Common Trading Strategies

Hedge fund strategies encompass a broad range of risk tolerance and investment philosophies within a wide array of investments:

- debt
- equity securities
- Commodities
- Currencies
- Derivatives
- real estate
- other investment vehicles.

The horizon of hedge fund investment strategies has seen unprecedented expansion in recent years. Hedge fund investment terms are driven in large part by the fund's strategy and its level of liquidity.

Long/Short Equity

One of the most commonly used strategies for startup hedge funds is the long/short equity strategy.

As the name suggests, the long/short equity strategy involves taking long and short positions in equity and equity derivative securities. Funds using a long/short strategy employ a wide range of fundamental and quantitative techniques to make investment decisions. Long/short funds tend to invest primarily in publicly traded equity and their derivatives and tend to be long-biased.

Long/short funds also tend to have reasonably straightforward investment fund terms. Accordingly, lock-ups, gates, and other withdrawal terms are usually on the more permissive side because of the ease of liquidating positions when needed to facilitate investor withdrawals.

Credit Funds (1)

Credit funds make debt investments based on lending inefficiencies. Credit funds tend to follow cyclical patterns and are most active following economic downturns and restrictions in the credit market. Credit funds include distressed debt strategies, fixed income strategies, direct lending, and others.

- **DISTRESSED DEBT**

Distressed debt involves investment in corporate bonds, bank debt, and occasionally common and preferred stock of companies in distress. When a company is unable to meet its financial obligations or is in a liquidity crisis, its debt devalues. Distressed debt funds use fundamental analysis to identify undervalued investments. Hedge funds that invest in distressed debt need to employ more stringent lock-up and withdrawal terms, including side pockets, (accounts to separate illiquid assets). A fund sponsor looking to form a distressed debt fund should speak with experienced legal counsel to determine whether a private equity fund would be more appropriate. Unlike hedge funds that allow regular withdrawals, private equity funds are usually closed-ended. They have a finite duration, typically between five and ten years.

Credit Funds (2)

- **FIXED INCOME**

Fixed income funds invest in long-term government, bank and corporate bonds, debentures, convertible notes, capital notes, and their derivatives, which pay a fixed rate of interest. Many fixed income funds have lower risk tolerances than distressed debt funds and place capital preservation as a higher priority, leading to more diversification and volatility-reducing strategies. A conventional fixed income hedge fund strategy is fixed income arbitrage, discussed below.

Arbitrage

Arbitrage strategies seek to exploit observable price differences between closely-related investments by simultaneously purchasing and selling investments. When properly used, arbitrage strategies produce consistent returns with low risk. However, because price inefficiencies between investments tend to be slight, arbitrage funds must rely heavily on leverage to obtain significant returns. Due to heavy use of leverage, some arbitrage firms have suffered monumental losses when pricing differences shifted unexpectedly. One of the more memorable examples of this type of loss was Long Term Capital Management, the infamous fixed income arbitrage fund from the 1990s. Long Term Capital Management suffered catastrophic losses. It had to be bailed out by a government-brokered consortium of Wall Street banks.

Arbitrage Examples (1):

- **FIXED INCOME ARBITRAGE**

Fixed income arbitrage seeks to exploit pricing differences in fixed income securities. Most commonly, by taking various opposing positions in inefficiently priced bonds or their derivatives, with the expectation that prices will revert to their true value over time. Typically, fixed income arbitrage strategies include swap-spread arbitrage, yield curve arbitrage, and capital structure arbitrage.

- **CONVERTIBLE ARBITRAGE**

At its most basic level, convertible arbitrage involves taking long positions in a company’s convertible securities while simultaneously taking a short position in a company’s common stock. Convertible arbitrage seeks to profit from price inefficiencies of a company’s convertible securities relative to its company’s stock. Although simple in theory, proper execution of this strategy requires careful timing to avoid losses. Increasing in popularity, convertible arbitrage has effectively diminished available price inefficiencies, making it difficult to achieve significant returns without using extensive leverage.

Arbitrage Examples (2):

- **RELATIVE VALUE ARBITRAGE**

Relative value arbitrage, or “pairs trading” involves taking advantage of perceived price discrepancies between highly correlated investments, including stocks, options, commodities, and currencies. A pure relative value arbitrage strategy involves high risk and requires extensive expertise.

- **MERGER ARBITRAGE**

Merger Arbitrage involves taking opposing positions in two merging companies to take advantage of the price inefficiencies that occur before and after a merger. Upon the announcement of a merger, the stock price of the target company typically rises, and the stock price of the acquiring company usually falls. Merger arbitrage is a form of event-driven hedge fund strategy, discussed below.

Event Driven

Event-driven strategies are closely related to arbitrage strategies, seeking to exploit pricing inflation and deflation that occurs in response to specific corporate events. Among these can include mergers and takeovers, reorganizations, restructuring, asset sales, spin-offs, bankruptcy, and other events creating inefficient stock pricing. Event-driven strategies require expertise in fundamental modeling and analysis of corporate events. Some examples of event-driven strategies are merger arbitrage, risk arbitrage, distressed debt, and event-based capital structure arbitrage.

Quantitative

Quantitative hedge fund strategies rely on quantitative analysis to make investment decisions. Such hedge fund strategies typically utilize technology-based algorithmic modeling to achieve desired investment objectives. Quantitative strategies are often referred to as “black box” funds since investors ordinarily have limited access to investment strategy specifics. Funds that rely on quantitative technologies take extensive precautions to protect proprietary programs.

Global Macro

Global macro refers to the general investment strategy making investment decisions based on broad political and economic outlooks of various countries. The global macro strategy involves directional analysis, which seeks to predict the rise or decline of a country's economy, as well as relative analysis, evaluating economic trends relative to each other.

Global macro funds are not confined to any specific investment vehicle or asset class. They can include investment in equity, debt, commodities, futures, currencies, real estate, and other assets in various countries. Currency traders rely heavily on global macro strategies to forecast relative currency values. Likewise, interest rate portfolio managers, which trade instruments that are keyed into sovereign debt interest rates, are heavily involved with global macro fundamental analysis.

Multi-Strategy

Multi-strategy funds have the discretion to use a variety of investment strategies to achieve positive returns regardless of overall market performance. They are not married to a single investment strategy or objective. Multi-strategy funds tend to have a low-risk tolerance and maintain a high priority on capital preservation.

Suggested reading list

- An Introduction to Market Microstructure and Trading Strategies, ANATOLY B. SCHMIDT
- Empirical Market Microstructure, Joel Hasbrouck
- QUANTITATIVE EQUITY INVESTING (Techniques and Strategies) FRANK J. FABOZZI, SERGIO M. FOCARDI, PETTER N. KOLM

Gaining an edge

- Uniqueness of the strategy
- Better technology/research process
- Better algorithms
- Getting data before your competition
- Cleaning unstructured data

"Black edge"

Crime and Punishment :)

"With adequate profit, capital is very bold.

A certain 10% will ensure its employment anywhere;

20% certain will produce eagerness; 50%, positive audacity;

100% will make it ready to trample all human laws;

300%, and there is not a crime at which it will scruple, nor a risk it will not run, even to the chance of its owner being hanged."

- Karl Marx -

Insider Trading

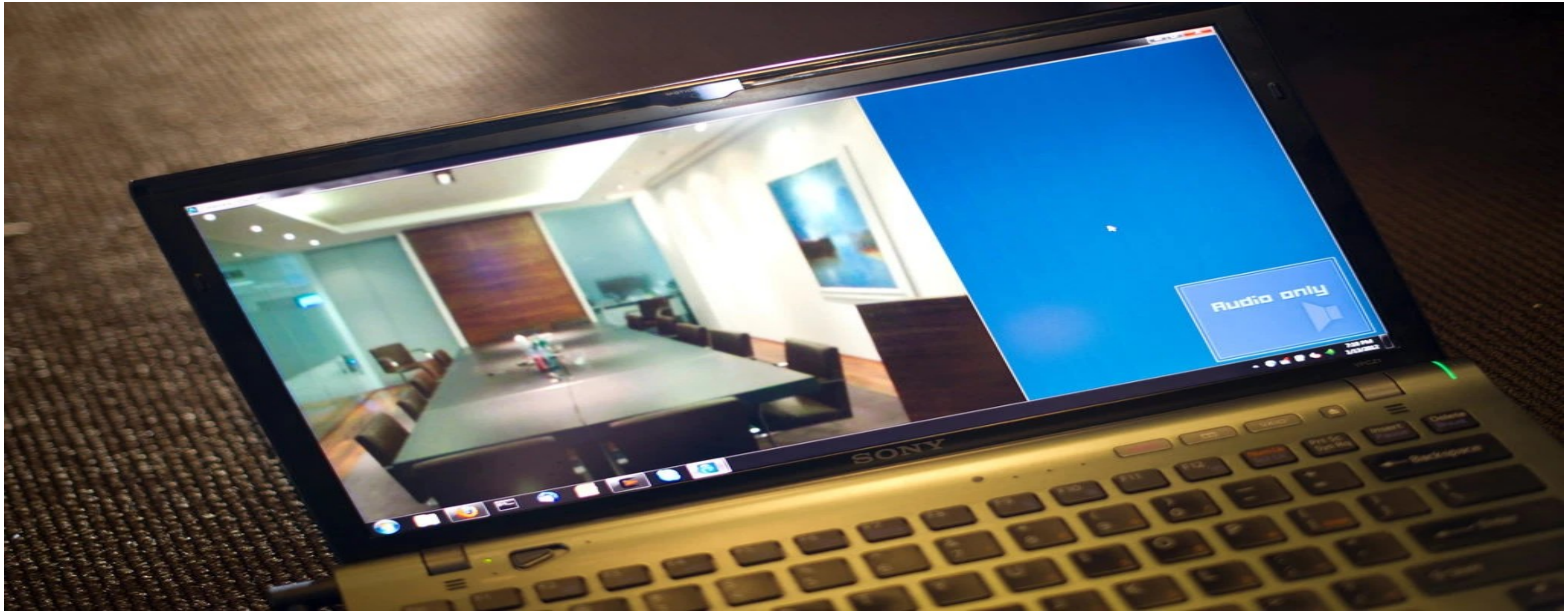
So Heard on the Street In 1982 to 1984, R. Foster Winans was one of two regular authors of the Wall Street Journal column "Heard on the Street." This popular column regularly reported news, analyses, perspectives, and rumors about companies. Although much of the material was public information, the prices of stocks featured in the column often moved following the publication of the column. From October 1983 through March 1984, Winans conspired with Kidder, Peabody and Co. stockbrokers Peter N. Brant and Kenneth P. Felis to provide them with information about the content of his upcoming "Heard on the Street" columns. They made 600,000 dollars on the information. Winans was paid 31,000 dollars for his part in the scheme. An observant investigator at the SEC identified the pattern of their trades. Two others were involved in the conspiracy. In 1985 Winans was convicted of 59 counts of securities fraud and conspiracy, even though he claimed that his columns did not contain inside information about the corporations discussed in his column. However, he did violate the Wall Street Journal's confidentiality policy. The legal doctrine under which he was convicted is called the misappropriation doctrine. Brant and Felis also were convicted of fraud and conspiracy. Winans was sentenced to 18 months in federal prison and fined 10,000 dollars. Felis was sentenced to six months and fined 10,000 dollars. Brant, who cooperated with the prosecution, was sentenced to eight months and fined 10,000 dollars.

Insider Trading

Mathew Martoma, who is serving nine years in prison for carrying out the most lucrative insider trading scheme in history, said he should be freed after an appeals court tossed two other insider-trading convictions. The former portfolio manager for Steve Cohen's SAC Capital Advisors said in new court papers filed Tuesday that a recent appeals court decision narrowing the definition of insider trading "at the very least… demands a new trial." Martoma is one of a handful of inside traders who are appealing their convictions based on the stricter standard. He is also the most profitable, helping SAC avoid losses and generate $275 million in profits during the summer of 2008, prosecutors said. Martoma, who has spent the past six months in federal prison in Miami, was also ordered to pay $9.3 million, the size of his bonus the year the trades were made. But Martoma's lawyers say the evidence doesn't hold up based on an appeals court ruling that raised the bar for prosecutors and set a new standard for illegal trading...

Cameras May Open Up the Board Room to Hackers

https://www.nytimes.com/2012/01/23/technology/flaws-in-videoconferencing-systems-put-boardrooms-at-risk.html



Frontrunning

- Illegal frontrunning ---> eg. broker using information about client order and trading in anticipation of market impact
- Legal frontrunning ---> trading ahead of Index funds rebalances
- Legal frontrunning ---> HFT strategies identifying in real time big orders

Market Manipulations

- Spreading rumors to impact the prices. “Pump&dump”
- Trading aggressively with the intention to cause market impact which could be exploited

High Frequency Trading Strategies

- Previous example ETF market making
- Capturing bid/ask spread, collecting liquidity rebates
- Capturing short-term momentum/front running trades of big players
- Options Market Making
- Manipulative strategies

Examples of (HFT) - bad strategies

Manipulating closing print

Athena Capital “Gravy Strategy”