Strategies

5.1 Complexity of Investment Strategies

The strategy of hedge fund investment is very complex. Complex quantitative models, complex financial instruments, complex trading strategies, these to require hedge funds need to be managed by fund managers with specialized skills. Hedge funds borrow various financial derivatives and design fancy investment strategies so as to gain excessive profits.

5.2 High Leverage of Investment Strategies

Hedge funds often use very high leverage to invest. Many hedge funds borrow at extremely high leverage, expanding their investment capital several times or even dozens of times from their original capital to achieve maximum returns. In contrast, the use of high leverage to invest in public funds is not allowed. This also greatly enhances the chances and risks for hedge funds to obtain high returns.

5.3 Diversity of Investment Strategies

Hedge funds have a wide variety of investment strategies, as long as they can achieve the purpose of obtaining returns and controlling risks. It is not necessary to stick to the rules, and fund managers can make full use of their abilities, resources and creativity to develop investment strategies. Hedge funds can borrow all financial derivative instruments to control risk and generate returns, and can also choose to buy and sell with the help of various studies on the changes in the prices of securities market products.

5.4 Invisibility of Investment Strategies

The investment strategy of a hedge fund is hidden, and the fund manager is not required to disclose the specific investment strategy to the investors. The hedge fund can use all available financial instruments and portfolios, make full use of borrowed funds, and obtain returns with its own manipulation. The covert nature of hedge funds can make hedge fund investments often unexpected and rewarding.

6. Future Trends of Hedge Fund Strategies

6.1 New Investment Strategies Will Emerge

In the future, more new hedge fund strategies will emerge in China. With the gradual improvement of China's financial market and the emergence of more financial derivatives, hedge fund managers can design more diverse and better investment strategies. For example, the development of computer technology has enabled various programming and algorithms to be incorporated into hedge fund strategies. The analysis of big data has also enabled hedge funds to dig deeper into the trends of asset price movements and research

6.2 The Research of Investment Strategies Will Become More In-Depth and Perfect

Since it has only been about 10 years since the emergence of China Private Equity Association, the history of hedge fund strategy research is not yet long. There will be more and more research on investment strategies in the future, and various investment strategies will be optimized and improved. Many hedge fund strategies that still have loopholes in the Chinese securities market will be gradually improved and more trading tools will be added to control and avoid risks.

6.3 More Talents and Resources Will Lean Towards The Hedge Fund Strategy Field.

It is common to see news on the internet about public fund managers moving to private equity funds. There will be more and more talents moving to the hedge fund industry in the future. More and more hedge funds are being established and hired to make more people understand and familiar with hedge funds, leading to more people interested in the industry to invest in it. The future is a good time for hedge funds to grow, and more talent will be able to invest in more flexible hedge fund management and strategy research execution without having to stick to the conservative rules of public funds.

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