# The Role of Hedge Funds in China's Economic Development

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**Abstract.** A striking characteristic of this sector is that it is more flexible than common funds and other types of investment instruments. Hedge funds are subject to lower levels of supervision compared to those of mutual funds or other investment vehicles. Each hedge fund is structured so that it can exploit certain identified market opportunities. Hedge funds employ a variety of investing strategies. Therefore, it is usually classified according to investment style, and there is a big difference between style attributes and venture capital. This paper aims to elaborate the background, purpose and importance of the research through a comprehensive discussion of the definition, operation mode, core characteristics and advantages and disadvantages of hedge funds, and on this basis, extract conclusions and put forward future prospects. Through this research, this paper further understands a series of knowledge such as financial industry, capital investment and hedge fund, analyzes the advantages and disadvantages of hedge fund investment, and completes the research of this subject.

**Keywords:** Fund, Hedge Fund, China, Global, Economy.

## 1 Introduction

Hedge fund refers to the use of hedge trading means of funds, also known as hedge funds or hedge funds. It is a kind of finance fund that is created by the combination of finance futures, finance options, and other financial institutions. Hedge fund is a kind of model profit finance fund, and it can decrease the risk by means of hedge transaction. It is a kind of private equity fund and a form of investment fund. Because of the outstanding performance of hedge funds in the crisis, after the 2008 financial crisis, the Chinese government implemented an active and relatively loose monetary policy, and the scale of hedge funds expanded rapidly after the financial crisis [1].

The formula concept is the most advanced investment theory + the most flexible investment strategy + the boldest investment leverage + the best managers = hedge funds. The high yield and high risk of hedge fund is one of its major characteristics, which makes it subject to different evaluation and choice of investors from different fields, including some financial giants. There are many international cases about the success and failure of hedge funds [2,3].


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Among them, the application field has an important impact on the return effect of hedge funds. The risk and return of hedge funds in different fields are different, and the application in unsuitable fields may lead to investment failure and investor bankruptcy due to excessive risk or other objective factors affecting the risk. As a result, the market is divided on the advantages and disadvantages of hedge funds, and the mystery and increasing influence brought by their unconventional strategies and less public information have made investors increasingly need to know their information.

An investment fund, also called a mutual fund or a trust, is an organization. That raise capital by selling shares of funds to the public and then invest in Securities. The investment fund is managed by the fund manager and managed by The fund custodian, and carries out securities investment activities in the form Of asset portfolio to serve the interests of the fund shareholders [4,5]. Hedge fund This refers to the use of hedge trading means of funds, also known as hedge funds or hedge funds. It refers to a financial fund for profit after financial Derivatives such as financial futures and financial options are combined with financial institutions. This paper hopes that investors can have a basic understanding of hedge funds and better consider the choice of hedge funds when choosing fund investment.

## 2 Characteristics of Hedge Funds

Because of its high risk and high yield, it is characterized by its highly lever, complex, private-funded way, covert and flexible. The term "Hedge Funds" has been coined as a kind of new investment mode, which takes advantage of the lever function of finance and has the guts to take large risks for the purpose of obtaining a good yield. Hedge funds have four major features: complex, high-lever, privately invested and invisible.

First, for complexity. Along with the complexity and innovation of all kinds of finance derivatives, including futures, options, swaps and so on, it has been a major operational instrument for hedge funds. Although they are mainly used as collateral, they are cheap, risky and highly profitable. They have been used as a kind of investment instrument in the field of investment. Hedge funds combine them with sophisticated portfolio designs, which allow them to invest on the basis of market predictions, gain super-profits if they are correct, or to develop an investment strategy that exploits imbalances created by short term swings in the period, and then captures the gap as soon as the market recovers.

Secondly, it is highly leveraged. There are two major types of leverage employed by hedge funds: lending to create leverage, as well as investment in financial products that are linked to leverage. Under the first scenario, hedge funds are able to increase their initial capital by leveraging loans to maximise their profits. Hedge funds have a high level of liquidity in their securities, which makes it easier for them to borrow. A hedge fund, for instance, has $200m worth of equity collateral that can be used to re-collateralise its equity and loan it out to finance its business. Lever effect refers to the fact that the net profit of the company after lending is far greater than that of only the initial funds. High leverage is a double edged sword, which may produce excessive profits or put hedge funds at risk of excessive losses [6].

Thirdly, private placement. The organization structure of hedge funds is usually partnership. If fund investors contribute majority of equity but no participation in the investment of the fund with equity and expertise and take charge of the due to the need for secrecy and flexible management, the United States' mutual fund partners typically have fewer than 100 employees, with each partner contributing over US $1m (depending on the rules applicable to hedge funds). Japan's hedge funds, for instance, have a membership limit of under 50.) Since most of them are privately owned, they evade the stringent U. S. rules on disclosure of public money. Because of the highly risky and complicated investing system, the West has banned its publicly recruiting capital for the purpose of safeguarding the benefit of common investors. In order to evade U. S. taxation and SEC rules, hedge funds in the U. S. market typically integrate offshore assets in low taxation, loose rules such as the Bahamas or Bermuda, and are restricted to borrowing from foreign investors.

Fourth, hiding. Compared with other common investors, there is a great gap in the level of investors, the way to raise money, the need to disclose the information, and the supervising. Moreover, there is a lot of diversity in the equity and flexibility of investment.

In general, there is a more explicit definition of the portfolio of assets. For example, the equilibrium fund means the shares and bonds of the fund, and the growth fund is an investment that concentrates on the high-potential shares. Meanwhile, the mutual funds cannot invest with the loan capital, whereas the hedge funds do not restrict or define them. Because of its high secrecy and flexibility and its leverage, this paper thinks it will have a significant impact on Chinese fund sector, and it remains in the world.

# 3 The Particularity of Hedge Funds

Hedge funds' returns differ from those of traditional assets. The traditional investment strategy is to make use of the difference obtained by the rise of securities to obtain income, while hedge funds comprehensively use a variety of investment strategies, make full use of a variety of financial instruments, hedge long and short risks, and use leverage effect to obtain income. Hedge funds can carry out multiple types of digital crypto asset trading 24/7, and the investment is distributed in multiple trading platforms, which can increase timely arbitrage opportunities, thus providing investors with more stable returns [7].

Hedge funds have two particularities as follows. First, in terms of the organization of funds, the number of fund investors is small, and the fund is mainly issued in the way of private placement, so most hedge funds belong to private placement funds. Second, in terms of investment, more use of financing, and invest in options, such as financial derivatives. On the one hand, under the same market environment, the returns of hedge funds may be significantly different from those of general mutual funds. On the other hand, while the amplification of financing and financial derivatives improves the expected return, it may also increase the investment risk if used improperly.

For the purpose of more accurate classification, Shenzhen Zhongjin Alpha Investment Research Co., Ltd based on the international famous hedge funds classification criteria, analyzes the present status and tendency of the industry in China. The form of "Strategic Classification of Hedge Funds Index and Evaluation System".

The Hedge Fund Index & Rating System consists of 4 types, which are classified as strategic type, issue channel type, type of investment type and implement approach. Based on its investment strategy, this paper analyzes the status quo of IFF and classifies it into 3 kinds of tactics, i. e., orientation, value and event. These 3 kinds of policies are classified into the first category and the secondary one.

Therefore, enterprises affected by hedge funds can not only optimize the allocation of corporate resources, but also effectively allocate human capital in the whole industry, which can encourage the whole industry to actively innovate.

## 4 Analysis of Pros and Cons of Hedge Fund Investment

### 4.1 Hedge Fund Interests

Hedge funds can avoid and resolve investment risks to a certain extent by using financial derivatives such as futures and options. Different asset classes have different volatility and yields in different market conditions, and hedge funds can reduce the risk of their overall portfolio by diversifying their investments.

Resist market volatility. Hedge funds use a variety of strategies to deal with different situations in the market cycle, with relatively low historical retracements and relatively stable returns. Hedge funds are well protected against risk in a down market environment and perform well in an up market environment.

### 4.2 Disadvantages of Hedge Fund

Exposure to market risk: Hedge funds operate across a variety of asset classes and markets, such as stocks, bonds, futures, foreign exchange, etc. Market volatility may lead to changes in the value of the fund's assets, resulting in risks.

Highly leveraged risk: Hedge funds often use leverage financing to increase the size of their investments, which magnifies the returns of the fund, but also magnifies the risks. In the event of adverse market movements, the fund may face greater losses.

Liquidity risk: Some hedge fund investment strategies may involve assets that are difficult to liquidate, which may result in timely redemption when cash is needed [8]. The complex investment strategies and instruments used by hedge funds require a high degree of market judgment and investment experience. If the fund manager's judgment error or improper operation, may lead to investment losses. Credit risk: A hedge fund may invest in risky bonds or other fixed income products and may face losses if the debtor defaults.

# 5 Global Hedge Fund Market Development Status

The global hedge fund industry has undergone significant evolution since its inception in 1949 when Alfred Winslow Jones pioneered the first modern hedge fund. As sophisticated investment vehicles utilizing derivatives, leverage, and alternative strategies, hedge funds have mirrored broader market dynamics, enduring cyclical booms and crises. The late 1990s to early 2000s marked a turbulent era, characterized by high-profile collapses such as Long-Term Capital Management's (LTCM) 1998 implosion—a $4.6 billion bailout orchestrated by the Federal Reserve—and the dot-com bubble's burst in 2000–2002. These events sparked widespread skepticism about the sector's sustainability. Yet hedge funds demonstrated remarkable resilience, adapting through enhanced risk protocols, diversified strategies, and opportunistic plays in volatile markets, ultimately emerging stronger.

By 2023, the industry has reached unprecedented scale, with global hedge fund assets under management (AUM) hitting $4.6 trillion, per Hedge Fund Research (HFR). When accounting for leveraged positions and affiliated alternative vehicles like private equity co-investments, this figure expands to $36 trillion. This growth is particularly striking given recent market upheavals. The COVID-19 pandemic year of 2020 proved pivotal: Hedge funds delivered their strongest performance in a decade, with the HFRI Fund Weighted Composite Index surging 11.6%—its highest annual gain since 2009. Over 60% of funds achieved double-digit returns, eclipsing traditional benchmarks; the S&P 500, for instance, returned 9.5% including dividends. Modern hedge funds now operate as multifaceted financial ecosystems. Artificial intelligence underpins quantitative models, enabling real-time analysis of vast datasets, while ESG (environmental, social, governance) mandates shape nearly 30% of allocations, per Morningstar. Cryptocurrency exposure has also surged, with 15% of funds now holding digital assets, according to PwC. Geographically, North America dominates (65% of AUM), but Asia-Pacific hubs like Singapore and Shanghai are gaining traction, driven by tech-focused quant funds and family office demand.

Despite regulatory pressures and margin compression, hedge funds remain vital for portfolio diversification. Their ability to generate alpha in both bullish and bearish markets—such as 2022's rate-hike environment, where the HFRI Index outperformed equities by 14%—underscores their strategic value. As geopolitical risks, climate transition, and AI disruption redefine markets, the industry's $4.6 trillion core (and $36 trillion extended footprint) positions it as a linchpin of global finance [9,10].

# 6 Conclusion

In summary, the advantages of hedge funds are also very many. The investment objects of hedge funds are very similar to the main investment objects of traditional funds, that is, investment choices need to be made through comprehensive evaluation of the investment objects, and investment products with positive development potential will also be selected. While investing in the main investment objects, hedge investment objects will be selected.

But hedge funds also have certain disadvantages. As people all know, returns and risks are proportional, if investors want high returns, then they must be prepared to bear high risks; Accordingly, hedge funds are a way of investing with excess returns, so there is more risk involved.

Establish a unified monitoring system to prevent systemic risks. Correct understanding of hedge funds and mandatory information disclosure. Maintain strict regulatory models for hedge funds. Carry out innovation of financial products with controllable risks and effectiveness. Establish long-term investment and value investment concept.

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