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Hedge Funds A-Z
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Introduction to Hedge Fund Strategies II

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Overview

- What is relative value?
- What is arbitrage?
- Strategies that use arbitrage
- Event driven strategies
- Credit related strategies
- Carry trades
- Credit and the carry trade
- Post mortem
- 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, carry trades and capital structure arbitrage

Strategies That Use Arbitrage

- Event driven
- Credit strategies
- Capital structure arbitrage
- Statistical arbitrage
- Merger or risk arbitrage
- Fixed-income arbitrage
- Index arbitrage
- Municipal bond arbitrage

Event Driven Strategies

- Merger or risk arbitrage
- Distressed securities
- Capital structure arbitrage
- Convertible bond arbitrage
- High yield investing

Credit Related Strategies

- Convertible bond arbitrage
- Fixed-income arbitrage
- Mortgage-backed securities
- Municipal bond arbitrage
- Distressed securities
- *Carry trades*

Carry Trades

- Buy security that pays a high interest rate
- Borrow a security that has a low interest rate
- Pay lower interest rate
- Expect convergence

Carry Trade

- Long 10 year Treasury future
- Borrow underlying Treasury bond in order to short it
- Yield incremental returns on a daily basis
- Monitor spread
- Convergence

Credit And The Carry Trade

- Pay tomorrow for use of something today
- True nature of money is depicted in credit-debt relationships
- US Treasury
- Spread blow-out
- Convergence?

Post Mortem

- Creditworthiness of the US Government
- Financing of basic positions changed forever
- Credit will have to loosen
- Lending will be measured
- We all have short memories

Summary

- Relative value is a part of every arbitrage strategy
- Event driven strategies look for convergence
- Credit related strategies are affected by outside factors
- Convergence is no longer guaranteed when credit disappears
- Learn from these experiences

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