Hedge Fund Strategies 101. A Primer

Hedge funds come in many shapes and sizes. They operate many diverse investment strategies that seek to generate returns that are less dependent on the direction of traditional equity, bond, commodity and currency markets. This makes them useful in diversifying traditional risk factors in an investment portfolio. There are a number of well established hedge fund strategies.

Equity long short investing is one of the most common and well known strategies. It is an extension of traditional long only equity investing but adds the ability to sell short and to use leverage. The basis of equity long short investing is to seek good companies or undervalued companies to buy on the long side, and poorly run or overvalued companies to sell short. Buy balancing long and short exposures market risk can be hedged to the desired level. Most equity long short funds run a net long bias. Some equity long short funds are market neutral in that they seek to hedge out all their market exposure. The risk they run is idiosyncratic company specific risk.

Credit long short investing is another hedge fund strategy. It is less common than equity long short investing, however, the main principles are similar. The manager seeks good and undervalued companies to buy long and poorly run or overvalued companies to sell short. In this case, however, instead of trading in the equity of these companies, the manager buys and sells the debt of the companies. This includes bonds, convertible bonds, bank debt, trade receivables and credit default swaps.

A special case of credit long short is capital structure arbitrage. This is a more sophisticated form of credit long short and more often than not involves buying and selling the equity or debt instruments issued by the same company. Very often capital structures of companies are not properly valued because the investors who trade equities and the investors who trade bonds are different and have different objectives. Examples of capital structure arbitrage are long senior debt versus short subordinated debt. In case of default or reorganization the recovery value in the senior security is higher than in the subordinated security.

Convertible arbitrage is a very interesting form of hedge fund investing because it combines elements of equity, credit and volatility trading. The typical trade in

convertible arbitrage is to hold the convertible long, short a delta amount of equity, and hedge out the credit risk with CDS or an asset swap. Convertible arbitrage can take advantage of mispriced equity optionality where the manager consistently re-hedges the convertible with a delta amount of equity as the equity price fluctuates. Convertibles can also be used to create high carry levered positions with little equity risk. Convertibles also feature in distress or stressed investing.

Fixed income arbitrage refers to non-credit related bond and bond derivative trading and is usually expressed in sovereign issues. There are two main schools which include Macro and Arbitrage. Macro fixed income investing is based on the premise that pricing in fixed income markets reflect macro conditions and economic policy. Managers seek to make money by having a macro view and expressing it by trading sovereign fixed income securities and derivatives. Arbitrage strategies are predicated on the thesis that relationships between different securities tend to a no-arbitrage position over time. Managers seek inefficiently priced securities and bet that they converge to efficient pricing.

Distress investing involves investing in the securities of companies in distress or bankruptcy. This can range from equity to debt, bank debt, CDS, trade claims, options et al. Often these securities are incorrectly valued and priced and often holders of such securities are forced to dispose of them at uneconomic prices. Sometimes the manager will be an activist in steering the outcome of the bankruptcy process. Distress investing brings together business valuation, legal understanding of bankruptcy processes, trading ability and an understanding of the motivations of incumbent stakeholders from shareholders to creditors to management.

Merger arbitrage invests in situations where one company is taking over another. It usually involves buying the target company and selling the acquiring company (in a stock offer) or just the target (in a cash offer.) The strategy has evolved to include investing in any hard catalyst (announced deal) situation to include de-mergers or spin offs, asset sales and other special corporate actions. The strategy seeks to make money by deciding if a situation will evolve as announced or not. More evolved strategies also opine on the path of a situation playing out to completion or deal break.

Global Macro is one of the oldest and most well known hedge fund strategies. Broad types of macro strategies include Fixed Income, the most common type, which avoids

the idiosyncratic risk inherent in equities or corporate credit, Commodities, which are very much driven by demand and supply and thus correlated to industrial production, FX, which is an extension of fixed income macro with elements of inflation and rates and finally Equities, which is a less common expression of global macro as it contains the idiosyncratic risk inherent in companies’ financial performance and outlook.