**Hedge Fund Strategies Audio Transcript**

Hello my name is Derek Taylor and I would like to welcome you to this video lesson which forms part of the advanced online three month Institutional Trader Programme developed by Knightsbridge Trading Academy in association with London Stock Exchange Group Academy. This lesson is divided into four modules.

Module 1 is a refresher and recap on the Hedge Fund industry. Then in module 2 we look at the key features of Hedge Funds. The third module explores the five main Hedge Fund styles and groupings leading to the final module which looks at the more automated, systemic models and strategies such as Managed Futures and Global Macro. Where appropriate examples and case studies are used.

Now let’s turn to **Module 1.**

Hedge Funds are private pooled investment limited partnerships which currently fall outside of many of the rules and regulations governing mutual funds. Hedge Funds can therefore invest in a variety of securities and asset classes on a leveraged basis. Many hedge funds are based offshore in places such as the Cayman Islands, where there is no, or light regulation and little or no tax.

We are looking at a timeline produced by the Alternative Investment Managers Association (AIMA), viewed by many as the Hedge Funds “trade body”.

Some historical dates spring out, such as when George Soros and his Quantum Fund making a reported £1bn from by speculating that the pound would exit the European Exchange rate mechanism in 1992.

The Russian debt crisis of 1998, and the collapse of Long Term Capital Management (LTCM) on of the most famous and now infamous Hedge Funds.

Followed by the “dot com” boom and bust, when stock markets crashed between 2000 and 2003, after the huge rallies of the late nineties. Hedge Funds tend to outperform traditional “long only” asset managers in times of market chaos.

Stock markets recovered strongly between 2003 and 2008, driven in part by the credit bubble produced by the massive growth in securitisation, which in turn led to the collapse of the credit markets, followed by a stock market rout as the banking industry collapsed.

Then, just as stock markets started to recover, the Eurozone crisis threatens……

**Hedge funds** are alternative investment vehicles that explicitly pursue absolute returns on their underlying investments. The term "hedge fund" has come to incorporate any absolute return fund investing within the financial markets (stocks, bonds, commodities, currencies, derivatives, etc.) and/or applying non-traditional portfolio management techniques including, but not restricted to, short selling, leveraging, arbitrage, swaps, etc.

There are roughly 11,000 Hedge Funds with Assets Under Management (AUM) of about 2.3 trillion US dollars.

Management fees are around 1.6% per annum with additional performance fees of 20%.

Initially devised in the US in 1949 by Alfred Winslow Jones, who used the concepts of “leverage” (borrowing additional money to increase the size of investments), and “short-selling” (selling shares that you do NOT own to buy them back cheaper at a later date).

Hedge funds really took off in the late eighties, and now form a key part of both institutional and private client portfolios. They are normally used in a portfolio context rather than being considered as stand-alone investments.

As you can see, North America dominates the Industry with 67%, with Europe as the next largest geographical  sector, with Europe the next largest at 23%. So the US and Europe dominate the market with 90% between them.

A typical fund requires a minimum investment size from investors, plus fees of between 1.5-2% per annum and a performance management fee which can be around another 20%. The fund will require investors to “lock up” their investment depending on the type of fund and underlying asset strategies. Property funds are not very liquid and have been known to suspend redemptions. For example many UK property funds stopped investors selling out after Brexit.

The Hedge Fund will have a designated Portfolio Manager, who will be responsible to the auditors and administrators. Funds often outsource administration to Global Custodians responsible for safekeeping, settlement and valuation. There will be separate legal advisors, registrar and transfer agents.

Trade execution will be handled through executing brokers, while Prime Brokers handle leverage and operational support.

Hedge Funds utilize the services of Prime Brokers and Global Custodians

**Prime brokerage** is the generic name for a bundled package of services offered by investment banks and securities firms to hedge funds and other professional investors.

Prime brokers normally offer:

- Global custody (including clearing, custody, and asset servicing)
- Securities lending and borrowing facilities
- Financing (to facilitate leverage)
- Customized technology (provide hedge fund managers with portfolio reporting needed to effectively manage money)
- Operational support

**Global Custodians** – A specialised financial institutions who hold, safeguard and service client's financial assets:

Custody Banks offer services such as:

- Safekeeping for securities and other financial assets.
- Settlement of trades
- Collecting income from deposits, dividends, coupons and payment of tax
- Administer Corporate Actions (mergers, dividends, bond calls etc.)

- Banking, cash management and FX transactions

And that concludes module 1

**Module 2**

**Slide 8 - Key features of hedge funds**

- **Absolute returns:** Hedge fund managers pursue absolute returns rather than returns relative to an index or benchmark, allowing them to generate gains even when the traditional markets are failing or range bound.
- **Skill-based strategies:** Returns of hedge funds are derived mostly from the skill of the hedge fund manager in executing their chosen strategy rather than exclusively relying on asset appreciation in rising markets.
- **Flexibility:** Hedge funds have the ability to trade on the long and short side of various financial instruments.
- **Diversity:** Hedge fund managers trade across a spectrum of markets and exchanges, investing in a diverse array of financial instruments including equities, bonds, currencies and derivatives.
- **Alignment of interest:** Hedge fund managers often invest their own money, which aligns their interests with those of their investors.

**Characteristics of Hedge Funds**

Key performance driver is manager skill rather than market returns

- They target consistent returns in the long term rather than outperformance of a benchmark index
- Managers are unrestricted in their choice of investment strategies
- They can invest in any asset class or instrument, equities, ETF’s, bonds, rates, currencies or commodities

Please note how Long/Short Equity still dominate the strategies, although around half as much as they did. The balance has switched to CTA/Managed Futures and Event Driven styles.

The Eurekahedge Hedge Fund Index (USD) is an equally weighted index of 1719 constituent funds. The index is designed to provide a broad measure of the performance of underlying hedge fund managers The index is base weighted at 100 at Dec 1999, does not contain duplicate funds and is denominated in local currencies.

The constituents of the underlying hedge fund managers can be obtained from Eurekahedge in Singapore.

Fundamental Analysis uses both quantitive and qualitative information to provide investment decisions.

Technical Analysis is the study of market action, primarily through the use of charts, for the purpose of forecasting future price trends.

Quantitive analysis – systematic investigation using statistical, mathematical or computational techniques.

Qualitative analysis – data collection by unstructured or semi-structured techniques to provide an in-depth picture of how and why things happen.

Short Selling – the sale of a security or asset that is not owned by the seller, or that the seller has borrowed. Short sellers are motivated by the belief that the assets price will fall, allowing the short seller to buy it back at a lower price, to make a profit. The asset will then be repaid to the original lender.

An understanding of the short selling process is fundamental within Hedge Fund strategies, so I will explain it in a bit more detail

**Short selling** is an investment strategy which includes selling the shares that are anticipated to fall in value.

The seller needs to **borrow the shares** from someone who owns them. Institutional long only investors, will lend stock for fees. Prime brokers will arrange this, for a fee (basis points).

Cost will vary depending on stocks liquidity/free float/special situation etc. No pre-determined time-frame.

The trade is closed out when the borrower repurchases all shares and delivers them back to the Lender. The short seller keeps the capital gain (or loss), while the lender keeps the fees, which are then added to their fund, generating additional returns, known as portfolio enhancement.

Short selling is the exact opposite of the normal process of purchasing shares on margin. Margin depends upon the securities shorted, the value of the position and Exchange requirements.

The equivalent transaction in the bond market is the Sale and Repurchase agreement (Repo). With a repo there is an actual transfer of ownership of the shorted

Alfred Winslow Jones is generally regarded as the pioneer of the modern "hedge fund." Jones's strategy, to construct a portfolio 130% long and 30% short, known as "130/30.

He found that by combining leverage (investing borrowed money) and short selling (borrowing stock to trade) he could effectively produce a conservative investment portfolio.

The fund's capital is both leveraged and "hedged."

In effect, the hedge concept puts Jones in a position to make money on both rising and falling stocks, and also partially shelters him if he misjudges the general trend of the market.

This strategy is known today as 'equity long/short'.

As you can see in the chart, in 1960-1965, his fund outperformed the mighty Fidelity and showed a return way in excess of 100% above the Dow Jones Industrial average.

130-30 strategies share three investment techniques with hedge funds:

1. they are allowed to use short selling,
2. they are leveraged vehicles
3. they typically have a performance-linked compensation.

130-30 strategies do not seek absolute returns regardless of the performance of the market. They aim at outperforming a benchmark, often an index, like traditional funds.

A 130-30 fund fully invests, say £10,000 in a basket of stocks, possible the FTSE 100. They then short £3000 of stocks that they consider to be overvalued. Then they then purchase an additional £3000 of stocks they consider to be undervalued, by using the proceeds of the short sale.

Market exposure is called beta, and 100% exposure to the market equals a beta of 1. Long only and 130-30 strategies are referred to as beta-one strategies.

Hedge Funds employ long/short strategies. A market neutral strategy (50-50) therefore has a beta of zero.

**What is Beta?**

- This common measure compares the sensitivity of movements in a Share price to that of a Benchmark Index of which it is a component part
- For instance Standard Chartered Shares have a beta of 1.51, but Royal Mail is 0.32. The FTSE has a beta of 1.00

Clearly sometimes Beta can help the investor, sometimes not – which is where Alpha comes in….

Alpha is designed to take Beta one step further. Looks at the relationship between a Fund's *historical* beta and its *current* performance. *It should be noted that it is simple to calculate the beta of an entire fund.*

- **Zero Alpha** - the Fund did as well as expected, considering the risks it took.
- **Positive Alpha**, means it returned more than its Beta predicted.
- **Negative Alpha** means it returned less.

*It follows, then, that investors want to find high-Alpha Funds. After all, these are funds that are delivering returns higher than they should be, given the amount of risk they assume.*

- *However, Alpha is very expensive when compared to Beta reflected by Hedge Fund Fee structures.*
- *Does Alpha reflect managerial skill or just plain old luck? Is that high-Alpha manager a genius, or did he just stumble upon a few hot stocks? If it is the latter, a positive Alpha today may turn into a negative Alpha tomorrow*

**Let us now move along to Module 3**

**Module 3**

These are the groupings of the five main Hedge Fund Styles.

We will look at various strategies within these broader style groups;

Relative value, Global Macro, Event Driven, Managed Futures and Equity Hedged. Some are discretionary, based on fundamentals while others are systemic, employing models.

**Long/Short Equity**

In this type of Hedge Fund Strategy, the Investment manager maintains long and short positions in equity and equity derivative securities.

The fund manager will purchase the stocks that they deem are undervalued and sell those which are overvalued.

Wide varieties of techniques are employed to arrive at an investment decision. It includes both quantitative and fundamental techniques.

Such a hedge fund strategy can be broadly diversified or narrowly focused on specific sectors.

It can range broadly in terms of exposure, leverage, holding period, concentrations of market capitalization and valuations.

*We have already looked at long/short funds such as the 130/30 funds and will now look at Market Neutral strategies……*

In a **market-neutral strategy**, hedge funds target zero net-market exposure which means that shorts and longs have equal market value.

In such a case the managers generate their entire return from stock selection.

*Market Neutral is beta zero and has a lower risk than the long/short beta - one strategies already discussed. At the same time the expected returns are also lower.*

***Example of Market Neutral Strategy***

*A fund manager may go long in the 10 tech stocks that are expected to outperform and short the 10 tech stocks that may underperform.*

*Therefore, in such a case the gains and losses will offset each other in spite how the actual market does. So even if the sector moves in any direction the gain on the long stock is offset by a loss on the short.*

Returns generated by a traditional long-only actively-managed portfolio have two components:

1. beta, or the investment gain attributable to market returns, and
2. alpha, the excess return that stems from the skill of the investment manager.

Under a market neutral approach beta, or market risk, is minimised and **alpha, or security specific risk**, is maximised by giving managers the discretion to build both long and short positions.

**Event Driven Strategies**

**Merger arbitrage** is a type of **Event-Driven investing**, which is a strategy that seeks to exploit pricing inefficiencies that may occur before or after a corporate event, such as a bankruptcy, merger, acquisition or spinoff.

***There are two distinctly different types of mergers:***

**Cash mergers**

An acquiring company purchases the shares of the target company for cash.

The stock usually trades at a discount to the acquisition price, reflecting the market's uncertainty that the deal will complete. The hedge fund can buy the stock and make a profit if the deal does go through.

***Not really arbitrage, but speculating on the merger completing.***

**Stock for stock merger**

Where the acquiring company exchanges its own stock for the stock of the target company. So the hedge fund buys the stock of the target company while shorting the stock of the acquiring company.

***If the merger completes and the two company's stocks merge, a profit is realised.***

**Convertible Arbitrage**

Convertibles generally are the hybrid securities including a combination of a bond with an equity option.

A convertible arbitrage hedge fund typically includes long convertible bonds and short a proportion of the shares into which they convert.

The aim is to capitalize on mispricing between a convertible bond and its underlying stock.

- If the **convertible bond is undervalued** relative to the underlying stock, the arbitrageur will take a long position in the convertible bond and a short position in the stock.
- On the other hand, if the **convertible bond is overpriced** relative to the underlying stock, the arbitrageur will take a short position in the convertible bond and a long position in the underlying stock.

The fund manager tries to maintain a delta-neutral hedge so the bond and stock positions offset each other during market fluctuation.

***Delta Neutral Position-*** *A trading strategy designed to offset/neutralise the stock position of the Portfolio when changes occur in the value of the underlying security.*

Convertible arbitrage generally thrives on volatility.

The reason for the same is that, more the shares bounce, more the opportunities arise to adjust the delta-neutral hedge and book trading profits.

**Example of Convertible Arbitrage Strategy**

Baseline & Co. decide to issue a 1-year bond that has a 5% coupon rate. So on the first day of trading it has a par value of $1,000 and if you held it to maturity (1 year) you will have collected $50 of interest.

The bond is convertible to 50 shares of Baseline's common shares whenever the bondholder desires to get them converted. The stock price at that time was $20.

If Baseline's stock price rises to $25 then the convertible bondholder could exercise their conversion privilege. They can now receive 50 shares of Vision's stock.

50 shares at $25 are worth $1250. So if the convertible bondholder bought the bond at issue ($1000), they have now made the profit of $250. If instead they decide that they want to sell the bond, they could command $1250 for the bond.

But what if the stock price drops to $15? The conversion comes to $750 ($15 *50). If this happens you could simply never exercise your right to convert to common shares. You can then collect the coupon payments and your original principal at maturity ($1000 plus $50).

We are now moving on to Module 4 - Systemic Funds and Algo trading

**Why Hedge Funds**

**Benefits**
Investing in certain types of hedge fund can be a riskier proposition than investing in a regulated fund, despite a "hedge" being a means of reducing the risk of a bet or investment. Many hedge funds have some of these characteristics:

**Low Correlation** - Hedge funds are typically lowly correlated or non-correlated with stocks and bonds. Adding a non-correlated asset class to a portfolio could improve its risk-adjusted performance. This aid to **diversification** is the most recognized feature of hedge funds.

**Expertise** - Hedge fund managers may have disproportional advantages to market research and or data. His/her management in the fund may yield unusually high returns compared to other asset classes.

**Absolute Returns** - Many hedge funds offer products that yield absolute returns, guaranteeing a certain return per year. This may be essential enhancements to many complex portfolios.

**Correlation** is a single number that describes the degree of relationship between two variables.

**Correlation coefficient** is a measure that determines the degree to which two variables' movements are associated

**Managed Futures**

Managed futures programs generally take long or short positions in futures contracts, offered worldwide, such as equity indexes (S&P futures, FTSE futures), soft commodities (cotton, cocoa, coffee, sugar), metals (gold, silver), grains (soybeans, corn, wheat), foreign currency and government bond futures. Some funds utilize systematic computer driven mechanical strategies and others employ discretionary methods.

One of the major benefits of including managed futures in a portfolio is risk reduction through portfolio diversification by means of low or negative correlation between asset groups. As an asset class, managed futures programs are non-correlated with stocks and bonds.

***Note the risk reward profile from the diagram. By the addition of a 20% exposure to a managed futures fund to a more traditional portfolio, risk has been reduced AND returns enhanced.***

The strategies and approaches within “managed futures” funds are extremely varied. The one common characteristic is that these managers trade highly liquid, regulated, exchange-traded instruments and foreign exchange markets.

Managed futures funds employ many strategies:

- Trend following  -  ***use algorithms to capture and hold long term positions (months to a year).***
- Counter trend – ***seek to capitalise on rapid reversals within longer term trends.***
- Short term trading ***(maybe less than a day)***
- Fundamental Analysis – ***supply and demand***
- Systemic programs ***using quantitative techniques such as  signal processing, neural networks and genetic algorithms.***

**Algorithmic trading**

**High frequency trading** is an automated **trading** platform used by large investment banks, hedge funds and institutional investors which utilizes powerful computers to transact a large number of orders at extremely high speeds.

**Algorithmic Trading** – the use of computer programs for entering trading orders. Algorithms decide on aspects of orders such as timing, price, quantity, or in many cases initiating orders without human intervention.

Widely used by Buy Side institutional traders, to divide large trades into several smaller trades (possibly across different Pools) in order to manage market impact and risk without impacting public quote.

*Notice that anonymity of trading activity is the key reason to use algorithmic execution. According to the latest (2016) survey Reduced Market Impact now outweighs cost consideratio*ns.

**Global Macro**

This hedge fund strategy aims to make profit from large economic and political changes in various countries by focusing in bets on interest rates, sovereign bonds and currencies.

Managers analyse how macroeconomic trends will affect interest rates, currencies, commodities or equities around the world. They can use systemic, quantitative and fundamental analysis  and prefer to trade using highly liquid instruments such as futures contracts and currency forwards.

***Example of Global Macro Strategy Black Wednesday 16th September 1992***

*An excellent example of a Global Macro Strategy is George Soros shorting of the pound sterling in 1992. He then took a huge short position in sterling. Soros made 1.1 billion on this particular trade.*

*George Soros's Quantum Fund led a field of speculators who borrowed UK Government Bonds (Gilts), only to sell them and buy them back later at cheaper prices.*

*The sterling realised by selling the Gilts, was then sold back into the market as a short GBP position and long Deutschemark. He would then sell the Deutschemarks and buy the pounds back later, which could then be used to buy back the Gilts and repay the lenders.*

*The irony is that the Bank of England were the only buyers of pounds against Deutschemarks that day. So in effect he was using the Bank of England's own debt to speculate against them.*

*Jim Trott, former chief dealer for the Bank of England, described the day as "stunningly expensive". He bought more pounds in 4 hours than anyone before or since. The Exchange Rate Mechanism was the forerunner of the Euro, and Central Banks allowed European currencies, including the pound, to trade in bands, to maintain values relative to each other. Sterling was the weakest within its band and the Deutschemark was the strongest.*

*As Jim Trott tells it, the Bank of England was furiously buying sterling but little was done by the Bundesbank to sell deutschmarks.*

*"The cavalry were the Bundesbank. We kept on looking over the hill, but there was no dust and there were no hats and no sabres. And then later at the conference call they suddenly didn't speak English, which was extraordinary. So we were kind of stretched on that day," he said. Thirteen years later, Treasury papers would be released showing the cost to be an estimated £3.3bn.*

Thank you for watching and listening.