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Overview of Hedge Fund Strategies

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Many investors and observers are baffled by how hedge funds work, so let's shed a little light on their investment strategies.

About one-third of hedge fund money is invested in a relatively easy to understand strategy called Equity Long/Short. Hedge funds using this strategy try to find one stock that they think will do better than a second stock, usually in the same industry. They then buy or go long the first stock; and sell or short, the second stock. (When an investor is long a stock he makes money if it goes up and loses money if it falls. If they are short, the opposite is true – they lose money when it goes up and make money when it falls.)

A simple example helps illustrate how this strategy works. If the manager feels GM will do better than Ford, he would buy GM stock and sell short the same dollar amount of Ford stock. If both stocks rose or fell the same amount in percentage terms there would be no gain or loss.

However, if GM increased 10 percent and Ford went up 6 percent his net profit would be 4 percent (plus 10 percent in GM; minus 6 percent in Ford). He could also make money if both stocks decline, as long as Ford drops more than GM.

One nice aspect to this strategy is that the investor is not directly affected by the overall market moving up or down, only by the relative performance of GM and Ford.

Wow, this seems pretty easy – just hedge your bets by buying a good company and selling a bad one. That is why it is a popular strategy and its returns are often good - but not spectacular.

One potential problem is that market prices already reflect if a company is expected to do well or poorly. The manager needs to find “good” companies whose stock price, not the company itself, will perform better than the “bad” company’s stock price. This can cause a problem as we saw in 2003. After the bear market, investors were again willing to take more risk, and bought weak companies in the belief their stock prices had been pushed too low. So even though managers identified good companies, the prices of “weaker” companies went up more quickly.

Convertible Arbitrage is another popular hedge fund strategy. (Arbitrage refers to buying something cheap in one market and selling for more money in another market.) This is much more complicated and given limited space, I can only give a short, simplified overview. As the name implies, the strategy is built upon using convertible bonds which

pay lower interest rates than straight bonds and allow owners to convert the bonds into common stock if the stock price increases.

A “simple” way to view a convertible bond is as a bond with an embedded call option. If the company’s stock moves higher, the holder exercises the call option and uses the bond to buy the stock. For the most part, the call options embedded in the bonds are relatively cheap in volatility terms compared to the underlying stock. So the “arbitrage” is to buy cheap volatility as part of the bond and then sell volatility in the stock and/or options market.

The most famous hedge fund managers, including George Soros, run Macro hedge funds. These funds scour the globe for investment opportunities and are willing to invest in any asset class including stocks, bonds, currencies and commodities. One of Mr. Soros most famous trades was a \$2 billion bet against the U.K. government’s attempt to stabilize the British pound. Soros won!

Other hedge fund strategies include:

- Risk or Merger Arbitrage - where investors work to profit from price discrepancies between pending merger partners.
- Distressed Securities strategies buy mostly bonds of bankrupt companies. For instance they may buy bonds for 25 cents on the dollar and hope to receive 50 cents when the company emerges from bankruptcy.
- Activist Funds that buy into companies and then attempt to force management to make changes which they hope will increase the stock price. This is what Carl Icahn tried to do with Time Warner, and he may try again.
- Multi-Strategy Funds - designed to shift their money between strategies as opportunities arise which is somewhat similar to Marco Funds.

In order to invest in several strategies, some wealthy individuals use Fund of Funds where they let professionals choose the different funds. Fund of Funds’ main attractions are: first, they have the expertise to analyze many funds whereas most individual investors lack the skills and/or access to the information to do this well. Secondly - they invest money across a large number of funds which diversifies an investor’s risk (and reward).

The downsides are two-fold. First - Fund of Funds adds an additional layer of fees which cuts into returns. Secondly, while most Fund of Funds have substantial expertise, it is still very difficult to analyze hedge funds. This was most recently evident at the troubled fund, Amaranth, in which a number of highly regarded Fund of Funds had placed money.

If you have any questions or comments about hedge funds or other investment topics, please call or write me.

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