# The Morningstar Category™ Classifications for Hedge Funds

Morningstar Methodology Paper

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# Introduction

The Morningstar Category™ classifications for Hedge Funds were introduced in 2005 and revised in 2007 to help investors understand the different types of investment strategies used by hedge funds around the world. Hedge fund managers typically focus on specific areas of the market and/or specific trading strategies. For example, some hedge funds buy stocks based on broad economic trends, while others search for arbitrage profits by pairing long and short positions in related securities. The Morningstar categories divide the universe of hedge funds based on these different approaches.

Morningstar supports 17 hedge fund categories, which map into five broad category groupings (Equity, Arbitrage, Global, Event, and Multi-Strategy). These categories and category groupings can help investors make meaningful comparisons between hedge funds. Investors can use these peer groups to identify top-performing funds, evaluate a fund's performance against its peers, and find similar funds. For example, if an investor wanted to evaluate how well a fixed-income arbitrage fund performed, they could compare its performance to that of the fixed-income arbitrage category and the broad arbitrage category grouping.

Morningstar assigns a category to each hedge fund based on a review of the hedge fund's memorandum document, manager-provided investment strategy descriptions and supporting data, conversations with portfolio managers, cluster analysis, and portfolio statistics acquired via surveys. Currently, Morningstar does not have access to portfolio holdings for hedge funds and must instead rely on other information provided by the asset managers.
We regularly review the category structure and the hedge funds within each category to ensure that the system meets the needs of investors. The driving principles behind the classification system are as follows:

- Individual funds within a category use similar strategies and techniques to create value.
- Individual funds within a category can, in general, be expected to behave more similarly to one another than to funds outside the category.
- Categories have enough constituents to form the basis for reasonable peer group comparisons. (Small categories are permitted when a subset of funds is substantially different than other categories.)
- The distinctions between categories are meaningful to investors and assist in their pursuit of investing goals.

# Equity

Funds in the equity category grouping primarily invest in stocks and may take long or short positions. Managers may also use options to lever their position or to hedge. Hedge funds with more varied degrees of short positions are more likely to have different risk parameters, beta exposures, and return streams than traditional long-only funds or indexes. Most managers assemble portfolios via fundamental equity research, although some managers may use top-down strategies.   These funds will usually have either net long or net short market exposure to equities, unlike arbitrage funds, which tend to balance out long and short equity market exposures.

**Equity, US**

These funds primarily take long and short positions in U.S. equities. These funds follow a strategy consisting of equity investments with at least 60% of the fund's assets are invested in US, Canada, and Developed Americas (UCDA) equities. However, the fund may also include some derivative instruments.  These funds tend to have betas of 0.4 and higher relative to broad US market indices like the S&P 500 and DJ Wilshire 5000.

**Small-Cap Equity, US**

These funds primarily take long and short positions in U.S. small-cap equities. These funds follow a strategy consisting of equity investments, but may also include some derivative instruments. Portfolios should have at least 40% net exposure to small-capitalization US, Canada, and Developed Americas equities and the fund should not maintain a regular exposure to larger capitalization US, Canada and Developed Americas equities.  The fund maintains at least a 40% net exposure to small-capitalization US equities, and does not maintain a regular exposure to large-capitalization US equities. These funds tend to have betas of 0.4 and higher relative to small-cap US market indices like the Russell 2000.

**Equity, Developed Asia**

These funds primarily take long and short positions in Asian equities.  At least 60% of the fund's assets are invested in Developed Greater Asia equities.  These funds follow a strategy consisting of equity investments, but may also include some derivative instruments.

# Equity (continued)

**Equity, Europe**
These funds primarily take long and short positions in European equities. At least 60% of the fund's assets are invested in Developed Greater Europe equities. These funds follow a strategy consisting of equity investments, but may also include some derivative instruments.

**Equity, Emerging**
These funds take long and short positions in emerging-market equities.  Emerging markets are defined as South and Central America, Mexico, Asia ex-Japan and Hong King, Middle East, Africa, and Eastern Europe.  At least 60% of the fund's assets are invested in equities from these regions. These funds follow a strategy consisting of equity investments, but may also include some derivative instruments. Funds should invest a majority of their net assets in emerging markets over other regions.

**Equity, Global**
These funds primarily take long and short positions in equity securities, but do not fit into any of the other regional categories because they do not have a primary regional focus.  At least 60% of the fund's assets are invested in equities.

**Equity, Short**
These funds dedicate a majority of the fund's assets to equities. Most of the portfolio is dedicated to short stock positions, in an attempt to take advantage of anticipated market or stock declines producing a net exposure to equities of less than or equal to negative 20%. Some managers invest the proceeds from their short positions in low-risk assets, while others dedicate a portion to long stock positions in order to hedge against broad market rallies. In the event of a broad market rally, these funds will lose money on their short positions but will experience a gain on their long positions. Short positions typically account for 60% to85% of fund assets, although some managers may be 100% short.

# Arbitrage

Funds in the arbitrage category grouping study the pricing relationship between pairs of related securities. Managers take a long position in the security that appears to be under-priced and a short position in the security that appears to be over-priced. The manager will hold the positions until the pricing discrepancy disappears. These strategies are usually market neutral. Because markets are generally efficient, pricing discrepancies are typically very small and short-lived. Therefore, these funds tend to be highly leveraged, using borrowed money to increase the size of possible gains.

**Arbitrage, Convertible**
These funds study the relationship between a company's stock and its convertible bonds. Convertible bonds contain an option that allows the bondholder to trade in the bond for common stock at a certain price and under certain conditions. Usually, the bond trades for less than the stock so managers buy the bond and short the stock. These funds craft strategies to manage their exposure to interest rate risk, default risk, and illiquidity in the convertible bond market, and pricing volatility in both the stock and bond markets. Because the pricing discrepancies are usually very small, many of these funds employ leverage to maximize return.

**Arbitrage, Equity**
These funds invest in offsetting long and short positions in equity securities. The profit from one position will offset the loss in the matching position, therefore protecting the fund from large market swings and providing absolute returns. These funds attempt to eliminate systematic risk by either taking a beta neutral, dollar neutral or sector neutral position. These funds tend to have low beta exposures ($<$ 0.4 in absolute value) to equity market indices like the S&P 500 or EAFE World. This is in contrast to other equity categories, which have higher have net market exposures.

**Arbitrage, Debt**
These funds seek out pricing discrepancies between various private and public fixed income instruments, usually looking for global opportunities. Portfolio managers in this strategy primarily invest in fixed-income derivative instruments. These funds tend to have low beta exposures ($<$ 0.4 in absolute value) to bond market indices like the Lehman Aggregate Bond index. This is in contrast to other debt categories, which have higher net market exposures.

# Event

Funds in the broad event category grouping attempt to profit when stock or bond prices change in response to certain corporate actions, such as bankruptcy, mergers, or acquisitions. Managers will typically use short positions or derivatives to hedge their market exposure. These positions help the fund capture the price change related to the event itself and insulate the fund from broad market changes.

**Event, Corporate Actions**
These funds attempt to profit from price changes related to a variety of corporate actions, including bankruptcy, emergence from bankruptcy, mergers, acquisitions, divestitures, stock buybacks, dividend issuance, major shifts in corporate strategy, and other atypical events. Most strategies involve purchasing or shorting elements of a company's capital structure and could involve senior debt, junior debt, convertible bonds, preferred stock, or common stock.

**Event, Distressed**
These funds specialize in financially troubled companies that may face bankruptcies, distressed sales, corporate restructurings, or financial reorganizations. A fund might take long positions only in the company stock or debt, or it might exploit pricing discrepancies between different parts of the company's capital structure, e.g. buying senior debt and shorting preferred stock. The hedge fund may try to accumulate a controlling stake in the company in order to influence the outcome. During bankruptcy proceedings, debt holders often exchange their debt for an equity stake in the post-bankrupt entity.

# Debt

Funds in the debt category grouping study broad-based changes and prices in fixed-income products. In many cases, then manager will select various fixed-income products such as high - yield or emerging market debt to provide a fixed investment stream. Many funds may apply a small amount of hedging to the portfolio, but do not use short positions as investment techniques. Many debt funds leverage their returns to provide larger returns. Unlike Debt Arbitrage funds, these types of funds tend to have a net long market exposure.

**Global, Debt**
These funds primarily take long positions in global debt. The majority of the funds' assets are invested in debt investments, but the fund manager may also include other instruments. These funds may invest in emerging market, US, or global debt issuance.

# Global

Funds in the global category group class study broad-based changes and prices in global markets. Often, these funds make tactical decisions about an optimal global asset allocation mix, and they use equities, bonds, currencies, derivatives, and commodities in their portfolios. Many managers look for emerging trends in countries, industries, and geopolitical institutions. Some managers will also attempt to profit from general market volatility during times of uncertainty.

**Global, Trend**
These funds trade liquid global futures, options, and foreign exchange contracts largely according to trend-following strategies (i.e. greater than 50% of fund assets are allocated to such strategies). These strategies are price driven (technical), rather than fundamental, and systematic (automated) rather than discretionary. Trend-followers typically trade in diversified global markets, including commodity, currencies, government bonds, interest rates, and equity indexes. However, some trend followers may concentrate in certain markets such as currencies. These strategies prosper when markets demonstrate sustained directional trend, either bullish or bearish.

**Global, Non-Trend**
These funds fall into two camps. The first includes funds that trade global futures, options, and foreign exchange contracts largely according to technical, systematic, *non-trend* following strategies. Counter-trend is an example of such a strategy. The second group encompasses funds with primarily fundamental, macro-view strategies. They look for investment opportunities by studying the global economy, government policies, interest rates, inflation, and market trends. As opportunists, these funds are not restricted by asset class and chose among the most attractive ones, including global equities, bonds, currencies, derivatives, and commodities. For example, a fund manager might decide that European stocks look overvalued while Asian debt looks undervalued.



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# Multi-Strategy

The multi-strategy broad asset class contains the hedge funds that merge multiple techniques into one single fund.

**Multi-Strategy**
These funds offer investors exposure to several different hedge fund investment tactics. In most of these cases, all of the assets are managed in-house at the hedge fund, but the assets may be divided between multiple portfolio managers, each of whom focuses on a different strategy. This is not to be confused with a Fund of Funds, which uses external portfolio manager and strategies. An investor's exposure to different tactics may change slightly over time in response to market movements.

**Fund of Funds**
These funds offer investors exposure to several different hedge fund investment tactics. In most of these cases, the fund-of-funds manager selects outside hedge funds as part of a multi-manager portfolio allocation process. Each external hedge fund selected by the fund-of-fund manager may focus on a different strategy. An investor's exposure to different tactics may change slightly over time in response to market movements.