



deniad

Hedge Funds 101 & 102
June 2008

Demystifying Relative Value/Arbitrage Strategies

Andrew Pernambuco
CEO, Deniad and Company LLC

Disclaimer

This material is for general information purposes only and is not an offer or solicitation to buy or sell any security. Any offer or solicitation may only be made by means of delivery of a definitive offering memorandum. This material does not take into account the particular investment objectives, financial situation or needs of a particular client. Before acting on any advice or recommendation in this material, you should consider whether it is suitable for your particular circumstances. This material has been prepared based upon information that Deniad & Company LLC believes to be reliable. However, Deniad & Company LLC does not represent that it is accurate, complete and/or up-to-date in every respect and accepts no liability if it is not. Opinions expressed are current opinions only. Deniad & Company LLC does not accept any responsibility to update any opinions or other information contained in this material.

Overview

- What is relative value?
- What is arbitrage?
- Types of arbitrage
- Convertible bond arbitrage
- Capital structure arbitrage
- Statistical arbitrage
- Merger arbitrage
- Types of hedge fund strategies
- Summary

What is Relative Value?

- How attractive is one security relative to a *similar* security with respect to return, risk and liquidity
- How attractive a security with a stated maturity can be relative to the same security with a *different* maturity
- Seen in a number of hedge fund strategies e.g., capital structure arbitrage and fixed-income arbitrage

What Is Arbitrage?

- Arbitrage refers to “risk-less profits”
- Simultaneous buying and selling of a security in two different markets resulting in “profits without risks”
- Assumes that markets are inefficient so opportunities exist
- Can be seen in convertible bond arbitrage, merger arbitrage, statistical arbitrage and capital structure arbitrage

Types Of Arbitrage

- Convertible bond arbitrage
- Capital structure arbitrage
- Statistical arbitrage
- Merger or risk arbitrage
- Fixed-income arbitrage
- Index arbitrage
- Municipal bond arbitrage

Convertible Bond Arbitrage

- Buy a convertible security
- Short the underlying equities that it converts into at a pre-determined level
- There is a contractual relationship between the securities
- Classic CB arbitrage is based on non-market dependent events

Convertible Bond Arbitrage

The non-market dependent events are:

- cash flow
- dynamic hedging
- convergence (maturity, call or default)

Convertible Bond Arbitrage

- Volatility arbitrage within CB arbitrage
- Credit arbitrage within CB arbitrage
- Distressed securities
- Capital structure arbitrage

Capital Structure Arbitrage

- Looking at the relative value of a security with a specific maturity to the same security with a *different* maturity
- Convertible bonds, straight debt or equity versus debt
- Probability of convergence

Capital Structure Arbitrage

- Buy a convertible security with a maturity of 2010
- Short the same convertible security with a maturity of 2015
- Analysis of cash flow, management and maturity
- Intraday inefficiencies not as important as in statistical arbitrage

Statistical Arbitrage

- Use of complex computer models to try to capture small abnormalities in a security's intraday return
- Usually equity market neutral
- Trades in large baskets
- May encompass pairs trading, index arbitrage and basket trading

Statistical Arbitrage

- Summer of 2007
- Models
- Crowded space
- Takeover premium

Merger Arbitrage

- Also called risk arbitrage or event driven
- Buy the security of the target company
- Short the security of the potential acquirer
- Capture the spread

Merger Arbitrage

- Must borrow the security to short
- Risk that the security may be called away
- May be dependent on regulatory or anti-trust issues
- Spread relationship may disintegrate

Types Of Hedge Fund Strategies

Categories of Hedge Fund Strategies

EQUITY

Long/Short Equity
Opportunistic Equity
Value
Short Bias

GLOBAL MACRO

Managed
Futures
Emerging
Markets
Global Macro

RELATIVE VALUE

Convertible
Arbitrage
Mortgage-Backed
Arbitrage
Fixed Income

EVENT DRIVEN

Merger Arbitrage
Distressed
Special Situations
High Yield/
Aggressive Growth
Market Timing

Summary

- Relative value is a part of every arbitrage strategy
- CB arbitrage depends on the contractual relationship between securities
- Capital structure arbitrage exploits the differences among securities of the same class
- Statistical arbitrage takes advantage of intraday inefficiencies in the same security or a basket of securities
- Merger arbitrage tries to capture the spread between an acquirer and its target

For More Insight:

- Visit us at:

www.deniad.com

email: apernambuco@deniad.com