# MODULE 2 UNIT 1
# Lesson Interactive Infographic 1 Transcript



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# Classifying hedge fund strategies

Since many investors consider hedge funds an alternative investment that significantly diversifies their portfolios, hedge fund managers need to ensure their strategies are repeatable and scalable.

The many strategies managers can use typically fall into four primary categories: equity hedge, event-driven, relative value, and macro.

## Primary hedge fund strategies

### Equity hedge

Equity hedge strategies aim to reap the benefits of equity investing while limiting potential losses associated with a fall in the market. In the most common equity hedge strategy, the long-short equity strategy, managers take a long position on stocks (to buy) that are expected to go up and a short position on stocks (to sell) expected to go down. Shorting can take the form of borrowing stocks and then reselling them in the hope that the stock price decreases and the amount they have to pay back decreases as well. Managers can also use futures and options to achieve a similar hedging effect.

The idea is to isolate the risk of a specific stock from the overall risk of the market or industry. The long-short equity strategy can therefore provide returns uncorrelated with market performance. This can be achieved in practice using pair trades, such as balancing a long position on AT&T with a short position on Verizon or by offsetting long equity with short index, such as buying Apple stock and selling short the S&P 500.

### Equity hedge strategy composition

The following is the composition of equity hedge strategies by assets under management (HFR, n.d.). Fundamental value and fundamental growth strategies together account for more than 70% of all assets invested using equity hedge strategies.

- **Fundamental value (57.60%):** Managers allocate funds to companies that seem undervalued compared to relative benchmarks.

- **Fundamental growth (15.42%):** Managers allocate funds to companies they expect to experience significant earnings growth and capital appreciation.

- **Technology/healthcare (9.02%):** Managers maintain a greater than 50% exposure to these sectors to track their performance.

- **Equity market neutral (6.14%):** Managers aim for returns completely independent of the market (i.e. the fund has zero market exposure). This can be achieved by holding long and short positions that perfectly offset each other. In practice, managers maintain no more than a 10% net long or short exposure to the market.

- **Multistrategy (4.84%):** Managers maintain no more than 50% of their portfolio in any equity hedge substrategy.

- **Quantitative directional (3.33%):** Managers use quantitative analytical techniques to develop views on future price movements or relationships.

- **Energy/basic materials (2.90%):** Managers maintain a greater than 50% exposure to these sectors to track their performance.

- **Short bias (0.74%):** Managers maintain a net short position on overvalued companies to profit from a decrease in their value.

## Event-driven

In event-driven strategies, investment is driven by significant potential corporate events, such as mergers, restructuring, liquidation, bankruptcy, and reorganisation. Managers need a detailed understanding of the situation to effectively implement this strategy, which is subject to significant "event risk". The strategy aims to take advantage of price inefficiencies before or after these events (BarclayHedge, 2012).

For example, in October 2008, three Icelandic banks (Kaupthing, Landsbankinn, and Glitnir) were nationalised. At the time, the recovery on Kaupthing debt was 6.625% (Global Custodian, 2008), and distressed debt hedge funds bought Kaupthing bonds at an extremely low level, betting that they would be able to recover an increased amount in the future. By 2011, Kaupthing bonds were trading roughly 25% higher. By the next year, the UK division of Kaupthing had repaid almost three-quarters of the £4.6 billion it owed and, in September of 2013, it was estimated that creditors recovered between 86–90% of the total claim (The Chartered Institute of Public Finance & Accountancy, 2013).

## Event-driven strategy composition

The following is the composition of event-driven strategies by assets under management (HFR, n.d.). Investment using an activist strategy grew at more than twice the rate of other hedge fund strategies, and regularly surpassed the S&P 500 index, between 2010 and 2015 (German, 2015).

- **Special situations (47.05%):** Managers identify and adapt their equity position to future events (restructuring, share issuance or repurchase, spin-offs, etc.) that will impact a company's value.

- **Distressed and restructuring (23.39%):** Managers purchase fixed-income securities that have lost a significant amount of value due to actual or perceived financial difficulty experienced by the underlying company.

- **Activist (15.80%):** This is essentially value investing; managers not only identify undervalued public companies, but actually spend their own resources to actively develop the value of the company (German, 2015). Managers maintain more than 50% of their portfolio in activist positions. To learn more about what activist hedge funds are and how they operate, read Victor German's explainer on The Street.

- **Multistrategy (8.65%):** Managers have no more than 50% of their portfolio in any one event-driven substrategy.

- **Merger arbitrage (2.54%):** Managers take long and short positions on two merging companies. An arbitrage opportunity exists, as there is a risk the merger will be delayed or will not happen, and the stock of the company being acquired will sell at a discount. As a result, managers take a long position on the company being acquired and a short position on the acquirer.

- **Credit arbitrage (1.89%):** Managers focus on corporate fixed-income instruments to take advantage of anticipated idiosyncratic developments with little or no exposure to broad credit markets.

- **Private issue and Regulation D (0.67%):** Managers invest in small companies, typically those that are private and illiquid, and often those that are eligible for Regulation D exemption.

## Relative value

With this strategy, managers enter positions to take advantage of a predicted valuation discrepancy in the relationship between multiple assets. Think of it relative to event-driven strategies, which bet on the outcome of a corporate transaction. Relative value strategies bet on pricing differences in securities related to the transaction (HFR, n.d.).

## Relative value strategy composition

The following is the composition of relative value strategies by assets under management (HFR, n.d.), with the primary share of 60% being invested using multistrategies.

- **Multistrategy (60.06%):** Managers look at the relative value across asset classes and instruments.

- **Fixed income – Corporate (16.81%):** Managers focus on the relative values of related instruments, of which at least one is a corporate fixed-income security. Typically, managers focus on relative values of multiple corporate bonds or of corporate and government bonds.

- **Fixed income – Asset-backed (10.29%):** Managers trade related instruments, of which at least one is a fixed-income security that is securitised by collateral obligations. Managers aim to profit by analysing the relative values of these asset-backed securities.

- **Fixed income – Convertible arbitrage (6.39%):** Managers buy convertible fixed-income securities and sell related instruments of the same issuer. The aim is to profit from any price differences between the convertible and non-convertible securities.

- **Fixed income – Sovereign (2.60%):** Managers focus on opportunities for spread between related instruments, typically between multiple sovereign bonds or between corporate and government bonds.

- **Yield alternatives (1.94%):** Managers trade related instruments, of which at least one contains either direct or indirect exposure to certain niche markets (such as energy or real estate). The aim is to profit from yield differentials between the securities.

- **Volatility (1.91%):** Managers trade volatility as an asset class. This is primarily achieved through the use of options.

## Macro

Macrostrategies focus on how movements in key macroeconomic metrics will affect security prices (HFR, n.d.). Both systematic and discretionary analyses are applied here. Some strategies are similar to those of relative value, but macrostrategies bet on the predicted movements of underlying instruments, as opposed to the creation of value discrepancies in the securities themselves.

## Macrostrategy composition

The following is the composition of macrostrategies by assets under management (HFR, n.d.), showing almost half of assets are invested using systematic diversified strategies.

- **Systematic diversified (46.90%):** Managers use mathematical models to identify trends and patterns in securities or asset classes. Once the models have been developed, there is little or no individual involvement in strategy implementation.

- **Discretionary thematic (25.90%):** Managers evaluate a range of macroeconomic variables and use a top-down approach to identify opportunities, which are typically in the equity space, but can include other asset classes.

- **Multistrategy (16.89%):** This strategy employs components of both discretionary and systematic strategies.

- **Commodity (4.44%):** Managers use mathematical models to identify trends and opportunities in commodity markets. This strategy can be broken down to focus on one or more specific commodity markets, such as agriculture or metals. Managers use dedicated commodity-exposure strategies for more than 35% of their portfolio.

- **Active trading (2.53%):** Managers use active trading strategies, such as high-frequency trading or leverage. Investments are based on systematic and quantitative macroeconomic evaluation and typically possess shorter holding periods than trend or discretionary trading strategies.

- **Currency – Systematic (2.28%):** Managers use mathematical models designed specifically to identify trends across currency markets and asset classes. Managers use dedicated currency-exposure strategies for more than 35% of their portfolio.

- **Currency – Discretionary (1.07%):** This strategy relies on the fundamental analysis of currency markets by individuals charged with making trading decisions for a specified portfolio. Managers identify relationships and differentials between instruments, with most positions based on volatility. Investments include positions in both listed and unlisted global foreign exchange markets. Managers use dedicated currency-exposure strategies for more than 35% of their portfolio.

## Asset allocation over time

Compare the percentage of total funds invested using each primary hedge fund strategy in 1990 versus 2014 (HFR, n.d.).

### 1990

- Event-driven: 9.75%
- Relative value: 13.88%
- Equity hedge: 37.07%
- Macro: 39.30%

### 2014

- Event-driven: 26.52%
- Relative value: 26.70%
- Equity hedge: 27.72%
- Macro: 19.07%

You can see a clear reallocation between 1990 and 2014, with the use of macro and equity hedge strategies decreasing, and event-driven and relative-value strategies becoming more commonplace.

Based on more recent reports leading up to 2020, hedge fund managers have opted for more risk-averse strategies following the 2008 financial crisis, with equity hedge and event-driven returning some of the highest returns for investors.

# Bibliography

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