Fixed Income Hedge Fund Strategies – Is There Anything for the Long Only Manager?

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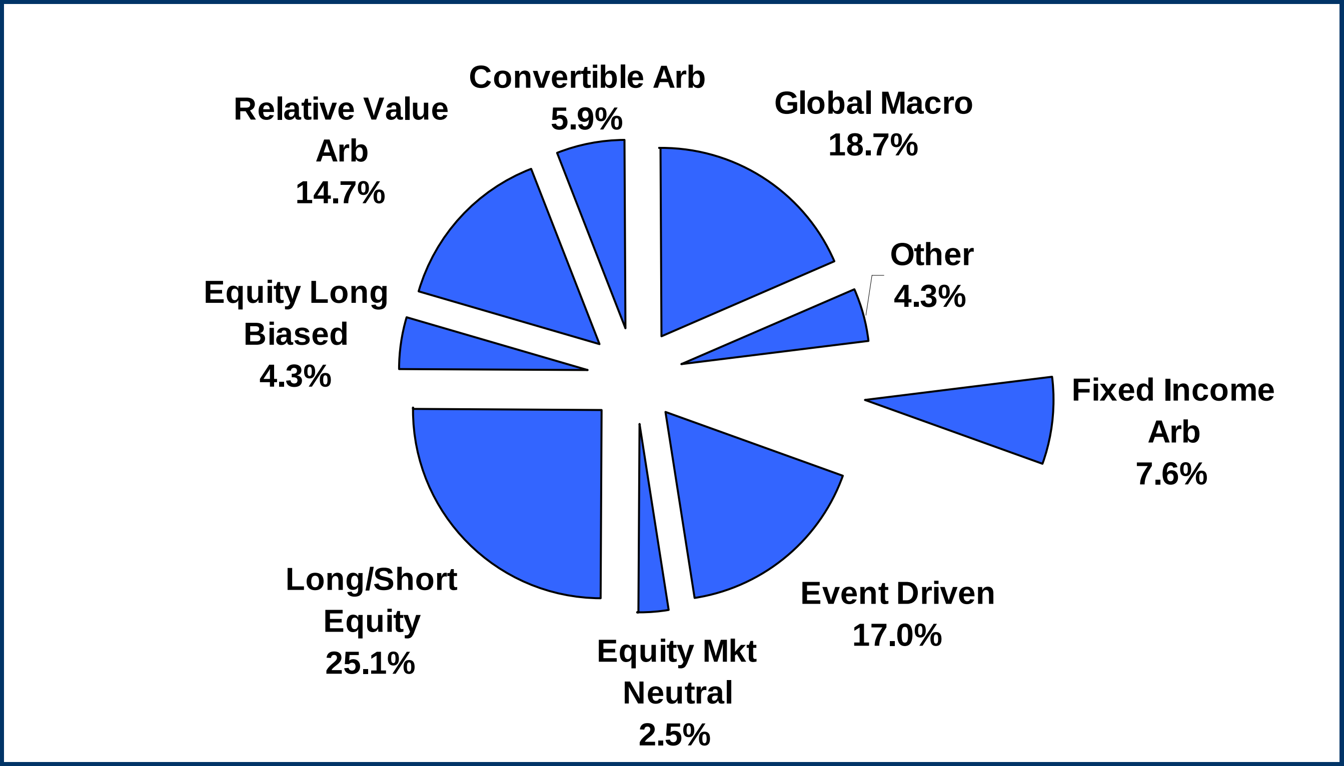
Fixed Income Hedge Fund Strategies – Is There Anything for the Long Only Manager?

- Long only managers may want to consider some of the strategies and tactics of FI hedge fund managers
- Fixed income hedge funds generally have higher return with lower risk than traditional long only FI managers
- Some hedge fund strategies and tactics may help traditional long only managers increase return and reduce risk
- Any changes in strategy should be done carefully to avoid numerous pitfalls

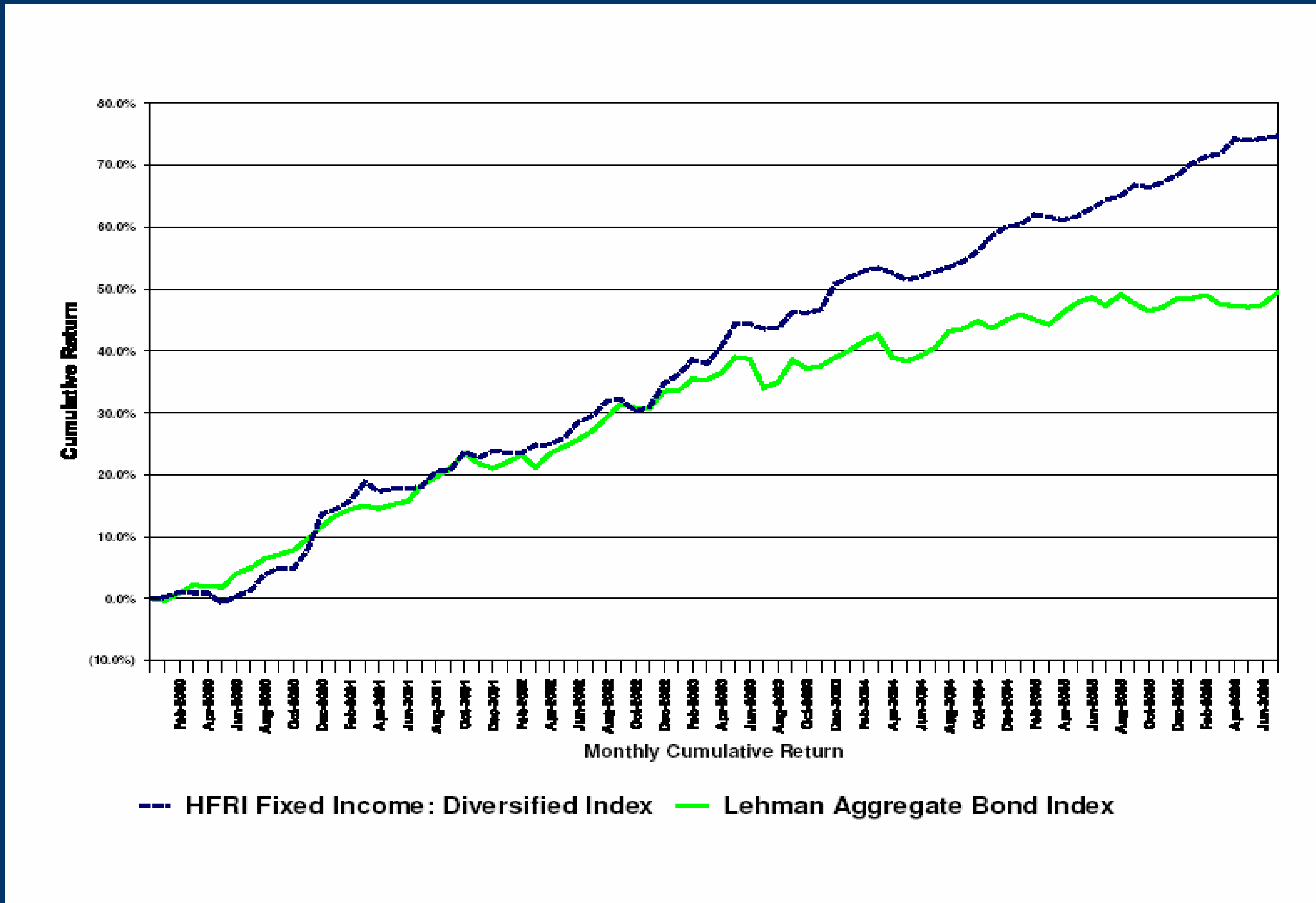
Evolution of Markets Toward Hedge Fund Strategies

- Traditional FI as buy and hold to preserve capital and obtain steady income
- Market evolution and financial innovation has expanded the number of instruments and strategies available to managers
  - Interest rate swaps/futures/options/credit default swaps/international/repo/EM/non-dollar
- Improved computing power and technological innovations
- Global regulatory framework and transparency
- Advancement of risk management and financial theory
- These and other factors have spawned the development of FI hedge funds
- There is a movement of traditional FI managers toward HF strategies

Hedge Fund Strategy Buckets



HFR FI Hedge Fund Index vs Lehman Aggregate Index



HFR FI Hedge Fund Index vs Lehman Aggregate Index

Year	HFR FI Index Return*	Lehman Agg Return	Diff
2000	13.65%	11.63%	2.02%
2001	8.95%	8.42%	0.53%
2002	8.81%	10.27%	-1.46%
2003	11.91%	4.11%	7.80%
2004	6.16%	4.34%	1.82%
2005	5.21%	2.43%	2.78%
2006 (to Jul)	3.74%	0.62%	3.12%
2000-7/06 Ave	8.87%	6.35%	2.52%
Ann Std. Dev.	3.85%	3.77%	
Sharpe Ratio	0.96	0.34	

(*HFR FI: Diversified Index net of fees)

FI Hedge Fund Management vs Traditional Long Only FI Management

- Diversified FI hedge indices may offer higher potential returns with lower risk compared to broad bond market indices and traditional bond strategies
- But individual FI hedge funds have a wider dispersion of return (positive and negative) compared to traditional fixed income managers
- Changing a traditional FI manager’s investment objective and/or guidelines will introduce the potential for both positive and negative performance results vis-à-vis the index
  - *There have been numerous “blow-ups” in FI hedge funds, indicative of large potential downside manager risk, but this risk can be lowered by diversification of managers*
  - *Asset allocation and risk management at the manager level vs consultant level*
  - *Therefore, attempts by traditional FI managers to capture hedge fund returns by utilizing hedge fund strategies and tactics must be done with care and consideration*

Reasons to Invest in Fixed Income

FI Hedge Fund

- Provide positive total rate of return in all markets
- Produce favorable risk return characteristics
- Provide uncorrelated returns to other major asset classes

Traditional FI

- Preserve capital
- Produce income
- Capital gain

FI Hedge Fund Management vs Traditional Long Only FI Management

	FI Hedge Fund	***Traditional FI***
Objective	Positive return	Outperform Index
Inv. Guidelines	Broad	Narrow
Leverage	Yes	No
Shorting	Yes	No
Style	Trading/Technical	Investing/Fundamental
Global	Yes	No
Currency	Multi-currency	Dollar
Credit Rating	Less constrained	More constrained
Options	Buy and sell	No
Futures	Unlimited	Limited
EM	Yes	No
Risk Management	VAR/other	Duration/Credit
Trading/Turnover	Active/high	Low/low
Liquidity	Varies	Varies

(Comparisons are generalizations)

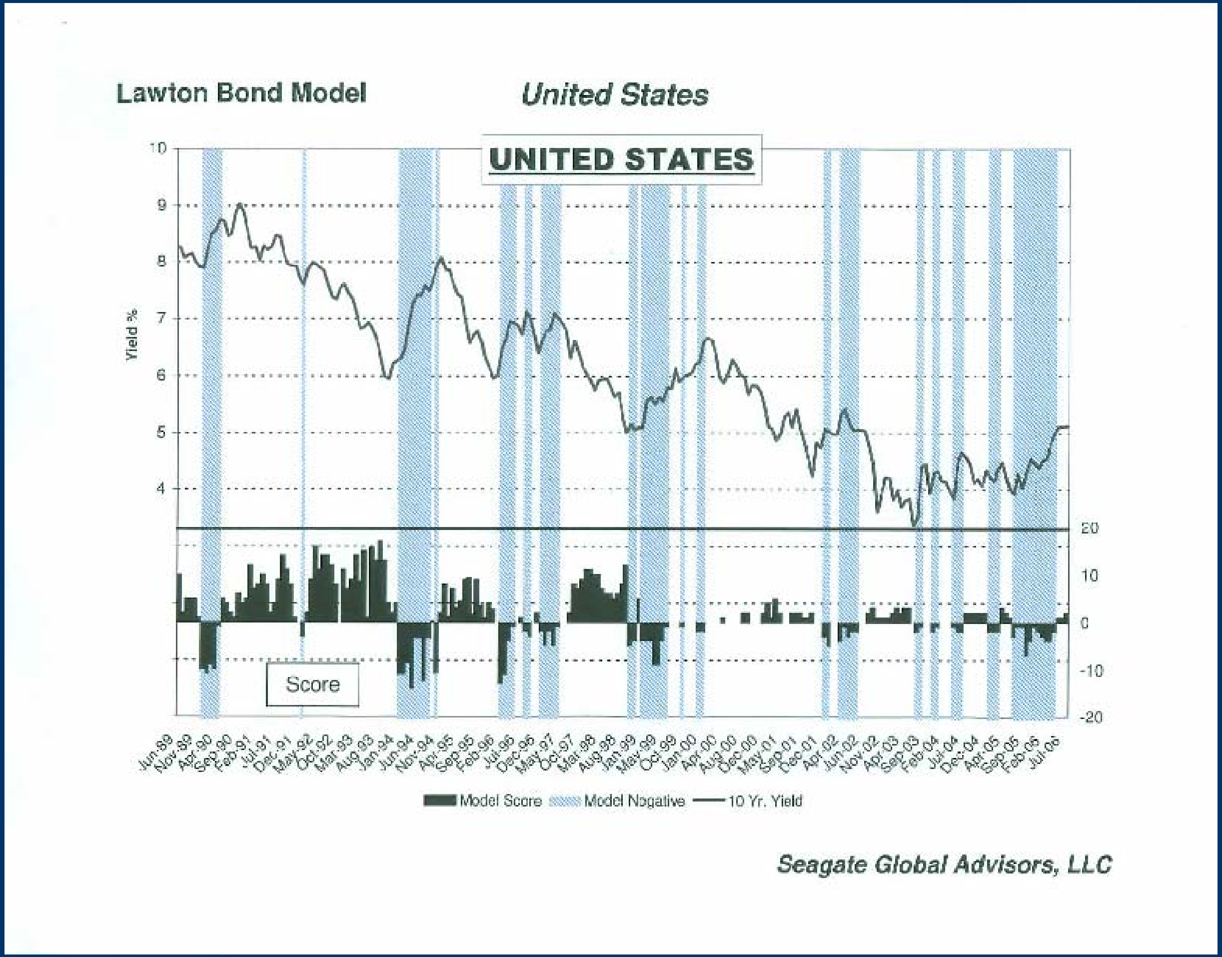
Traditional FI Culture vs Hedge Fund Culture

- Hedge fund companies have very different cultures than traditional fixed income management companies
- Hedge funds are organizationally structured to produce high returns, while traditional managers, with a more narrow mandate, are structured in a more defensive manner
- Hedge fund managers often have a large part of their net worth in their funds while traditional managers do not, and may even be restricted from investing in the funds they manage
- Hedge fund managers often have equity ownership in their firms, while traditional managers often do not
- If hedge fund managers do a good job, they get 20% of the upside, and therefore have an incentive to produce higher returns, and are fired if they fail
- Traditional managers keep funds under management and their job if the do slightly better than the index, and are fired if they under-perform
- The evolution of global markets and technology has made markets more efficient and new information is discounted more quickly
- The faster responding hedge funds have a competitive advantage over over slower moving traditional managers
- Traditional managers may want to implement some of the organizational features of hedge funds to improve performance

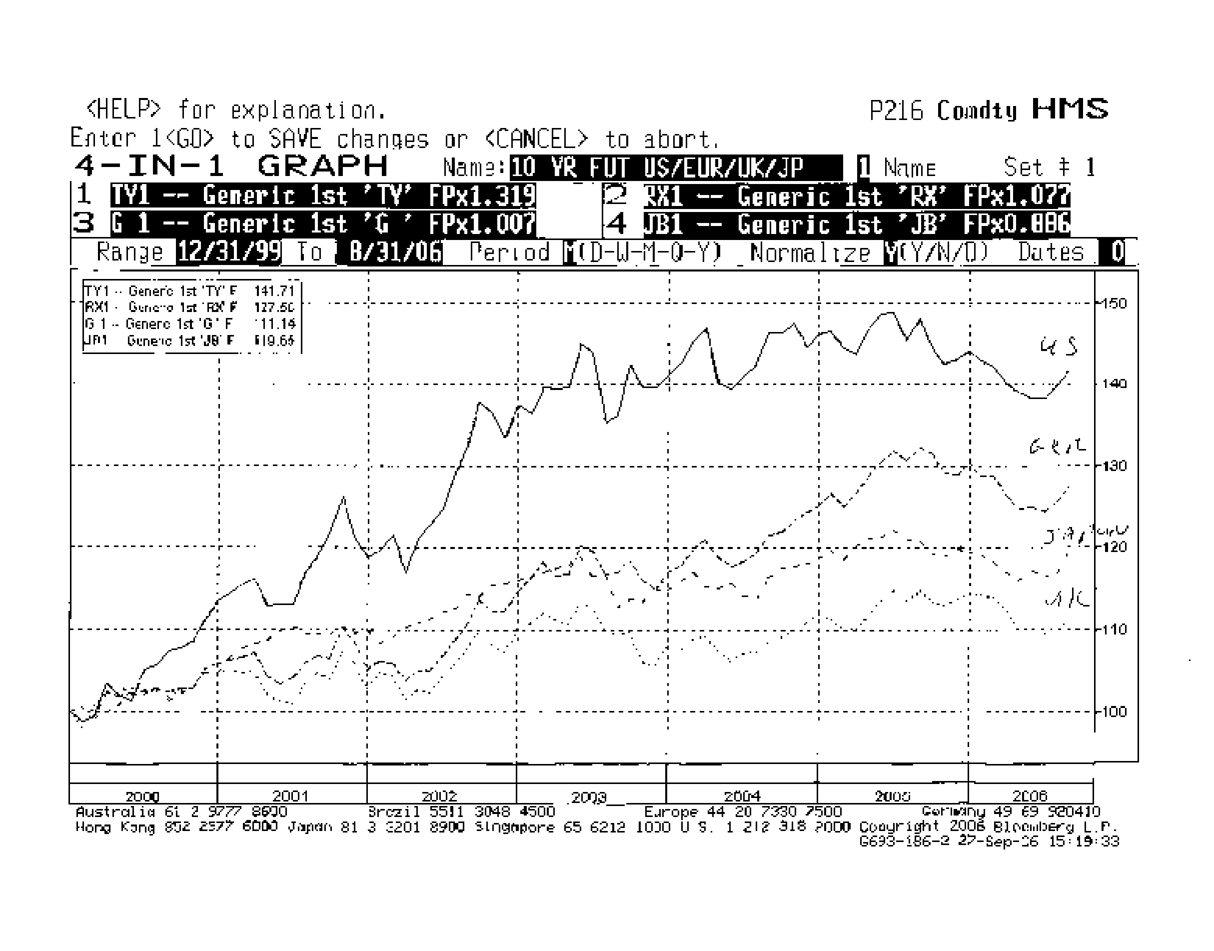
FI Hedge Fund Strategies: Let’s Get Basic- Duration

- FI hedge funds often aggressively use one of the most powerful tools available to a fixed FI manager to increase return or reduce risk: Duration
- Hedge funds may extend duration sharply or go to 100% cash, ignoring the duration of an index
- Traditional fixed income managers usually modify duration versus their index by limited amounts
- Most traditional FI managers already have this tool available but few fully employ it
- Most managers that are successful in aggressively using duration have a model or definable process

Duration Model



FI Hedge Fund Strategies: Global Asset Allocation/ Big 4 Markets



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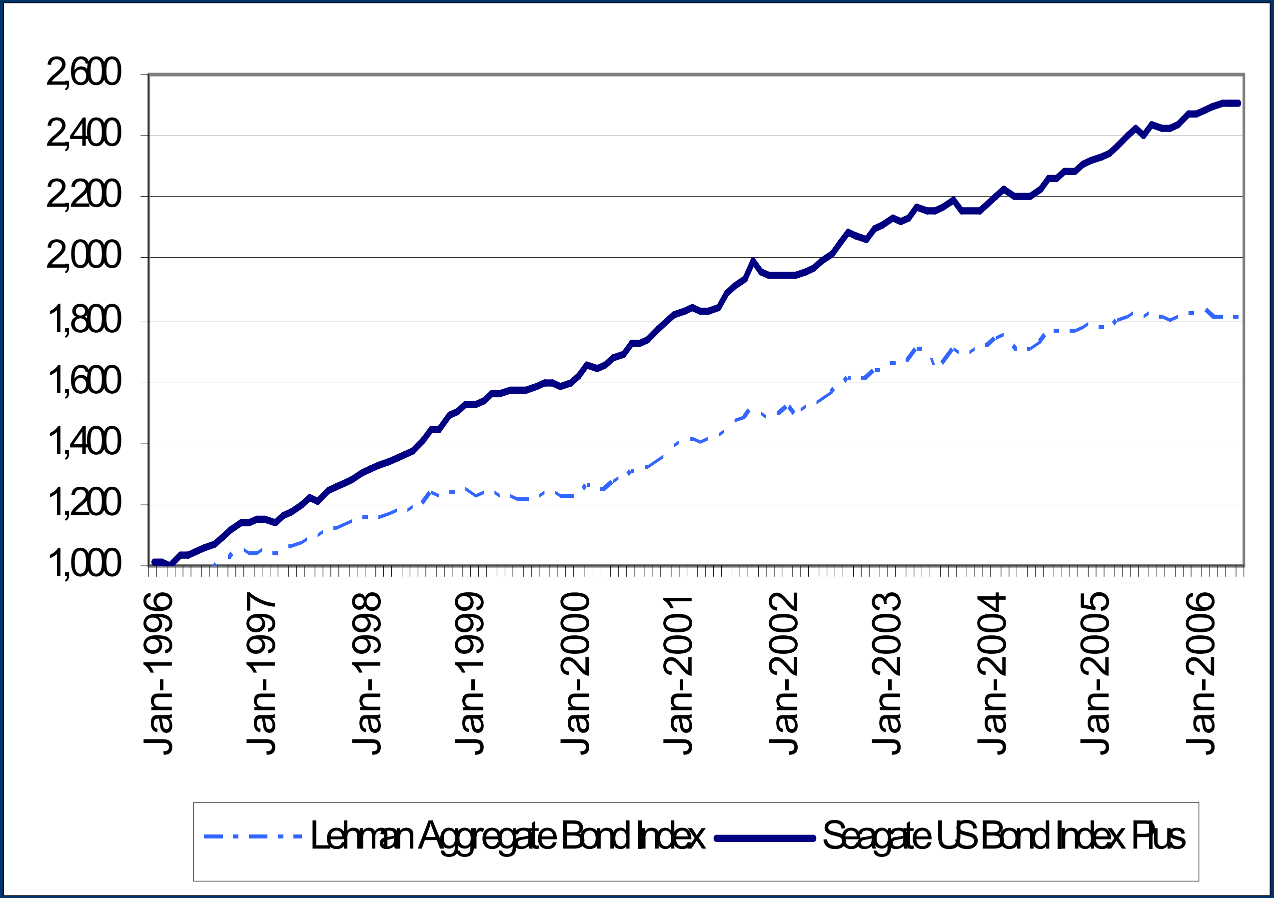
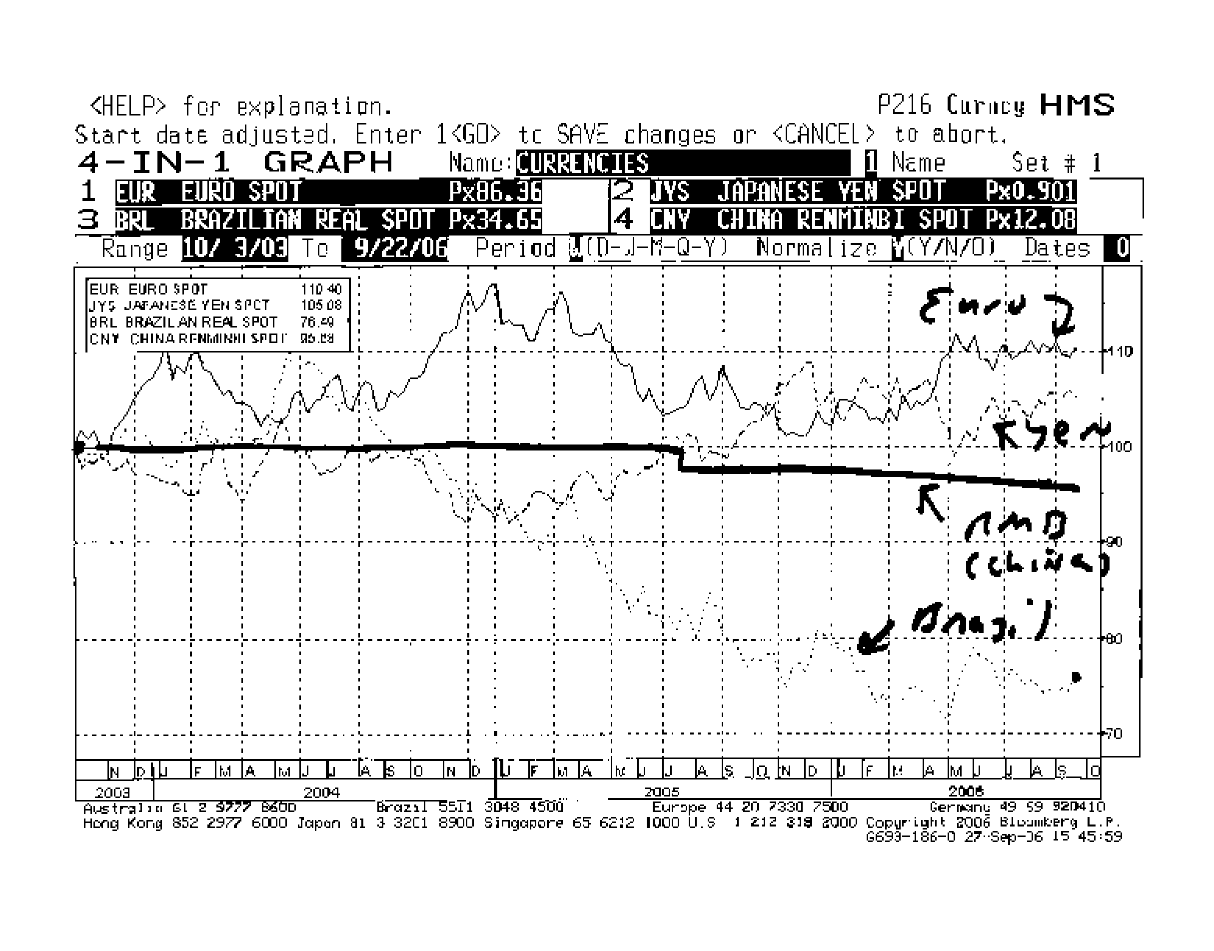
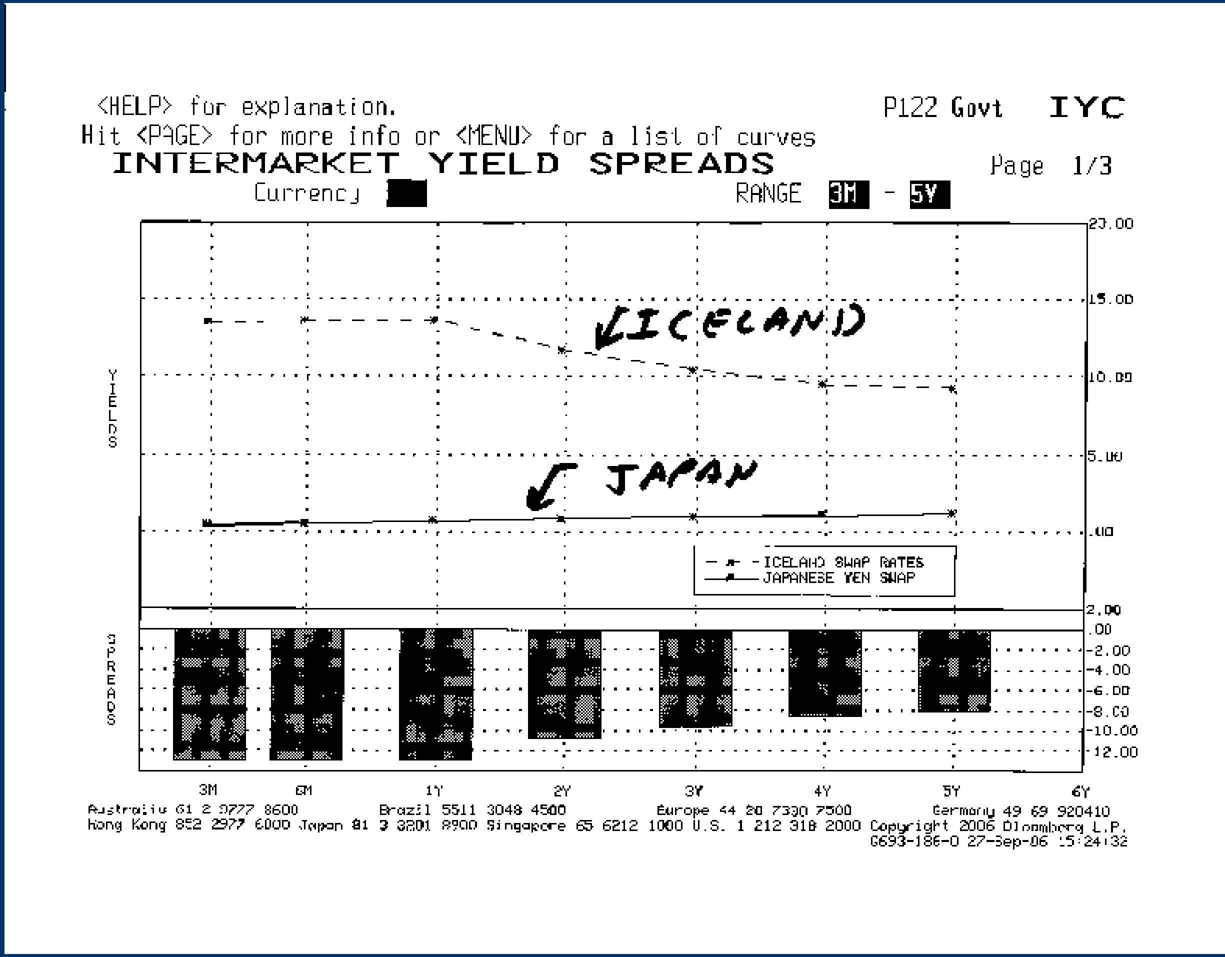


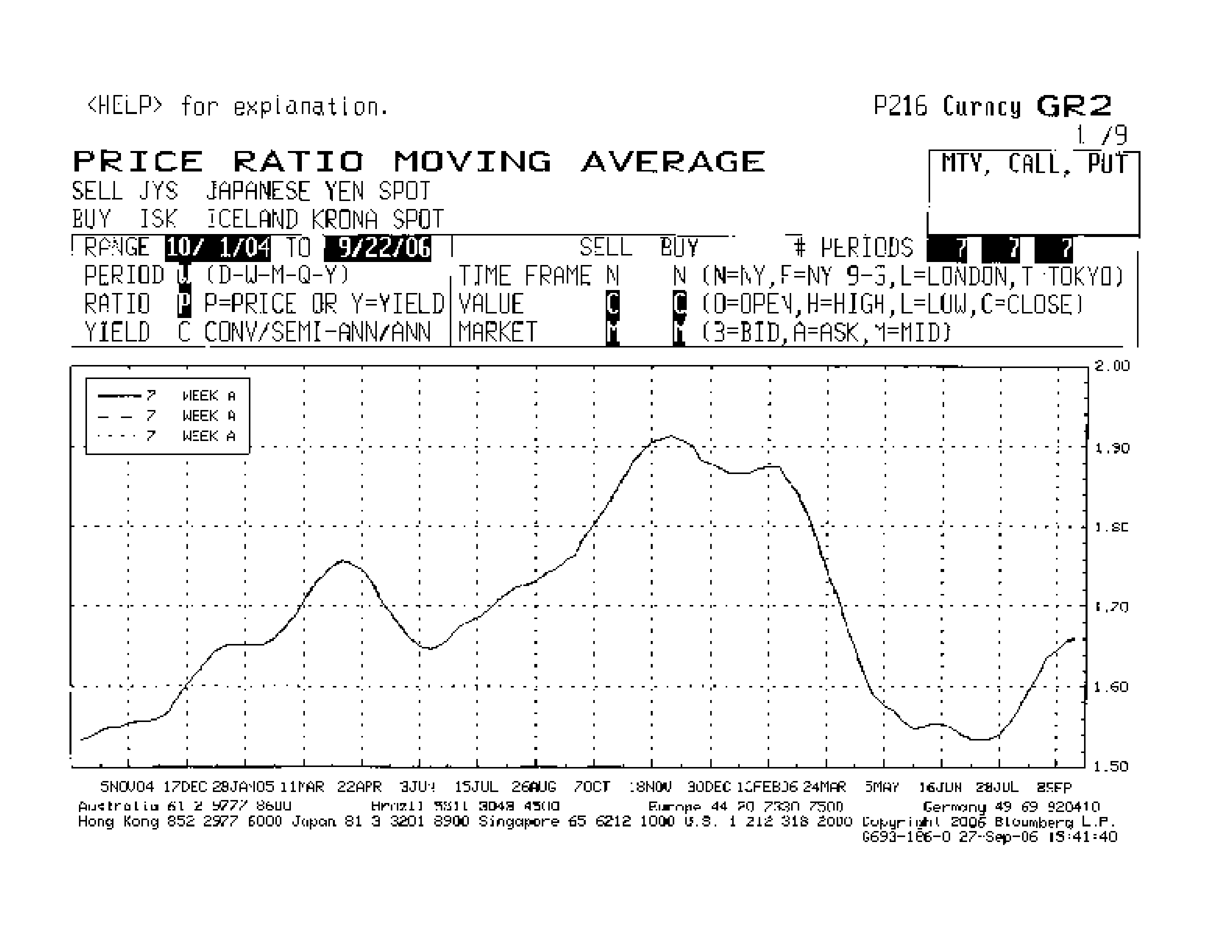
FI Hedge Fund Strategies: Currency Selection



FI Hedge Fund Strategies: Relative ValueTrades-Japan vs Iceland



FI Hedge Fund Strategies: Fund in Yen/Invest in Iceland



FI Hedge Fund Strategies: Leverage

- Leverage is one of the fundamental tools for FI hedge fund managers
- Leverage is well suited to FI instruments as the investment can easily be used as collateral in a repo transaction
- Income from the investment can be used to pay the repo interest, and produce a positive spread
- Leverage may be obtained in a number of other ways
  - Interest rate swaps
  - Credit default swaps
  - Futures
  - Options
  - Forward purchase and sales
- The benefits and risks of leverage are well known
  - Skilled managers will be able to use leverage effectively, and the unskilled manager can create disaster

FI Hedge Fund Strategies: Trading/Technical Analysis/Models

- FI hedge funds typically are more active traders than traditional fixed income managers
- FI Hedge funds usually use models and/or technical analysis to buy and sell compared to a fundamental analysis emphasis by some traditional managers
- HF time horizons can be much shorter than for traditional FI managers
- HF trading size can be quite large
- Turnover can be very high in some strategies

FI Hedge Fund Strategies: Volatility

- Many FI hedge funds trade fixed income volatility in a number of strategies
- Market risk can be delta hedged for sellers of vol
  - Losses are possible in the event that there is a sharp market movement making delta hedging difficult
- Losses are also possible for naked sellers of vol when realized vol is greater than estimated vol
- Purchasing volatility is a strategy to increase returns with defined downside risk, but may lose money in the event that markets stay in defined ranges
  - Purchasing vol strategies may be best suited for traditional fixed income managers, and also be used for hedging strategies

FI Hedge Fund Strategies: Credit Default Swaps

- The credit default swap market was almost non-existent several years ago
- The CDS market has exploded in the past several years in terms of volumes
- Credit default swaps are in many cases more liquid than the underlying bonds they trade against
- CDS’s are leveraged instruments
- The development of the CDS market can fundamentally change the way a fixed a fixed income manager trades and invests in sovereign and corporate credits

Risk Management

- Traditional long only FI managers have limited risk compared to the unlimited risk FI hedge funds may have
- Traditional FI managers primarily manage duration risk and credit risk, and a handful of other risks
- The tools they use as risk managers are limited, and much of the portfolio risk is determined at the asset allocation and investment guideline level
- Broader investment guidelines opens the potential to increase returns, but also increases risk
- FI hedge funds often use state of the art risk management techniques and software to manage the higher level of risk
- Traditional managers must adopt hedge fund risk management approaches if they are to successfully implement hedge fund strategies and tactics

Risk Management

- Value at risk
  - RiskMetrics
- Targeted positive returns in all markets
- Acceptable volatility
- Position sizing
- Value of a basis point
- Tail risk
- Stops

Conclusions

- Hedge funds are different from traditional fixed income strategies and managers in a number of ways
- FI hedge funds on average have had higher return with lower risk than traditional managers
- However the risk of individual hedge funds is, on average, higher than with traditional managers
- Traditional managers seeking to emulate hedge funds may produce higher returns, but with higher potential risk
- Superior traditional managers only may be able to improve risk/return characteristics of their accounts by expanding the investment guidelines to allow the manager more flexibility
- Expanded investment guidelines using HF strategies create the potential for portable alpha strategies
- Some HF strategies are more suited to traditional long only FI managers than others
- Changes in organizational structure and risk management should accompany expansion of investment guidelines

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