
Bourne Park Capital

New Investments

Winchester College
The Ramsey Society

January, 17th 2006

Review of the Different Financial Markets

We commonly distinguish among *asset classes* within the financial markets:

Stock Market	Bond Market	Currency Market (Foreign Exchange)	Derivatives Market
<p>General term for the organized trading of stocks through exchanges and over-the-counter.</p> <p><i>Stock:</i> instrument that signifies an ownership position in a corporation, and represents a claim on its proportional share in the corporation's assets and profits.</p>	<p>The market for all types of bonds, whether on an exchange or over-the-counter.</p> <p><i>Bond:</i> debt instrument issued for a period of more than one year with the purpose of raising capital by borrowing.</p>	<p>Market where currencies are exchanged to satisfy the need in foreign currencies from various participants (States, companies, etc.).</p> <p>Foreign currency requirements come from international trade, foreign investments, etc.</p>	<p>Market where derivative products are traded.</p> <p><i>Derivative product:</i> financial instrument whose characteristics and value depend upon the characteristics and value of an underlier, typically a stock, bond or currency.</p>

Alternative Investments

Alternative Investments are operated by money managers actively managing their investments in different markets and can be divided into four main categories:

Hard Assets	Hedge Funds	Private Equity	Other
<p>Have been used as investments for centuries (e.g. Dutch Tulip crisis). Today investments can be direct, through funds and derivatives.</p> <p>Real Estate, timber, gold and commodities such as energy, water rights, etc.</p>	<p>Funds that are exempted from many of the rules and regulations governing other financial investments. This enables them to implement active and complex investment strategies using public securities, and derivatives.</p>	<p>A fund which raises money from shareholders (limited partners) and invests the money in private companies. The investment strategy is based on long term prospects of a successful restructuring and subsequent company growth.</p>	<p>New investment opportunities have emerged together with the development of the financial markets. Such opportunities have emerged in the insurance and other financial sectors.</p>

Investing In Financial Markets

Investing in financial markets can be carried out:

- ▶ By a private investor, using an intermediary to access specific markets. The investor would then decide the allocation of his investment across the different asset classes.
- ▶ By giving a mandate to a professional money manager who would be in charge of the asset allocation of the portfolio.

The money can be managed:

- ▶ *Passively*: invest in an asset class (e.g. stock) and hold it in order to benefit from income and capital appreciation (e.g. dividend and increase in stock price).
- ▶ *Actively*: continuous screening of market movements to take advantage of market shifts and subsequent investment opportunities.

Hedge Funds: What are they?

- ▶ The *American Heritage Dictionary* defines a hedge fund as:
 - ▶ *“An investment company that uses high risk techniques, such as borrowing money and selling short, in an effort to make extraordinary capital gains.”*
- ▶ However, not all hedge funds attempt to make extraordinary gains. Anson (2002) provides a better definition:
 - ▶ *“A privately organised investment vehicle that manages a concentrated portfolio of public securities and derivative instruments on public securities, that can invest both long and short, and can apply leverage.”*

Hedge Fund Characteristics

- ▶ Various trading strategies (long short equity, global macro, distressed debt)
- ▶ Can go short
- ▶ Can use leverage
- ▶ Can trade all asset classes
- ▶ Use forward, futures, options, derivatives in all geographic zones
- ▶ Seek absolute returns and attempt to preserve capital
- ▶ Performance reflects the skill of the manager rather than market direction
- ▶ Low correlation with stock and bond markets
- ▶ Charge a management and incentive fee (2% and 20% pa)
- ▶ Withdrawal of capital subject to lock up (monthly/quarterly)
- ▶ Typically set up to provide an offshore entity for foreign investors
- ▶ Less regulated than mutual funds

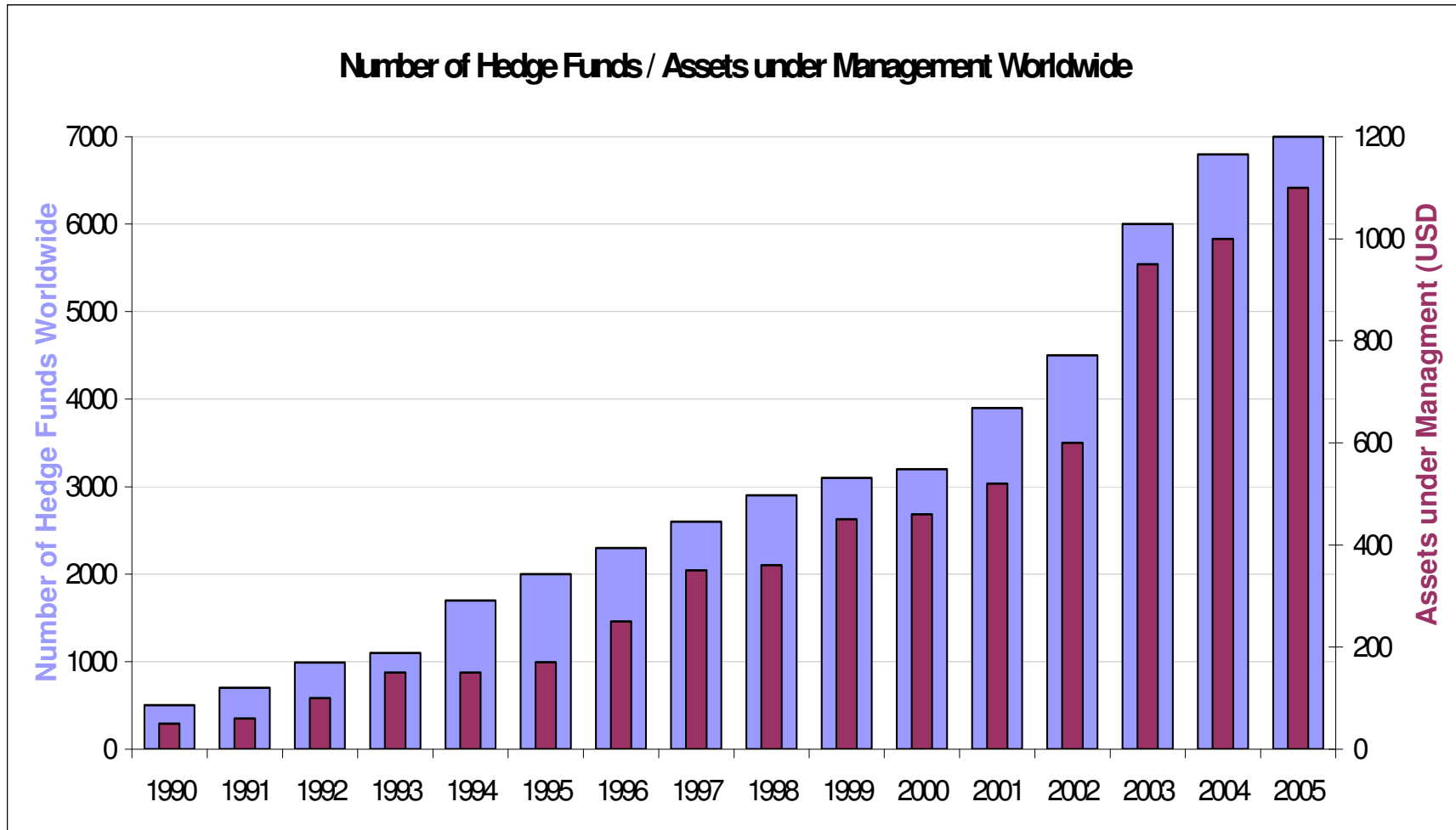
Hedge Fund Evolution

- ▶ Late 1940s: A.W. Jones originated the idea of hedging a portfolio of stocks by shorting other stocks to mitigate the risk
- ▶ Outperformed leading mutual funds by a wide margin
- ▶ Late 1960s: 200 hedge funds
- ▶ Mid 1970s: commodity trading using trend following models
- ▶ Mid 1980s: concept of shorting had been cast aside in the hope of chasing a strong equity market, or *bull market*

Hedge Fund Evolution cont.

- ▶ Early 1990s: reputation of some firms to earn stellar and steady returns (mostly global macro names)
- ▶ 1993 – 2000: hedge funds hurt by a bull stock market, and the collapse of a statistical arbitrage firm in 1998 do to excessive leveraging (LTCM)
- ▶ 2000 – 2004: Renewed demand for hedge funds with the dismal performance of mutual funds in a bear volatile stock market environment.
- ▶ New European institutional investors start getting involved. Many new hedge funds are being launched in Europe in particular in London
- ▶ There are about 7,000 hedge funds managing US \$ 1.2trn.

The Hedge Fund Market

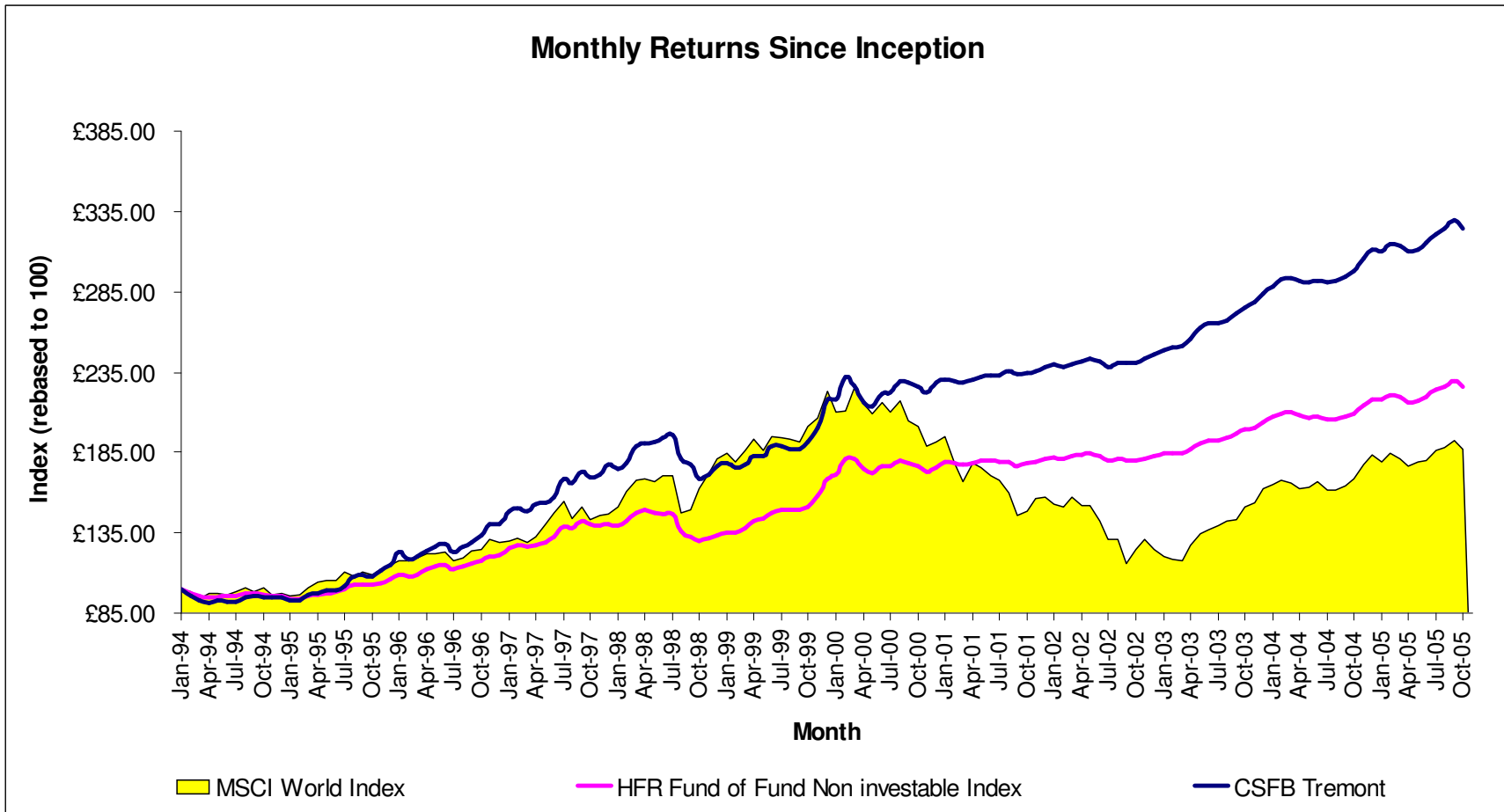


The Hedge Fund Market today

- ▶ 2003 and 2004 top single hedge funds achieved 12%-16% annual returns. Total asset flows into hedge funds are listed below
 - Total 2004: US\$123 billion
 - Q1-Q3 2005: US\$ 48.8 billion
- ▶ Institutional investors
 - ➡ Insurance companies: increasing part of their asset allocation (from 1% to 5%)
 - ➡ Pension funds: standard in the US (often >5%), popular in the Netherlands, increasing in the UK
 - ➡ Endowments: in the US often >20% (e.g. Harvard, Yale), also in Europe increasing (UK)
 - ➡ Family Offices: „core investors“ of hedge funds, large endowments
- ▶ Private investors
 - ➡ Regulation typically prevents public marketing to private investors

Hedge Fund Returns

- ▶ Hedge funds are seek to generate returns in rising as well as falling markets – protection of capital



Hedge Fund Strategy Performance

Index / Sub Strategies	Value	Nov-05	YTD	1 Year	Avg Annl	Std Dev	Sharpe
CSFB/Tremont Hedge Fund Index	333.11	1.48%	5.90%	7.60%	10.63%	7.90%	0.86
HEDG Convertible Arbitrage	266.96	-0.43%	-3.48%	-2.81%	8.59%	4.78%	1
HEDG Dedicated Short Bias	79.75	-1.25%	19.33%	13.52%	-1.88%	17.38%	-0.33
HEDG Emerging Markets	256.03	2.43%	14.59%	16.19%	8.21%	16.48%	0.27
HEDG Equity Market Neutral	306.64	0.18%	4.63%	5.53%	9.86%	2.95%	2.05
HEDG Event Driven	361.76	1.28%	7.39%	9.84%	11.39%	5.71%	1.33
HEDG Distressed	446.31	1.63%	9.84%	11.95%	13.37%	6.48%	1.48
HEDG E.D. Multi-Strategy	321.74	1.03%	5.86%	8.64%	10.30%	6.12%	1.06
HEDG Risk Arbitrage	241.93	1.01%	2.21%	3.55%	7.70%	4.23%	0.92
HEDG Fixed Income Arbitrage	206.74	-0.58%	0.17%	0.78%	6.28%	3.77%	0.66
HEDG Global Macro	451.35	1.08%	7.55%	8.32%	13.48%	11.17%	0.87
HEDG Long/Short Equity	374.95	2.22%	6.72%	9.46%	11.73%	10.32%	0.77
HEDG Managed Futures	215.11	4.17%	2.48%	3.22%	6.64%	12.06%	0.24
HEDG Multi-Strategy	281.02	1.30%	5.54%	6.87%	9.26%	4.35%	1.25

Strategy Case Study: Long Short Equity

- ▶ Combines long and short stock positions in expectation of
 - profiting from both undervalued securities (held long) and overvalued securities (sold short)
 - and of benefiting from the ability of the short positions to cushion the portfolio from a decline of broad market indices
- ▶ Managers' net market exposure of long positions minus short positions tends to have a positive bias. That is equity long / short managers tend to be long market exposure
- ▶ A hedge fund's ability to go short is a powerful tool for earning excess returns.
- ▶ The flexibility to implement a strategy not only involving stocks and sectors that are expected to increase in value but also stocks and sectors that are expected to decrease in value is a key characteristic of long / short equity managers

Strategy Case Study: Long Short Equity cont.

- ▶ Long short hedge funds come in two flavours
 - ▶ *Fundamental long / short:*
 - Traditional economic analysis on a company's business prospects compared to its competitors and the business environment.
 - ▶ *Quantitative long / short:*
 - Broad in their analysis and use of mathematical models to analyse the effect of various quantitative variables such as a companies earnings growth or financial ratios on a company's stock price.
 - Based on certain mechanical rules a hedge fund manager will buy or sell a particular stock

Conclusion

- ▶ New investments are currently changing the landscape of the financial service industry
- ▶ Its dynamic nature and the growing use of technology has dramatically increased the importance of hedge funds in today's financial markets
- ▶ Young, energetic and well educated professionals are in increasing demand

Conclusion

Wykamists could not be better positioned!

Thank you for your attention

Bourne Park Capital