

## Week 7 Learning Objectives

- Understand the hedge funds market.
- Understand hedge fund strategies.
- Understand the differences between Mutual Funds and Exchange Traded Funds and Hedge Funds.



## Week 7 Lecture - Hedge Funds

It's pretty typical that the same media that told folks to stick it out for the long haul while the market melted in 2000 and 2001 are now writing smear pieces about hedge funds simply because they're not minting money this year. Indeed, we're now in the golden age of hedge fund hysteria, with each passing day delivering new negative charges against an industry that by almost every yardstick should be celebrated, not demonized.

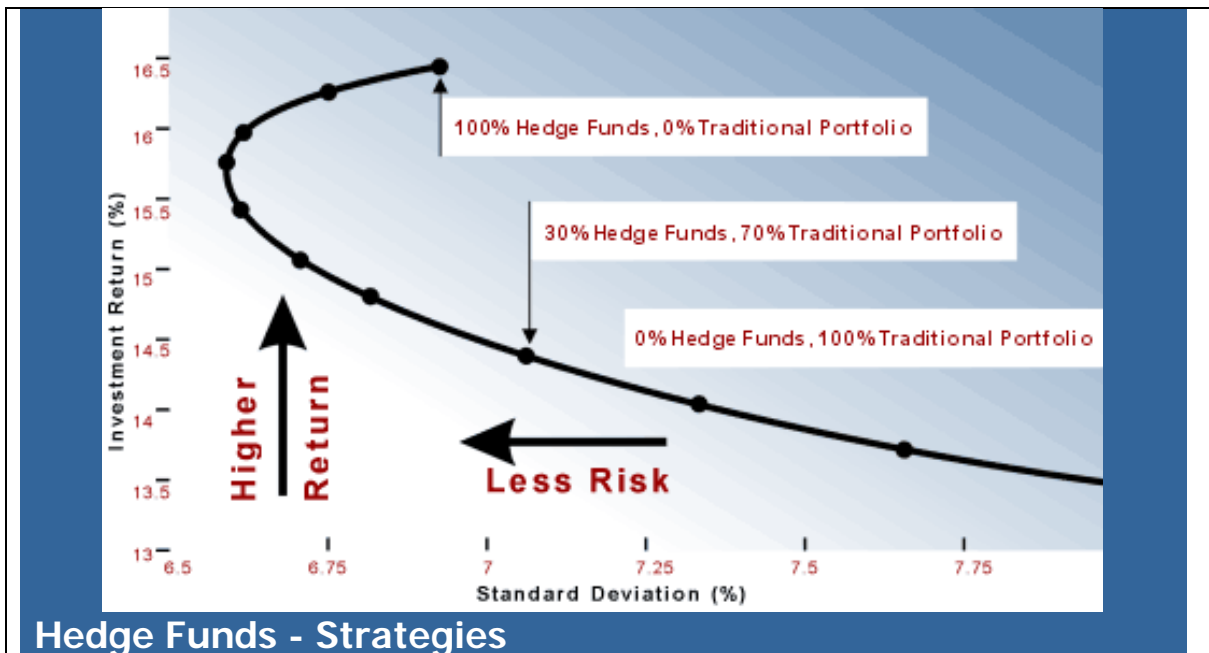


At the heart of this hysteria is a complete ignorance of what hedge funds really are, both among the regulators who oversee them and the financial media that have, written stories about how hedge funds threaten to disrupt financial markets world-wide. So let's start by simply defining the term: A hedge fund is a pool of money pledged by "accredited" (read: rich) investors and managed by a general partner. While most people assume that hedge funds trade frequently and make big bets on financial esoterica, the truth is a hedge fund is a legal structure, not an investment technique.



There are an estimated 8,350 hedge funds with assets of \$875 billion (about half in the U.S.), according to the Hedge Fund Association in Washington, D.C.

Federal Reserve Chairman Alan Greenspan warned that hedge funds had picked the 'low-hanging fruit' of easy profits and may be set for a fall as they assume more risks in a quest for high returns. This was during testimony before the Senate Budget Committee, on Capitol Hill in Washington, April 21, 2005.



There are many types of investment strategies. Here are a few:

- **Aggressive growth:** Investing in stocks expected to accelerate in price, or earnings. Typical investments: technology, biotech firms, small (relatively unknown) companies.

- **Distressed securities:** Stocks or bonds of companies in or facing bankruptcy, usually bought at deep discounts. The hope is to gain from the market's lack of understanding of the firm's true value.



- **Emerging markets:** Firms' stock or debt in foreign markets, tending to have higher inflation or volatile growth.

- **Arbitrage:** Attempt to profit by taking offsetting positions. For example, buying one contract of gold in New York and selling one for more in Chicago.

- **Market timing:** Shifting assets among various investment classes, entering and leaving markets based on assumptions of market outlook.

- **Special situations:** Investing in companies involved in hostile takeovers, mergers, reorganizations, and leveraged buyouts. Can involve buying stocks of both the takeover target and the bidding company.

- **Short-selling:** Selling stock that isn't owned but borrowed from a broker, in anticipation of being able to buy it later at a lower price. An example: A stock is selling for \$50 a share.

The investor sells the borrowed stock. The shares fall to \$20, and the investor buys at that price to repay the loaned stock.



One other thing that must be mentioned is that hedge fund managers aren't required to stick with their "style" of investing. Someone that has been doing convertible arb trades can stop that and invest in Hong Kong real estate. The investors have no say what so ever. So style drift, in search of better returns, is a concern.

Read the following and then do your own research on the subject. Lots and lots of articles are out there on the web. It's a very hot topic.

## Hedge Funds – Supplemental

Here is one article on Hedge Funds to get you some perspective on where we were just a few years ago.

### *Hedge Fund Investing: Looking for That Edge*

Investors who chafe under the legal limitations on mutual funds' investing strategies have an alternative, if they're wealthy enough: hedge funds.



These generally unregulated funds can use leverage, derivative plays, short-selling and other strategies banned in the mutual fund world to boost returns or seek "market neutral" results – attempting to produce steady gains regardless of what the broad market is doing. The public knows little about these funds, since the average investor falls far short of the net worth requirements to invest.

Seven members of a panel on hedge funds at the Nov. 7 Wharton Investment Management Conference described a variety of approaches taken in this freewheeling industry.

Hawkshaw Capital Management, for example, describes itself as a research intensive, value-oriented, mid-cap, long/short U.S. equities fund. That, said co-founder Kian Ghazi, means the fund relies on its own research – such as talking to a company's suppliers and customers to get views not provided in routine SEC filings – to get a "unique insight" into a stock it may buy or sell short. "We want to feel confident we are smarter than the 95 other people investing in that stock," he said.

At Korsant Partners, analysts also "look for an edge" – typically a stock that's "off other

people’s radar screens,” said Joel Lusman, portfolio manager and partner. Korsant is a family partnership that uses a variety of strategies and allocates some capital to outside management.

Carlson Research and Analytics focuses on convertible arbitrage, merger arbitrage, distressed debt and relative value strategies. Essentially, said R. Harold Schroeder, the company’s president and manager of the relative value portfolio, Carlson looks for inefficiencies, such as periods when two stocks that normally behave the same are instead diverging – with one rising and the other falling, for example. Combinations of long and short trades can make money when the normal relationship is restored.

Steven Marks, senior research analyst at Blue Ridge Capital, a long-short stock fund, is “very much focused on trying to get an informational edge.” And Dan Sobol, securities analyst for Loews, a holding company for the Tisch family, hunts for companies in distress, or for other “special situations.” He focuses on utilities, textiles and steel.

Finally, Erika G. Long, managing director and portfolio manager for the consumer products sector at Maverick Capital, tends to use plenty of leverage to amplify results of pairs of long-short bets designed to make money regardless of whether the broad market moves up or down. “We really do go for that informational edge,” attempting to be the most knowledgeable non-insider with any stock in which the fund takes an interest, she said.

#### Flood of New Money

Hedge fund assets have jumped from an estimated \$400 billion in 2001 to about \$600 billion today – a dramatic increase given that stocks fell during much of that period. The panelists were asked how they handle such a large influx of cash.

Lusman recalled that about two years ago he met a broker who was able to quickly raise more than \$50 million for a new hedge fund, despite having virtually no experience. “There are a lot of people out there raising money, starting hedge funds,” he said. “It’s a lot more competitive, especially on the sell side.” As a result, fund managers have less time to evaluate prospective investments. “Instead of weeks, you have days.”

Schroeder argued that the influx of new cash has caused too many in the industry to focus on attracting new investors rather than improving their funds’ performance. Funds typically charge investors an up-front fee of 1%. Perhaps funds should reduce that fee and base more of their earnings on meeting performance goals, he said.

The flood of new money also forces managers to invest in large-capitalization stocks, since it’s too difficult to find enough small- and mid-



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cap stocks to soak up all the new money, he noted. Unfortunately, he added, big-cap stocks don't offer as many big returns. They are so heavily scrutinized by analysts, the press and money managers that potential opportunities don't remain undiscovered for long.

Moderator Chris Argyrople, founding partner of Delta Partners, which runs the Prism funds, said that once a fund has more than \$200 million, it's difficult to focus on small stocks, where the best opportunities are. According to Lusman, the ideal size for a fund is usually \$150 million to \$200 million. At that level, a fund can afford top quality research, but if it gets to \$1 billion, "you're no longer nimble."



Julian Robertson

Asked to describe some of their big winners, Ghazi said his have tended to be companies that use lots of leverage, though that also makes investments riskier. "Keep in mind that operating leverage hurts in reverse," he warned.

What kinds of investments have turned out to be the biggest mistakes? The most disastrous have been short sales – bets that a stock would fall, said Long. In one of her worst shorts, it turned out the company's management was really quite good and the stock went up instead of down. A good short is a stock facing an immediate crisis, not just a battery of nagging problems, she noted. "Without a near-term catalyst, you can lose a lot on a short investment." Merely thinking a

stock is overpriced is not enough reason to place a short bet, added Argyrople. "If you haven't been killed on a valuation short, you will."

The panelists also were asked if they use a different approach to choosing long and short bets. Generally, said Long, the two are mirror images: a long prospect has good management, the short has a bad one; the long has good cash flow, the short doesn't. The analysis of both stocks is essentially the same.

Lusman, however, said he thinks the two are quite different. With a short, the potential profit is capped at the price of the short sale. If a stock is sold short for \$10, the most the fund can make is \$10 a share if the stock falls to zero. But the potential loss on a short is unlimited. If the stock soared to \$100, the fund would lose \$90 on every share it bought to replace those it had borrowed to make the short sale.

The dynamics of a long are the opposite, he said. The potential profit is unlimited if the share price goes through the roof; the fund can lose no more than it paid. "Timing on a short is absolutely crucial," he said, adding that he has done better on shorts than longs, probably because the potential for unlimited loss makes him more careful.



Published: March 25, 2004