

# A COMMON COMPARISON

*How to evaluate three popular hedge fund strategies.*



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This paper will touch on some of the broad qualitative guideposts that investors can look for when evaluating three of the most common hedge fund strategies.

## LONG/SHORT EQUITY

In long/short equity, one of the first guideposts is gross exposure, defined as longs plus shorts (both a percentage of fund capital). There is an enormous range of gross exposures of individual hedge fund managers but generally speaking there tend to be groupings of managers around 100%, 120% to 150%, and 180% plus.

After gross exposure, the next guidepost that investors tend to focus on is the level and range of the fund's net exposure (net exposure is defined as longs minus shorts, as a percentage of fund capital). Generally, the higher the net exposure, the more long-biased the manager may be and the higher percentage of the fund's returns which may come from beta as opposed to alpha. Also, the range of the net exposure can be important. If the range is very wide, or moves around very frequently, it may indicate that the manager is trying to use net exposure to time the market. Many investors believe that this is difficult to do over long periods of time and therefore frown on wide ranges of net exposure—especially if they are driven by top-down views on the market versus a bottom-up approach.

Another guidepost is sector exposure. If we look at the “big buckets” such as healthcare, technology, etc., we generally prefer to see a healthy level of both longs and shorts within each of the sectors. We would then look at the net exposure of each sector as a percentage of fund capital. Generally, we like to see these within certain bands: it would be worrisome if a fund had, for example, 0% net exposure overall but was 60% net long technology and 60% net short healthcare. Obviously, this might indicate some type of sector rotation strategy which many investors could consider either risky or not sustainable over a long period of time. Finally, it is critical to evaluate the interaction between gross exposure

and sector exposure. Generally speaking, the higher the fund's gross exposure, the lower the amount of net sector exposure that would be tolerable.

## HEDGED CONVERTIBLE BONDS

When evaluating a hedged convertible bond fund, it is helpful to break the strategy down into its component parts—a long-term equity call option and a corporate bond. We can then evaluate the risk management processes and limits for each. For example, for the equity option component, all of the “greeks” apply such as vega (volatility), gamma (rebalancing), theta (time decay), rho (interest rate) and delta (outright) exposures. In terms of the corporate bond component, we can evaluate how much credit risk is being taken (after assets swaps, credit default swaps, high-delta converts, etc.), the type of credit risk (investment grade versus non-investment grade) and the amount and quality of the resources (especially dedicated credit analysts) that the firm has put in place to evaluate the credit exposure taken. Other factors to consider are the historic size and frequency of problem credits in the portfolio.

## RISK ARBITRAGE

In risk arbitrage, we feel that a good guidepost to focus on is the percentage and concentration of the deals that are in announced deals versus “anticipated” deals.

When analyzing the announced deals, we look further into differentiating between those that are considered relatively “safe” (e.g., friendly transactions, usually strategic in nature with little/no anti-trust or anticompetitive issues) versus those that might be considered having material risk elements (hostile deals, deals subject to a contingent financing, deals with significant anti-trust issues). In terms of analyzing “anticipated deals, a good guidepost to focus on is the sophistication of the hedging program and the manager in eliminating market risk from the positions. ■