What is a hedge fund?

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When financial crises hit and billions are lost, hedge funds are often somewhere in the story — sometimes as the villain, sometimes as the only entity smart enough to have seen it coming. So what actually are they?

A fund that hedges its bets

A hedge fund is a pooled investment vehicle — a collection of money from wealthy investors, managed by professionals who try to generate returns regardless of what the overall market is doing. The word "hedge" refers to the original idea: using clever strategies to reduce risk and profit in both rising and falling markets.

In practice, modern hedge funds often take enormous risks rather than reducing them. The name has outlasted the original concept.

🎲 Imagine a very sophisticated gambler at a casino who doesn't just bet on red or black. They bet on red, but also take out a side bet that pays out if the ball lands on black. They study patterns, bet on multiple outcomes simultaneously, and use borrowed money to amplify their winnings. They can profit even when most gamblers are losing — but when their strategy goes wrong, the losses can be spectacular. That's roughly the hedge fund model.

What makes them different from normal funds?

Several things. First, they're only open to wealthy or institutional investors — in the UK you generally need to be investing hundreds of thousands of pounds minimum. Second, they charge much higher fees — typically "2 and 20" (2% of assets per year plus 20% of any profits). Third, they can use strategies that normal investment funds can't, including **short selling** (betting that a stock will fall), heavy use of **leverage** (borrowing money to amplify bets), and derivatives (complex financial contracts).

Short selling — the controversial one

Short selling deserves its own mention because people find it particularly confusing and infuriating. When a hedge fund "shorts" a company, they're essentially borrowing

shares, selling them immediately, waiting for the price to fall, buying them back cheaper, and pocketing the difference. They profit when companies fail. This is legal and actually serves a function — it keeps overhyped companies in check — but it enrages people when funds short companies that then go bust, putting workers out of jobs.

Can they crash the economy?

They can certainly make things worse. Because hedge funds use borrowed money to amplify their bets, when things go wrong they can go very wrong very quickly — and a large fund unwinding its positions can move entire markets. The collapse of Long-Term Capital Management in 1998 was a close call; the Federal Reserve had to organise a bailout to prevent a wider financial meltdown. They're powerful, largely secretive, and only lightly regulated — which is why they remain controversial.

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