Hedge Fund Selection & Investment

Instructor: Fabio Savoldelli
Course Time: Wednesday, 5:45-9PM
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General Course Information:
This class uses a combination of instructor lectures, class discussions and guest lectures to teach students the methodologies of hedge fund analysis and investments from the perspective of investors considering investing into hedge funds, as well as portfolio managers running actual hedge funds. The course will have a particular focus on the limitations and pitfalls of applying traditional security analysis to investments into hedge funds, and the drivers of success in hedge funds. The course will focus on the investments techniques employed by, and the evaluation of, managers involved in Directional Investing (equity and macro), Event Driven Strategies, Arbitrage and Relative Value Strategies. Exposure to basis risk and hedging strategies will also be reviewed. Course participants will be exposed to some Wall Street best practices for hedge fund investing and performing hedge fund due diligence, with guest lectures from active investors and portfolio managers in the field. Given recent events special focus will be given to the market melt-down of 2008, and to review the risks presented by both operations (Madoff) and market liquidity. The course is “free flowing”. While there are defined lectures, students should also expect current, live, market conditions to form an important part of the class discussion. The topics in the syllabus will be covered, though the order may vary if “live market” conditions allow for teaching from a current example, or to accommodate guest speakers.

Who should take this course?
Hedge funds are moving from the fringes of investments to the core. Anyone who is heading into an asset management related activity will find themselves interacting with hedge funds, either as investors, marketers, counterparties or potential hedge fund managers. Although covered, the focus is not only on classic “value equity” investing, but covers the broad range of other hedge fund strategies, including special situations, arbitrage based and macro investment styles.

Who Should NOT take this course:
This course will be taught to a broad range of students. Some students may find the level of expected market knowledge a challenge. There is NEVER a penalty for asking a question, Please do so. I also welcome questions during the break on any concepts or terms you are unfamiliar with. Some students, perhaps coming out of trading or investment banking programs, may instead find some sections of the material familiar. For them, the instructor is happy, on a time available basis, to go into greater depth on concepts with them, letting the class know this is an “extra”. Nevertheless, if you find a digression to help a student with differing knowledge frustrating, this will not be an easy
class to attend for you. Again, it is for a broad range of students, and this must be accommodated.

The class “format” is one of an “Investment Committee Meeting” with the Instructor as quasi-Chief Investment Officer, who will (as happens in virtually all investment environments) ask the students (quasi- hedge fund investment analysts) questions throughout the session. Questions (and student answers) are fundamental to how this course is taught. If you are uncomfortable with “cold call” questions, this is simply not the course for you.

The class tries, as much as possible, to draw on current events. EVERY class starts with a section on current markets, and how a hedge fund manager, as opposed to long-only investor, might seek to profit from the current, live, market situation. You WILL be called on at some point. This does NOT require students to know about upcoming IBM earnings expectations to the penny. Nevertheless, students are expected to read the Wall Street Journal, Financial Times or the business periodical of their choice and be knowledgeable of current financial events so they can participate. Students should be able to come to class with at least one thing of note that struck them as a potentially “investable” financial development. Students can raise almost any situation (from macro political events to individual company news) as an item of interest. If a student is comfortable being ignorant (even at the very basic ‘first paragraph of a Wall Street Journal article’ level) of any and all current financial developments it is likely this course for NOT them. Issues raised can be in almost any area: development in the European situation, changes in Chinese growth, activity in the oil market, a major take-over announcement that week, almost anything can be raised. The answer to “what interesting thing happened this week?” in global financial markets is almost NEVER “Nothing, Professor”. You are not expected to know the resultant investment opportunity, or how to structure an investment to profit from it, but you are expected to have sufficient currency with financial markets to participate in the thought processes that follows.

Finally, the thirteen lectures in this course will not fully prepare students to either launch a fund, or invest in one, the week they graduate.

**Grading**
20% Class participation
10% Presentations
70% final project, fund review and assignments

Presentations will be given weekly by small teams. During these they will gain experience in “pitching” a hedge fund to investors, and in presenting a sample trade consistent with that strategy.

For the final project student teams will visit various actual (New York Area) hedge funds and perform a mock due diligence on the fund and their investments, culminating in a
“buy sell or hold” recommendation on the fund. For those unable to attend any fund a take-home option will also be available.
About me:
Mr. Savoldelli most recently served as Chief Investment Officer for Optima Fund Management. He is also a Contributing Editor on Bloomberg Television, commenting on developments from a hedge fund perspective. Previously, Mr. Savoldelli was Managing Director & Chief Investment Officer at Merrill Lynch Investment Managers Alternative Strategies. At Merrill Lynch, Mr. Savoldelli chaired the Investment and Asset Committee and oversaw investments into hedge funds and managed futures funds, a position he held for over ten years. At Merrill, his group managed assets through commingled and customized hedge fund of fund vehicles. Prior to that, Mr. Savoldelli was CIO for the Americas at the Chase Manhattan Private Bank, where he was responsible for managers investing assets in international and domestic institutional, private client and ERISA funds. Previously, he was Deputy CIO & Head of Fixed Income and Foreign Exchange at Swiss Bank Corp. Mr. Savoldelli received a DBS from the London School of Economics and a BA in Economics from the University of Windsor in Canada.

He has been a prominent critic of Madoff and is widely quoted in the industry on hedge fund investment and related issues.

Every session:
We always open with a 15 to 20 minutes review of the week’s events, looking at how managers might, employing hedge fund strategies, seek to profit from resultant market movements. After that, class teams will, on a rotating basis, pitch a “fictional” fund and present individual trade opportunities from the perspective of Directional, Event Driven, Arbitrage and Relative Value Strategies.

Lap Tops/Cell phones: Any student needing to use these during class should inform me PRIOR to the start of class, and request will be reviewed on a case-by-case basis.

NOTE: The class structure will certainly vary from the outline below, reflecting time restrictions, time dedicated to reviewing (unpredictable) market events and availability of guest speakers.

Class progression:
The following topics are scheduled to be covered, in approximately this order. To give an indication of readings I have included links to papers that are instructive.

- “Delivering Alpha” Alpha drivers, categories and styles
Hedge fund classification and strategy, a brief review

Potential Readings:
Asset-Based Style Factors for Hedge Funds Financial Analysts Journal William Fung,
The Statistical Properties of Hedge Fund Index Returns and Their Implications for Investors C Brooks, H Kat - Journal of Alternative Investments

Generalised style analysis of hedge funds: Agarwal, V; Naik, NY; Journal of Asset Management, Volume 1, Number 1, 1 July 2000, pp. 93-109(17)

The Brave New World of Hedge Fund Indices N Amenc, L Martellini; Edhec/Misys, 2003

- **Quantitative Return Measures:**
  Performance metrics, (Sharpe, Traynor. Sortino. Jensen ratio etc.) will be reviewed, with a focus on the application of each

**Potential Readings:**

DOI: 10.3905/jai.2003.319075

Does the choice of performance measure influence the evaluation of hedge funds?
Martin Eling Frank Schuhmacher a Institute of Insurance Economics, University of St. Gallen, Kirchlistrasse 2, 9010 St. Gallen, Switzerland

- **Prime Brokers,**
  Their role as market intermediaries, and selection criteria

- **Hedge Fund Leverage:**
  “Too much of a good thing?” Sources of leverage, and the impact on risk vs. return characteristics. Use of leverage to decrease risk.

**Potential Readings:**


- **Short Selling. Mechanics of short selling, risk and returns**

**Potential Reading:**


- **Hedge Fund Industry Overview: evolution of the industry, and current investor allocations and flows.**

Overview and historical analysis of returns. Merely being a “hedge” fund does not mean one is, in fact, immune to market movements. Quantitative review of major strategies to review historical performance, particularly in time of market stress

**Potential Reading:**

Systemic Risk and Hedge Funds, Nicholas Chan, Mila Getmansky, Shane M. Haas, Andrew Lo NBER Working Paper No. 11200, Issued in March 2005
Hedge fund “core investment philosophy” and “residual trade risk”

The return characteristics and risks of prominent investment styles will be reviewed. These will include George Soros “Theory of Reflexivity” Richard Dennis “Turtle Trading”, David Shaw “Granular Correlations” Paul Tudor Jones “The Rules” and others, with an attempt to summarize the role of “residual risk”, a key concept in this course.

Potential Readings:


Taking A Peek Inside The Turtle’s Shell, John A Anderson School of Economics and Finance Queensland University of Technology http://e-m-h.org/Ande.pdf

Are “market neutral” hedge funds really market neutral, AJ Patton; London School of Economics

Merger Arbitrage as a “classic arbitrage strategy” with parallels to written options. M&A cyclicality and the basis for Merger Arbitrage Profitability.

Potential Readings:

Risk Arbitrage in Takeovers Francesca Cornelli, David D. Li The Review of Financial Studies, Vol. 15, No. 3 (Summer, 2002), pp. 837-868


Fixed Income Arbitrage: key concepts and Risks

Potential Readings:


A simple approach to arbitrage pricing theory, Gur Huberman; Graduate School of Business, University of Chicago, Chicago, Illinois 60637, USA


- Other Strategy Review, depending on time and class interest.

Potential Readings:
Neutrality of market neutral funds D Capocci - Global Finance Journal, 2005
Statistical Arbitrage and Securities Prices O Bondarenko; Review of Financial Studies
Hedge Funds and the Technology Bubble MK Brunnermeier, S Nagel; The Journal of Finance, 2004

- Long Term Capital: Lesson in Risk Control. Some learned, some not...

Potential Readings:
Sifting Through the Wreckage: Lessons from Recent Hedge-Fund Liquidations
M Getmansky, AW Lo, SX Mei - Journal of Investment Management, 2004


- Launching a Hedge Fund Business: practical matters (Possible Guest Lecture)
- Equity Investing From a Hedge Fund Perspective (Possible Guest Lecture)

Potential Readings:
Quantative selection of long-short hedge funds; K Chen, A Passow - 2003 - Mimeo, University of Lausanne

- Macro Investing From a Hedge Fund Perspective (Possible Guest Lecture)

Potential Readings:
The Risk in Hedge Fund Strategies: Theory and Evidence from Trend Followers; William Fung, David A. Hsieh
Managed Futures and Hedge Funds: A Match Made in Heaven; HM Kat Journal of Investment Management, 2004

- Hedge Fund Due Diligence: Questions to Ask

Potential Readings:
Systemic Risk and Hedge Funds, Nicholas Chan, Mila Getmansky, Shane M. Haas, Andrew Lo NBER Working Paper No. 11200, Issued in March 2005