Understanding Portfolio Strategies

Hedge Funds Strategies 101

By Bryan Goh, Senior Vice President, DBS Bank

Hedge funds come in many shapes and sizes and are typically privately managed investment funds. They operate many diverse investment strategies that seek to generate returns that are less dependent on the direction of traditional equity, bond, commodity and currency markets. This makes them useful in diversifying traditional risk factors in an investment portfolio. There are a number of well established hedge fund strategies.

1. **"Equity long short"** investing is one of the most common and well-known strategies. It is an extension of traditional long only equity investing but adds the ability to sell short and to use leverage. The basis of "equity long short" investing is to seek good companies or undervalued companies and to buy them, while "shorting" poorly run or overvalued companies. A "short" is an asset held in anticipation of a fall in value. By balancing long and short exposures, market risk can be hedged to the desired level. Most "equity long short" funds run a net long bias, that is they have more "long" exposure than short exposure. Some of these funds are market neutral and are equally long and short the market. The reason: to hedge out all their market exposure. The risk they are primarily exposed to is company specific risk. Notable equity long short managers include Omega Advisers run by Leon Cooperman and Lone Pine Capital, run by Stephen Mandel.

2. **"Credit long short"** investing is another strategy. It is less common than "equity long short" investing but the main principles are similar. The manager seeks good and undervalued companies to buy long and poorly run or overvalued companies to sell short. In this case, however, instead of trading in the equity of these companies, the manager buys and sells the debt of the companies. These debt instruments include bonds, convertible bonds, bank debt, trade receivables and credit default swaps. One of the most notable credit long short managers is JP Morgan alumnus Andrew Feldstein, whose BlueMountain Capital has performed consistently even through the 2008 crisis.

3. A special case of credit long short is **"capital structure arbitrage"**. This is a more sophisticated form of "credit long short" that typically involves buying and selling the equity or debt instruments issued by the same company. Company capital structures are sometimes not properly valued because the investors who trade equities and the investors who trade bonds have different objectives. Examples of "capital structure arbitrage" are buying long the senior debt versus selling short the subordinated debt of the same company. In case of default or reorganisation, the recovery value in the senior security is higher than in the subordinated security. This means the investor makes money. Capital structure arbitrage is the preserve of a few specialized funds. One such example is Pine River Capital, a firm based in Minnesota whose mortgage trade made money in the 2008 crisis.

4. **"Convertible arbitrage"** combines elements of equity, credit and volatility trading. The typical trade in convertible arbitrage is to buy the convertible bond, sell short a proportion of equity, and hedge out the credit risk with credit default swaps or an asset swap. Convertibles can also be used to create high carry levered positions with little equity risk. They also feature in distress or stressed investing. Convertible arbitrage was once a much favoured strategy but reliance on excessive leverage has made the strategy less popular among investors. Philippe Jabre, formerly portfolio manager of the GLG Market Neutral Fund remains one of the foremost convertible arbitrageurs with his own Jabre Capital Multi Strategy Fund.

5. **"Fixed income arbitrage"** refers to non-credit related bond and bond derivative trading. It is usually expressed in sovereign bonds and the two main types of funds come in the form of macro and arbitrage. Macro fixed income investing is based on the premise that pricing in fixed income markets reflect macro conditions and economic policy. Managers seek to make money by having a macro view and expressing it by trading sovereign fixed income securities and derivatives. Arbitrage strategies are predicated that relationships between different securities tend to a no-arbitrage position over time. Managers seek inefficiently priced securities and bet that they converge to efficient pricing. Fixed income arbitrage was made famous by the ill-fated LTCM. Today, fixed income arbitrageurs are few and far between.

6. **"Distress investing"** involves investing in the securities of companies in distress or bankruptcy. This can range from equity to debt, bank debt, credit default swaps, trade claims, and options, among others. These securities are often incorrectly valued and holders of such securities are forced to dispose of them at uneconomic prices. Sometimes the manager will be an activist in steering the outcome of the bankruptcy process. "Distress investing" brings together business valuation, legal understanding of bankruptcy processes, trading ability and an understanding of the motivations of incumbent stakeholders from shareholders to creditors to management. The distressed investor par excellence is Randy Smith who pioneered the approach at Bear Stearns some 30 years ago. He remains active today managing Alden Global Capital, a distressed investing hedge fund.

7. **"Merger arbitrage"** invests in situations where one company is taking over another. It usually involves buying the target company and selling the acquiring company (in a stock offer) or just the target (in a cash offer.) The strategy has evolved to include investing in any hard catalyst (announced deal) situation to include de-mergers or spinoffs, asset sales and other special corporate actions. The strategy seeks to make money by deciding if a situation will evolve as announced or not. More evolved strategies also bet on the path of a situation playing out to completion or a deal breaking down. Notable merger arbitrageurs include the likes of John Paulson, before his excursion into the mortgage market, Tom Sandell and Bernard Oppetit.

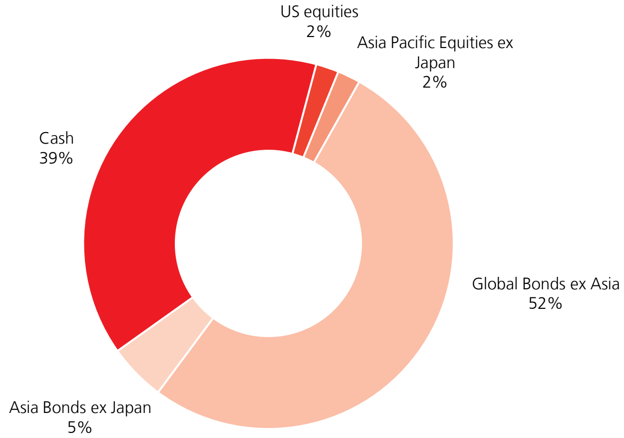
8. **"Global Macro"** is one of the oldest and most well-known hedge fund strategies. Broad types of macro strategies include Fixed Income, the most common type, which avoids the risk inherent in equities or corporate credit; Commodities, which are very much driven by demand and supply and thus correlated to industrial production; FX, which is an extension of fixed income macro with elements of inflation and rates and finally - Equities, which is a less common expression of global macro as it contains the idiosyncratic risk inherent in companies' financial performance and outlook.

Asset Allocation

DBS 3-Month Tactical Model Portfolio – Q3 2013

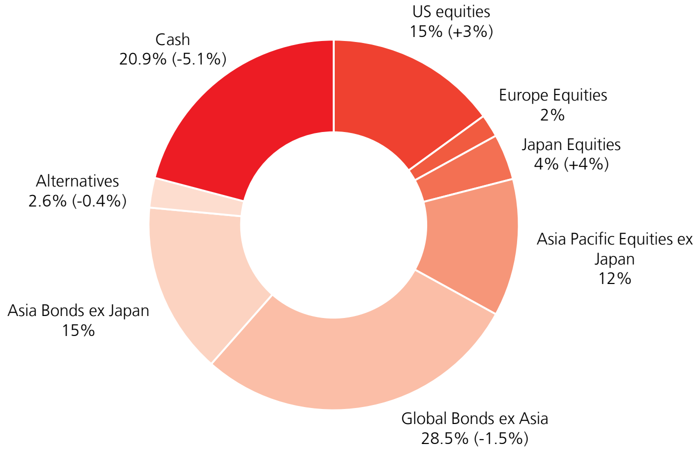
1. Defensive

Capital preservation with minimal risk exposure



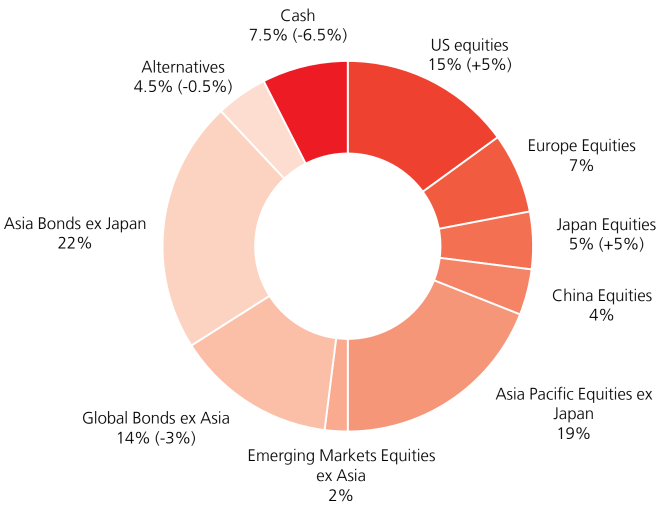
2. Conservative

Capturing some capital growth with low risk exposure



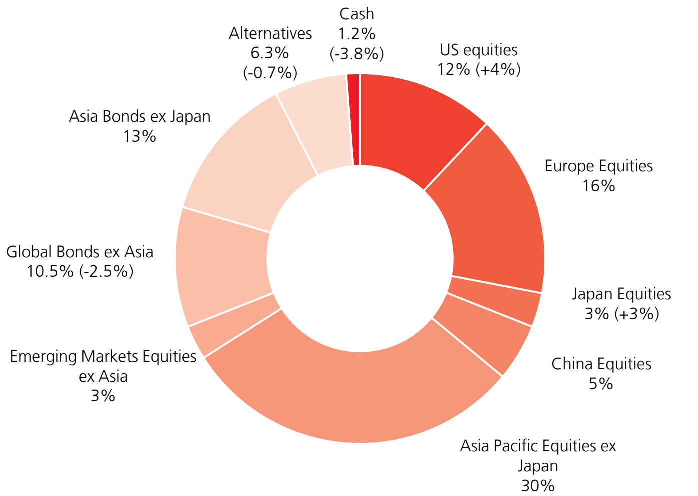
3. Balanced

Capturing modest capital growth through a balanced risk-and-return approach



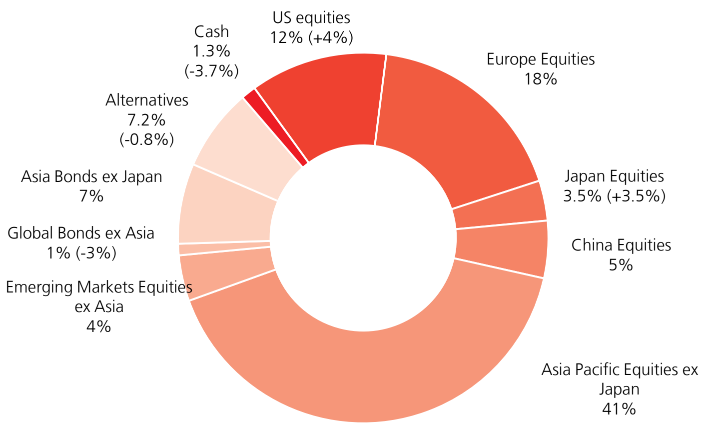
4. Growth

Higher wealth enhancement through greater exposure to risky assets



5. Aggressive

Maximising capital growth potential through exposure to a large portion in risky assets



Notes:
Percentages denote actual tactical asset allocation weights for a 3 month time horizon.
Asia Pacific ex Japan equities excludes both Japan and China equities.
Figures in brackets refer to the tactical weight shifts versus the strategic allocation. Taking the Balanced model as an example, "US Equities 15% (+5%)" represents an overweight of 5% compared to the neutral weight of 10%.

Tactical Asset Allocation – Q3 2013

Asset Class	Region	3m view	12m view	Rationale
Equities	US	Overweight	Overweight (Previous: Neutral)	- We maintain our 3M OW stance while upgrading our 12M view to OW as well because of the improving economy and corporate earnings. - Eventual rates normalization will unlikely be negative for US equities if it is done against a backdrop of rising employment and strong economic outlook. Favour cyclical yielding stocks over defensive yielding stocks.
	Europe	Neutral	Neutral	- We stay Neutral on Europe as the economy remains mired in recession while the jobless rate stays elevated in the face of austerity measures. - That said, the pledge of unlimited bond purchases by the European Central Bank has vastly reduced the likelihood of further systemic risks. - European equities have underperformed US and Asia year-to-date and the market currently trades below its long-term mean on Price-to-Book basis. Nonetheless growth remains scarce and our Neutral stance.
	Japan	Overweight	Overweight	- We keep our 3M/12M OW stance on Japan. It is among our major high conviction calls and we view the recent pullback as a buy opportunity. - The Japanese equity market is expected to benefit from the government's plan to double its monetary base as well as recent government initiatives. - Japan has revised up its 1Q GDP growth to 4.1%, an early sign that its recently launched stimulus program is bearing fruit.
	China	Neutral (Previous: Overweight)	Overweight	- We downgrade China to 3M Neutral while staying 12M OW. - We believe that China's macro momentum is starting to decelerate as the country shifts towards a consumption-driven economic model. The HSBC Flash Manufacturing PMI for June shows a decline from 49.2 in May to 48.3. A figure below 50 is contractionary. The market continues to suffer from a lack of catalysts and for it to re-rate from here, structural reforms must take place. However, the timeline for such policy moves lacks clarity at this juncture. - A 3M Neutral on China is appropriate on cheap valuations.
	Asia Pacific ex- Japan	Neutral (Previous: Overweight)	Overweight	- We downgrade APxJ from 3M OW to 3M Neutral and this tactical switch is mainly driven by our near-term cautious stance on Australia, a market which accounts for significant weight within APxJ. - We believe that recessionary risk in Australia is on the rise given the decline in investment spending and the softening of global commodities demand. As China transits to a more domestically-driven economy, commodities demand will decline as an offshoot. - Australian banks, which have thus far been benefitting from the global search for yield, is likely to pull back
	Emerging Markets	Neutral (Previous: Overweight)	Overweight	- We downgrade EM equities from 3M OW to 3M Neutral and this view ties in with weakening China growth. - Despite moderating economic growth, inflation in EM countries (Brazil, Turkey) remains high and limits the room for policymakers to maneuver. - Valuations for key markets like Brazil and Russia are currently trading below their long-term mean on both Price/Earnings and Price/Book.
Bonds	Global ex-Asia	Underweight	Underweight	- Global bonds to face further downside risk as a hawkish Federal Reserve statement suggests that QE tapering is at hand. Stay 3M and 12M UW.
	Asia ex-Japan	Neutral (Previous: Overweight)	Neutral (Previous: Overweight)	- We downgrade APxJ bonds from 3M/12M OW to 3M/12M Neutral. Asian bonds are vulnerable to further downside as QE tapering and the eventual normalization of rates draw closer. - Recent sharp moves in US Treasuries are particularly negative for Asian credits given the tightening of spreads in recent years. Reduce duration towards shorter tenor papers while avoiding bonds with high foreign ownership.
Alternatives	N/A	Underweight (Previous: Overweight)	Overweight	**Property** (3M Neutral; 12M Neutral) – REITs to face downward pressure as interest rates normalise. However, the risk-reward looks fair. **Commodities** (3M Neutral; 12M Overweight) – Range-bound trading expected for commodity markets as the supply outlook remains unfavourable while inventory is high relative to demand. As China's economic momentum shifts to a lower gear, we would expect limited catalysts for commodities demand during the 2nd half. Downgrade to 3M Neutral. **Gold** (3M Underweight; 12M Underweight) – Impending QE tapering, USD resilience and steady growth to weigh on gold. **Hedge Funds** (3M Neutral; 12M Neutral) – Maintain 3M/12M Neutral.
Cash	N/A	Underweight	Underweight	Negative real interest rates around the world make cash very unattractive.

Figures and estimates are as of 27 June 2013.
Asia Pacific ex Japan equities excludes both Japan and China equities.

Strategic Asset Allocation Models

Investment Objectives of the Model Portfolios

The DBS Strategic Model Portfolios have been developed in consultation with Morningstar Associates, LLC based on a set of capital market assumptions. Morningstar Associates, LLC, the industry leader in fund of funds management, investment consulting and retirement advisory services, has developed five portfolios for DBS Bank.

Each portfolio is diversified across many types of asset classes and investment styles in order to benefit from the top performing asset classes and reduce the impact of lower performing asset classes.

- Defensive - This model is ideally suited for investors who are seeking to preserve their capital and are uncomfortable sustaining losses. Its 4% allocation to equities means the portfolio will have lower returns while striving to reduce risk exposure over the medium to long term. To help minimize risk; this model has a sizeable allocation to cash, global and Asia ex-Japan bonds.

- Conservative - This model is ideally suited for investors who are fairly risk adverse and are seeking more stable returns. Its 26% allocation to equities strives to capture some growth potential, without assuming too much risk over the medium to long term.

- Balanced - This portfolio is ideally suited for investors who are seeking to strike a balance between risk and returns. Although the 42% allocation to equities and 5% allocation to alternative investments give this model a riskier profile than either the Defensive or Conservative models, it is better positioned for modest growth over the medium-to-long term.

- Growth - This model is ideally suited for investors seeking to grow their capital and who can tolerate higher risk and considerable market volatility over the medium-to-long term. Although its 62% allocation to equities (with a sizeable bias to Asian equities) and 7% exposure to alternative investments position the model for growth, it also exposes the investor to potentially high losses.

- Aggressive - This model is ideally suited for investors who are seeking to maximize growth and can tolerate losses and market fluctuations over the medium-to-long term. Its 76% allocation to equities and 8% exposure to alternative investments position the investor to capture the upside of the market, but also expose them to the potential of sustaining extensive losses on the downside. This model has the highest allocation to Asia Pacific and China equities, while still maintaining some exposure to bonds and cash.

The target investment horizon of a Strategic Asset Allocation Model portfolio is five years.

Strategic Asset Allocation Models for 2013

		Defensive	Conservative	Balanced	Growth	Aggressive
Equities	US	2%	12%	10%	8%	8%
	Europe	0%	2%	7%	16%	18%
	Japan	0%	0%	0%	0%	0%
	China	0%	0%	4%	5%	5%
	Asia Pacific ex Japan	2%	12%	19%	30%	41%
	Emerging Markets ex Asia	0%	0%	2%	3%	4%
	Equities	**4%**	**26%**	**42%**	**62%**	**76%**
Bonds	Global ex Asia	52%	30%	17%	13%	4%
	Asia ex Japan	5%	15%	22%	13%	7%
	Bonds	**57%**	**45%**	**39%**	**26%**	**11%**
Alternatives		**0%**	**3%**	**5%**	**7%**	**8%**
Cash		**39%**	**26%**	**14%**	**5%**	**5%**
Expected Return (%)		2.1	5.0	7.6	10.1	11.6
Expected Risk (%)		4.4	8.0	12.0	15.9	18.5

Notes:

- The expected annual return of the strategic portfolio is based on capital market assumptions derived from Morningstar's econometric model that relies on historic, current and forecasted data on the indices highlighted below. The information is for reference only.
- The expected risk (or annual standard deviation) of the strategic portfolio represents the expected risk level of the portfolio based on historical asset class relationships (correlations) and volatility, using monthly returns from 2003 to 2013 based on the indices highlighted below. The information is for reference only.
- Morningstar Associates' model portfolios started on 1 October 2010. Morningstar reviews the strategic asset allocation on an annual basis. The current Strategic Asset Allocation (SAA) is as of end May 2013.
- Based on the model portfolios, the Aggressive model has the highest risk, followed by Growth, Balanced and Conservative, with Defensive being the least risky. The risk consideration that was used in formulating the Strategic Asset Allocation was the annualized quarterly average drawdown. A maximum annualized average quarterly drawdown constraint is in place for the different portfolios, with the defensive portfolio having the most restrictive and the aggressive portfolio having the most accommodative risk constraints.
- The investor type classification for the portfolio has no direct relationship with the Financial Needs Analysis customer risk profile types and the portfolios are not assigned any product risk rating based on the bank's proprietary risk rating methodology.
- The above model portfolios are effective from July to September 2013 and are subject to change.
- Asia Pacific ex Japan equities excludes both Japan and China equities.
- The expected return and expected risk are based on the following indices for calculation:
  - o Equity: US - Russell 3000 TR USD; Europe - FTSE World Europe TR EUR; Japan - Topix TR JPY; Asia Pacific ex Japan - MSCI Pacific Ex Japan NR USD; Emerging Market ex China - MSCI EM
    Ex Asia NR USD; China - MSCI AC Zhong Hua NR USD
  - o Bond: Global Aggregate - BarCap Global Aggregate TR USD; Asia Pacific - BarCap Asian Pac non Japan TR USD
  - o Alternatives: 10% S&P Global REIT TR USD (Property), 30% DJ UBS Commodity TR USD (Commodities), 30% S&P GSCI Gold TR (Gold) and 30% Greenwich Global HF (Hedge Funds)
  - o Cash: BofAML HKD LIBOR 1 Mon CM TR

Morningstar Associates' Asset Allocation Approach:
A hallmark of Morningstar Associates' asset allocation approach is to broadly diversify the models across investment styles, sectors, sub-asset classes, market caps, and regions. This approach aims to ensure that some part of the portfolio will be performing well in most markets, while the long-term gains of all parts will accrue to investors over time.

In determining the asset allocation targets, Morningstar Associates uses a multifaceted approach that features of a number of sophisticated mathematical models to forecast returns on various asset classes. The modelling process is designed to provide asset targets appropriately aligned with current market conditions and investor expectations. Morningstar Associates also subjects the asset allocation models to 10,000 simulations to determine how well or poorly they stand up to different market conditions over a five-year period and then make any necessary adjustments.

Morningstar Associates refines the asset allocation targets based on local market characteristics and behaviours. This results in significant overweight to the Asian markets, both equity and fixed income, in the DBS Strategic Asset Allocation Models, although each model retains varying degrees of exposure to the global markets.

In determining the most efficient asset targets for the DBS Strategic Asset Allocation Models, Morningstar Associates also factored in a couple of client considerations. First, a maximum "annualized average quarterly drawdown" constraint was imposed for each model. The maximum annualized average quarterly drawdown is the largest average quarterly percentage loss (on an annualized basis) that Morningstar Associates will tolerate for each model, based on calculations using data over the past 10 years. By accommodating the drawdown, the asset mix can be optimised to better meet investor's long-term performance and risk expectations, as well as better understand each model's risk potential. In addition, Morningstar Associates maintained a minimum 5% strategic allocation to cash in each model to provide a buffer against market volatility.

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