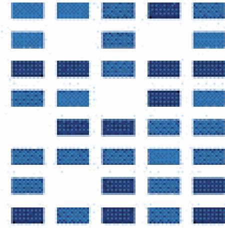

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# OVERVIEW OF HEDGE FUND CATEGORIES

## HOW DO THEY GENERATE PERFORMANCE

**By Thomas Ian Alessie, Partner & Co-Founder**

**November 2004**

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# AGENDA

- **HEDGE FUND STRATEGIES REVIEW**
  - **Definitions**
  - **Statistics**
- **PERFORMANCE GENERATION**
  - **Hedge Funds Sources of Return**
  - **Event Driven – Risk Arbitrage Example**
  - **Relative Value – Convertible Arbitrage Example**
- **PERFORMANCE GENERATION TODAY**
  - **What are the Real Issues?**
  - **Which Models Work?**

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# HEDGE FUND DEFINITIONS

## Hedge Fund Definition

"Hedge funds are private partnerships wherein the manager or general partner has a significant personal stake in the fund and is free to operate in a variety of markets and to utilize investments and strategies with variable long/short exposures and degrees of leverage."

From Crerend William J. (1995) "Institutional investing in hedge funds."

## Hedge Fund Characteristics

- Hedge Fund Managers are exposed to little regulation and have high levels of flexibility
- Hedge Fund Managers perform better in niche, unsaturated and inefficient markets
- Hedge Fund Managers perform better when Entry Barriers to the strategy are high
- Hedge Funds perform better when their size in terms of Assets is in line with the opportunities they are faced with in a given strategy
- Hedge Fund Managers perform better when the actors in a given market are well diversified and have different objectives

# HEDGE FUND DEFINITIONS

| STRATEGY NAMES | BROAD DEFINITIONS |
|---|---|
| R.V. – Convertible Arbitrage | Convertible arbitrage attempts to profit from the mispricing of convertible securities and/or expected trends in factors influencing convertible securities |
| R.V. – Fixed Income Arbitrage | Seeks to exploit price differences within and across global fixed income markets and their derivatives, using leverage to enhance returns |
| R.V. – Equity Market Neutral | This investment strategy seeks to exploit equity market inefficiencies and usually involves being both long and short matched equity portfolios of the same size |
| E.D. – Risk Arbitrage | Focuses on corporations involved in special situations or significant restructuring events: Mergers & Acquisitions, and reorganizations |
| E.D. – Distressed Securities | Investing in the debt or equity of companies that experience distress and exploiting opportunities that arise in their mispricing |
| Long/Short Equity | This strategy combines taking long as well as short equity positions. Alpha can come from the long as well as the short side. Often a long bias |
| Short Selling | Focuses on short selling activities. Not often used as a unique strategy because of the risks taken by focusing on one side of the market |
| Global Macro | Opportunistic on a global basis applying a top down approach, motivated by a conviction of economic developments. |
| Emerging Markets | Opportunistic approach focusing essentially on Emerging Markets. Very often a Long Bias |
| CTA – Commodity Trading Advisors | Systematic or discretionary trading of global futures, Foreign Exchange, Equity Indices, and Interest Rate markets. |

R.V.: Relative Value
E.D.: Event Driven

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# HEDGE FUND DEFINITIONS

| STRATEGY NAMES | POSITIVE ENVIRONMENTS | NEGATIVE ENVIRONMENTS |
|---|---|---|
| R.V. – Convertible Arbitrage | Credit Improvement – High Volatility | Fraud Scandals – Low Volatility |
| R.V. – Fixed Income Arbitrage | Low Volatility – Pricing Inefficiencies | Credit Risk – Flattening Yield Curve |
| R.V. – Equity Market Neutral | Pricing Inefficiencies | Too Many players on same deals |
| E.D. – Risk Arbitrage | Deal Flow – Recovering Economy | Non Completion of M&A Deals |
| E.D. – Distressed Securities | Economic Growth - Low Interest Rates | Bear Markets |
| Long/Short Equity | Fundamentally Driven flat or bull Mkts | Volatile Bear Markets |
| Short Selling | Volatile Bear Markets | Bull Markets |
| Global Macro | Global Trends – Inefficient Markets | Stressed Markets |
| Emerging Markets | Long Term EM Growth Trend | Emerging Markets Drawdowns |
| CTA – Commodity Trading Advisors | Global Trends – Inefficient Markets | Trend Reversals – Trendless Markets |

R.V.: Relative Value
E.D.: Event Driven

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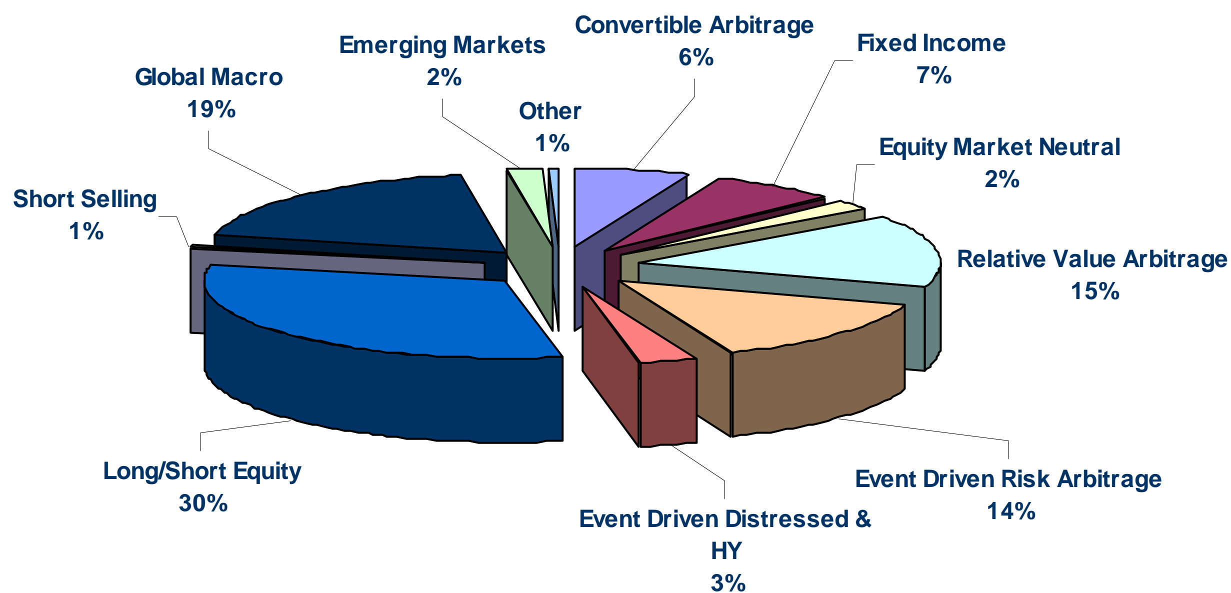
## Strategy Breakdown by Assets under Management

- Estimated AUM of Hedge Fund Universe: $ 800 billion (without leverage)
- From 1990 to 2003: 4x more Hedge Funds & 20x more AUM
- Hedge Funds AUM still only represent 1% of world Equity and Bond Capitalisation




Sources: Hedge Fund Research, Inc Data as at Q403 & Van Hedge Fund Advisors

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# HEDGE FUNDS SOURCES OF RETURN

## Structural Advantages

- Lack of Regulations
- Limited constraints (small organizations, liquidity, effective risk taking)
- Incentives (performance fee, managers co-investment)
- Migration of investment talent to the Alternative Investments

## Exploiting Market Inefficiencies

- Better models and market expertise
- Low cost trading and better risk systems
- Focusing on niche Markets

## Deal Techniques

- Combining trades to isolate a Spread
- Long and Short transactions
- Using Derivatives and eventually Leverage

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## Definition

Risk arbitrage managers invest in securities of companies that are undergoing any kind of corporate restructuring including mergers, acquisitions, liquidations, and spin-offs.

## Good or Bad News for Risk Arbitrageurs

- ↑ Restructuring and consolidation activity
- ↑ New deal announcements
- ↑ Successful deal completion
- ↑ Competitive bids
- ↓ Deal cancellation
- ↓ Low deal spreads due to increasing demand
- ↓ Major catastrophic events such as 9/11

## Basic Risk Arbitrage Position

- **Long:** Target Company's Stock
- **Short:** Acquiring Company's Stock

Source: Fundana Case Studies

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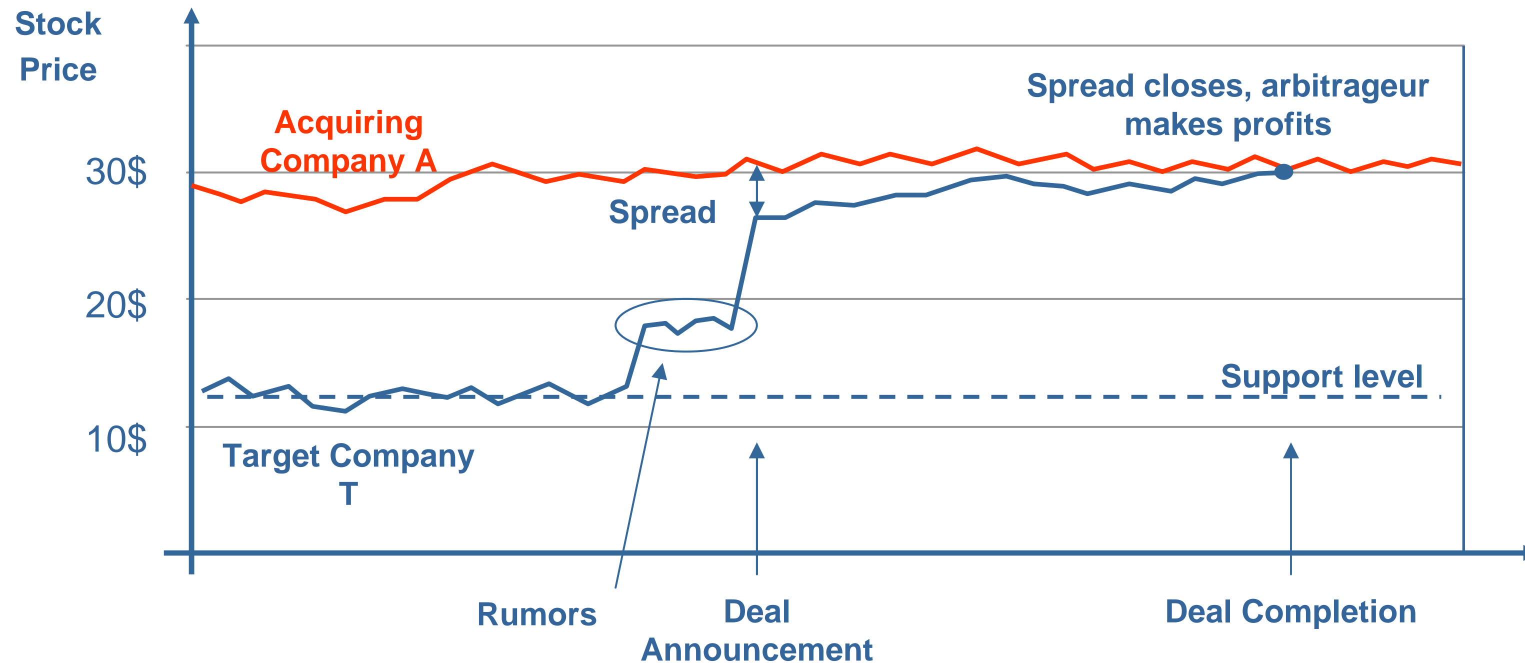
## Example of Deal Competion




## Sources of Return and Risk

- **Return:** The Spread, Difference between bid price stock A & share price of stock T
- **Risk:** Possibility of Deals being cancelled

Source: Fundana Case Studies

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## Evolutions in the Strategy over the Past Years

- Initially standard Risk Arb Position: Long the Target Company & Short Acquirer
- Decreasing Spreads due to increasing number of actors: Introduction of new techniques
- Example 1: Playing the opposite Spread (Chinese Deals): Short the Target and Long the Acquirer
- Example 2: Playing the spread between the Target Company and a basket of companies belonging to the same sector once the deal has taken place

## Reasons

- Too Many Managers in the Industry working on the same trades
- Low Entry Barriers
- Little M&A Deal Flow

Source: Fundana Case Studies

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# RELATIVE VALUE – CONVERTIBLE ARBITRAGE

## Definition

Convertible Arbitrage consists in identifying pricing disparities between convertible bonds and the underlying stocks.

## Convertible Bonds

- Convertible Bonds are hybrid instruments with both bond and equity characteristics
- Convertible price fluctuations will depend on both bond and equity fluctuations
- Convertible Arbitrageurs initially generated profit because of the difficulties in combining a classic fundamental stock analysis with a credit risk analysis.

Source: Fundana Case Studies

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## Good or Bad News for Convertible Arbitrageurs

- ↑ Large Number of cheap/bargain Convertible Issues available
- ↑ Increasing Volatility which helps the option side of the convertibles
- ↑ High Volatility makes Gamma Trading more profitable
- ↑ Large number of Convertible Issues (positive for Medium and Long Term)
- ↑ High Interest Rates

- ↓ Unexpected Credit Default cases (e.g. Enron)
- ↓ Big Swings in Interest Rates
- ↓ Widening of the Credit Spreads
- ↓ Too Many Issues (negative for Short Term)
- ↓ Lack or Decrease of Volatility

Source: Fundana Case Studies

# RELATIVE VALUE – CONVERTIBLE ARBITRAGE

## Sources of Return

- Long Position in Convertible generates Coupon payments
- Short Position in Equity generates cash on which the Manager receives interest payments
- Profit from capturing market inefficiencies between convertible and underlying
- Profit generated from Gamma Trading

## Sources of Risk

- Market Risk: Optionality of the conversion exposes the arbitrager to Market Risk
- Interest Rate Risk: Price of the Convertible exposed to Interest rate levels
- Credit Risk: Long position in Convertible exposes Manager to Credit Risk
- Other Risks: Liquidity, Leverage, Dividend risk, Call Risk

## Basic Convertible Arbitrage Position

- Long: Convertible Bond
- Market Risk Hedge: Short Underlying Stock
- Credit Risk Hedge: Buy Put and/or Credit Default Swap
- Interest Rate Risk Hedge: Interest Rate Swap or Sell Treasuries

Source: Fundana Case Studies

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# RELATIVE VALUE – CONVERTIBLE ARBITRAGE

## Evolutions in the Strategy over the Past Years

- Initially standard Convertible Arbitrage Position: Long the Convertible & Short the Stock
- Managers have been concentrating more on Gamma Trading to generate higher returns
- Others concentrate on their Credit Risk Fundamental analysis. Thus accepting larger unhedged Credit Risk exposure
- Others decrease their Credit and Market Risk Hedges in order to generate more returns based on their Macro convictions

## Reasons

- Too many Managers in the Industry focusing on the same trades
- 70% of the Convertible business is taken by Hedge Funds
- Lack of Market Depth (everybody has same objectives)
- Low Barriers to Entry
- Low level of Interest Rates

Source: Fundana Case Studies

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# WHAT ARE THE ISSUES

**Weak Performance in 2004**

- Limited Relative Value Opportunities due to low interest rate and volatility levels
- Large inflow in Hedge Funds have made it difficult to find new niche opportunities
- Lack of momentum, visibility and clear trends at the Macro levels

**Increasing Number of Players**

- Low Barriers to Entry in certain strategies have attracted large number of new entrants
- Some strategies have too many players focusing on the same deals

**Structural Changes at Hedge Fund Manager Level**

- Hedge Funds size is slowly eroding returns
- Limited Capacity due to Demand growing faster than Supply
- Consolidation of Hedge Funds in the sector

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# WHICH MODELS WORK

## Where to Make Returns

- Invest in Hedge Funds where size is an accordance with investment strategy
- Invest in strategies where there are fewer Hedge Funds and where Barriers to Entry are still high
- Invest in strategies and markets which offer depth and have a number of diversified players with different investment objectives (e.g. Equity & FX markets)
- Invest in Strategies where managers can actively switch and broaden their investment horizon (emergence of Multi-Strategy styles)

## How to Avoid Risk

- Concentrate on Low Leveraged Hedge Funds and unleveraged Fund of Hedge Funds
- Concentrate on Strategies that are comprehensible and liquid
- Avoid strategies that have an abnormal return distribution
- Adequately Diversify Investments

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