Definition of Terms

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Alpha

A coefficient which measures risk-adjusted performance, factoring in the risk due to the specific security, rather than the overall market. A high value for alpha implies that the stock or portfolio has performed better than would have been expected given its beta (volatility).

Beta

A statistical measure of the relative volatility of a stock, fund, or other security in comparison with the market as a whole. The beta for the market is 1.0. Stocks with betas above 1.0 are expected to be more responsive to the market; stocks with a beta below 1.0 are expected to be less responsive to the market. For example, if the market move 10%, a stock with a beta of 1.5 is expected to move 15%; a stock with a beta of .5 is expected to move 5%.

Commodity Trading Advisor (CTA)

Also know as Managed Futures, CTAs are a sub-set of Global Macro. CTAs take long and short positions in the global futures markets seeking to exploit small inefficiencies or a knowledge edge. At least some portion of the returns from CTAs is their willingness to assume risk that commercial hedgers seek to lay off on a counter-party.

Convertible Arbitrage

This strategy involves the purchase of a convertible bond and the simultaneous short sale of a certain percentage of the underlying stock, known as the hedge ratio. Profit has two main components—static return (coupons on bond plus interest on short proceeds less dividends paid on short position) and volatility return (Gamma trading). As the stock price changes, the hedge ratio changes as well, requiring rebalancing. Convertible arbitrage strategies are said to be “long volatility” because the option component of the convertible security increases in value with increased volatility.

Distressed Debt

The strategy generally involves investing in the securities of companies experiencing financial difficulty. The opportunity for the manager lies in the uncertainty and complexity of the situations and the manager’s skill in assessing and understanding the opportunities. Investments are typically in bonds, bank debt, subordinated debt, trade claims, and even directly in assets. If used, the level of leverage is usually low. Managers may seek to take controlling interests in order to help guide the outcome of their investment.

Equity Market Neutral

A specific case of long/short which is neutral in exposure to a variety of factors, including some or all of the following: dollar, beta, industry, market cap, style, currency, country. Portfolios are structured to remove broad market impacts and isolate exposure to the desired factors identified by the manager. Most often is leveraged.

Fixed Income Arbitrage

Manager attempts to benefit from price anomalies between related fixed income securities by trading the spread relationship between securities or by structuring a positive carry trade. Since the profit opportunities are small, leverage is generally high (5–20 times and even higher). Strategies can be credit- and duration-neutral, or directional. Because managers often hold less liquid investments, they also tend to be short volatility. It is the short volatility profile combined with high leverage that gives the strategy meaningful “tail risk” during periods of market stress.

Global Macro

Global macro managers trade a broad array of securities including equities, debt, currencies, and commodities. Global macro managers take wide latitude in implementing various trades and attacking different opportunities. Their portfolios can change dramatically in exposure and structure from period to period as they identify new opportunities (trades). Funds rely on either discretionary or systematic methods. Global macro managers form a macro view and then develop trades to exploit any observed market disconnects from that view.

Merger Arbitrage

Also known as risk arbitrage, this strategy involves investing in securities of companies involved in mergers and acquisitions. In its simplest form, managers take a long position in an announced target company and an equal dollar short position in the acquiring company. This trade isolates the deal risk, which is the risk that the deal either does not go through as proposed, or does not close in the stated timeframe. Managers add value by correctly assessing the prospects for each deal. This strategy requires a unique skill set as analysis relies on such factors as knowledge of anti-trust law and Federal Trade Commission enforcement policies.

Definition of Terms

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Long/Short Equity

A directional strategy that consists of both long and short positions, with a bias toward one or the other. The manager may decide to shift concentrations within style (growth vs. value) or capitalization, make sector or geographic bets, and may hedge some portion of the portfolio at times with options or futures. The short positions generally fall into one of two buckets—return generation or hedge. The net long exposure can vary widely but is most typically –20% to 80%. Managers may also specialize in any of a number of areas ranging from international to emerging markets to sectors. Dedicated short sellers maintain a net short position at all times. Long/short equity is the hedge fund strategy most highly correlated to the equity market.

Private Equity

Private equity is a broad term that refers to any type of equity investment in an asset in which the equity is not freely tradable on a public stock market. Categories of private equity investment include leveraged buyouts, venture capital, growth capital, angel investing, and mezzanine capital, among others.

Special Situations

This is a catch-all of other event-driven strategies that are designed to capture price movements on unique corporate situations. Strategies include Reg. D (privately negotiated positions taken in public companies), parent/stub/holding company investments, share class arbitrage (duel listed companies, voting/non-voting), and investing in companies that are emerging from bankruptcy.

Venture Capital

Money used to support new or unusual commercial undertakings. This funding is provided to new or existing firms that exhibit above-average growth rates, a significant potential for market expansion, and the need for additional financing for business maintenance or expansion.