

# Hedge Funds

*Saurabh Singal, Nov 2006*

# Top Earners on Wall Street in 2005.

(Trader Monthly magazine.)

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- No.1 Mark McGoldrick, (Goldman Sachs) - \$40 to \$50 million.
- No.2 shared by Raanan Agus, (Goldman), Ken Karl (UBS), Boaz Weinstein (**Deutsche Bank**) - \$30 to \$40 million.
- No. 5 shared by Simon Greenshields (Morgan Stanley), Jonathon Hoffman (Lehman Brothers), Michael Hutchins (UBS) Rajeev Mishra (**Deutsche Bank**), Arvind Raghunathan (**Deutsche Bank**), Olav Refvik (Morgan Stanley) and a few other names - \$20 to \$25 million.

*Source: Trader Monthly magazine (tradermonthly.com)*

# Top Earners Hedge Funds in 2005.

(Trader Monthly magazine.)

1. T. Boone Pickens, BP Capital, age 77, \$1.5 Billion
2. Steve Andy Cohen, SAC Capital, over 1 Billion
3. James Simon, Renaissance Technologies, around \$1 Billion
4. Paul Tudor Jones, Tudor Investment Corp, \$800 to \$900 million.
5. Stephen Feinberg, Bruce Kovner, Eddie Lampert, David Shaw, Jeffery Gendell and Louis Bacon make up the rest of the top ten, all with over a quarter billion.

# What is a Hedge Fund?

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- Private Investment vehicles for **accredited** investors.
- These are structured as partnerships or LLP's. The hedge fund management company is the general partner is usually an LLC.
- Largely unregulated, though SEC tried hard...
- More freedom in terms of strategy/instruments/leverage.
- Fee structure.(2 and 20)
- Number of investors is limited.

**Returns are absolute and not benchmarked.**

# History

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- First hedge fund started by Alfred Jones, a reporter for Fortune magazine, around 1950.
- He felt he could not guess the direction of the market but was not bad at stock picking.
- Long Short Equity.

<b>Benchmark Performance Summary</b>	<b>YTD</b>	<b>5 Year Cumulative</b>	<b>5 Year Avg</b>	<b>corr with S&amp;P</b>
				<i>since 1994</i>
<b>Credit Suisse/Tremont Hedge Fund Index</b>	<b>9.6%</b>			
<b>Convertible Arbitrage</b>	<b>11.4%</b>	<b>31.42%</b>	<b>5.62%</b>	<b>0.14</b>
<b>Dedicated Short Bias</b>	<b>-1.8%</b>	<b>-22.62%</b>	<b>-5.00%</b>	<b>-0.76</b>
<b>Emerging Markets</b>	<b>13.6%</b>	<b>125.90%</b>	<b>17.70%</b>	<b>Not available</b>
<b>Equity Market Neutral</b>	<b>9.1%</b>	<b>42.89%</b>	<b>7.40%</b>	<b>0.36</b>
<b>Event Driven</b>	<b>11.6%</b>	<b>70.52%</b>	<b>11.26%</b>	<b>0.56</b>
<b>Distressed</b>	<b>11.9%</b>	<b>83.90%</b>	<b>12.96%</b>	<b>Not available</b>
<b>Risk Arbitrage</b>	<b>4.5%</b>	<b>21.25%</b>	<b>3.93%</b>	<b>Not available</b>
<b>Fixed Income Arbitrage</b>	<b>6.6%</b>	<b>30.88%</b>	<b>5.53%</b>	<b>Not available</b>
<b>Global Macro</b>	<b>10.4%</b>	<b>80.79%</b>	<b>12.57%</b>	<b>0.23</b>
<b>Long/Short Equity</b>	<b>9.2%</b>	<b>57.84%</b>	<b>9.56%</b>	<b>0.59</b>

*S&P 500*

*41.93%*

*7.26%*

*Citigroup World Govt Bond Index*

*42.63%*

*7.36%*

*Source: CS Tremont*

# Earlier Stars

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## George Soros (1970's to now)

- Macro trader.
- Broke the Bank of England in 1992
- GBP and Italian Lira fell out of EMS; Soros made 1 billion in a day.
- George Soros's most successful partners have Jim Rogers, Victor Niederhoffer and Stanley Druckenmiller.
- Lost money and changed style; Robert does most of the work now. Soros philanthropist.

# Earlier Stars (contd..)

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## Michael Steinhardt (1980's and 90's)

- Often had a macro view and then selected stocks that would benefit most, should the view be correct.
- Directional, frequent trades.
- Autobiography : *No Bull: My Life in and out of Markets*. Variant Perception
- SEC fines.
- Losses in 1994, partially re-couped in 1995; closed down in 1995.



# Earlier Stars (contd..)

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## Julian Robertson (1980's and 90's, stock picker)

- "... mandate is to find the 200 best companies in the world and invest in them, and find the 200 worst companies in the world and go short on them. If the 200 best don't do better than the 200 worst, you probably should get in another business".
- Through the 1980s and early '90s, his compound rate of return to his investors was 32%.
- Internet bubble did him in. When the Standard and Poor's 500-stock index climbed 21 percent in 1999, the Tiger funds declined 19 percent. Funds went from 26 billion to 6 billion; closed down.

# Fixed Income Arb

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Fixed Income stars from Salomon Brothers.

- Started in 1910, it was the premier bond house on the Street.
- Mortgage backed securities started here.
- At one time largest bond issuer; later almost entirely a prop shop.
- Fixed income arbitrage – example, spread between on the run and off the run securities.
- Fined close to 300 bucks in early 90's for manipulating a short squeeze in Treasuries.
- Meriwether and the other quants/traders went to form LTCM. (Gregory Modest, Scholes, Merton).
- **Saman Majd** came to **Deutsche** – smart move.

# Examples of Fixed Income Trades

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- Not really “arb” in the strictest sense – often involve some view.
- Flatteners: Buy bonds in the far end and short the near end of the curve.
- Steepener – opposite
- Butterflies: Either long the wings and short the body (kink/trough in the curve) or the other way around (hump in the curve)
- Mortgages rich area.

# Relative Value

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- The archetypical a yen carry trade
  - Borrow yen from a Japanese bank
  - Convert the funds into U.S. dollars
  - Buy T-bills for the equivalent amount.
  - Say the bill pays 5% and the Japanese interest rate at which you borrowed was at 0.5%.
  - 4 Times Leverage and a profit of 18%.
  - FX risk.
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- In currencies suffering from hyper inflation, e.g., Turkey.
  - The government was depreciating the currency at a fixed rate per annum.
  - The interest rate was very high- over 100% .
  - The interest rate implied by the currency forwards was lower than this.
  - Borrow in US Dollars, buy Turkish bills, sell FX fwd.

# Event Driven – Merger Arb

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- When a merger or takeover is announced, it is not certain the deal will go through.
- The play is on the probability of the deal going through. (Preliminary agreements/terms and conditions/audit of financial reports/shareholders approval/ Approval by regulatory and Anti Trust authorities.)
- Typically long the company being acquired and short the acquirer.
- Small chance of large loss and large chance of many modest wins.
- In Oct 2000, GE bid for Honeywell - everyone thought good synergy etc; US DoJ approved the merger – EU Competition commissioner, Mario Monti cried foul. Spread tripled. Large loss.
- Best merger arb funds are alumni of Goldman.
- Robert Rubin – joined in '66 and partner in 1971.
- Salomon and Goldman (Erich Mindich, Dinakar Singh) spawned the most hedge funds.

# Capital Structure Arb

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# Vol “Arb”

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- Again, not necessarily an arb.
- Vol is a mean reverting series.
- Or at least, it has been, in the past.
- Selling vol when it spikes
- Selling long dated vol and going long near dated vol.
- Variance swaps
- Problems come when vol of vol behaves in an expected fashion, example this year.

# Equity Market Neutral

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- Either look at cointegrated sets of stocks. Typically two stocks in the same industry.



# Capital Structure Arbitrage

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