

# ALMA

## Introduction to Hedge Funds

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*key*  
KEY ASSET MANAGEMENT

# Agenda

- Key Asset Management overview
- Introduction to hedge funds
- Strategy & manager examples
- Hedge funds vs fund of funds
- Conclusions

# Key Asset Management

## Overview

- 17 years experience of managing hedge funds of funds
- 32 people in total
- Headquartered in London, with satellite offices in Norway, Sweden, Switzerland and the U.S.
- Focused in its entirety on hedge funds
- Over \$2.0 billion assets under management
- Asset base is split 80% institutional & endowment, 20% individual
- Relationship driven client services includes advice on other investments, risk profiling and ongoing communication programme

# Hedge Funds

- One of the few ways of making money from stocks and bonds when the markets fall as well as rise
- Not a new thing
  - First hedge fund established in 1949
- Not all the same
  - Hedge fund is an umbrella term that covers many different strategies and levels of risk

# Hedge Funds - Key Characteristics

- Absolute return objective
  - Aim to make money whatever the direction of the underlying markets
- Use of non-traditional investment techniques
  - Short selling, leverage, derivatives, varying levels of investment
- Arguably best/most skilful managers
  - Often the best 'traditional' managers move on to set up hedge funds
- Capacity constraints
  - Some of the best funds are 'closed'
- Management and performance fees
- High minimum investments (millions)

# Hedge Funds - Strategies

Long/Short Equity - Directional

Long/Short Equity - Quantitative

Long/Short Equity - Market Neutral

Statistical Arbitrage

Merger Arbitrage

Event Driven

Distressed/High Yield

Volatility Trading/Arbitrage

Convertible Bond Arbitrage

Fixed Income Arbitrage

Mortgage Backed Security Arbitrage

Discretionary Trading

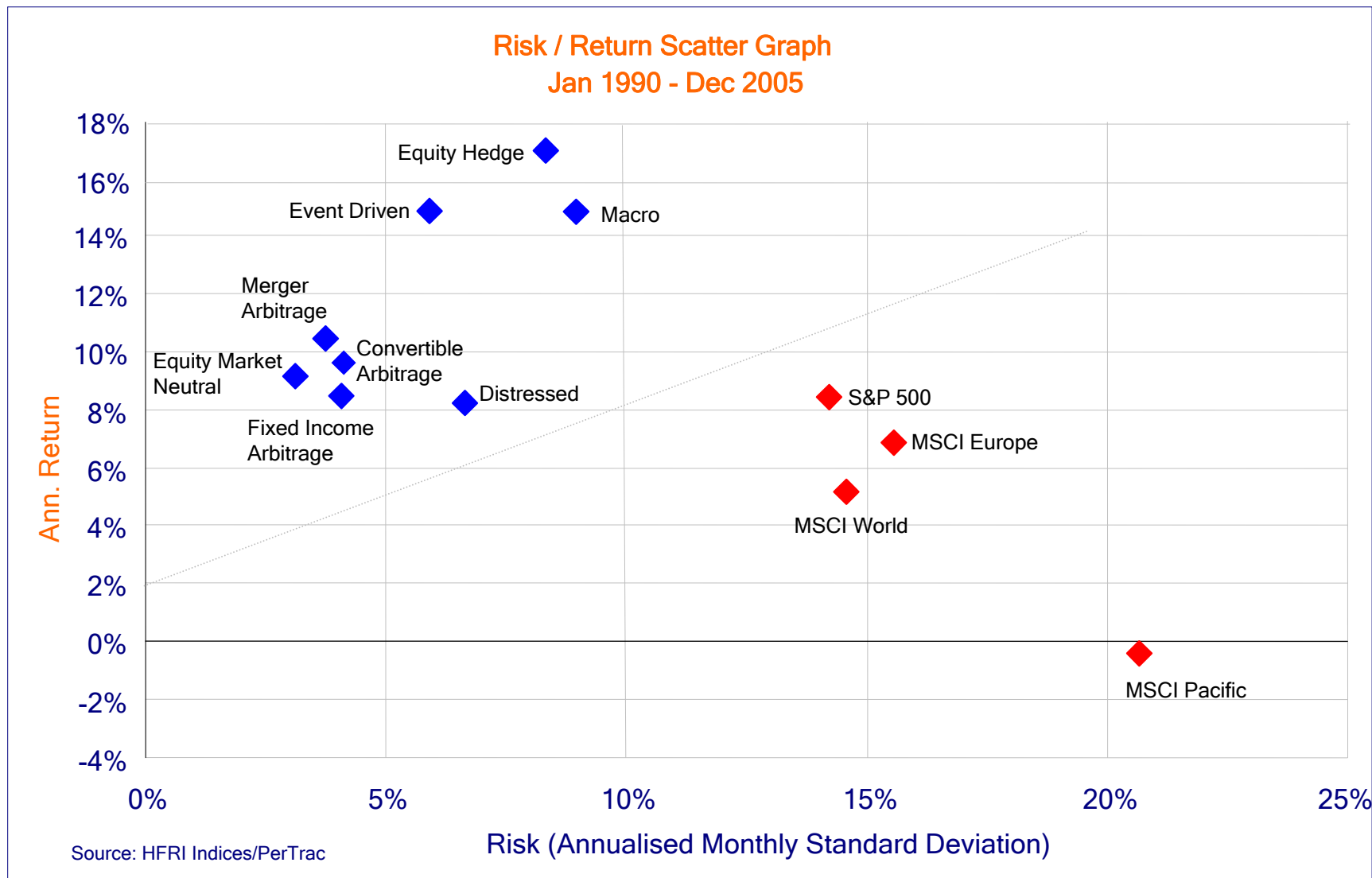
Global Macro

Systematic Trading

## MOST IMPORTANT THING TO REMEMBER

The term hedge fund covers a wide range of strategies that vary radically in terms of market exposure and risk

# Hedge Fund Performance



# Hedge Fund Performance

- Too good to be true...how are these returns possible?
  - Arguably 'best' managers with best incentives (for downside protection as well as capital appreciation)
  - Specialisation / niche skills
  - Strategies that traditional investment world can't practice

# Hedge Fund Strategies

- Equity Long/Short
- Event Driven
- Relative Value / Arbitrage
- CTA and Macro

# Hedge Fund Performance

- Sustainability of Performance
  - Cyclicity
  - Inefficiency from
    - Imbalance of capital
    - Imbalance of information
    - Imbalance of constraints and objectives

# Hedge Fund Example

Example of a constituent fund\*

- CQS (Capital Structure Arbitrage/Convertible Bond Arbitrage)
  - USD 5bn assets under management
  - Staff of 120
  - Formed company in 1999
  - Principal Michael Hintze former Head of UK Trading and Convertibles at Goldman Sachs and CSFB
  - Average annual return in excess of 15% p.a. after fees, worst performing year = +6.53% (Convertible Bond Arbitrage Fund)
  - Fund closed to new investment but Key has capacity

\* Provided for information only. Not an invitation to subscribe in any fund

# Improving Portfolio Efficiency

- Historically hedge funds have produced superior risk-adjusted return irrespective of market direction
  - Have almost always gone up when the market has gone up
  - Often go up when the market goes down
  - Many strategies particularly uncorrelated to underlying markets
- As a result, investing in (the right types of) hedge funds should yield very steady positive returns and add to portfolio efficiency
  - Especially useful for portfolio diversification in volatile and/or bear markets
  - Steady positive return stream useful for
    - inflation plus returns / liability matching / LDI
    - ‘portable alpha’
    - DB schemes

# Hedge Funds - Snags

- Where's the catch?
  - Wide range of strategies and managers
  - Strategies vary in terms of risk and return and can be complex
  - Small business risk
  - There may be a lack of transparency and poor reporting
  - Benchmarking and risk control issues
  - Hedge funds can be expensive
  - There are usually high minimum investment requirements
  - The best managers and funds are often 'closed' to new investment
    - *But there are ways to access them!*

# Why Use Fund-of-Funds?

- Most individuals and institutions choose to access them through a fund of funds product
- Need specialists to select the funds and avoid the pitfalls (and transfer risk!)
- Well-diversified access to the hedge fund asset class
- Access to the best funds (otherwise closed)
- Overcome the high minimum investments in the underlying funds
- Ongoing strategy analysis, monitoring and risk management

# The Need For Specialists

- Need specialists given non-standard nature of the asset class
  - Specialist hedge fund selection, risk management, monitoring, operational risk awareness
- The hedge fund universe have a multitude of strategies, styles and risk management approaches
  - e.g. some hedge funds do not hedge, are over-leveraged and over-concentrated
- A rigorous selection and monitoring process is required to construct and manage a portfolio of suitable hedge funds
- Quantitative analysis of track record alone can be a bad indicator of risk and of future performance
- It is easy for some types of risk not to be reflected in the track record...until it's too late

# Summary

- Hedge funds can be expected to improve the efficiency of a portfolio when combined with stocks and/or bonds
- The 'asset class' is close to maturing and risk management is now up to scratch
- It is still a specialist area however
- Fund of funds approach is favoured option for most institutions...for next few years at least

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