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 a qualified investor's investment portfolio into hedge funds, you should understand how they work, as well as the varied strategies pursued by their managers. A qualified investor is typically a person that is considered an accredited investor (a net worth of at least $1 million or an annual income above $200,000) or a qualified purchaser (a net worth of at least $5 million).

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 may have the ability to produce attractive returns for investors. On the other hand, not all hedge fund strategies pay off at any point in time.

Therefore, one option that appeals to some qualified 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 may be less of an impact on a qualified investor's overall returns. Qualified investors in a fund of hedge funds may have a more diversified, and potentially less volatile portfolio than a similar qualified investor in a single manager hedge fund.

In general, both single manager hedge funds and funds of hedge funds allow investors to diversify their holdings, and may provide a great deal of flexibility. Typically hedge funds produce returns that are not correlated with the stock and bond markets.

Of course, there are also some disadvantages associated with hedge funds. Qualified investors need to do their homework and understand the strategies, goals, and risks as hedge funds can be highly illiquid, speculative, subject to risks, including the loss of principal, and are not suitable for all investors. Because of their complexity, these investments can be more difficult to analyze than stocks, bonds or mutual funds. As part of that research, qualified 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.

Nevertheless, hedge funds can be an important component of many qualified investors' portfolios. With their potential for generating above average returns (sometimes called "alpha") while reducing overall portfolio volatility, hedge funds are worth a close look in 2012 for qualified investors.

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