INTRODUCTION TO HEDGE FUND STRATEGIES

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Agenda

1. Brief Introduction of Hedge Funds
2. Equity-hedged
3. Macro
4. Relative-value
5. Event-driven
6. Summary

1 BRIEF INTRODUCTION OF HEDGE FUNDS

- What are the differences between mutual funds and hedge funds?
- What are some general types of hedge fund strategies?

Since hedge funds are ***not*** regulated by the SFC …

They **cannot**
market themselves.

They **cannot**
take $$$ from the public.

Hedge Funds *vs.* Mutual Funds

Mutual Funds

- Only take long positions in securities
- Less active in trading their portfolio investments (usually without leverage) as they attempt to create returns that track (and ideally outperform) the market

Hedge Funds

- Employ *dynamic investment strategies* designed to find unique opportunities in the market
- Actively trade their portfolio investments (both long and short) in an effort to maintain high and diversified absolute returns (often using leverage to enhance returns)

Some Groups of Hedge Fund Strategies

1. Equity-related
2. Macro

- Impacted by movements in the market
- Require intelligent anticipation of price changes in stocks, bonds, foreign exchange and physical commodities

3. Relative-value
4. Event-driven

- To achieve returns that are **uncorrelated with general market movements**
- E.g. price discrepancies between related securities, using derivatives and active trading based on computer driven models and extensive research

2 EQUITY-HEDGED STRATEGIES

- Long/short
- Short Selling
- Market Neutral

2. Equity-hedged Funds

2.1 Long/Short

Long/short (the ideal case):

- Taking ***long*** positions (***buy***ing it) in an ***undervalued*** stock that are expected to ↑ in value ➡ $$$

- Taking ***short*** positions in an ***overvalued*** stock (borrowing a stock you don't own and ***sell***ing it) that are expected to ↓ in value ➡ Buying it back at a lower price than you paid for it and return the borrowed shares

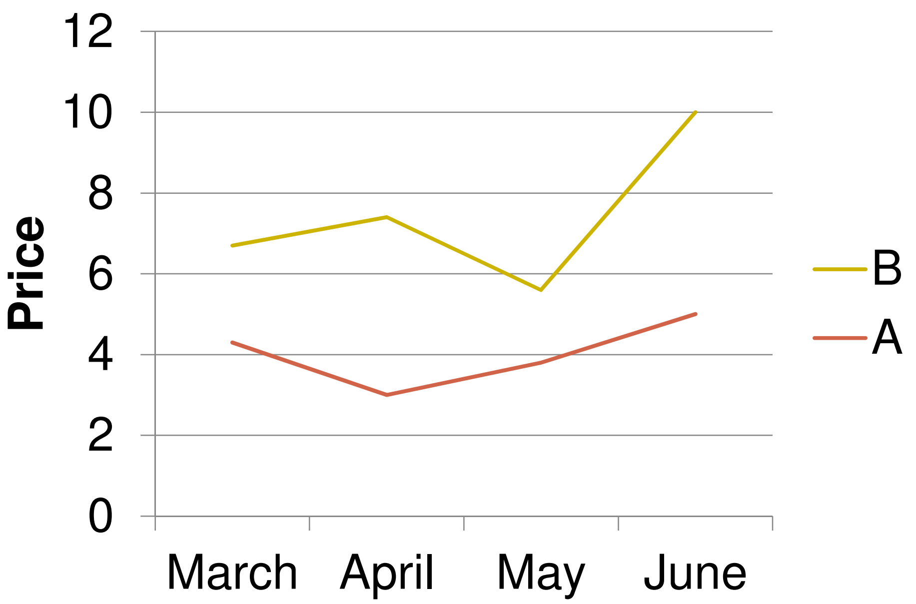
http://www.barclayhedge.com/research/educational-articles/hedge-fund-strategy-definition/hedge-fund-strategy-equity-long-short.html

2. Equity-hedged Funds

2.2 Example

2. Equity-hedged Funds

2.3 Example



- ***Long*** Company B: ***buy*** $10/share
- ***Short*** Company A: ***sell*** 2 x $5/share

<u>If the market ↑</u>

- B: $10 ➡ $15: +$5
- A: $5 ➡ $7: -$2
- Net: $5 + 2*(-$2) = +$1

<u>If the market ↓</u>

- B: $10 ➡ $7: -$3
- A: $5 ➡ $2: +$3
- Net: -$3 + 2*($3) = +$3

2. Equity-hedged Funds

2.4 Risks

- The portfolio manager must correctly ***predict*** the relative performance of two stocks, which can be difficult

- “***Beta mismatch***”: when the stock market declines sharply, long positions could lose more than short positions

http://www.barclayhedge.com/research/educational-articles/hedge-fund-strategy-definition/hedge-fund-strategy-equity-long-short.html

2. Equity-hedged Funds

2.5 Market Neutral

- Same basic concepts
- Equal amounts of investment in both long and short positions, e.g. 50% and 50%
- **Net exposure** of the fund: 0%
- **Gross exposure** of the fund: 100%

3 MACRO

- Global Macro
- Emerging Markets

3. Macro

3.1 Global Macro

- Invest in instruments whose prices fluctuate based on the changes in economic policies, along with the flow of capital around the **globe**.

Let’s say…

- If a manager believes that the US is headed into recession, then he might short sell stocks and futures contracts on major US indexes or the USD.

- A manager, seeing big opportunity for growth in Singapore, might take long positions in Singapore’s assets.

3. Macro

3.1 Global Macro: Example

Famous Example of Using the Global Macro Strategies:

- On Sep 16, 1992 [Black Wed], Soros' fund sold short more than $10 billion in pounds, profiting from the UK govt’s reluctance to either raise its interest rates to levels comparable to those of other European Exchange Rate Mechanism (“ERM”) countries *or* to float its currency.
- Finally, the UK withdrew from the ERM, devaluing the pound.
- Soros's profit on the bet was estimated at over $1 billion.

3. Macro

3.2 Emerging Markets

- Invests in equity or debt of emerging (less mature) markets which tend to have higher inflation and volatile growth.

- *Expected Volatility:* **Very High**

4 RELATIVE-VALUE STRATEGIES

- Relative-value Strategies
- Convertible Arbitrage
- Fixed-income Arbitrage

4. Relative-value Arbitrage

4.1 Principle

- The purchase of securities on one market (↑) for immediate resale on another market (↓)

- Gain profits from the price discrepancy

4. Relative-value Arbitrage

4.2 Example

Company X	Price	Coupon	Term	Current Interest Rate
Bond A	$1000.00	6%	30 years	6%
Bond B	$1276.76	8%	30 years	6%

*Coupons are paid every six months.
**Maturity is assumed to be the same for both bonds.

Assume: the 8% bond is trading at $1100.00; the 6% bond is trading at $1000.00

To take advantage of this price discrepancy: buy the 8% bond and short sell the 6% bond

http://www.investopedia.com/university/hedge-fund/strategies.asp

4. Relative-value Arbitrage

4.3 Convertible Arbitrage

- A convertible bond can be converted into a certain number of shares
- Assume a convertible bond is selling for $1,000 and is convertible into 20 shares of company stock. This would imply a market price for the stock of $50.

4. Relative-value Arbitrage

4.4 Fixed-income Arbitrage

- An investment strategy that exploits pricing differentials between fixed-income securities

- Invests with primary focus on yield or current income rather than solely on capital gains.

- May utilize leverage to buy bonds and sometimes fixed income derivatives in order to profit from principal appreciation and interest income.

- *Expected Volatility:* **Low**

5 EVENT-DRIVEN STRATEGIES

- Merger Arbitrage
- Distressed Securities

5. Event-driven Strategies

5.1 Principle

- Simultaneously buys and sells the stocks of two merging companies.
- Analyze the potential acquisition—looking at the reason for the acquisition, the terms of the acquisition and any regulatory issues (such as antitrust laws)—and determine the likelihood of the acquisition actually occurring.
    - If it seems likely that the deal will close, the event-driven investor will purchase the stock of the company to be acquired, and sell it after the acquisition, when its price has risen to the acquisition price (or greater).
- Typically used only by large institutional investors, such as hedge funds and private equity firms.

http://www.barclayhedge.com/research/educational-articles/hedge-fund-strategy-definition/hedge-fund-strategy-event-driven.html

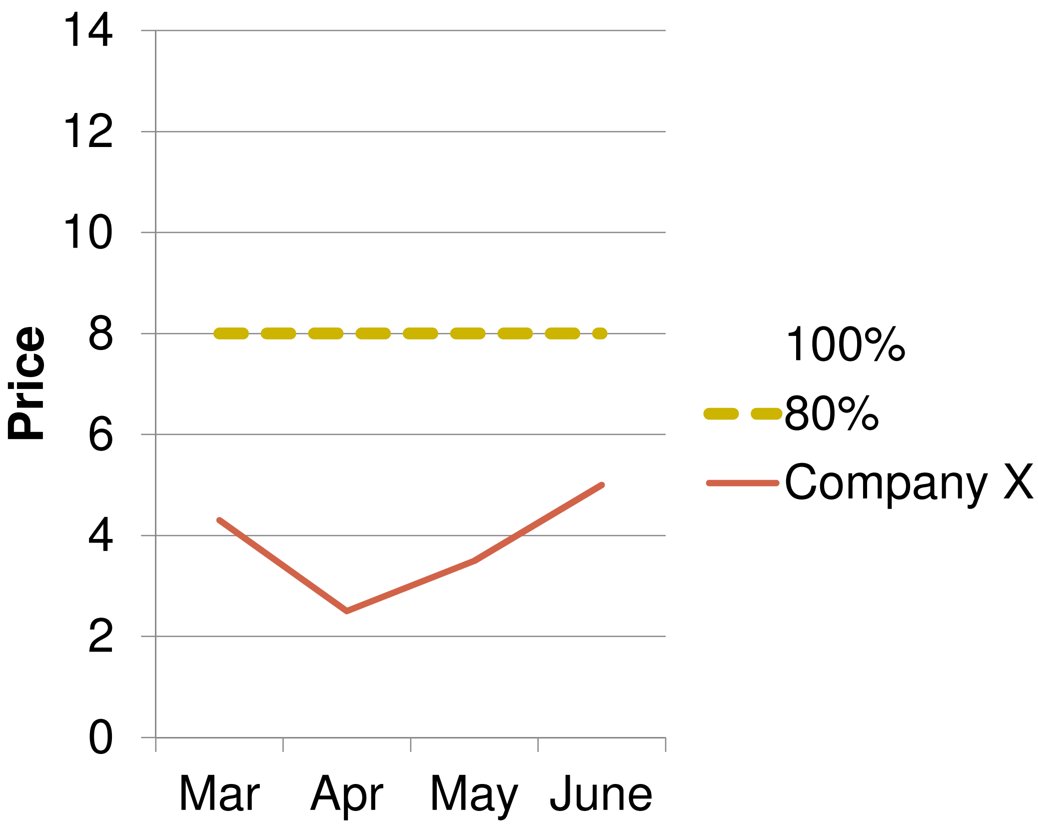
5. Event-driven Strategies

5.2 Merger Arbitrage

- An investment strategy
- Seeks to exploit pricing inefficiencies that may occur before or after a corporate event, such as a bankruptcy, merger, acquisition or spinoff.

5. Event-driven Strategies

5.2 Merger Arbitrage: Example



Consider A Potential Merger:
(a simple math question)

- Company X is at $5/share.
- Company Y **intends** to acquire Company X at $10/share.

- But the price will not jump from $5 to $10…
- No 100% chance that the acquisition will happen

- If predicted 80% chance ➨ $8.

Sources: KhanAcademy

5. Event-driven Strategies

5.3 Merger Arbitrage

With **cash mergers**, an acquiring company purchases the shares of the target company for cash. Until the acquisition is complete, the stock of the target company typically trades below the acquisition price. So, one can buy the stock of the target company before the acquisition, and then make a profit if and when the acquisition goes through. This is not arbitrage, however; this is a speculation on an event occurring.

With a **stock-for-stock merger**, an acquiring company exchanges its own stock for the stock of the target company. During a stock-for-stock merger, a merger arbitrageur buys the stock of the target company while shorting the stock of the acquiring company. So, when the merger is complete, and the target company's stock is converted into the acquiring company's stock, the merger arbitrageur simply uses the converted stock to cover his or her short position.

5. Event-driven Strategies

5.4 Merger Arbitrage: Risks

- Deals-breaking (issues with funding, shareholder approval, target firm’s management, or regulatory action)

- Muted deal activity

5. Event-driven Strategies

5.5 Distressed Securities

- Involved purchasing securities (most often corporate bonds, bank debt) that have lost a considerable amount of their value because the company is in some sort of distress, i.e. heading toward or in bankruptcy
- A company may be coming out of bankruptcy and a hedge fund would be buying the low-priced bonds if their evaluation deems that the company's situation will improve enough to make their bonds more valuable.

http://www.russell.com/documents/institutional-investors/research/four-hedge-fund-investing-strategies.pdf

5. Event-driven Strategies

5.5 Distressed Strategies: Risks

Very risky if many companies do not improve their situation…

- Default or sudden illiquidity – cash flows dry up
- Sensitivity to the economic cycle
- Lack of protection within corporate structure
- Poor information regarding credit ratings, underlying assets, structure and its covenants
- Some probability of large loss
- Uncertain exit strategy from restructured securities

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6 SUMMARY

6. Summary

Equity
- Equity long/short
- Short selling
- Market neutral

Macro
- Global macro
- Emerging markets

Relative-value
- Relative-value arbitrage
- Convertible arbitrage
- Fixed-income arbitrage

Event-driven
- Merger arbitrage
- Distressed securities

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