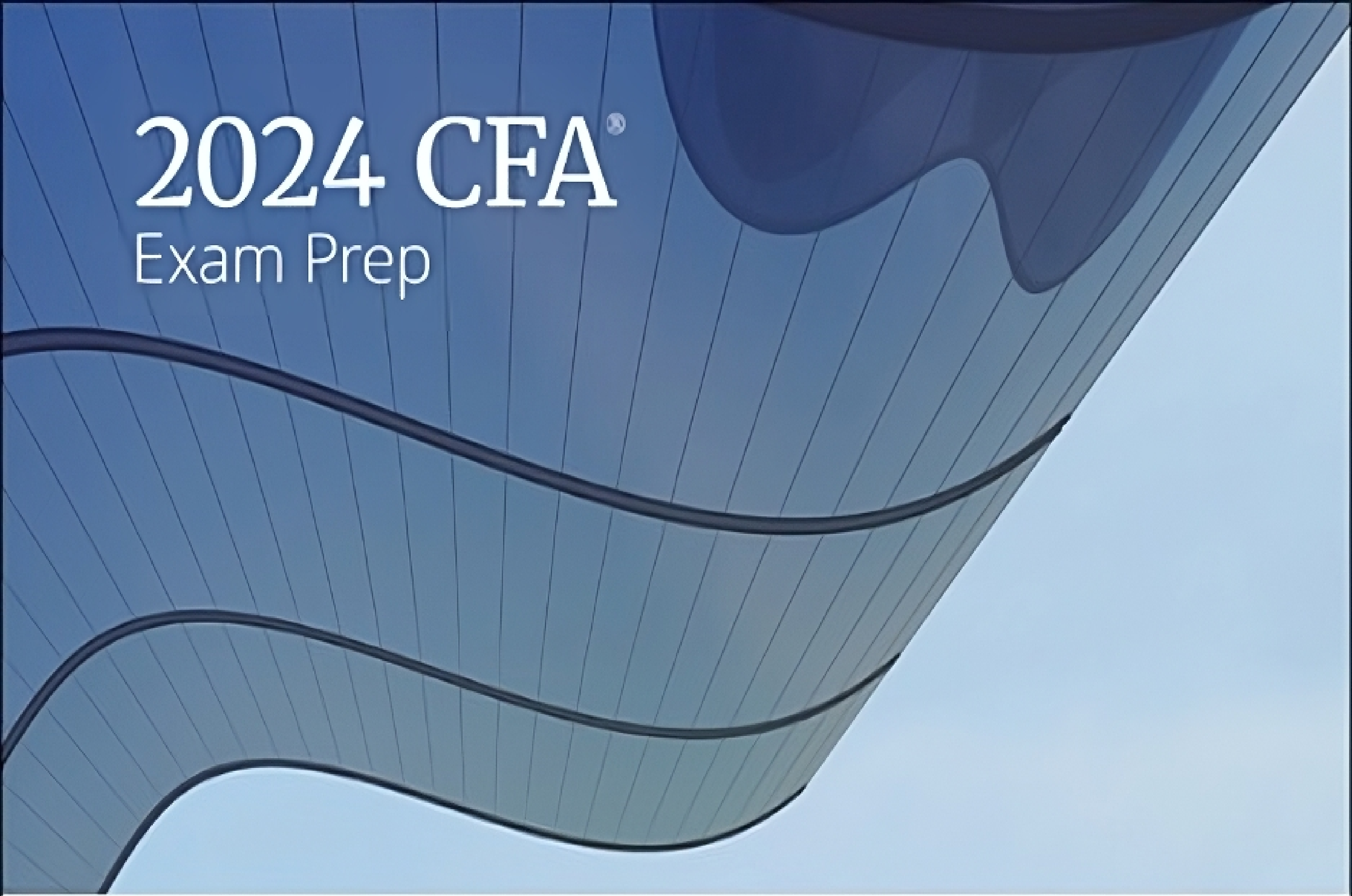

2024 CFA® Exam Prep

SchweserNotes™

Alternative Investments, Private Wealth Management, and Institutional Investors

LEVEL III BOOK 4

KAPLAN SCHWESER

Book 4: Alternative Investments, Private Wealth Management, and Institutional Investors

SchweserNotes™ 2024

Level III CFA®

KAPLAN SCHWESER

SCHWESERNOTES™ 2024 LEVEL III CFA® BOOK 4: ALTERNATIVE INVESTMENTS, PRIVATE WEALTH MANAGEMENT, AND INSTITUTIONAL INVESTORS

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CONTENTS

READING 20
Topics in Private Wealth Management

READING 21
Risk Management for Individuals

READING 22
Portfolio Management for Institutional Investors

Learning Outcome Statements (LOS)

17. Hedge Fund Strategies

The candidate should be able to:
a. discuss how hedge fund strategies may be classified.
b. discuss investment characteristics, strategy implementation, and role in a portfolio of equity-related hedge fund strategies.
c. discuss investment characteristics, strategy implementation, and role in a portfolio of event-driven hedge fund strategies.
d. discuss investment characteristics, strategy implementation, and role in a portfolio of relative value hedge fund strategies.
e. discuss investment characteristics, strategy implementation, and role in a portfolio of opportunistic hedge fund strategies.
f. discuss investment characteristics, strategy implementation, and role in a portfolio of specialist hedge fund strategies.
g. discuss investment characteristics, strategy implementation, and role in a portfolio of multi-manager hedge fund strategies.
h. describe how factor models may be used to understand hedge fund risk exposures.
i. evaluate the impact of an allocation to a hedge fund strategy in a traditional investment portfolio.

18. Asset Allocation to Alternative Investments

The candidate should be able to:
a. explain the roles that alternative investments play in multi-asset portfolios.
b. compare alternative investments and bonds as risk mitigators in relation to a long equity position.
c. compare traditional and risk-based approaches to defining the investment opportunity set, including alternative investments.
d. discuss investment considerations that are important in allocating to different types of alternative investments.
e. discuss suitability considerations in allocating to alternative investments.
f. discuss approaches to asset allocation to alternative investments.
g. discuss the importance of liquidity planning in allocating to alternative investments.
h. discuss considerations in monitoring alternative investment programs.

19. Overview of Private Wealth Management

The candidate should be able to:
a. contrast private client and institutional client investment concerns.
b. discuss information needed in advising private clients.
c. identify tax considerations affecting a private client's investments.
d. identify and formulate client goals based on client information.
e. evaluate a private client's risk tolerance.
f. describe technical and soft skills needed in advising private clients.
g. evaluate capital sufficiency in relation to client goals.
h. discuss the principles of retirement planning.
i. discuss the parts of an investment policy statement (IPS) for a private client.
j. prepare the investment objectives section of an IPS for a private client.
k. evaluate and recommend improvements to an IPS for a private client.
l. recommend and justify portfolio allocations and investments for a private client.
m. describe effective practices in portfolio reporting and review.
n. evaluate the success of an investment program for a private client.
o. discuss ethical and compliance considerations in advising private clients.
p. discuss how levels of service and range of solutions are related to different private clients.

20. Topics in Private Wealth Management

The candidate should be able to:
a. compare taxation of income, wealth, and wealth transfers.
b. describe global considerations of jurisdiction that are relevant to taxation.

c. discuss and analyze the tax efficiency of investments.
d. analyze the impact of taxes on capital accumulation and decumulation in taxable, tax-exempt, and tax-deferred accounts.
e. explain portfolio tax management strategies and their application.
f. discuss risk and tax objectives in managing concentrated single-asset positions.
g. describe strategies for managing concentrated positions in public equities.
h. describe strategies for managing concentrated positions in privately owned businesses and real estate.
i. discuss objectives—tax and non-tax—in planning the transfer of wealth.
j. discuss strategies for achieving estate, bequest, and lifetime gift objectives in common law and civil law regimes.
k. describe considerations related to managing wealth across multiple generations.

21. Risk Management for Individuals

The candidate should be able to:
a. compare the characteristics of human capital and financial capital as components of an individual's total wealth.
b. discuss the relationships among human capital, financial capital, and economic net worth.
c. describe an economic (holistic) balance sheet.
d. discuss risks (earnings, premature death, longevity, property, liability, and health risks) in relation to human and financial capital.
e. describe types of insurance relevant to personal financial planning.
f. describe the basic elements of a life insurance policy and how insurers price a life insurance policy.
g. discuss the use of annuities in personal financial planning.
h. discuss the relative advantages and disadvantages of fixed and variable annuities.
i. discuss how asset allocation policy may be influenced by the risk characteristics of human capital.
j. recommend and justify appropriate strategies for asset allocation and risk reduction when given an investor profile of key inputs.

22. Portfolio Management for Institutional Investors

The candidate should be able to:
a. discuss common characteristics of institutional investors as a group.
b. discuss investment policy of institutional investors.
c. discuss the stakeholders in the portfolio, the liabilities, the investment time horizons, and the liquidity needs of different types of institutional investors.
d. describe the focus of legal, regulatory, and tax constraints affecting different types of institutional investors.
e. evaluate risk considerations of private defined benefit (DB) pension plans in relation to 1) plan funded status, 2) sponsor financial strength, 3) interactions between the sponsor's business and the fund's investments, 4) plan design, and 5) workforce characteristics.
f. evaluate the investment policy statement of an institutional investor.
g. evaluate the investment portfolio of a private DB plan, sovereign wealth fund, university endowment, and private foundation.
h. describe considerations affecting the balance sheet management of banks and insurers.

READING 17

HEDGE FUND STRATEGIES

EXAM FOCUS

This reading describes some of the most important categories of hedge fund strategies and examines their investment characteristics and how these strategies are implemented. First, we discuss some unique characteristics of hedge funds and consider how various strategies might be categorized. Then, investment characteristics and implementation strategies are presented for six major hedge fund strategy categories: equity-related, event-driven, relative value, opportunistic, specialist, and multi-manager strategies. Next, we introduce a model for understanding the risk exposures of each of these strategies. The final LOS assesses the contribution of each hedge fund strategy to the return and risk of conventional stock and bond portfolios.

MODULE 17.1: OVERVIEW OF HEDGE FUND STRATEGIES

Video covering this content is available online.

Introduction

Hedge funds represent an important subgroup of alternative investment opportunities; however, they do come with many advantages and disadvantages.

Key features that distinguish hedge funds from traditional investments include:

- Lower regulatory and legal constraints.
- Flexibility to use short selling and derivatives.
- A larger investment universe.
- Aggressive investment exposures.
- Comparatively free use of leverage.
- Liquidity constraints for investors.
- Lack of transparency.
- Higher cost structures.

Perhaps the largest question to be answered is whether the high expense levels of hedge funds is made worthwhile by the return and diversification that hedge funds are intended to deliver.

Some asset managers seek out hedge funds as a source of alpha, which is never easy to come by. Others see hedge funds as a way to access top investing talent.

LOS 17.a: Discuss how hedge fund strategies may be classified.

Classifications of Hedge Fund Strategies

Hedge fund strategies are categorized based on the kinds of securities they invest in, the trading strategy used, and the kinds of risk exposures taken.

There are numerous ways to classify hedge funds, but in this topic review, we use the following six strategy categories:

1. *Equity related.* These fund strategies focus on stocks, and hence the primary source of risk is equity risk. Amongst this category of strategies are several subtypes, including long/short equity, dedicated short bias, and equity market neutral.
2. *Event driven.* These hedge fund strategies relate to corporate actions such as governance activities, mergers, acquisitions, bankruptcies, and other major business events. The main risks of these strategies are event risk; the possibility that outcomes will not unfold as expected, including the failure of a merger, credit downgrades, or bankruptcy. In the following LOSs, the event-driven hedge fund strategies that we will examine are merger arbitrage and distressed securities.
3. *Relative value.* These hedge fund strategies seek to profit from the relative valuation differences between securities. Credit and liquidity risks often complicate these strategies, because the valuation differences being exploited often relate to securities with different credit quality or liquidity. Two relative value strategies that will be considered further are fixed income arbitrage and convertible bond arbitrage.
4. *Opportunistic.* These strategies employ a top-down approach, often consider multiple asset classes, and vary with market conditions. The two opportunistic strategies that will be considered here are global macro and managed futures.
5. *Specialist.* These hedge fund strategies often require specialized market expertise or knowledge. Often the risks of these strategies arise due to exposure to specific sectors or unusual securities. The two such specialist strategies we will consider in this topic review are volatility strategies and reinsurance strategies.
6. *Multi-manager.* These strategies use other hedge fund strategies as building blocks, combining different strategies together and rebalancing exposures over time. The two types of multi-manager hedge funds we will consider are multi-strategy funds and funds-of-funds.

MODULE QUIZ 17.1

1. A convertible bond arbitrage strategy is *most likely* classified as:
   A. a specialist strategy.
   B. an event-driven strategy.
   C. a relative value strategy.

2. A managed futures hedge fund strategy is *most likely* classified as:
   A. an opportunistic strategy.
   B. a specialist strategy.
   C. a relative value strategy.

MODULE 17.2: EQUITY, EVENT-DRIVEN, AND RELATIVE VALUE STRATEGIES

Video covering this content is available online.

LOS 17.b: Discuss investment characteristics, strategy implementation, and role in a portfolio of equity-related hedge fund strategies.

Equity-Related Hedge Fund Strategies

Equity-related hedge fund strategies focus primarily on stock markets, and the majority of their risk profiles involve equity-oriented risk. Within this equity-related category, long/short equity, dedicated short bias, and equity market neutral are the main strategies that will be discussed further.

Long/Short Equity

Long/short (L/S) equity hedge funds are straightforward to understand. The fund manager purchases (takes long positions in) stocks that they think will rise in value, and sells (takes short positions in) stocks that they believe will fall in value.

Investment Characteristics

When L/S equity managers combine long and short positions, the resulting portfolio has a beta (i.e., market exposure) equal to the sum of the positive and negative betas of the various long and short positions.

L/S equity hedge funds generally do not seek to *eliminate* market exposure entirely. L/S funds will typically have a 40%–60% net long exposure, which is beneficial considering that markets generally trend upward over time.

Many L/S equity managers aspire to provide returns comparable to that of a long-only fund but with half the amount of standard deviation.

Strategy Implementation

Because successful implementation of an L/S equity strategy requires managers to identify overpriced and underpriced stocks, the majority of L/S equity funds take a sector-specific focus, choosing stocks from a particular industry that they are familiar with. They may also use index funds to achieve a desired exposure. L/S funds that are comparatively market neutral may need to use leverage to achieve worthwhile returns.

Role in a Portfolio

The goal of most L/S equity managers is to attempt to source alpha from long and short exposures to single stocks, while also benefitting from a moderate overall long exposure.

When considering an investment in an L/S equity fund, one should consider whether the investment is worthwhile given the potentially high fees. Taking a traditional long-only equity position may be a more efficient way to achieve a comparable beta exposure.

Dedicated Short Selling and Short-Biased

As the name suggests, **dedicated short-selling** funds seek out securities that are overpriced in order to sell them short. These managers look for poorly managed companies, firms in declining market segments, or even firms with deceitful accounting. **Short-biased** managers use a similar strategy, except that the short position is somewhat offset by a long exposure.

One major challenge of being a short seller is that markets inevitably rise over time, which creates a tendency toward negative returns for shorts.

A notable subset of short selling is **activist short selling**, in which the fund manager not only takes a short position in a stock, but also presents research that contends that the stock is overpriced.

Investment Characteristics

Managers using short-biased strategies as well as dedicated short-selling strategies primarily aim to produce a negative correlation with conventional securities. Compared to other hedge fund strategies, expectations of return for short strategies tend to be lower. Compared to L/S equity hedge funds with their balanced beta exposures, short strategy funds tend to have greater volatility.

Strategy Implementation

Hedge fund managers go "short" a security by borrowing the security, selling it at the current market price, and then (ideally) profit by repurchasing the same security later at a lower price in order to return it to the lender.

The most challenging part of profiting from shorting stocks is finding securities that are going to lose value. Managers use a bottom-up approach to identify firms with unprofitable business models, bad management, too much debt, or even shady accounting.

A dedicated short seller takes on no long stock exposure; rather, they carefully select stocks for a pure short exposure, typically 60%–120% short. A dedicated short manager who wishes to temper the fund's market exposure will typically do this by holding cash.

Short-biased managers have a similar strategy; however, they may also take on some long exposure, while remaining net short, often 30%–60% net short.

For both dedicated short sellers and short-biased managers, relatively little leverage is used.

Role in a Portfolio

The primary goal of dedicated short-selling and short-biased funds is to produce returns that are uncorrelated (or negatively correlated) with the return of conventional portfolio assets. When successful, these negative correlations provide tremendous benefit to a portfolio.

However, this goal of negative correlation comes at a cost: expected returns for short strategies are relatively low. Historical performance of short strategies suggests that these strategies have produced returns that are unreliable and often underwhelming.

Equity Market Neutral

Equity market-neutral (EMN) strategies seek to attain a near-zero overall exposure to the stock market. They do this by taking long and short positions in various equities; the betas of these positions should sum to zero. The alpha of EMN strategies is intended to be derived from taking positions in securities that are temporarily mispriced.

Investment Characteristics

The overall goal of EMN funds is to create a portfolio that not only generates alpha, but is also relatively immune to movements in the overall market. Not surprisingly, without beta exposure, the returns of EMN funds tend to be modest. On the positive side, however, EMN funds can offer significant diversification and low volatility.

Strategy Implementation

Hedge fund managers for EMN funds take long positions in particular stocks thought to be temporarily undervalued and short positions in stocks seen as overvalued. When mean reversion eventually occurs, alpha should result.

While some EMN managers rely on intuition (i.e., discretionary managers), it is more common that they instead rely on a fixed set of rules to identify trade opportunities (i.e., quantitative managers).

Because EMN deliberately hedges away market beta, leverage is generally applied in order to achieve acceptable levels of return.

Popular subtypes of EMN funds include:

- **Pairs trading.** Two stocks with similar characteristics are identified that are respectively overvalued and undervalued. For example, the two securities might represent different share classes of the same firm, or one might be the stock of a firm and the other the stock of its holding company. In any case, the securities must be related but relatively mispriced.
- **Stub trading.** This EMN strategy involves going long and short shares of a subsidiary and its parent company. Generally the positions taken correspond to the percentage of the subsidiary owned by the parent.
- **Multi-class trading.** This strategy entails going long and short relatively mispriced share classes of the same firm, for example non-voting and voting shares. As the pricing of these shares reverts to their traditional valuations, profits can be made.

Besides investments in stocks, other instruments used to achieve a state of zero beta include options, stock index futures, or other kinds of derivatives.

Role in a Portfolio

EMN portfolios attempt to produce alpha without taking market beta risk. EMN strategies are of particular value in times when markets are volatile and performing poorly. The construction of EMN funds allows these funds to produce less volatility than funds that rely on beta as a source of return.

LOS 17.c: Discuss investment characteristics, strategy implementation, and role in a portfolio of event-driven hedge fund strategies.

Event-Driven Strategies

Event-driven hedge fund strategies are those that attempt to profit from predicting the outcome of corporate events, such as bankruptcies, mergers, restructurings, acquisitions, et cetera. To do this, these funds take positions in securities of these corporations or in related derivatives. A **soft-catalyst event-driven approach** is an investment made before an event is being announced, whereas a **hard-catalyst - event-driven** approach is an investment made after a corporate event is being announced, taking advantage of security prices that have not fully adjusted. Soft-catalyst investing is generally more volatile and, thus, riskier than a hard-catalyst approach.

The main risk that impacts event-driven strategies is event risk. The chance that the outcome of the event will not be the one anticipated. For example, a merger arbitrage hedge fund may anticipate that a particular merger will be successful and then suffer a large loss when the merger fails.

In this topic review, we will consider two types of event-driven hedge fund strategies in detail: merger arbitrage and distressed securities.

Merger Arbitrage

Merger arbitrage strategies are investment schemes that attempt to earn a return from the uncertainty that exists in the market in the time between an acquisition being announced and when the acquisition is completed.

Hedge fund managers in the merger arbitrage space profit by correctly anticipating the outcome of various deals. One way to view merger arbitrage is to compare it to writing insurance on an acquisition. If the acquisition is completed as planned, the hedge fund earns an insurance premium. If the transaction fails, however, then the hedge fund stands to lose money, analogous to an insurance company making a payout.

Investment Characteristics

In the case of a merger deal that fails, the price movements that originally occurred when the merger was announced will reverse: the price of the target will fall, and the price of the acquirer will rise. A hedge fund that had taken a position based on the merger succeeding is likely to suffer a significant cost when the deal fails unexpectedly; possibly in the order of a 40% loss. This kind of potential outcome gives merger arbitrage significant left-tail risk.

Compared to typical hedge fund strategies, merger arbitrage is more liquid.

Strategy Implementation

In the most common merger arbitrage scenario, the portfolio manager takes positions in the securities of the companies involved, with the expectation of a successful deal. For example, in a stock-for-stock deal, the hedge fund manager will typically purchase the stock of the target company and *short* the stock of the acquiring company in anticipation of profiting when the deal is completed.

Less often, the hedge fund manager may have the opinion that the merger will fail (for example, the deal might be blocked by the government because it would stifle competition.) In this scenario, the fund would take the opposite position to those described above.

In order to generate a worthwhile level of return, hedge funds pursuing a merger arbitrage strategy will typically apply 300%–500% leverage in order to achieve low-double-digit returns.

One specific variety of merger arbitrage involves cross-border mergers and acquisitions (M&A) where two countries and two regulatory authorities are involved. Such mergers are seen as more risky.

Role in a Portfolio

The Sharpe ratios of merger arbitrage strategies tend to be high, as these strategies usually produce relatively steady returns. However, on top of these steady returns is significant left-tail risk.

Distressed Securities

Hedge funds that pursue a **distressed securities** strategy take positions in the securities of firms that are in financial distress, including firms that are in bankruptcy or near bankruptcy. Firms may find themselves in this position for a number of reasons, including too much leverage, difficulty competing in their sector, or accounting issues. The securities of such a firm will often trade at greatly depressed prices.

Compounding the discounting of the securities of distressed firms is the fact that institutions such as insurance companies and banks are often not permitted to hold non-investment-grade securities. The selling of such securities can create significant pricing inefficiencies and can open up opportunities for hedge funds seeking profit.

When a firm is liquidated, the assets of the company are sold and then the various investors are paid back *sequentially* depending on their seniority (e.g., senior secured debtholders first, then junior secured debt, unsecured debt, convertible debt, preferred stock, and lastly common stock).

As an alternative to liquidation, a firm may instead be able to reorganize, which may involve renegotiating the company's liabilities. Holders of debt may be asked to exchange that debt for new equity or to agree to an extension of the maturity.

Investment Characteristics

Considering the various event-driven hedge fund strategies, returns of distressed securities investing strategy tend to be somewhat greater, though generally with larger variability of outcomes.

The lock-up periods for investors in event-driven hedge funds tend to be comparatively long (often allowing no redemptions for the first two years), reflecting the fact that the outcome of distressed security investments generally takes an extended period of time to value and exit.

Strategy Implementation

Distressed investing can take different forms. Some managers may make only a passive investment in the distressed securities, while other managers will attempt to acquire the majority of a certain class of security in order to take creditor control during bankruptcy.

Successful distressed securities investing requires a particularly broad range of skills in order to navigate the various legal aspects of the strategy, including the bankruptcy and reorganization proceedings.

While shorting distressed securities is a possibility, the majority of distressed investing takes the form of long investments.

Distressed investing generally makes low use of leverage.

Role in a Portfolio

Distressed securities investing involves moderately high levels of illiquidity due to the nature of the assets being purchased. The returns of distressed securities investing is higher relative to other event-driven strategies, though it can be somewhat unpredictable and sensitive to declines in the overall market.

LOS 17.d: Discuss investment characteristics, strategy implementation, and role in a portfolio of relative value hedge fund strategies.

Relative Value Hedge Fund Strategies

As the name suggests, **relative value** strategies attempt to exploit valuation differences between securities. The most common securities used in relative value strategies are hybrid convertible debt, as well as fixed-income securities.

When successful, relative value strategies will earn various premiums over time, including liquidity, credit, and volatility premiums, reflecting differences in liquidity or credit quality between securities. However, in times of turbulent markets, losses can occur.

Two relative value hedge fund strategies that we will consider in detail are fixed-income arbitrage and convertible bond arbitrage.

Fixed-Income Arbitrage

The idea behind **fixed-income arbitrage** strategies is to take advantage of temporary mispricing of fixed-income instruments, by going long comparatively undervalued securities, and going short comparatively overvalued securities. Idiosyncrasies that might be exploited include yield curve kinks or anticipated changes in the shape of the yield curve.

The securities may be fixed-income instruments of many types, including consumer debt, bank loans, corporate bonds, or sovereign bonds. Hedge fund managers take positions in these securities under the assumption that prices will revert toward their fair values.

Fixed-income arbitrage strategies often make use of significant leverage, in pursuit of sufficient levels of return.

Strategy Implementation

Two subtypes of fixed-income arbitrage strategies that we will consider in further depth are (1) yield curve trades and (2) carry trades.

- **Yield curve trades.** In this strategy, the hedge fund manager has a view of how the shape of the yield curve will evolve over time based on macroeconomic forecasts. The portfolio manager makes long and short investments in fixed-income instruments in order to profit from the anticipated yield curve steepening or flattening. As usual, the portfolio manager will profit when the prices of the long securities rise and the prices of the short securities fall. If the positions taken are in securities of different firms, then liquidity, credit, and interest rate risks will be present. For positions in securities of the same issuer, interest rate movements would be the main source of risk.
- **Carry trades.** In a carry trade, the portfolio manager shorts a low-yielding security and goes long a high-yielding security. The source of return here is twofold; first, from the yield differential, and second from the price changes as mean reversion occurs.

Because fixed-income securities tend to be priced fairly efficiently, the amount of profit that can be earned by fixed-income arbitrage is somewhat limited. As a result, substantial leverage is often applied to fixed-income arbitrage strategies. (400% leverage is not uncommon; even 1500% leverage is not unheard of.)

Investment Characteristics

Generally, the return to fixed-income arbitrage strategies are relatively small, so significant levels of leverage are used to increase the amount of return.

The liquidity of fixed-income arbitrage depends on the particular strategy employed and the kinds of fixed income instruments used. Strategies involving U.S. Treasuries are very liquid, while strategies that make use of mortgage-backed securities or foreign instruments, for example, are less liquid.

Role in a Portfolio

Return distributions for a fixed income arbitrageur tend to be similar to writing puts. If the trade unfolds as expected, the investor will earn a return from the spread narrowing, plus a return from positive carry. However, if the spread between the two instruments widens unexpectedly, the return to the investor may become quite negative.

One drawback to fixed income arbitrage strategies is that their highly leveraged nature can cause modest price volatility to lead to a domino effect of margin calls and deleveraging. For example, the Asian Financial Crisis of 1997 and the Russian

Ruble Crisis of 1998 led to the collapse of the renowned hedge fund Long-Term Capital Management.

Convertible Bond Arbitrage

Convertible bonds are fixed-income debt securities that make regular coupon payments but can additionally be exchanged for a prearranged number of common stock shares. The bond-to-stock conversion is at the bondholder's discretion, though it is only permitted at certain points in the bond's life.

One way to view convertible bonds is as a regular bond plus a long call option on the corresponding stock.

Analyzing convertible bonds is extremely complex due to impacts from a number of factors.

The primary goal of **convertible bond arbitrage** strategies is generally to profit from purchasing the implied volatility of convertible bonds, which is often underpriced. To do this without taking on excess risk, convertible bond arbitrageurs will take on other positions to try to hedge out the delta and gamma risk of the convertible bond holdings.

Investment Characteristics

Convertible bond arbitrage managers encounter two primary sources of liquidity issues; first, because the strategy requires the manager to borrow and then short sell the underlying equity and second, because the fixed income instruments being invested in are often complex niche products.

Strategy Implementation

Convertible arbitrage strategies generally exploit the fact that the options within convertible instruments usually exhibit low implied volatilities when compared to the historical volatilities of the equities that underlie the option. The challenge for the convertible bond arbitrage manager that invests in these convertibles is to hedge away the other sources of risk that are embedded in the convertible security including market risk, interest rate risk, and the credit risk of the bond issuer.

When a convertible bond's current conversion price is well above the current stock price, the OTM call (delta closer to zero) will cause the convertible bond to behave much like a straight bond and, therefore, conversion is not likely.

Conversely, when a convertible bond's current conversion price is well below the current stock price, the ITM call (delta closer to one) will cause the convertible bond to behave much like the corresponding stock and, therefore, conversion is likely.

Significant amounts of leverage are usually used to implement convertible bond strategies, often combining a three times long bond exposure with a two times short equity exposure. (The smaller short equity exposure stems from delta hedging the short stock exposure according to the delta of the long bond position.)

Role in a Portfolio

Convertible arbitrage strategies perform best during periods of normal market conditions, when liquidity is available, when volatility is modest, and when there is a good selection of convertible bonds being issued. Convertible arbitrage may not perform well in periods of illiquidity or weak credit.

MODULE QUIZ 17.2

1. Considering various equity-related hedge fund strategies, a strategy that is *most likely* to apply relatively high levels of leverage is:
   A. an EMN strategy.
   B. a dedicated short strategy.
   C. a short-biased strategy.
2. An equity-related hedge fund strategy with gross exposures of 80% long and 35% short is *most likely* to be classified as:
   A. a dedicated short strategy.
   B. a short-biased strategy.
   C. a long/short equity strategy.
3. Relative to other hedge fund strategies, EMN strategies are *most likely* to:
   A. exhibit relatively modest returns.
   B. be vulnerable to periods of market weakness.
   C. earn return from alpha and beta risk.
4. An investment in distressed securities is *most likely* to be characterized by:
   A. a long bias.
   B. a high level of liquidity.
   C. a large amount of leverage.
5. In a sequential payoff during a liquidation, the security holder that is *most likely* to be paid off first is the holder of:
   A. junior secured debt.
   B. convertible debt.
   C. preferred stock.
6. In implementing a convertible arbitrage strategy, the portfolio manager is *most likely* to take a position that is:
   A. long convertible bonds and short equity.
   B. long straight bonds and short convertible bonds.
   C. long convertible bonds and short straight bonds.

MODULE 17.3: OPPORTUNISTIC, SPECIALIST, AND MULTI-MANAGER STRATEGIES

Video covering this content is available online.

LOS 17.e: Discuss investment characteristics, strategy implementation, and role in a portfolio of opportunistic hedge fund strategies.

Opportunistic Hedge Fund Strategies

Opportunistic hedge fund strategies are a broad class of investing approaches that attempt to extract profits using a wide range of techniques in a broad range of securities markets. Rather than being focused on individual securities, these strategies take a top-down approach to make macro investments on a global basis across regions, sectors, and asset classes.

The returns of opportunistic hedge fund strategies are generally impacted by market cycles, global developments, and international interactions. The risks will depend on the particular strategy and asset classes involved.

The implementation of opportunistic hedge fund strategies can be based on a number of broad techniques. Technical analysis uses past price changes to forecast future price movements. Strategies based on fundamentals, on the other hand, attempt to analyze security prices, markets, sectors, and the relationships between markets, using economic data as the input.

Managers using a **systematic** implementation of their strategies use computer algorithms and rules to determine which trades to make. Managers using a **discretionary** process instead use their instinct to determine when to trade.

We will consider two opportunistic strategies in detail: global macro and managed futures.

Global Macro Strategies

Managers of **global macro** strategy funds attempt to profit from making correct assessments and forecasts of various global economic variables including inflation, currency exchange rates, yield curves, central bank policies, and the general economic health of different countries.

Global macro managers use a broad range of security types and global asset classes to take positions on these views.

A global macro manager that can identify a global trend early and take a position can profit.

Investment Characteristics

Global macro managers can take positions that are either **directional** (e.g., go long companies that are anticipated to benefit from expected interest rate hikes, and short companies that will be disadvantaged), or **thematic** (e.g., buy firms that will benefit from forthcoming free trade deals).

Unlike some hedge fund strategies, low-volatility-mean-reverting markets are not generally favorable for global macro returns.

Because global macro managers take investment positions based on their predictions of the future, there is significant potential for unsuccessful investments when global economies do not behave as expected or if unanticipated risks emerge. As a result, the returns of global macro funds tend to be uneven and volatile.

Strategy Implementation

Global macro strategies tend to be based on top-down analysis beginning with scrutiny of the global economy, then macro trends within economies, and so on, in order to identify potential opportunities.

Different global macro managers are likely to implement their strategies using very different techniques; for example, technical analysis vs. fundamental analysis, or discretionary implementation versus systematic implementation.

One commonality between global macro funds is that most tend to apply leverage, often representing 600% or 700% of fund assets.

A manager making directional predictions will generally use fundamental information to determine whether a particular asset is undervalued or overvalued on a historical basis. On the other hand, a manager using a relative value strategy will seek out securities that are overvalued or undervalued compared to one another.

Global macro managers tend to use discretionary approaches more than managed futures managers.

Role in a Portfolio

When added to a portfolio of traditional assets, a global macro hedge fund can bring a significant benefit (not only alpha, but also portfolio diversification).

A successful global macro manager will anticipate changes before other market participants and will then invest in a position and wait for the rest of the market to come around. This contrarian tendency can make an allocation to global macro strategies especially useful. For example, some global macro managers anticipated the United States' subprime mortgage crisis well before the housing bubble began to collapse in 2007.

During times of market stress, global macro funds have historically delivered right-tail skewed returns, which is extremely beneficial from a portfolio diversification perspective. However, this behavior cannot always be relied upon as such diversifying outcomes are not always realized.

Managed Futures

Hedge fund portfolio managers that pursue a **managed futures** strategy take long and short positions in a variety of derivatives contracts including futures, forwards, options on futures, swaps, and sometimes currencies and commodities.

Managed futures strategies can be as simple as trading index futures on a particular sector, or it can involve very exotic contracts such as futures on the weather.

Investment Characteristics

Managed futures funds do not buy and sell assets; rather, they enter into futures contracts in order to gain the desired exposures.

Because of the mechanics of futures contracts (requiring only a small amount of upfront collateral), managed futures funds can easily apply great amounts of leverage. Typically, a fund will use perhaps $^{1}/_{8}$ of its capital as collateral on futures contracts. The other $^{7}/_{8}$ or so will be invested in some highly liquid security (such as short-term government bonds) that will serve as collateral for the futures clearinghouse.