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8065 Leesburg Pike, Ste. 300
Vienna, VA 22182
www.keelpoint.com

Hedge Funds Demystified

How can hedge funds – with higher management fees, less liquidity, more complicated tax reporting, etc. – help to improve portfolio performance if investment markets are believed to be efficient? The efficient market theory would say that in perfectly liquid, deep public markets, all information about a company is reflected in its security prices at all times. It follows that it is impossible to have an edge, unless additional information is obtained, in any particular company or group of companies. Pricing anomalies would be quickly identified and arbitraged away by natural market forces. The efficient market cohort prefers to buy indexed products as dollars spent on active management of securities are considered wasted.

Over the years there have been many challenges to the hypothesis. Famously, researchers have shown that there is a size and value bias that persists in the market (both are common to stocks that outperform). Further, the school of behavioral economics has shown that humans and the markets they trade in are not always rational, leading to market anomalies that persist for longer than the efficient market group would like to believe.

In and of themselves, hedge funds are a challenge to the hypothesis. The fees, liquidity, and K-1s would deter us from investing if the same returns were available from the broader market. However, we believe there are persistent inefficiencies in capital markets that can be best exploited by hedge fund managers.

What follows is a three-page summary describing the make-up and behavior of each of the major strategies. Figure 1 gives a high level view of the prominence of each strategy in the universe. Figure 2, on the third page, is a quick-read summary of each strategy, our concession to you for attempting to squeeze a far-ranging, highly technical, topic into one *Investment Bulletin*. Each of the pie slices in Figure 1 (except multi-strategy, which is simply a combination of the other slices) is described in more detail in Figure 2. Additionally, each pie slice is in bold italics when first mentioned in the discussion below.

Directional Strategies

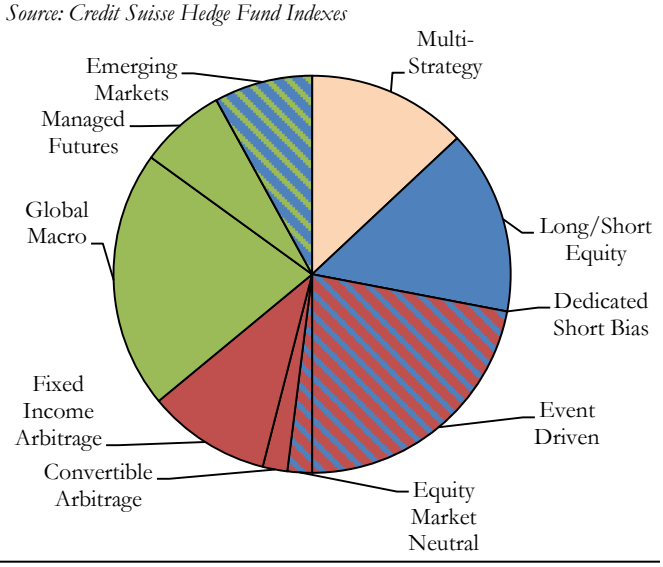
Consider a hypothetical active equity mutual fund manager. He or she combs through a universe of securities and selects thirty that are poised to outperform. The expectation is that those shares will beat the broader market by a nice margin to pay the investor for taking on "active risk" and the manager for their skill. Say that margin is 5% of which 4% goes to the investor. If your investment was $100 you have earned $4 ($5 gross) plus the market return.

Buried somewhere in the trash can at the manager's office you might also find thirty of the least attractive securities. If you believe the manager has the skill to identify outperformers, then it stands to reason he or she can identify the underperformers as well. In a hedge fund format, the manager can sell those securities short to earn additional alpha per dollar invested. (Operationally that means borrowing the securities, selling them, and then buying them back later to close the transaction, hopefully at a lower price, and booking the difference in price as a profit or loss).

A long/short equity manager might sell short $30 worth of those thirty securities for each $100 invested long. Ignoring costs and assuming the securities underperform by the same amount as the long securities outperform, relative profit on the short side of the book is $1.50 ($30 x 5%). Total profit is $6.50 plus the market return minus the hedge fund's fees. So long as the manager's fees don't exceed $2.50, you have earned added value by expanding the investment mandate and likely reduced risk as well.

We can get an idea of how much risk reduction to expect by looking at a fund's net exposure. In this example, we would say the net exposure is $70 ($100 long - $30 short) or 70% and the gross exposure is $130 ($100 long + $30 short) or 130%. Both numbers are important to monitor. You might expect a fund with 100% net exposure to capture most of the market's upside and downside, while one with 70% exposure should capture two-thirds.

Figure 1: Share of Hedge Fund Marketplace
Directional, Arbitrage, Macro
Source: Credit Suisse Hedge Fund Indexes



Gross exposure is key too. Should the manager get it backwards (own the underperformers and short the outperformers) the damage would be proportional to the gross number. If a 70% net fund has 130% gross exposure, the relative underperformance will be much less than that of a 70% net fund with 260% gross exposure (165% long, 95% short).

Directional managers use the long/short mandate to improve risk-adjusted returns in a variety of capital markets. ***Long/short equity*** managers execute the strategy with stocks at net exposures north of 25% and sometimes higher than 100%. ***Dedicated short-biased*** equity managers will carry exposures less than zero. As you might guess, this discipline requires substantial skill as you must continually row against the current of stock price appreciation.

The persistent inefficiencies that exist in the equity marketplace allow for talented managers to add value net of their higher fees. Some believe the market does a poor job evaluating qualitative characteristics of companies such as the skill of C-level management. This presents an opportunity for the hedge fund that can properly value the management team. Corporate restructurings such as business unit spin-offs can offer value due to their complexity. Shares with limited coverage, such as small caps and ***emerging market*** stocks, present similar opportunities.

Credit hedge fund managers are often directional as well. These funds buy and sell short corporate bonds, structured debt, and derivatives of these securities rather than equity shares. As bonds have a pull to par, the natural convergence of the bond's price with its face value as it gets closer to maturity, you won't, in our experience, find short-biased credit managers. Managers thrive in areas where bonds are complicated and few have the tools to properly value them. This was famously true of mortgage bonds in 2008.

Distressed hedge funds fall into the long/short credit and ***event driven*** (a discipline that spans the three major strategies presented here and is characterized by investments with specific corporate event catalysts) categories. These managers buy deeply discounted bonds for which there are few buyers (many institutions are prohibited or discouraged from owning non-investment grade credits by their regulators thus distorting the supply/demand balance). Deep knowledge of the bankruptcy process and experience operating companies post-bankruptcy, often after the equity holders are wiped out and bond holders take the keys, add further value.

Arbitrage Strategies

Arbitrage strategies are different from their directional brethren because they do not take much by way of market risk. Net exposures are usually closer to zero; instead the risk borne by the strategy is idiosyncratic security-specific risk. The job of an arbitrageur is to exploit mispricings that exist in or between securities. Leverage is frequently employed in such strategies to boost profits.

Market neutral arbitrage strategies are essentially the same as long/short strategies with the distinction of near zero net exposure. Both ***equity market neutral*** and ***fixed income arbitrage*** practitioners belong to this category. The returns generated by these managers are almost entirely due to manager skill. Risk can be lower thanks to minimal market exposure but the corollary is there is no market tailwind to boost returns.

Merger arbitrageurs, another group in the event driven category, buy and sell securities that are involved in an announced merger. Traditionally, the trade is a long position in the target company and a short position in the acquiring company. There is usually a spread between the price announced for the target shares and the price at which they trade in the period leading up to the closing of the deal to reflect the risk that it fails. Per AQR, an alternatives manager, spreads, in percentage terms, are usually in mid-single digits. This anomaly persists because arbitrageurs are providing an insurance service to the market for which they will demand a profit.

Convertible arbitrage is the final category in this discipline. Convertible bonds are regular debt securities with an option to convert to equity at a prearranged price. The market tends be less liquid; the arbitrageur's anomaly persists because of this illiquidity premium. Further, the securities are more challenging to value as the equity conversion option complicates the process. Skilled managers can add value by purchasing at a discount to fair value and hedging the equity and credit risk with shorts and/or derivatives.

Macro Trading Strategies

Most practitioners of the directional and arbitrage disciplines do intense work on companies and their securities rather than on broad markets. Macro traders rely on analysis of the latter and express their views with a variety of instruments, predominantly futures contracts on currencies, interest rates, commodities, and equity and credit indexes. The space is subdivided into a discretionary and systematic group. Trading decisions by the two sub-groups are made by a human portfolio manager or an algorithm respectively.

The discretionary ***global macro*** discipline relies on skilled portfolio managers to develop and implement investment themes based on views of fundamental drivers across economies. Inefficiencies persist in macro markets with non-economic participants (e.g. the foreign exchange rate of the Japanese yen is currently being indirectly managed by the Bank of Japan). Returns tend to be uncorrelated to equity and bond markets; volatility and performance are heavily dependent on the skill of the manager chosen and the risk controls in place.

On the other hand, systematic macro depends on the effectiveness of the algorithm making trading decisions. The discipline of ***managed futures*** fits in here. The algorithms are written to follow trends in futures, exploiting a momentum bias in capital markets (the tendency of investors to buy what has performed well therefore

driving the price even higher, and vice versa). The performance and risk story here is similar: uncorrelated and manager dependent.

The combination of an expanded toolbox, specifically the ability to short securities and use derivatives, and persistent inefficiencies endow hedge fund managers with the ability to generate a return stream that differs from your typical stocks and bonds manager. When selecting a hedge fund manager, we are looking for, among other criteria, a demonstration that inefficiencies exist in a certain market, and that the manager is best placed to exploit them. □

Figure 2: Hedge Funds Demystified…and Venn Diagrammed
Color Key as Follows:
Directional Strategies, Arbitrage Strategies, Macro Trading Strategies