

# Hedge Funds

Structures, Strategies, and  
Recent Developments

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# Hedge Funds

- Defining Hedge Funds
- Trading Strategies
- Returns and Statistics
- Shareholder Activism
- Communicating with Hedge Funds



# What is a Hedge Fund?



*An investment group usually in the form of a limited partnership that employs speculative techniques in the hope of obtaining large capital gains.*

*Merriam-Webster*



# What is a Hedge Fund?

- Legal Structure: Hedge Funds vs. Mutual Funds
- Alternative vs. Traditional Investments
- Absolute vs. Relative Returns

# Legal Structure

- Usually set up as LP or LLC
  - General partner has operational management of fund vs. board of directors
  - Pass through tax treatment for all partners
  - Limited liability for limited partners



# Legal Structure

- Do not have to register under the Investment Company Act of 1940
  - Exempt if fund is limited to 99 accredited investors (i.e. individuals with \$1 MM in liquid assets, \$200 mm annual or \$300 mm family income.)
  - Or if fund is limited to 499 qualified purchasers (i.e. families with \$5 MM in net worth or institutions with \$25 MM in investable assets.)
  - Do not actively market their product
  - New law requires registration if more than \$30 MM in AUM and less than 2 year lock-up

# Alternative vs. Traditional Investments

## ➤ Traditional Investments

Mutual Funds, Pension Funds,  
ETFs, Close-End Funds, Trusts.

## ➤ Alternative Investments

Venture Capital, Private Equity,  
LBO Funds, Real Estate,  
Managed Futures, Hedge Funds.

# Traditional Investments

- Traditional investments involve widely held, liquid investments in equity and fixed income securities.
- Long-only, un-levered positions

# Alternative Investments

- Alternative investments can include stocks, bonds, currencies, derivatives, options, futures and commodities, along with extremely illiquid positions in real estate and private companies.
- Long and short, often highly levered

*- LTCM achieved a staggering 100-1 leverage on certain positions.*



## **Mutual Funds**

### **- Daily liquidity**

- Daily NAV for purchases/redemptions
- 30-90 day redemption penalties

### **- Very transparent**

- Standard reporting requirements

## **Hedge Funds**

### **- Limited liquidity**

- Monthly or quarterly redemptions
- Lock-up periods (1-yr, 5yr)

### **- Significantly less transparency**

- Often negotiated

## Mutual Funds

**- Roughly 9,500 US Mutual Funds**

**- \$10 Trillion in AUM**

- Average Fund \$1.1 Billion
- Median Size \$100 to \$500 MM

**- 1% - 2% Management Fee**

## Hedge Funds

**- Roughly 9,500 Hedge Funds**

**- \$1.2 Trillion in AUM**

- Average Fund Size \$125 MM
- Median \$30 to \$100 MM

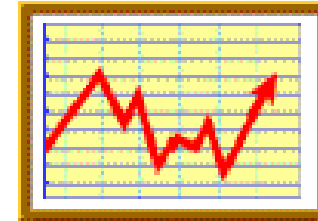
**- 1% - 2% Management Fee,  
plus 20%+ Performance  
kicker**

- Hurdle rate, Highwater Mark

# Relative vs. Absolute Return Strategies

- Relative Returns judged versus a benchmark index

e.g. S&P, Russell 3,000, or Nikkei 225



- Absolute or Total Return targets a specific return level

e.g. 5% to 20% per annum

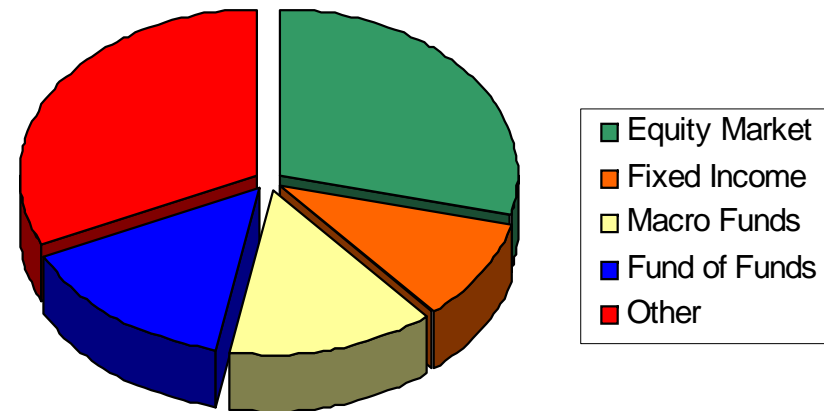


# Absolute Return Strategies

Five Categories:

- Equity Market
- Fixed Income
- Macro Funds
- Fund of Funds
- Other

Asset Allocation by Fund Type



Source: Schneeweis

# Absolute Return Strategies

## Equity Market Hedge Funds

- 1) Equity Long Only
  - Sector Specific
  - Emerging Markets
- 2) Dedicated Short Selling
- 3) Long/Short Equity
- 4) Equity Market Neutral

# Absolute Return Strategies

## Fixed Income Hedge Funds

- 1) Basis Trading and Asset Swaps
- 2) TED/Credit Spreads
- 3) Yield Curve Arbitrage
- 4) Relative Value/Carry Trade
- 5) CDO's, CMO's
- 6) Convertible Arbitrage

# Absolute Return Strategies

## Global Macro Hedge Funds

*“Gunslingers” of the hedge fund industry*

1) Global Macro – large directional bets in global equity, fixed income, commodity and currency markets

2) Managed Futures

A) Commodity Pool Operators (CPO's)

B) Commodity Trading Advisors (CTA's)

i) Discretionary

ii) Systematic

# Absolute Return Strategies

## Fund of Funds

- 1) Multi Strategy
- 2) Strategy Specific

## Other

- 1) Multi Strategy
- 2) Event Driven
- 3) Distressed Securities
- 4) Merger/Risk Arbitrage
- 5) Capital Structure Arbitrage
- 6) Options/Volatility Arbitrage



# Risk/Returns

	Jan 1994 - April 2004		
	Average Return	Standard Deviation	Correlation to S&P
S&P	12.05%	15.63%	1
Global Macro	15.20%	11.92%	0.232
Distressed	13.70%	6.89%	0.545
Long/Short Equity	12.66%	10.86%	0.583
Event Driven	11.65%	5.95%	0.552
CSFB/Tremont	11.41%	8.36%	0.476
Multi-Strategy	10.58%	6.27%	0.475
Convertible Arbitrage	10.53%	4.71%	0.126
Equity Market Neutral	10.46%	3.06%	0.399
Emerging Markets	8.77%	17.53%	0.48
Risk Arbitrage	8.40%	4.40%	0.437
Managed Futures	7.66%	12.31%	-0.21
Fixed Income Arbitrage	6.96%	3.91%	0.029
Dedicated Short Bias	-1.56%	17.80%	-0.757

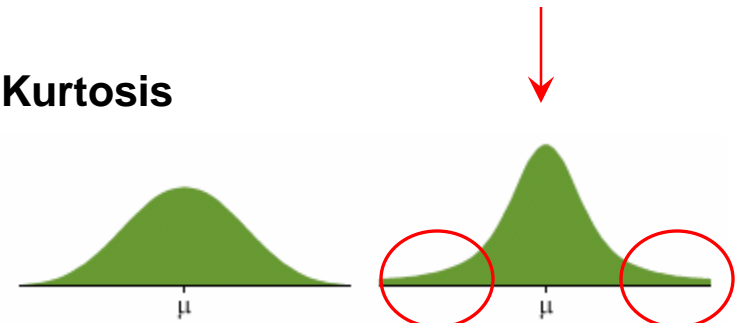
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# Higher Moments Risk

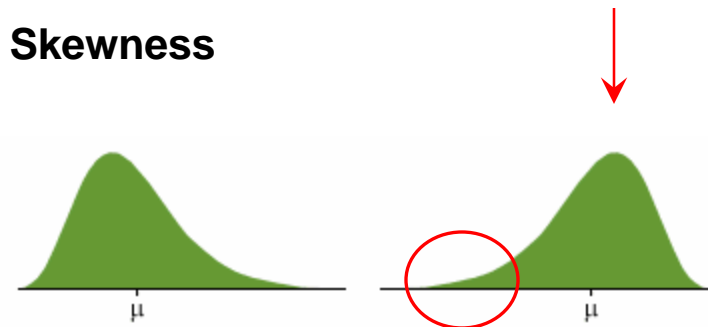
	Kurtosis	Skewness
S&P	0.408	-0.618
Event Driven	24.934	-3.672
Fixed Income Arbitrage	19.73	-3.549
Multi-Strategy	17.953	-2.809
Distressed	17.692	-2.922
Risk Arbitrage	6.389	-1.339
Convertible Arbitrage	4.381	-1.632
Emerging Markets	4.111	-0.654
Long/Short Equity	3.643	0.214
Global Macro	2.405	-0.027
Dedicated Short Bias	2.314	0.952
CSFB/Tremont	2.089	0.134
Managed Futures	0.415	0.03
Equity Market Neutral	0.306	0.213

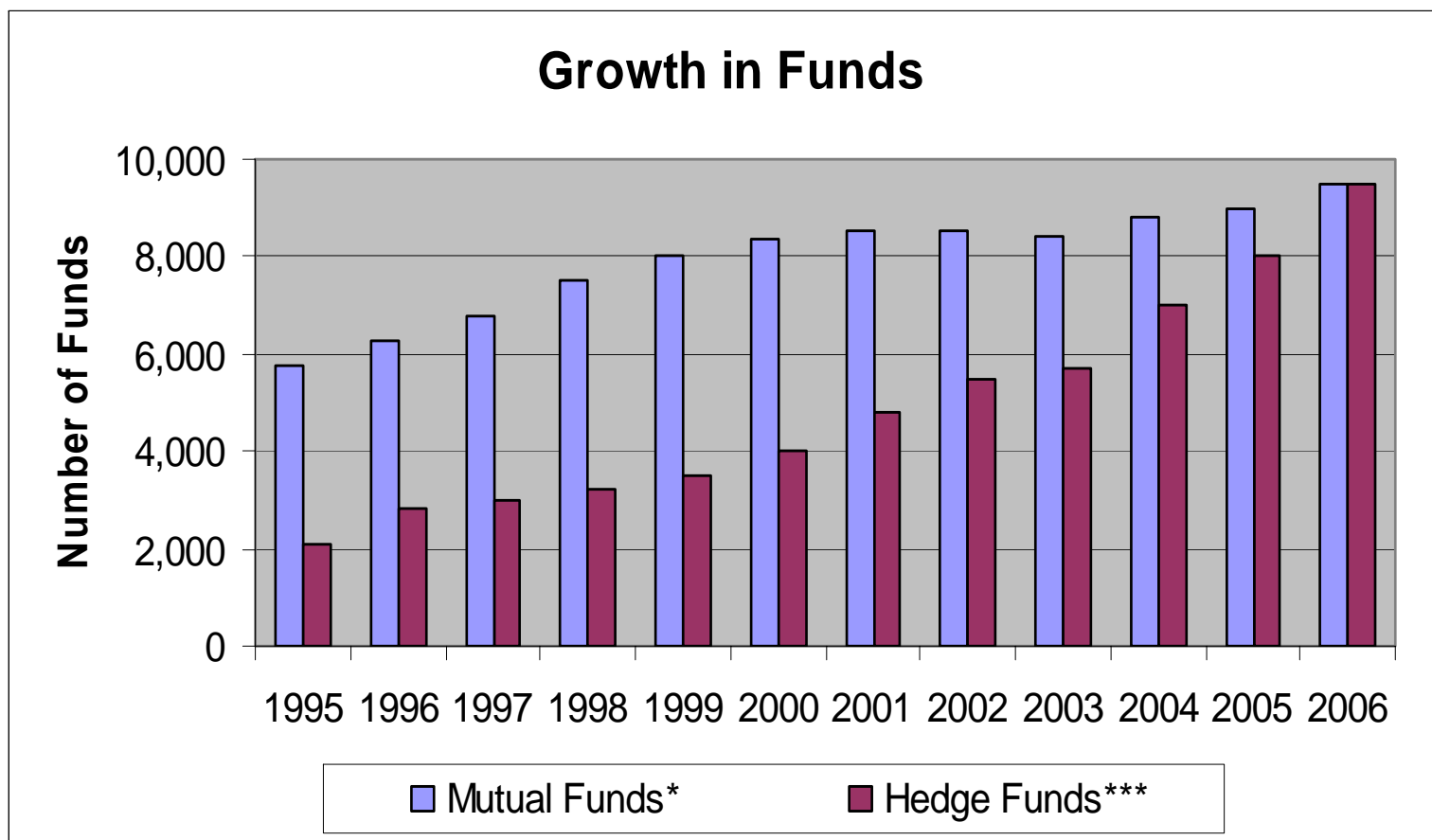
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## Kurtosis



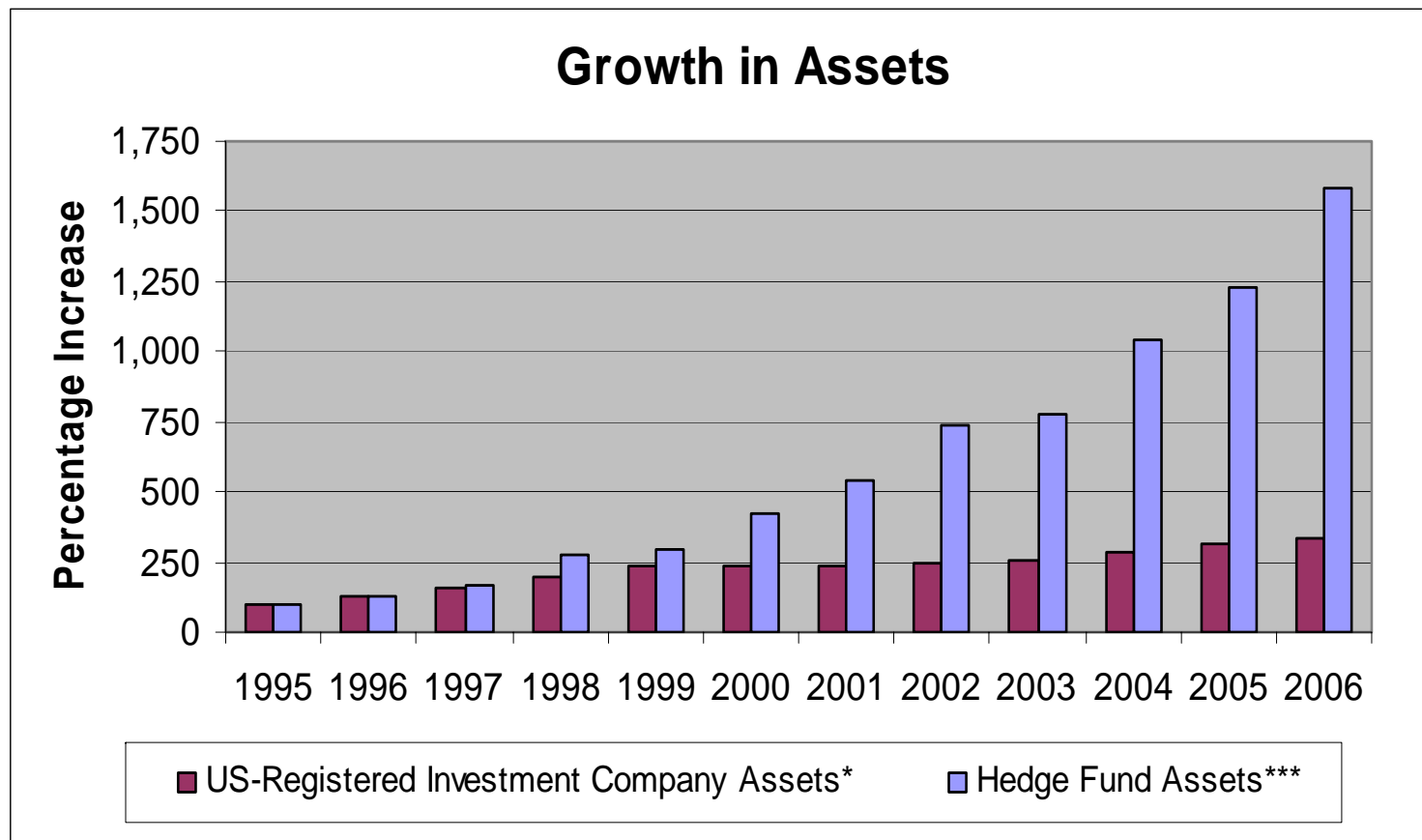
## Skewness





\* Source: Investment Company Institute - <http://www.ici.org/>

\*\*\* Source: Hennessee Group - <http://www.hennesseegroup.com/>



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Assets Under Management	3rd Qtr 06†	2nd Qtr 06†	1st Qtr 06†	4th Qtr 05†
Hedge Fund Industry *	\$ 1,457.8 B	\$ 1,324.7 B	\$ 1,271.6 B	\$ 1,184.7 B
Fund of Funds Industry	\$ 905.7 B	\$ 878.0 B	\$ 780.9 B	\$ 768.6 B
<b>Sectors</b>				
Convertible Arbitrage	\$ 33.4 B	\$ 30.7 B	\$ 29.3 B	\$ 38.5 B
Distressed Securities	\$ 92.9 B	\$ 86.4 B	\$ 79.1 B	\$ 78.1 B
Emerging Markets	\$ 247.1 B	\$ 172.7 B	\$ 170.6 B	\$ 140.5 B
Equity Long Bias	\$ 184.1 B	\$ 177.4 B	\$ 176.8 B	\$ 170.1 B
Equity Long/Short	\$ 220.0 B	\$ 212.8 B	\$ 214.9 B	\$ 183.9 B
Equity Long-Only	\$ 29.4 B	\$ 31.7 B	\$ 32.3 B	\$ 29.6 B
Equity Market Neutral	\$ 55.2 B	\$ 50.0 B	\$ 49.0 B	\$ 47.3 B
Event Driven	\$ 104.8 B	\$ 98.4 B	\$ 80.2 B	\$ 93.2 B
Fixed Income	\$ 134.0 B	\$ 126.7 B	\$ 119.7 B	\$ 121.2 B
Macro	\$ 70.3 B	\$ 68.2 B	\$ 62.9 B	\$ 50.6 B
Merger Arbitrage	\$ 18.6 B	\$ 16.7 B	\$ 19.2 B	\$ 19.8 B
Multi-Strategy	\$ 157.0 B	\$ 147.2 B	\$ 136.2 B	\$ 125.2 B
Other **	\$ 28.1 B	\$ 26.1 B	\$ 24.4 B	\$ 18.2 B
Sector Specific ***	\$ 83.0 B	\$ 79.7 B	\$ 77.0 B	\$ 68.4 B

\*\*\* Source: Barclay Group - <http://www.barclaygrp.com/>

Benchmark Performance Summary	Return	
	6-Nov	YTD
Credit Suisse/Tremont Hedge Fund Index	2.07%	11.81%
Convertible Arbitrage	1.06%	12.62%
Dedicated Short Bias	-5.46%	-7.20%
Emerging Markets	3.15%	17.16%
Equity Market Neutral	0.97%	10.18%
Event Driven	2.09%	13.92%
Distressed	1.59%	13.67%
Multi-Strategy	2.39%	14.57%
Risk Arbitrage	3.01%	7.62%
Fixed Income Arbitrage	1.16%	7.89%
Global Macro	1.44%	12.01%
Long/Short Equity	2.60%	12.05%
Managed Futures	2.22%	3.85%
Multi-Strategy	2.26%	12.54%

Source: CSFB/Tremont - [www.hedgeindex.com](http://www.hedgeindex.com)

# Dividend Strips

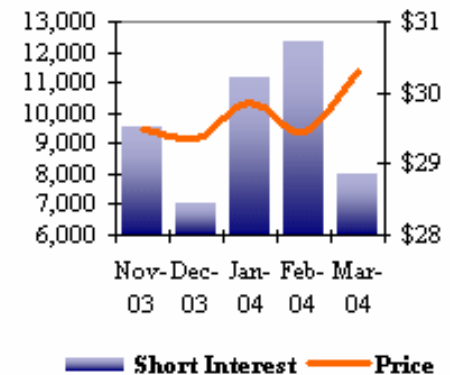
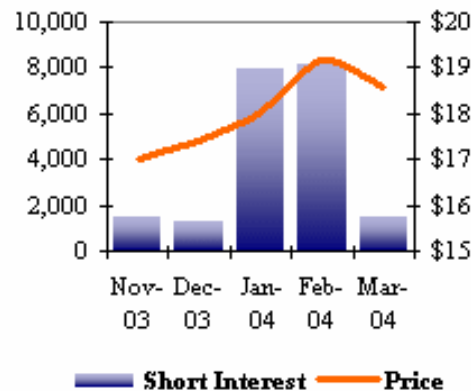
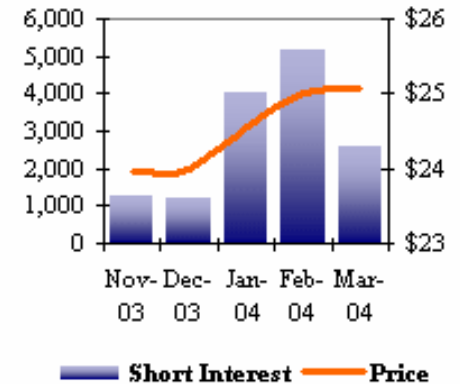
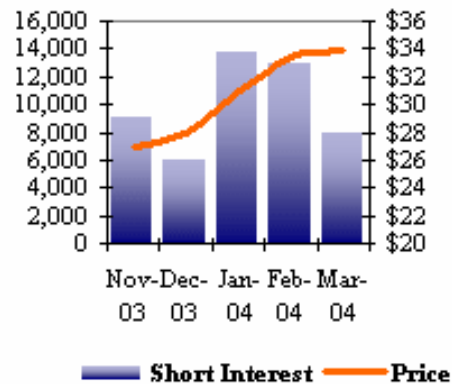
- Broker borrows shares from third party and “sells” them to a overseas investor/hedge fund
- Negotiate OTC forward contract to repurchase shares in future at lower price (current price – dividend)
- Hedge fund receives dividend yet realizes capital loss on resale of stock, takes advantage of foreign tax codes
- Broker makes short term capital gains on short sale, plus negotiated repurchase at lower price via futures contract
- Risk-free arbitrage

# Dividend Strips

- Borrowed shares count as short interest, as measured by stock exchanges (shares on loan)

- Short interest will increase dramatically for a basket of stocks

## Short Interest in 4 Regional Utilities





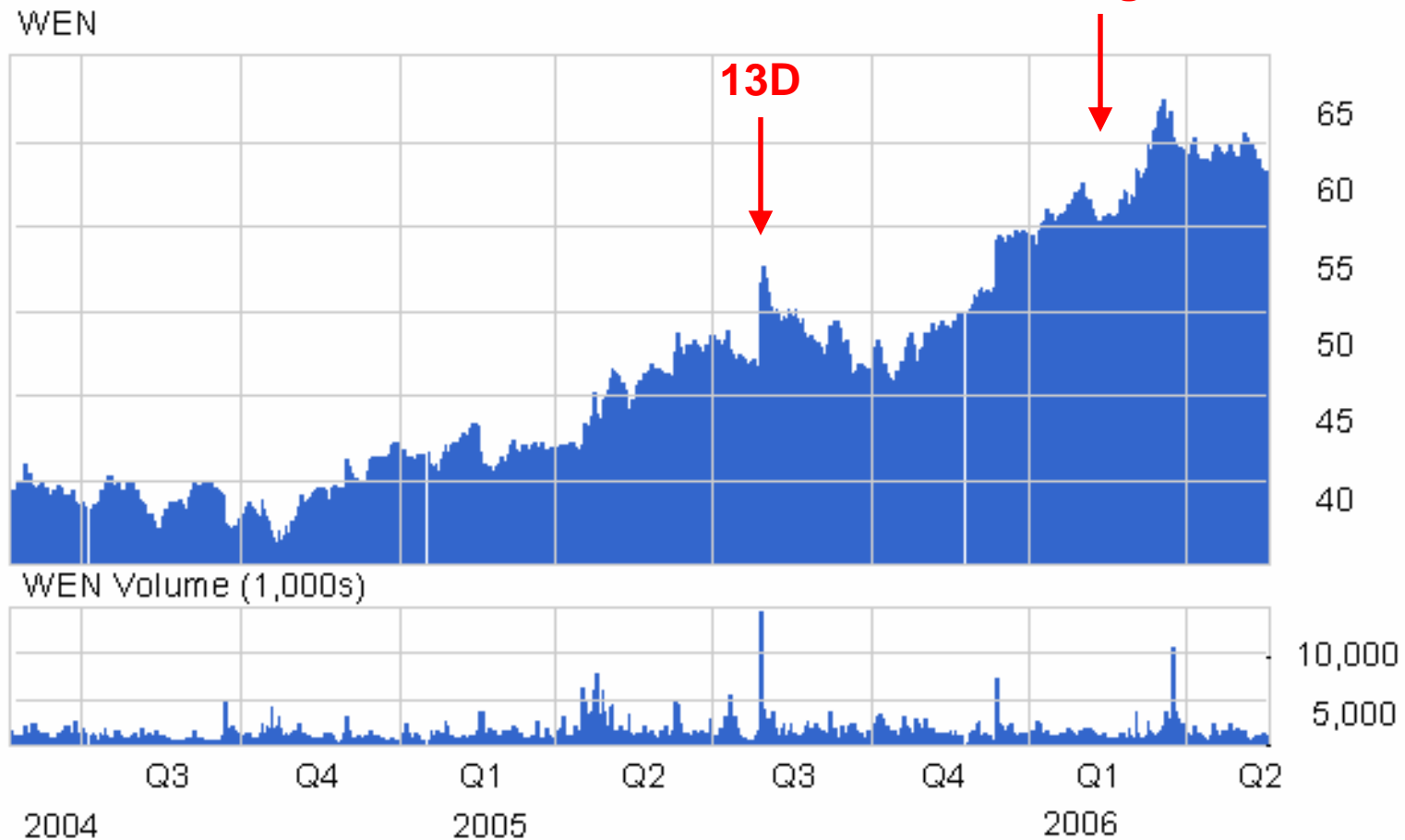
# Pershing Square

## *Wendy's International*

- August 2005, Pershing Square filed for ownership of 11,609,000 shares of WEN – 9.9%
- 13-D indicated just 1,366,000 shares – 1.2%
- Remainder was 102,430 call options, exercisable into 10,243,000 shares
- Company agreed to re-franchise company-owned stores, increase dividend and buyback, and spin-off Tim Horton's.
- Stock price surged

# Pershing Square

**20% 6-mo gain on WEN**  
**45% 6-mo gain on calls**

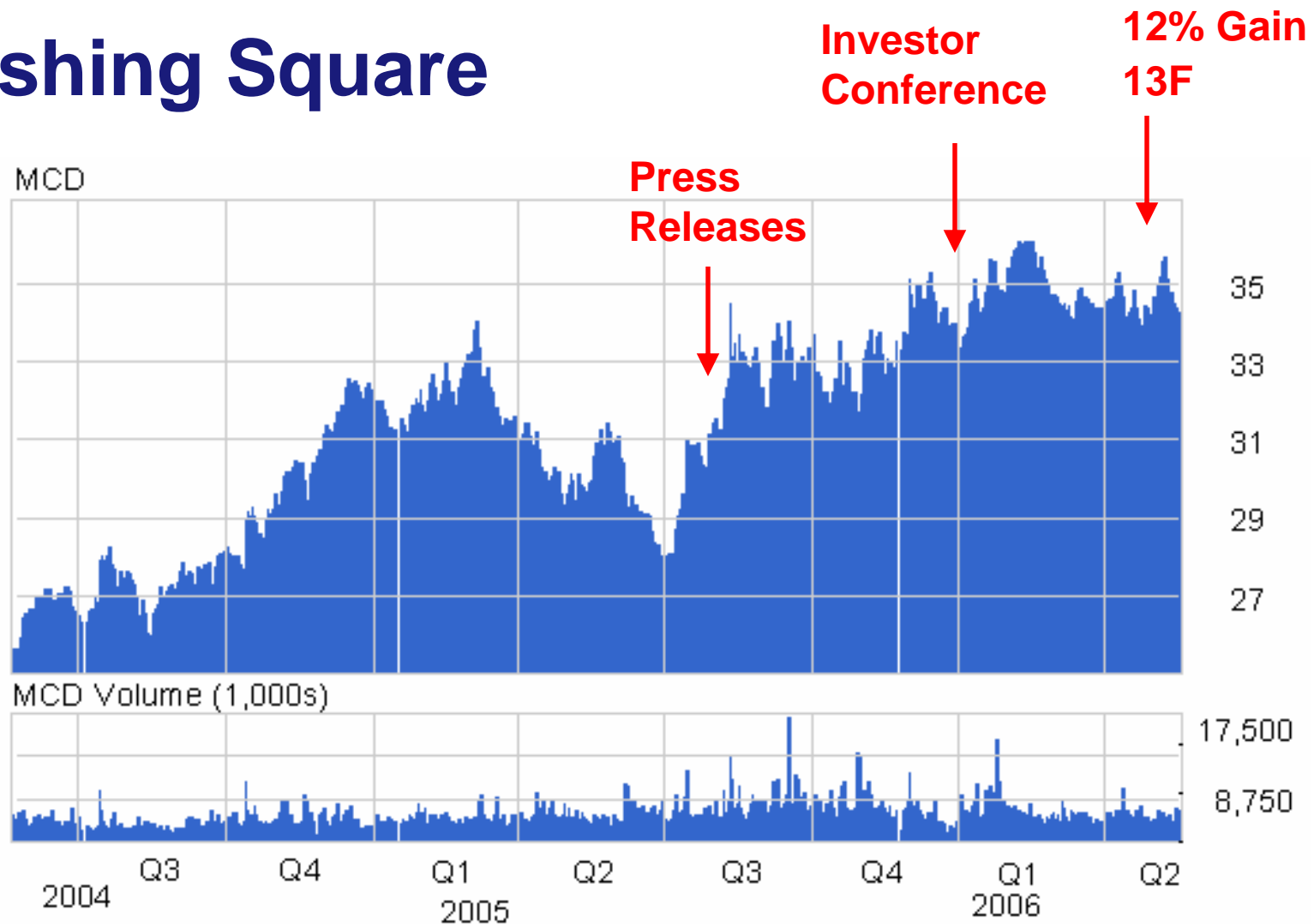


# Pershing Square

## *McDonald's International*

- Pershing Square began to pressure McDonald's management saying they owned 5%
- Investor conference detailing designs, spinning-off company owned stores as separate mega-franchisee
- Would boost stock value by "50%"
- 5% stake (63 MM shares) in MCD would cost roughly \$2 Billion
- Stock surged
- 13-F indicated just 105,000 shares – only 0.008%

# Pershing Square

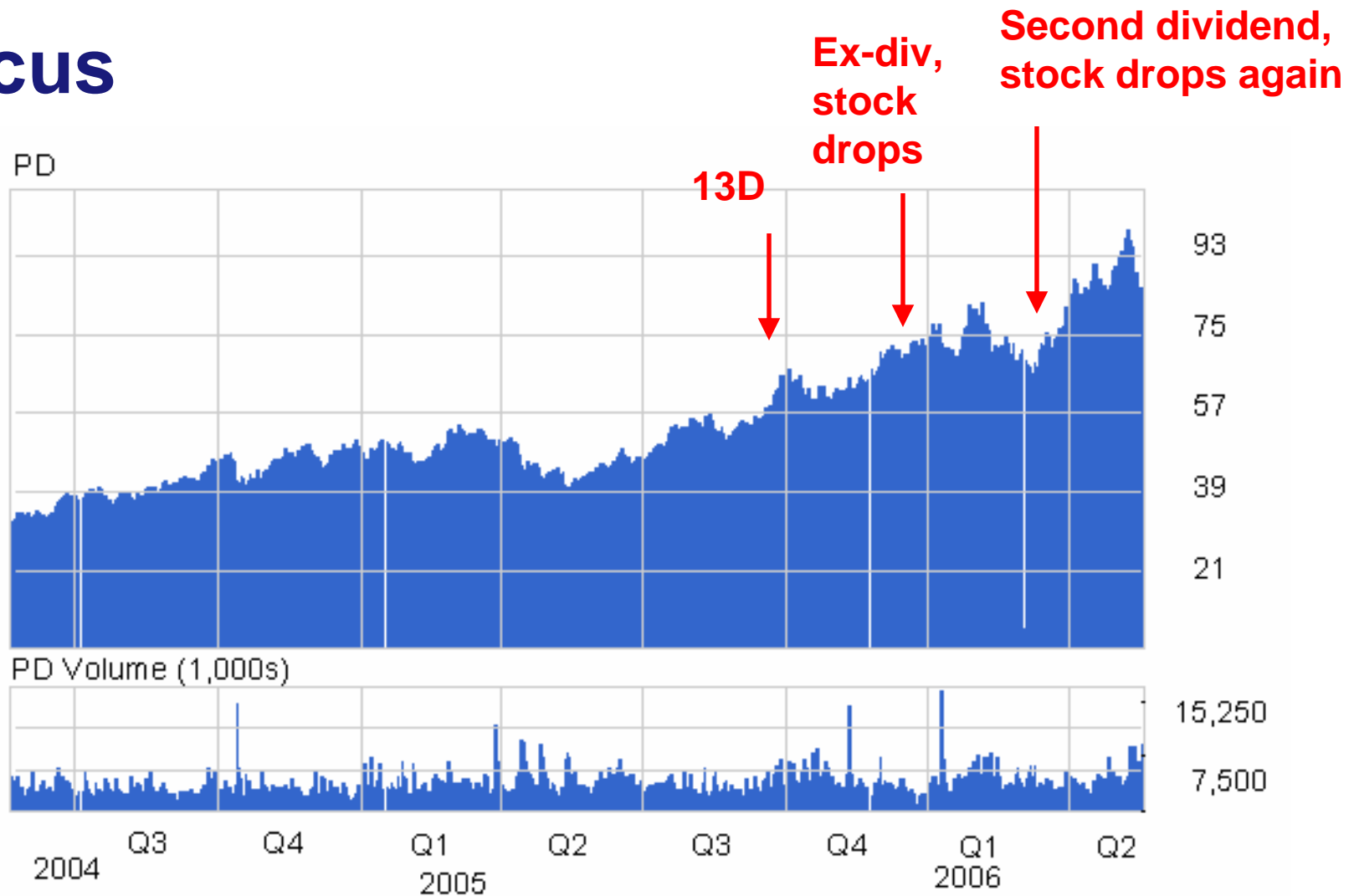


# Atticus

## *Phelps Dodge*

- October 2005, Atticus filed for 8.3 MM shares of PD stock - 08.6%
- Filing stated ownership of just 4 million shares, and options equivalent to 4.3 million
- Called on the company to return cash on hand to investors
- PD increased stock buybacks, and announced one-time \$5 cash dividend
- Stock fell \$7 on ex-date as holders got \$5 cash – options not adjusted, do not receive dividend

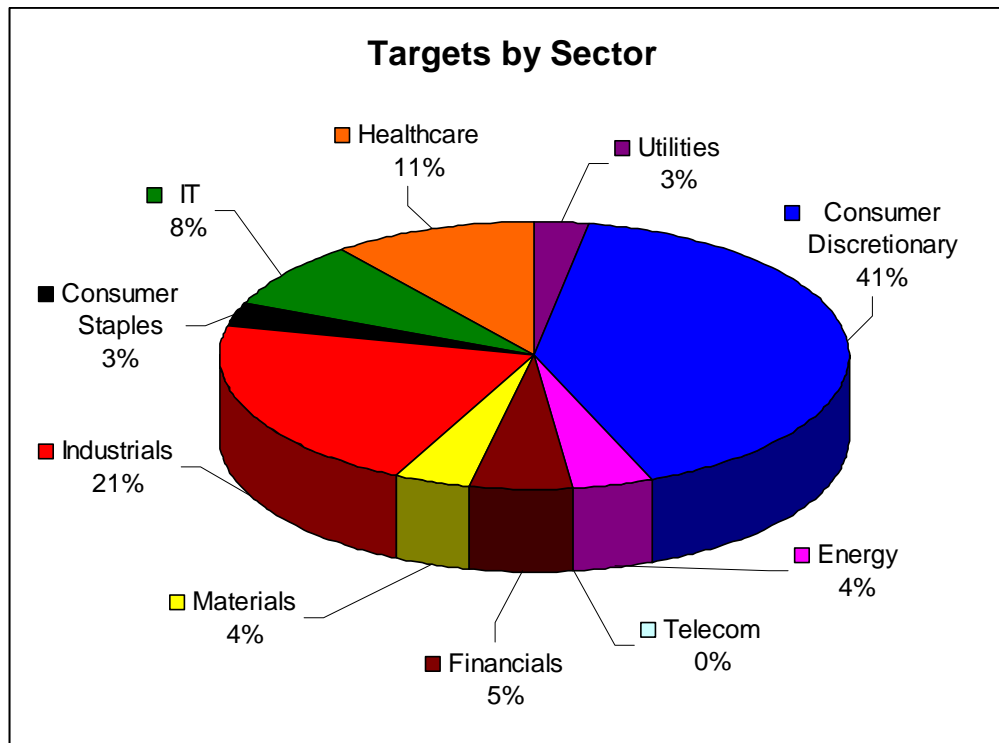
# Atticus



**Table 2: Recent Activist Efforts**

Hedge Fund	Target	Request	Result
Icahn Partners	Blockbuster and Hollywood	Merger with Hollywood	Failed
Icahn Partners	Blockbuster	Three Board seats	Successful
Icahn Partners and JANA Partners	Kerr-McGee	Asset sales, buyback	Successful
Icahn Partners	Mylan Labs	Reject merger with King	Successful
Perry Partners	Mylan Labs and King Pharma	Merge King with Mylan	Failed
Icahn Partners	Time Warner	Spin-offs, buyback	Pending
Icahn Partners	Temple Inland	Buyback	Successful
Burton Capital	Cenveo	Replace CEO and Chairman	Successful
Highfields Capital	Circuit City	Unsolicited bid for company	Failed
Highfields Capital and Copper Arch	Morgan Stanley	Sought ousting of CEO	Successful
Cannel Capital	BKF Capital	Sought ousting of CEO	Successful
JANA Partners, Atticus Capital and TCI	Deutsche Boerse	Abandon bid for London Stock Exchange, return of cash to shareholders, and ousting CEO	Successful
East Texas Capital and Par Capital	Independence Air	Sale of company	Pending
Orbimed Advisors	BioMarin Pharma	Board seats	Successful
Third Point Management	StarGas	Management changes	Successful
Apollo Group	Metals USA	Unsolicited bid for company	Successful
Pardus Capital and Liberation Investments	Bally Total Fitness	Management changes, asset sales	Pending
CD Capital, Magnetar Financial, and New World Opportunity Partners	Sunterra Corp	Seat on the Board	Pending

# Shareholder Activism



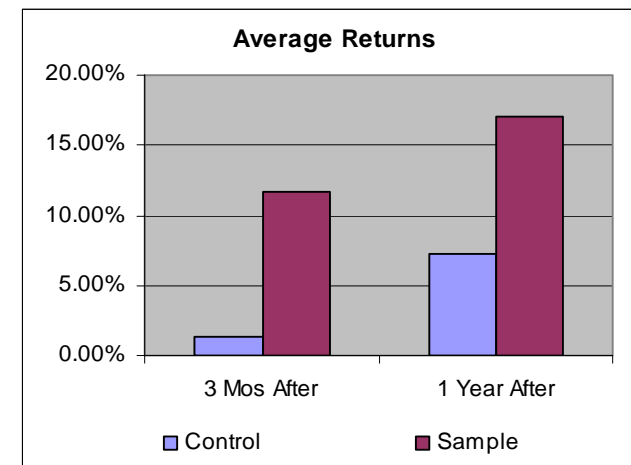
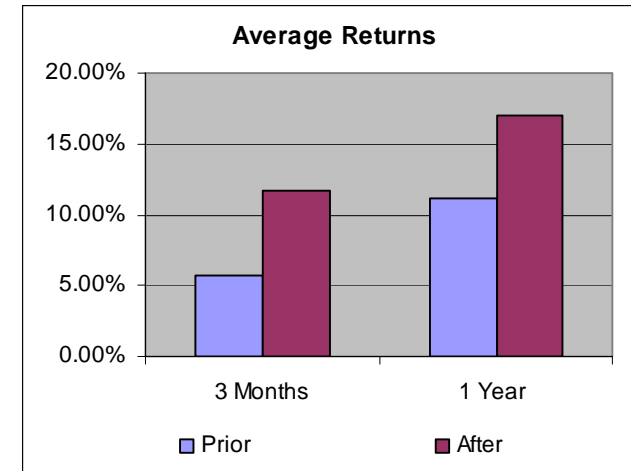
## Targets

- **Smaller market capitalization**
- **Substantial cash holdings**
- **Lower valuation multiples than their peers**
- **Slightly inferior pre-activism stock performance**



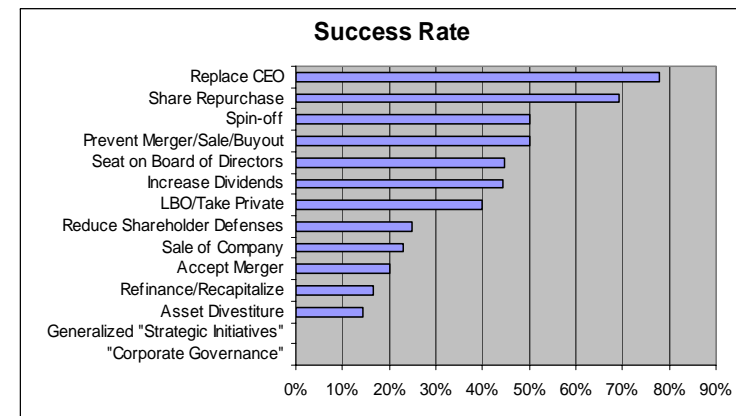
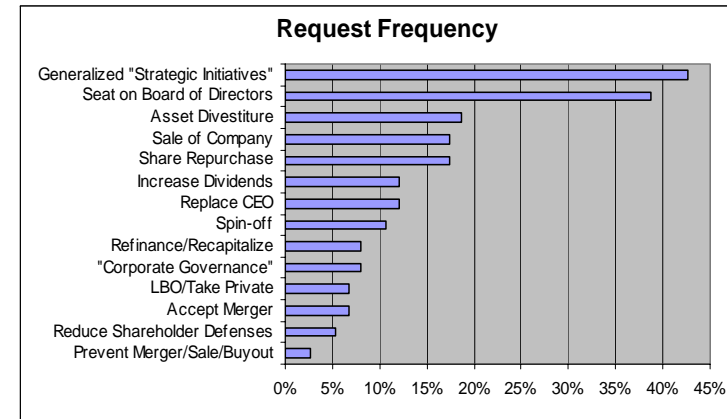
# Shareholder Activism

- Comparing same-stock returns, before and after the activist approach shows outperformance in both “After” periods.
- Comparing 3 month and 1 year after for sample versus a control group, activist sample dramatically outperformed in both periods.

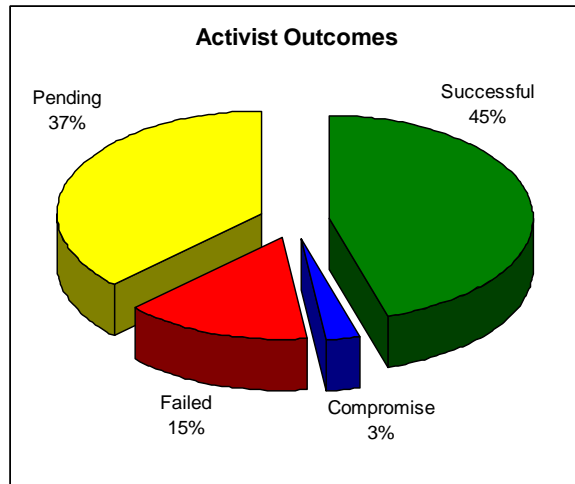


# Shareholder Activism

- Most frequently requested demands included a seat on the board of directors, asset divestitures, sale of the company and share repurchases.
- The highest success rate for a demand was replacing the CEO, at 77.8%. Other high-success requests included share buybacks, spin-offs and seat(s) on the board.

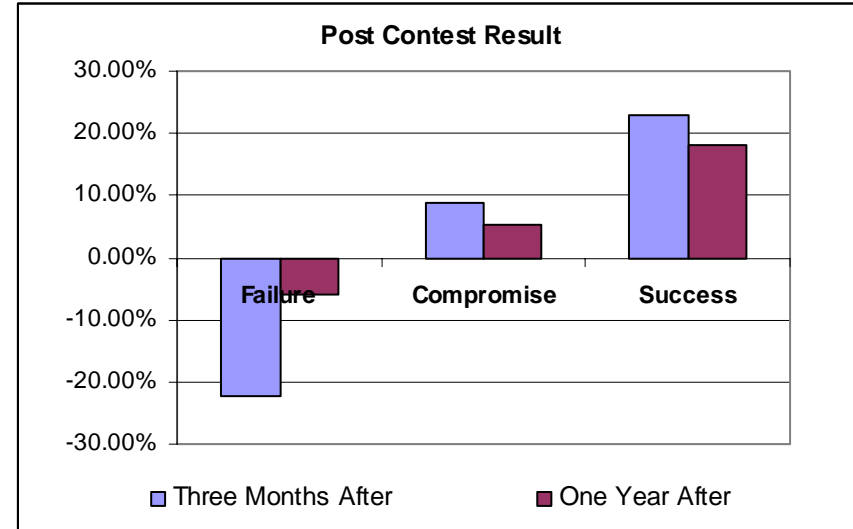


# Shareholder Activism



➤ In 45% of the 75 cases, an activist was successful in achieving at least one of their demands.

➤ Stock prices fell in both short and long run measures when activists failed, and rose when they succeeded.



# Activist Hedge Funds

<b>Fund</b>	<b>Assets (\$MM)</b>
1 Millennium Management	\$8,900
2 S.A.C. Capital	\$8,400
3 Atticus	\$8,000
4 Perry Partners	\$7,750
5 Highfields Capital	\$7,125
6 Relational Investors	\$7,000
7 Icahn Partners	\$6,150
8 Magnetar	\$4,675
9 Jana Partners	\$4,425
10 Apollo	\$3,875
11 Omega Partners	\$3,750
12 Steel Partners	\$3,400

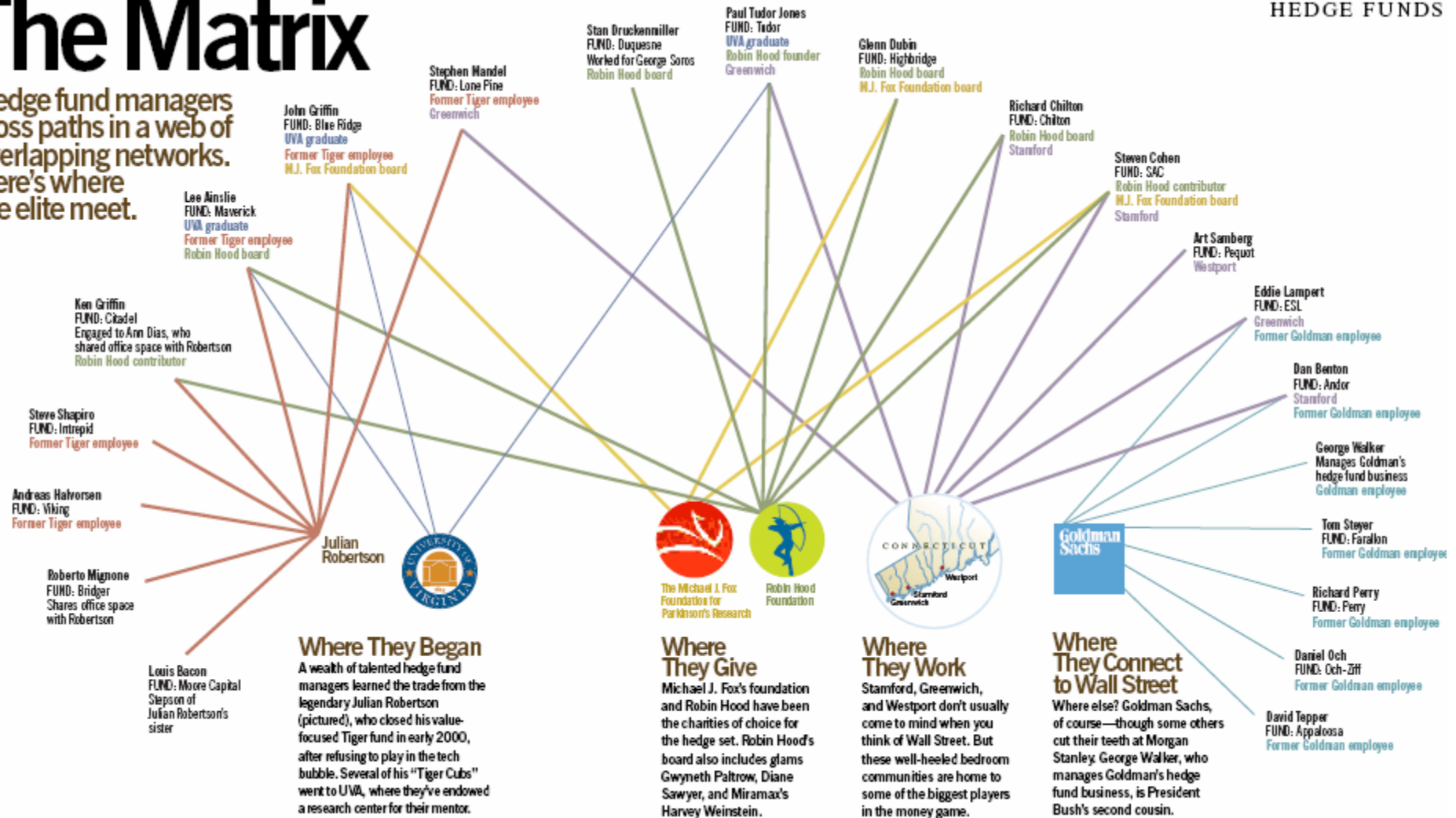
# Activist Hedge Funds

13 Third Point	\$3,200
14 Porter Orlin	\$3,000
15 Pirate Capital	\$2,000
16 Opportunity Partners	\$1,800
17 Appaloosa	\$1,750
18 Copper Arch	\$1,500
19 Pershing Square	\$850
20 Blue Harbor	\$675
21 Fairview Capital	\$670
22 Barington Capital	\$400
23 Burton Capital	\$200
24 Liberation Investments	\$200
25 Cannel Capital	\$125

# The Matrix

Hedge fund managers cross paths in a web of overlapping networks. Here's where the elite meet.

HEDGE FUNDS



# Addressing Activists

## Prior to Activism: Prevention

- 1) Step One: Create an internal response team to address potential instances of shareholder activism.
- 2) Step Two: Monitor shareholder base and proactively manage relationships with top investors.
- 3) Step Three: Build a unified message that address investor concerns.

## After a Public Approach: Response

- 4) Step Four: Create an open communication channel with the activist. Do not ignore them, and hope they will go away.
- 5) Step Five: Carefully review the proposals and gauge shareholder support.
- 6) Step Six: Determine the appropriate response. Formulate the response, with supporting arguments, and implement the plan.
- 7) Step Seven: Continue to manage relationships with top shareholders and gather feedback regarding strategic and financial plans.

# Communicating with Hedge Funds

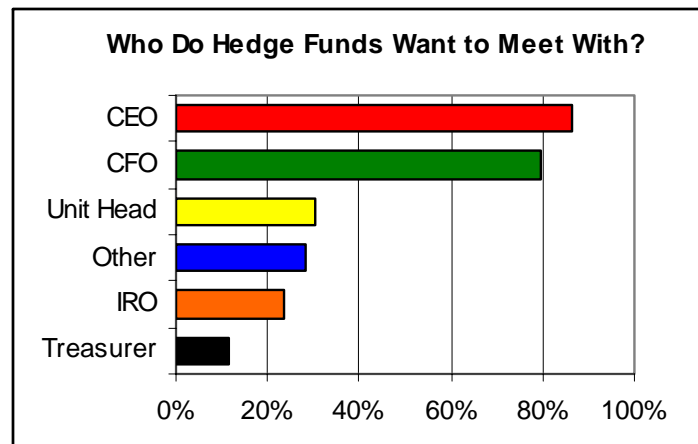
- Hedge fund respondents note their primary concern when communicating with a company is obtaining a tradable data point that would have otherwise been unavailable to them.
- 69% consider themselves to not be activists

*“We like any insights that give us a leg up, whether it be industry trends or a feel for pricing, margins, competition, etc.”*

*- Anonymous Hedge Fund Investor*

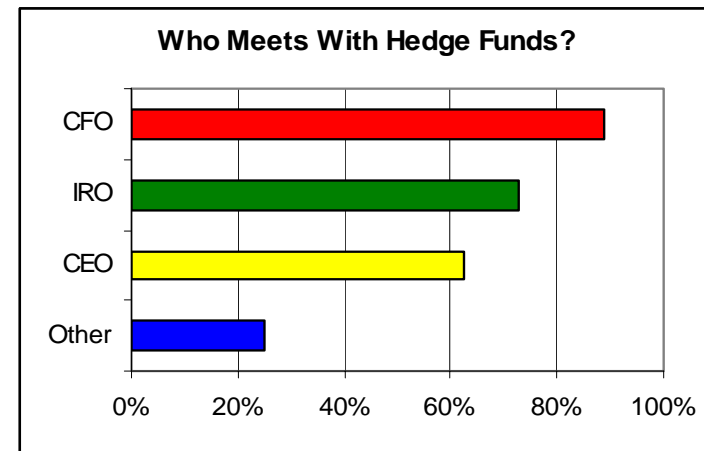


# Communicating with Hedge Funds



Hedge funds most often wish to speak with the C-level executives...

And most speak to the CFO, IRO and CEO respectively.



# Communicating with Hedge Funds

- Hedge funds utilize conference calls, analyst days, sell-side conferences,
- But prefer unscripted venues such as, one-on-one phone calls with executives or face-to-face meetings,
- Already have in-depth financial and strategic knowledge when they make contact,
- Will analyze visual and verbal cues, such as tone and body language,
- Want to gauge executives ability to think on their feet, reason through what-if scenarios, and get a broad industry perspective.

# Questions? Comments?

Feel free to contact:

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Thank you!

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