

Putting some weight behind 130/30

A less commented on advantage of the 130/30 structure is its ability to introduce investment techniques typically used by hedge funds and other sophisticated investors into a traditional stock picking portfolio.

These techniques, which congregate under the ambiguous heading of “arbitrage strategies”, offer opportunities for investors looking to diversify their portfolio’s active management.

Arbitrage strategies often have attractive risk return characteristics relative to pure stock picking, and the concepts are straightforward. However, with headings such as “risk-arbitrage”, “capital structure arbitrage” and “convertible arbitrage” it is hardly surprising that until now only sophisticated investors and hedge fund managers have sought to understand them.

Let’s start with capital structure arbitrage. When a company requires financing it can issue many different types of security, the most common are equity, in the form of shares, and debt, in the form of bonds. However, these are two broad headings and there are many different forms these securities can take. Within the equity a company issues there may be different rights attached to different types of shares; two examples would be different voting rights or preferred shares that have a priority over a dividend. At different times the rights attached to these shares will have a different value, for example during a takeover the voting rights increase in value.

As in traditional stock picking, when values are moving it is possible to make a return by buying the cheap share and selling the expensive share, even though those shares are in the same company. This is low risk as you are long and short the same company. However the returns tend to be lower as well, so you need to put the trade on in a reasonable size. This is where the flexibility of a 130/30 strategy comes in; it allows the short side of your trade to be bigger than in a long only portfolio structure. This type of strategy extends to valuation differences in a company’s shares that are listed on two different exchanges, and holding companies, where a listed company owns shares in other listed companies. Convertible arbitrage could also be considered as a subset of capital structure arbitrage, as you would buy the cheaper convertible bond and sell the equivalent equity exposure in the more expensive underlying stock of the same company. There is a large universe of these inefficient structures which are not being widely exploited to generate a return in traditional funds.

Risk arbitrage is slightly different. This strategy seeks to generate a return around market inefficiencies which arise when companies are merging or being acquired (M&A). When an offer is made for a company there is usually a premium to the current traded price as an incentive for the incumbent shareholders to sell. However, as there are often hurdles to overcome and a period of time before any deal can be consummated the share price of the company being acquired often trades at a discount to this offer. This discount represents the market’s view on the probability that the deal will go ahead: the larger the discount the lower the probability and vice versa. This discount may be small, say 2-3%, but if this is the return over a three-month period until the deal closes then this translates to an annualised return of 8-12% which is quite attractive. Again, to take advantage of this spread you have to buy the company being acquired and sell the acquiring company. A 130/30 structure allows you to increase the size of the trade and also participate in trades where the buyer is not an index participant.

The 130/30 structure has often been described as a “hedge fund light” investment, but this has caused confusion, particularly when explaining opportunities now available to fund investors following the introduction of new investment powers under the UCITS III regulations.

One of the most important of the new powers introduced under UCITS III is the ability to use derivatives as part of the active management of the portfolio, rather than purely for risk control or efficient portfolio management. This has led to the construction of funds that have flexible exposure to markets and thus target an absolute return with a cash benchmark, rather than an equity benchmark. Funds constructed with this absolute return objective are akin to hedge funds, which also aim to deliver a positive return to investors irrespective of market conditions.

A 130/30 structure differs significantly because it will always maintain its equity exposure at 100%, and therefore will always have an equity benchmark. While some of the investment techniques may be similar to those used by hedge funds, as described above, a 130/30 structure is not a “hedge fund light” because these funds target a relative return to a benchmark rather than an absolute return.

Alistair Sayer is Investment Director

3 March 2008

This article first appeared in Pensions Week