# Hedge Funds Trading Strategies

**As discussed in our previous article on hedge funds, alternative investments represent a vast number of strategies designed to generate increased returns with limited risk. The following section outlines the most common strategies among hedge funds.**

### Convertible Arbitrage

This strategy is exploited by investing in the convertible securities of a company. A typical investment is to be long in the convertible bond and short in the common stock of the same company, which also isolates the convertible option value. Positions are designed to generate profits from the fixed income security as well as the short sale of stock, while protecting the principal from market movements. Exchange traded interest rate futures such as the Euro Bund Future, the Euro Bobl Future and the Euro Schatz Future could be used to hedge the fixed income element of the trade and individual stock options to hedge the option value.

### Statistical Arbitrage

Believing that equities behave in a mathematically describable manner, managers can implement a low-risk, market-neutral analytical equity strategy. This approach captures momentary pricing aberrations in the securities being monitored. The strategy's profit objective is to exploit mispricings in as risk-free a manner as possible. Eurex sector futures and/or Exchange Traded Funds (ETFs) could also be used as a way of capturing sector anomalies or as a general hedge to neutralize sector exposures.

### Emerging Markets

This strategy involves equity or fixed income investing in emerging markets around the world. Because many emerging markets do not allow short selling, nor offer viable futures or other derivative products with which to hedge, emerging market investing often employs a long-only strategy.

### Equity Market Neutral

This investment strategy is designed to exploit equity market inefficiencies and usually involves simultaneous long and short matched equity portfolios of the same size within a country. Market neutral portfolios are designed to be either beta or currency neutral, or both. Well-designed portfolios typically control for industry, sector, market capitalization, and other exposures. Leverage is often applied to enhance returns. In this strategy, equity index futures, such as the Dow Jones EURO STOXX 50 Future or the Dow Jones EURO STOXX Sector Index Futures and/or ETFs could be used to efficiently provide leverage and/or neutralize certain parts of the portfolio during volatile market conditions.

### Event Driven

This strategy is defined as equity oriented investing designed to capture price movements generated by an anticipated corporate event. There are three popular sub-categories in event-driven strategies:

### Risk Arbitrage

Specialists invest simultaneously in long and short positions in both companies involved in a merger or acquisition. Risk arbitrageurs are typically long in the stock of the company being acquired and short in the stock of the two companies. The principal risk is deal risk, should the deal fail to close. In this instance, individual equity options could be used to mitigate some of the risk and enhance potential returns.

### Distressed Securities

Fund managers invest in the debt, equity or trade claims of companies in financial distress and general bankruptcy. In order to revive financial stability, the securities of companies in need of legal action or restructuring typically trade at substantial discounts to par value and thereby attract investments when managers perceive a turn-around. Where available, individual Eurex equity options might be used to benefit from the apparent volatility in equity price movement.

### High Yield

Often called junk bonds, this sub-set refers to investing in low-graded fixed income securities of companies that show significant upside potential. Managers generally buy and hold high yield debt. Where views are taken with respect to credit spreads versus a more creditworthy yield curve, interest rate futures such as the Euro Bund, Euro Bobl and Euro Schatz Future could be used as one leg of the credit trade.

### Fixed Income Arbitrage

The fixed income arbitrageur aims to profit from price anomalies between related interest rate securities. Most managers trade globally with a goal of generating steady returns with low volatility. This category includes interest rate swap arbitrage. Interest rate futures, particularly government bond futures such as the Euro Bund, Euro Bobl and Euro Schatz Futures are frequently used to exploit and hedge some of these opportunities.

### Global Macro

Global macro managers carry long and short positions in any of the world's major capital or derivatives markets. These positions reflect their views on overall market direction as influenced by major economic trends and/or events. The portfolios of these funds can include equities, bonds, currencies, and commodities in the form of cash or derivatives instruments. Most funds invest globally in both developed and emerging markets. This strategy lends itself to exchange traded futures and options more than most. Given the potentially global nature of the fund, using exchangetraded products is often one of the simplest and most efficient means to gain such coverage.

### Managed Futures

This strategy invests in listed financial and commodity futures markets and currency markets around the world. The managers are usually referred to as Commodity Trading Advisors, or CTAs. Trading disciplines are generally systematic or discretionary. Systematic traders tend to use price and market specific information (often technical) to make trading decisions, while discretionary managers use a judgmental approach. Interestingly, managed futures and global macro strategies have seen increasing interest amongst investors as the bull market has unravelled because they generally exhibit some of the lowest correlations in comparison to major equity index returns.

### Long/Short Equity

The most commonly used strategy among hedge funds in recent years is a directional strategy that involves equity oriented investing on both the long and short sides of the market. The objective is not to be market neutral. Managers have the ability to shift from value to growth, from small to medium to large capitalization equities, and from a net long position to a net short position. The focus may be regional, such as long/short US or European equity, or sector specific, such as long and short technology or healthcare securities. Long/short equity funds tend to build and hold portfolios that are substantially more concentrated than those of traditional equity funds. Managers may use equity index futures, such as the Dow Jones EURO STOXX 50 Future or the Dow Jones EURO STOXX Sector Index Futures, equity options and ETFs to hedge exposures and/or increase returns. However, this mandate style appears to be the least frequent user of exchange traded derivatives in Europe. Industry estimates suggest that approximately 50 percent of all funds are long/short, 35 percent convertible bond and event driven arbitrage, ten percent macro and the remainder made up of primarily fixed income arbitrage with newer fund styles such as volatility arbitrage coming to the forefront.

Eurex developed a number of brochures with background information on trading strategies for equity, equity index and fixed income derivatives. All brochures can be ordered or downloaded from the Eurex website **www.eurexchange.com/entrancehall/publications_brochures_en.html**.

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