



Professor	Roberto E. Wessels
Office	CBA 6.304C
Office Hours	make an app. by sending an email with a suggested day and time
Phone	(512) 475 8603
E-Mail	rewessels@frissestyn.demon.nl
Course Web Page	via Blackboard
Teaching Assistant	Rahul Shah (rahul.shah@mba09.mcombs.utexas.edu)
Classroom and Schedule	CBA 4.348 M-W 12.30 14.00

Course Description

The course will cover different aspects of investment vehicles commonly known as Hedge Funds. The emphasis will be on understanding investment strategies, performance, compensation and risk management practices of these investment vehicles.

Definition of a hedge fund

Hedge funds are private pooled investment limited partnerships which fall outside many of the rules and regulations governing mutual funds. Hedge funds therefore can invest in a variety of securities on a leveraged basis. Today, the term hedge fund refers not so much to the hedging techniques hedge funds may employ as it does to their status as private investment partnerships.

Hedge funds are an interesting phenomenon to study (Wikipedia has an extensive and worthwhile-reading article covering the many facets of hedge funds (en.wikipedia.org/wiki/Hedge_fund)). First, because they can execute a variety of strategies generally not open to other investment vehicles. Secondly, because the managers are generally also principals of the fund with substantial amounts of their own wealth at risk, the issues of how risks are shared between investors and fund managers are very different from, say the situation in a mutual fund where the fund manager is an employee of the company. Finally, the compensation of hedge fund managers is totally different from traditional investment managers. Hedge fund managers collect a substantial portion of the profits, which are defined as the positive performance of the portfolio above some threshold return with some wrinkles added. Traditional fund managers are paid a salary plus a bonus if their performance is relatively good. These three factors tend to make hedge funds fundamentally different from other investment vehicles such as mutual funds which are generally the focus of introductory investment courses.

Although hedge funds are not a new phenomenon (they were already around in the late 1940s), they started to attract widespread attention when George Soros' Quantum Fund allegedly caused the withdrawal of the pound sterling from the European Monetary System in 1992. An action which was reported to have netted his fund

profits in excess of \$1 billion. The hedge fund industry achieved further notoriety when Long Term Capital Management (LTCM), a partnership which included two Nobel prize winners, had to be bailed out in order to prevent a potentially disastrous situation, nowadays referred to as systemic risk.

The credit crisis responsible for plunging the economy into recession in August of 2008 has had a big impact on the hedge fund industry. For the first time since HFR started tracking the performance of hedge funds, hedge funds as a group, have returned negative performance. This has received wide-spread attention, especially since many icons of the hedge fund industry (i.e. Citadel, Farallon and Man) have been affected and several prominent universities that were heavily invested in hedge funds (Harvard and Yale, for instance) have seen their endowments shrink dramatically. As a result of the negative publicity and especially of the delivering of the economy, net money flows to the industry have become negative for the first time in 20 years. To their credit, hedge funds have not lined up to be bailed out alongside the (investment) banks.

The industry is now facing several challenges to its business model: clients no longer wish to pay premium fees for performance that is not stellar; cheap credit to leverage strategies that promise modest but quasi-riskless returns is no longer available; the liquidity of asset markets has evaporated making it difficult for funds to unwind position in illiquid strategies. As a result, many funds have frozen withdrawals while still continuing to collect management fees. This is not a stable situation, and changes to the basic operating model will have to be made before it's back-to-business time again.

The unfolding Madoff scandal (see <http://www.nytimes.com/2008/12/20/business/20madoff.html?pagewanted=4&sq=madoff%20pioneer&st=cse&sc p=1>) has inflicted terrible reputational damage on a segment of the hedge fund industry known as the funds-of-hedge funds. . Even though Madoff Securities itself was not a hedge fund, and was "closely" regulated by the SEC, many funds that invested in hedge funds on behalf of their clients channeled money to Madoff (often in return for a finder's fee) have lost a staggering \$50 billion. The fund-of-hedge-funds business model was based on access to the best funds, carefully selected after much due diligence, for which the clients then paid steep fees (on top of the fees already due to the funds they ultimately invested in). It has now emerged that huge conflicts of interest exist in this industry, where for instance Fairfield Greenwich Group is reported to have collected \$ 500 million in fees after steering \$ 7.3 billion of its clients' money to Madoff (New York Times, 23 December 2008). The claims made for the business model of the fund-of-hedge-funds industry are now viewed with some skepticism and it will take some time before all the fiduciary issues raised by the Madoff scandal are resolved.

Even if hedge funds are going through a rough patch, it is unlikely that their moment has passed. They are the victims of the crisis rather than the perpetrators. If there something that they can be blamed for, it is the inflated claim that they could make positive returns in good times and bad that many savvy investors took on trust after having looked at a very limited slice of historical data..

Topics to be covered during the course:

1. Risk and return
 - Measuring returns and return distributions
 - Measures of portfolio selection

- Target returns and shortfall probabilities
- Value-at-risk
- Exposure and hedging
- Hedge Fund benchmarks
- Hedge Fund performance persistence and predictability

2. Hedge Fund organizational structure

- Competitive environment
- Compensation and fee structure
- Regulatory environment

3. Hedge Fund trading strategies

- Long-short equities
- Convertible bond arbitrage
- Pairs trading
- Spread convergence
- Merger arbitrage
- Fund of Hedge Funds

Study materials

Required:

Case package. This package contains the cases which will be covered in class as well an extended note on Value@Risk . It can be obtained from Paradigm Books & Lecture notes, 407 W. 24th Street.

Two highly recommended textbook are:

Simon Benninga. 2008. *Financial Modeling*. 3rd edition. MIT Press.

This books provides extensive coverage of portfolio construction techniques using Excel software. This is a cornerstone of the portfolio management project.

Ludwig Chincarine and Daehwan Kim. 2006. *Quantitative Equity Portfolio Management*. McGraw-Hill.

The book provides extended coverage of Long/Short Portfolio Construction and will therefore be a useful companion for the Portfolio management project (see below).

Course Grading

Your grade in the course will be determined as follows (class participation is included):

Cases	45%
Portfolio project	55%
	100%

Plus/Minus grading applies to this course. The historical distribution of grades has been roughly as follows: 60% A's; 40% B's , but past performance is not a guarantee for future performance as grading is not done "on the

curve".

Three learning tracks

(1) The first track provides hands-on experience with portfolio construction, performance reporting and risk management. You are required to individually manage a long/short equity fund according to a set of common parameters. As a manager, you will be judged on several criteria: clarity of reporting, use of risk control techniques and returns generated by the fund.

(2) The second track is a series of case studies each addressing issues commonly faced by hedge funds, ranging from how to compensate managers to how to manage the growth in assets when the fund is successful. These two tracks involve individual work.

(3) The third track is classroom interaction: during discussions of current events, case solutions and class lectures. This track allows you to check your progress in understanding of the issues, raise questions and voice opinions.

Class attendance is required and class participation is an important part of the final grade. Should you miss 3 or more classes, you must take a make-up exam covering the material of the whole course. The exam will be scheduled for the end of the semester. You are responsible for any materials discussed or passed out in class, whether you attended the class or not.

Portfolio management project

A significant part of the course is devoted to managing a hedge fund. You are required to manage a portfolio of equities using a long-short equity strategy. Before starting to manage the portfolio you must write a strategy document in which a clearly stated investment idea is presented. The document must start from a general theme or background (i.e. the economy the recession is going to be shorter than most people expect and financial stocks will bounce back from their current depressed price levels) and then discuss an idea explaining how you intend to profit from this theme. For instance: you could propose to go long stocks in the financial sector and go short oil stocks.

From reading the document it should be clear what your fund promises in terms of risk and return; what your perceived competitive advantage in managing money is, and whatever else you deem material in order to attract investors to your fund.

In addition to the buying and selling of equities in accordance with your strategy, you are also responsible for reporting the performance of the portfolio on a 2-weekly basis. This report shall consist of the performance of the portfolio based on the daily NAV during the previous 2 weeks; changes in the composition of the portfolio during the week, including a small note attached to each change explaining why the change was made. If you change your investment theme, you should also provide a note explaining why you are changing course. An Excel sheet is not an acceptable format for a report. Performance reports are to be posted to the course's digital drop-box.

At the end of the semester, the portfolio must be liquidated and a final report on the portfolio's performance turned in. This report must provide a detailed analysis of the performance, in particular how the strategy adopted in the prospectus and the final performance are related.

Your grade for this project, which is 55% of your final grade, will be based upon the clarity, originality and comprehensiveness of the documents prepared during your tenure as portfolio manager as well as on the quality of your results (not necessarily the quantity). Strictly adhering to the investment mandate is considered very important. As the period over which the experiment is run is short, the significance that can be attached to your performance results is limited. Nevertheless, you should set up a reporting system that takes a digital feed of closing prices and calculates performance and risk measures of your portfolio on a daily basis.

Cases

The course will use 8 cases to illustrate some the main issues that hedge fund face. These issues can be either quite general or specific to particular kinds of strategies.

The cases are:

-Maverick (Long-short equity)

- MFS (Starting a hedge fund in a traditional mutual fund company)
- Harvard (Compensation of managers)
- Royal Dutch/Shell (Pairs trading)
- LTCM (I)(Spread convergence)
- LTCM (II)(Risk management)
- Farallon (Merger arbitrage)
- Common Fund (Setting up a Fund of Funds)

You must come to class prepared to discuss these cases. The preparation consists in understanding and being able to articulate the issues, choices and solutions that you would propose to the decision maker in the case.

Format for case write-ups:

For each case, a 3 to 4 pages, double-lined, position paper is due before the start of class. There is an Assignments area in Blackboard where you can file your submission. Please do not email your answers or bring me hard copy. I will not accept late submissions and you will not earn any points if you fail to submit your write-up in a timely fashion.

In preparing your write-up, you can assume that I'm familiar with the background of the case such as the firm history, products and strategies. You therefore need not spend time or space repeating the information provided in the case. This does not mean that the information provided in the cases is necessarily correct or that you can accept it at face value.

The write-up must consist of 3 separate and clearly identified sections:

A section in which you identify the crucial issue which needs to be addressed in the solution to the case;

A section analyzing the alternative courses of action or solutions that could be used to solve the crucial issue;

A section containing a set of recommendations that you would adopt if you were responsible for making the decision, together with your reasoning why you're proposing that particular course of action and what the balance of the risks and expected returns are of your particular solution.

As your case write-up and your contribution to the class discussion will be reflected in your grade as part of the component "Cases" which make up 45% of the total grade.

Students with Disabilities

Upon request, the University of Texas at Austin provides appropriate academic accommodations for qualified students with disabilities. Services for Students with Disabilities (SSD) is housed in the Office of the Dean of Students, located on the fourth floor of the Student Services Building. Information on how to register, downloadable forms, including guidelines for documentation, accommodation request letters, and releases of information are available online at <http://deanofstudents.utexas.edu/ssd/index.php>. Please do not hesitate to contact SSD at (512) 471-6259, VP: (512) 232-2937 or via e-mail if you have any questions.