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Most investors are familiar with mutual funds, which invest in various types of equities or bonds and generally make money when those markets go up. It's a straightforward, easily understandable approach based on the classic "buy low, sell high" investment formula.

In contrast, hedge funds look for opportunities to generate returns in many different ways, whether the financial markets are going up, down or sideways. They might sell one stock "short," anticipating it to fall in value, and go "long" on another stock. Other hedge fund managers seek to capitalize on small differences in foreign exchange rates, commodity values or other types of markets. But before putting a portion of your investment portfolio into hedge funds, you should understand how they work, as well as the varied strategies pursued by their managers.

Analysts often divide hedge funds into five different categories:

- Event-driven funds that focus on mergers, acquisitions, distressed securities, and bankruptcy situations
- Relative-value funds that look for opportunities to exploit small differences in buy-sell pricing, a strategy also called arbitrage
- Market-neutral funds that take offsetting long and short positions on certain stocks
- Long-short funds that vary the proportion of long and short stock positions over time
- Global macro funds that focus on price changes in stocks, bonds, currencies, commodities and their associated derivatives.

By moving quickly to take advantage of these types of opportunities, a skilled hedge fund manager can produce attractive returns for investors. On the other hand, not all hedge fund strategies pay off at any point in time. Over the past two decades these alternative investments have, on the whole, generated higher returns than the stock market with less volatility.

Therefore, one option that appeals to many investors is buying into a fund of hedge funds. This is a broader approach designed to reduce the risks inherent in pursuing just one strategy. So, if one fund underperforms there should be lessened impact on an investor's overall returns. Hedge funds are not an inherently risky asset class. The risk in hedge funds is the investment in one single hedge fund. That means an investor in a fund of hedge funds can have a more diversified, less volatile portfolio that can still produce appealing risk-adjusted returns.

In general, both individual hedge funds and funds of funds allow investors to diversify their holdings, and can provide a great deal of flexibility. Many types of funds produce returns that are not correlated with the stock and bond markets, reducing the overall risk and volatility of an individual's overall portfolio.

Of course, there are also some disadvantages associated with hedge funds. Investors need to do their homework and understand the strategies, goals and risks. Because of their complexity, these investments can be more difficult to analyze than stocks, bonds or mutual funds. As part of that research, investors should compare one fund with others that follow a similar strategy, as well as any benchmarks. An

“apples” to “oranges” comparison won’t tell you how well a particular hedge fund is doing compared to its peers.

Hedge funds also have higher management and performance fees than mutual funds, reflecting the more active role of fund managers. However, some analysts believe that hedge funds attract the most talented managers in the financial field. That means they could obtain potentially higher returns, more than offsetting their higher fees.

Nevertheless, hedge funds can be an important component of many portfolios, perhaps accounting for 5 to 15 percent of total assets. With their potential for generating above average returns (sometimes called “alpha”) while reducing overall portfolio volatility (sometimes called “beta”), hedge funds are worth a close look in 2012.

Note to FA and branch;

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