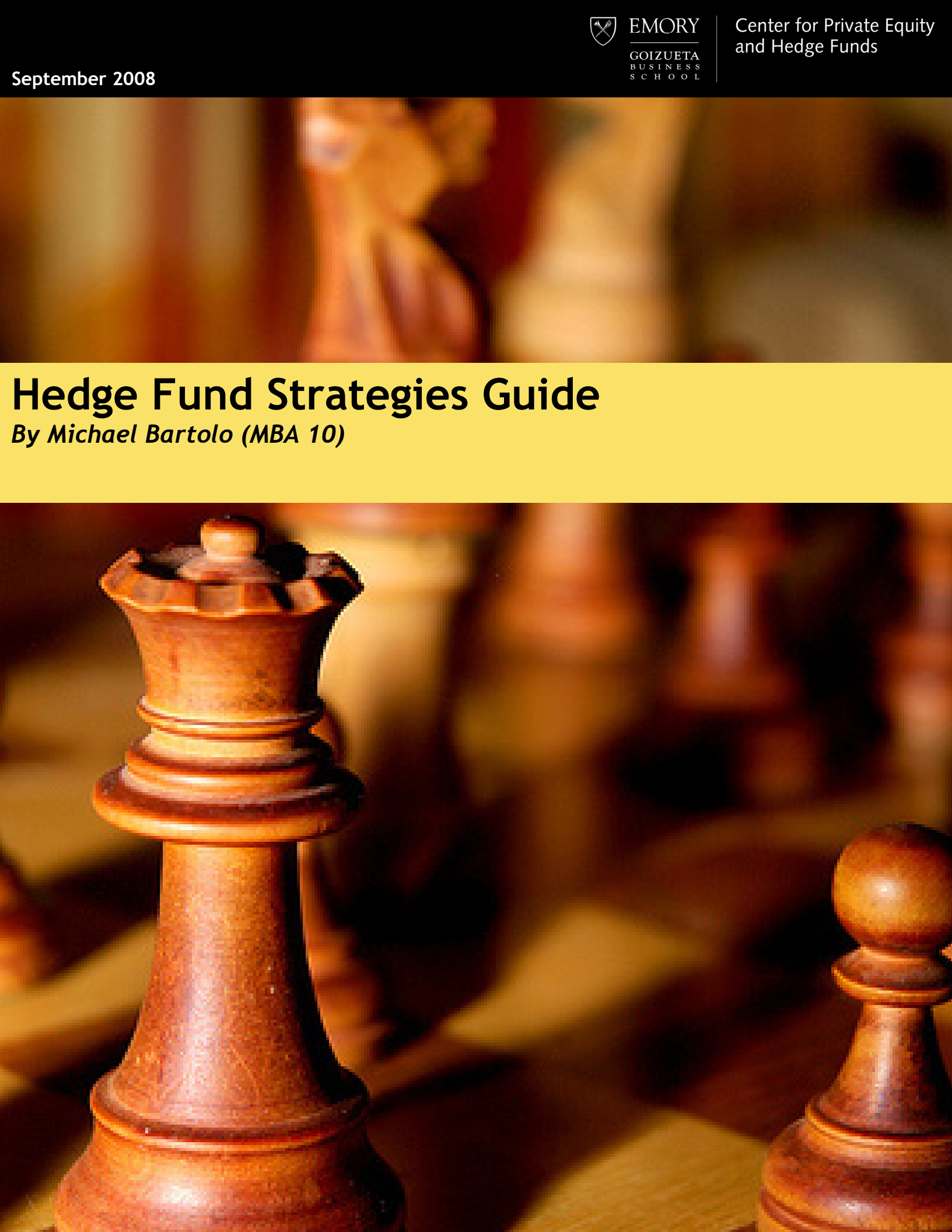


September 2008

# Hedge Fund Strategies Guide

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## Equity Hedge or Non-Hedge

Equity fund strategies can be split into two general categories, Hedge and Non-Hedge. The overlying concept involves the allocation of funds under management to equities that will outperform the market. The unique characteristic that differentiates both hedge and non-hedge funds from traditional long-only equity funds (i.e. mutual funds) is the use of leverage. Leverage is practical when the rate of return on the investment is higher than the interest rate of borrowed funds. Leverage can substantially multiply the rate of return or loss of a fund.

A hedge strategy incorporates the use of short selling and derivatives to minimize exposure to overall market risk. In strong market conditions (bull market) funds may have net long exposure, meaning the percentage of assets held in long positions is greater than that of assets held in short positions. In this scenario, the objective is for long positions to outperform the market, while short positions underperform the market. Short positions can be taken in individual equities (usually in companies within the same industry as a particular long position), in market indices, or in exchange traded funds (ETF's - encompasses a group of equities associated with a certain sector). The short positions can either create a profit for the fund, or act as protection for the fund in the event of a market decline.

In a weaker market (bear market) funds may choose to decrease net long exposure or have net short exposure, meaning a greater percentage of assets are allocated to short sales of equities of companies that are expected to decline at a greater rate than the overall market. Similarly, long holdings are expected to either appreciate or decline at a slower rate than the market.

A non-hedge strategy incorporates stock picking techniques that outperform the market, typical of mutual funds' strategies. However, returns can be multiplied by the use of leverage. Short selling and other techniques of hedging are not main components of non-hedge strategy, but given the degrees of freedom that are available due to the absence of SEC regulation, non-hedge strategies may use some hedge techniques in certain market conditions.

The use of various derivatives is also used to hedge market risk. Put options are purchased for individual stocks or indices that are held in long positions, allowing the underlying equities to be sold at a predetermined price (strike price) at a later date. This is used as a tool to minimize the downside of long exposure in any kind of market condition.

It should be noted that these are generalized descriptions of equity funds. Each individual equity fund can incorporate hedge or non-hedge strategies, as well as other strategies including value, growth, sector, event driven, or a combination. These strategies are discussed below.

## Event Driven and Special Situation

Corporate transactional events such as industry consolidations, mergers and acquisitions, spin-offs, recapitalizations, share buybacks, bankruptcies, and liquidations create opportunities for funds looking to profit from correctly predicting the outcome of such events. The market's uncertainty of these outcomes may cause valuation inconsistencies. The fund looks to identify these inconsistencies and determine the difference between the current market value and anticipated value following the event and take a position in them based on the predicted movement of the security or securities in question.

A public announcement identifying the corporate event, or potential opportunity, will usually cause a revaluation of the involved companies. This will provide the opportunity to perform analysis on any price disparities of the financial instrument (equity or debt).

Corporate events will fit into three general categories: risk arbitrage (liquidations, hostile takeovers, mergers, and acquisitions), distressed securities (restructurings, recapitalizations, and bankruptcies), and special situations (spin-off, share buybacks). The type of corporate events that take place throughout a corporation's life will fluctuate with the market cycles, thus affecting the type of events on which funds will focus. In a time of strong economic conditions there are more opportunities in risk arbitrage. In a time of weaker economic conditions there are more opportunities in distressed securities.

## Merger Arbitrage or Risk Arbitrage

Merger or Risk Arbitrage focuses on profiting from taking positions in corporations that are to undergo a form of corporate reorganization. As the name implies, this strategy focuses on taking advantage of price discrepancies developed by mergers and acquisitions opportunities. If it is perceived that an acquisition has a high probability of occurring, the fund will usually take a long position in the company being acquired, and a short position in the acquirer company. Conversely, if the probability of the deal occurring is low, the short and long positions will be reversed.

When a merger or acquisition is imminent, a price disparity between the two companies develops due to the market's uncertainty of the outcome. The target company's price is usually less than what it will be once the transaction is completed. This price difference is known as the spread. The spread will narrow as the transaction is finalized, allowing the investor to lock in a profit.

## Distressed Securities

Companies in distress face financial or other business related complications. The announcement of restructurings or reorganizations to deal with these financial or business issues often cause a price disparity of the underlying securities, debt or equity, within the market. Negative news regarding the company may provoke a widespread investor sell-off of the securities when few investors are willing to invest in the company, resulting in market devaluation. Often times, in the case of debt obligations, traditional long-only funds are not allowed to hold securities in a company whose

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credit rating is below a certain level. As in risk arbitrage, this price disparity is the result of the market's uncertainty of the outcome of the restructuring or reorganization.

Distressed security managers use their expertise and understanding in the analysis of distressed companies along with fundamental analysis to determine whether the underlying security is undervalued. The manager must determine the strength of the company's core business, operations, and management, and its ability to bounce back after the reorganization has taken place.

### Macro Investing

The macro investing strategy incorporates a 'big picture' analysis approach in order to identify extreme price valuations and other anticipated price movements in all types of securities on a global level. These opportunities are realized through equity markets, fixed-income markets, commodities markets, and currency markets. Using a macroeconomic analysis, taking into account both financial and political events that affect the global economy, it may be determined that a certain national economy or sector within an economy is expected to outperform the global market. Or perhaps, a pricing disparity, due to geographical imbalances, between two comparable government fixed-income securities (U.S. 10 years and U.K. 10 years) may be identified.

Macro investing has the advantage of being able to hold a position in almost any market in any type of security. The ability to take large positions in a variety of investments in different markets gives the strategy a great deal of flexibility in its analysis. However, timing is absolutely crucial in implementing the strategy and maximizing the value of specific opportunities.

### Fixed-Income Arbitrage

The main objective of fixed-income arbitrage is to identify fixed-income securities whose values are interrelated based on in-depth analysis. When the values of these securities shift out of correlation due to some type of market inefficiency, fixed-income arbitragers seek to profit on the convergence of the relationship (i.e. its return to the norm). By taking a long position in the undervalued security and a short position in the overvalued security, the effect of a change in interest rate is neutralized. By eliminating the effects of interest rates and other factors affecting the securities' pricing (through long and short off-setting positions), the investor does not have to determine the direction of the price movement of the overall fixed-income market. The profit is gained when the pricing of the two securities returns to its historical equilibrium.

These types of pricing shifts are usually very small. Therefore, funds incorporating this strategy will usually use large amounts of leverage to amplify returns on a given position.

## Emerging Markets

Emerging market strategies are attractive because of the potential for very high returns. This is due to the overall fast growth of an emerging market compared to that of a more advanced market. However, the risk involved in emerging markets is much higher due to political instability, less liquidity, and currency volatility. Furthermore, emerging markets often have not developed the same level of standards in accounting, securities regulation, and information availability.

These factors can increase risk substantially as well as give rise to opportunities due to the market's valuation inconsistencies. Having the ability or resources to gain relevant information within an emerging market that may not be readily available to the average investor can provide a valuable advantage in seeking out value opportunities.

## Equity Market Neutral

The underlying purpose of the equity market neutral strategy is to eliminate the risk of overall market trends by holding a net portfolio exposure of zero. Meaning, the dollar amount of long positions held is equal to, or very close to the dollar amount of short positions held. This strategy seeks to realize steady returns in both bull and bear markets by neutralizing the unpredictable events that affect direction of the general market. By minimizing the affects of overall market risk, the investor can focus on stock selection for both long and short positions.

Long positions are taken in equities that are expected to outperform the market and short positions are taken in equities that are expected to underperform. The amount of profit realized depends on the degree to which the long positions outperform the short positions (i.e. long/short spread). The concept of neutrality can be more specifically implemented within a sector, investment style (e.g. value or growth), or many other types of criteria.

## Sector

A sector is a section of the market whose components share similar characteristics, such as products produced or market targeted. Sector funds employ a strategy that involves acquiring positions in equities of a specific sector. This group of equities within the specific sector is referred to the fund's 'investment universe'. Usually the fund's management has an expertise in this sector of the market. Combining sector expertise with fundamental analysis is the core approach of this strategy.

Sector funds incorporate hedge or non-hedge techniques. Sectors are usually picked based on their historical ability to outperform the general market. By picking the potential top performers within the sector, the fund can increase its chances of attaining better returns than the overall market.

## Growth

Growth funds invest in companies that are expected to have an increased rate of growth in earnings per share. Growth stocks are usually smaller cap companies that often trade at high price-to-earnings ratios and have low to no dividends.

## Value

Funds focused on value stocks look to identify equities that are trading at a discount or undervalued by the market relative their intrinsic value. These investments require a long investment horizon to realize potential gains. Value stocks trade at lower price-to-earnings ratio and may have higher than average dividends.