

## Finance 397.6: SPECIAL TOPICS (HEDGE FUNDS)

#### **SPRING 2010**

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Course Web Page via Blackboard

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Classroom and Schedule UTC 3.120 M-W 2-3.30pm

# **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.

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, was taken over by a consortium of banks and liquidated in an orderly fashion at the urging of the Federal Reserve who feared that a bankruptcy of LTCM had the potential to plunge financial markets in a crisis.

The credit crisis, responsible for plunging the economy into recession in 2008, also 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 produced negative returns. 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 credit squeeze, 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 by the government alongside the banks.

The latest act in the saga has been the unraveling of the giant Ponzi scheme run by investor Bernard Madoff. The unfolding scandal<sup>1</sup> has inflicted terrible damage on the reputation of the investment vehicles known as funds-of-hedge funds. Even though Madoff Securities itself was not a hedge fund, and was regulated by the SEC, it lost an estimated \$50-65 billion. Most of this money had been invested with Madoff by so-called fund-of-hedge-funds. The clients of these funds, first heard of Madoff when they learned that their investments had evaporated. 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 finder fees after steering \$ 7.3 billion of its clients' money to Madoff<sup>2</sup>.

The hedge fund industry faces 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; and the liquidity of asset markets has evaporated making it difficult for funds to unwind position in illiquid strategies. As a result, many funds have restricted 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.

Even if the hedge funds went through a rough patch, many have recovered and are back in business. They were 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..

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 $\underline{\text{http://www.nytimes.com/2008/12/20/business/20madoff.html?pagewanted=4\&sq=madoff%20pioneer\&st=cse\&scp=1)}$ 

http://topics.nytimes.com/top/reference/timestopics/organizations/f/fairfield\_greenwich\_group/index.html?scp=2&s q=fairfield%20greenwich&st=cse

# Three learning tracks

The course has three tracks:

- (1) The first is to provide you with 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, demonstrating a clear understanding of risk control techniques and by how well you manage to achieve the investor's objectives...
- (2) The second is a series of case studies that address different 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 during class where we discuss current events, case solutions and class lectures. Investments are driven by getting and interpreting information. This track allows you to check your progress in understanding of the hedge fund industry, raise questions and voice opinions.

#### (1) Portfolio management project

A significant part of the course is devoted to managing a long-short 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 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 producing four reports based on the performance of the portfolio. More detailed instructions on the contents and layout of the reports will be provided in class.

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 35% 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.

## (2) Case studies

The course will use 7 cases to illustrate some the main issues that hedge fund have to 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 (Risk management) -Farallon (Merger arbitrage)

-Common Fund (Setting up a Fund of Funds)

You are required to write a solution to each case in which you detail what you think is the important issue that needs to be solved; enumerate the alternative courses of action you might contemplate and then argue which solution you would pursue if solving the issue was your responsibility. You must come to class prepared to discuss the cases.

# (3) Class participation

A significant part of your grade will be based on class participation.

Class attendance is required.

You have an allowance of two classes you can miss as long as you provide advance notice. For each class you miss in excess of the allowance, your participation score will be lowered by 20%.

#### Study materials

The course does not require a textbook or a course package. I assume that you have an recent, advanced textbook like Bodie Kane and Marcus from the prerequisites courses that you can consult to refresh your memory.

Two highly recommended textbook are:

Simon Benninga. 2008. *Financial Modeling*. 3rd edition. MIT Press. This book provides extensive coverage of portfolio construction techniques using Excel software.

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.

## **Course Grading**

Your grade in the course will be determined as follows:

Cases	35%
Portfolio project	35%
Participation	30%
Total	100%

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".

#### **Assignments**

Deliverables and due dates are provided in the Assignment section of Blackboard.

## 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.