Contents

The Main Themes in Three Simple Tables vii
Preface xi
   Who Should Read the Book? xiv
Acknowledgments xv
About the Author xvii
Introduction 1
   i. Efficiently Inefficient Markets 3
   ii. Global Trading Strategies: Overview of the Book 7
   iii. Investment Styles and Factor Investing 14

Part I Active Investment 17
Chapter 1 Understanding Hedge Funds and Other Smart Money 19
Chapter 2 Evaluating Trading Strategies: Performance Measures 27
Chapter 3 Finding and Backtesting Strategies: Profiting in Efficiently Inefficient Markets 39
Chapter 4 Portfolio Construction and Risk Management 54
Chapter 5 Trading and Financing a Strategy: Market and Funding Liquidity 63

Part II Equity Strategies 85
Chapter 6 Introduction to Equity Valuation and Investing 87
Chapter 7 Discretionary Equity Investing 95
   Interview with Lee S. Ainslie III of Maverick Capital 108
Chapter 8 Dedicated Short Bias 115
   Interview with James Chanos of Kynikos Associates 127
Chapter 9 Quantitative Equity Investing 133
   Interview with Cliff Asness of AQR Capital Management 158
### Contents

#### Part III  Asset Allocation and Macro Strategies  165

- Chapter 10  Introduction to Asset Allocation: The Returns to the Major Asset Classes  167
- Chapter 11  Global Macro Investing  184
  - Interview with George Soros of Soros Fund Management  204
- Chapter 12  Managed Futures: Trend-Following Investing  208
  - Interview with David Harding of Winton Capital Management  225

#### Part IV  Arbitrage Strategies  231

- Chapter 13  Introduction to Arbitrage Pricing and Trading  233
- Chapter 14  Fixed-Income Arbitrage  241
  - Interview with Nobel Laureate Myron Scholes  262
- Chapter 15  Convertible Bond Arbitrage  269
  - Interview with Ken Griffin of Citadel  286
- Chapter 16  Event-Driven Investments  291
  - Interview with John A. Paulson of Paulson & Co.  313

*References*  323

*Index*  331
Introduction

This book is about the trading strategies used by sophisticated investors such as hedge funds. It shows how to implement the key trading strategies and explains why they work and why they sometimes don’t. The book also includes interviews with some of the best hedge fund managers, who successfully developed and traded these strategies. Finally, looking through the lens of these trading strategies, the book shows how financial markets operate and how securities are priced in an efficiently inefficient way, as seen in Overview Table I.

Hedge funds have always been highly secretive, often so secretive that their own investors have only a vague idea about what strategies the funds pursue. The secret nature of the strategies has justified high fees and reduced entry into the industry. This book puts the main hedge fund strategies out in the open. It demystifies the trading universe by describing the most important strategies, how to evaluate trading strategies, how to trade them, how to manage their risk, and how to come up with new ones.

To really understand each hedge fund strategy and bring it to life, I include interviews with one of the world’s pioneers and leading hedge fund managers in each style, as seen in Overview Table II. We learn how star “Tiger Cub” Lee S. Ainslie picks stocks based on the methods he started honing working for the legendary Julian Robertson at Tiger Management. The famous short seller Jim Chanos explains how he bets against companies with flawed business plans and fraudulent managers and how he uncovered Enron before its collapse. Quant pioneer Cliff Asness discusses how his computer models buy and sell thousands of securities and how he turned his academic finding of the momentum effect into a real-world investment strategy as a complement to value and other factors. George Soros, who “broke the Bank of England,” talks about his big macro bets and his ideas about the evolution of markets. David Harding discusses how he developed a systematic trend-detection

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1 This book provides an academic treatment of investments, not investment advice. When I say that a trading strategy “works,” I use the word like finance academics and asset managers, namely to mean that they have historically produced positive average returns and may have a chance of outperforming on average in the future, but not always, not without risk, and the world can change. As Cliff Asness has said, “If your mechanic used the word ‘work’ to mean that your car might work 6–7 years out of 10, then you would fire your mechanic, but this is how asset management tends to ‘work.’”
system and how trends defy traditional notions of market efficiency. Myron Scholes explains how he traded on his Nobel Prize–winning insights in the fixed-income markets. We hear how Ken Griffin started trading convertible bonds out of his Harvard dorm room and how he grew from “boy king” to running a large firm. Finally, John Paulson describes his methods for merger arbitrage and event-driven investment, including his famous subprime “greatest trade ever.”

The managers I interviewed shine with true brilliance, and the hedge fund world has often been known as a mysterious realm in which genius managers deliver outsized returns by sheer magic. However, rather than being based on magic, I argue that much of the world of hedge fund returns can be explained by a number of classic trading strategies that work for good reasons. There exist many more hedge funds than unique hedge fund strategies in the world. If hedge fund returns are not just about magic, then the main hedge fund strategies can be learned and understood. This book teaches the general principles. To be successful in the long term, a hedge fund needs a repeatable process that makes money more often than not. This book explains many of these processes based on the lessons of top managers. Of course, putting this knowledge into action requires a lot of work, even more discipline, capital, brainpower, and trading infrastructure. Only those who master all the required skills can reap the benefits in an efficiently inefficient market.

Although the different trading strategies and the different hedge fund gurus invest in very different markets and asset classes using different methods, there are nevertheless some common overarching principles that I call “investment styles.” I discuss the key investment styles and show how many investment strategies and hedge fund gurus rely on value investing, trend-following investing, liquidity provision, and a few other key styles described in Overview Table III. These styles are general enough to work across asset classes and markets, even though their specific implementations (and the words used to describe them) differ across markets and investors.

The book also shows how securities are priced and how markets operate, but not as in traditional academic finance books. Whereas traditional finance books typically write some equation for the value of a bond or a stock and claim that this is how the security is priced because this is what the theory says, this book seriously analyzes the possibility that the market price can differ from the theoretical value and what to do about it. A discrepancy between the market price and the theoretical value has two possible interpretations: (1) It presents a trading opportunity, where you buy if the market price is below the theoretical value and sell otherwise; if such opportunities arise repeatedly, which can happen for reasons we discuss in detail, they give rise to a trading strategy; (2) The discrepancy can reflect that your theoretical value is wrong. How do you know if the truth is one or the other? You implement the trading strategy—in live trading or in a simulated backtest—and, if you make money, it’s (1) and, if you lose, it’s (2).
In other words, the book’s premise is that trading strategies present natural tests of asset pricing theories and, vice versa, asset pricing theories naturally give rise to trading strategies. The book shows how finance theory can be translated into trading ideas and how trading results can be translated into finance theory.

I. EFFICIENTLY INEFFICIENT MARKETS

To search for trading strategies that consistently make money over time, we need to understand the markets where securities are traded. The fundamental question concerning financial markets is whether they are efficient, a question that remains hotly debated. For instance, the Nobel Prize in economics in 2013 was awarded jointly to Eugene Fama, the father and defender of efficient markets, Robert Shiller, the father of behavioral economics, and Lars Hansen, who developed tests of market efficiency. As seen in Overview Table I, an efficient market, as defined by Fama, is one where market prices reflect all relevant information. In other words, the market price always equals the fundamental value and, as soon as news comes out, prices immediately react to fully reflect the new information. If markets are fully efficient, there is no point in active investing because the prices already reflect as much information as you could hope to collect. But without active investors, who would make the market efficient in the first place? Further, given that investors are paying billions of dollars in fees to active managers, either the securities markets are inefficient (so active managers can outperform) or the market for asset management is inefficient (because investors would pay fees for nothing)—it is logically impossible that all these markets are fully efficient.

Shiller, on the other hand, believes that security market prices deviate from fundamentals because people make mistakes and are subject to common biases that do not cancel out in aggregate. Humans make errors: they panic, herd, and get exuberant. But, if most investors were completely naïve and market prices had little relation to fundamentals, then shouldn’t beating the market be easy? In reality, beating the market is far from easy. Most investment professionals,

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2 Testing whether the market is efficient is difficult since most tests must rely on a specific asset pricing model. Hence, observing anomalous returns is a rejection of the “joint hypothesis,” meaning that either the market is not efficient or the asset pricing model is wrong, but not necessarily both. However, observing two securities with equal cash flows trading at different prices (i.e., an arbitrage) is a rejection of frictionless efficient markets.

3 Grossman and Stiglitz (1980) showed that the theory of efficient markets entails a paradox since investors must have an incentive to collect information. They concluded that securities markets must entail an “equilibrium level of disequilibrium.” Their point is strengthened by the fact that investors pay large fees for active management. Berk and Green (2004) propose that the market for money management is efficient while security markets are not. I argue instead that both security markets and the market for money management are efficiently inefficient, and this principle is modelled rigorously by Gârleanu and Pedersen (2018). See also Pedersen (2018) who sharpens the “arithmetic of active management.”
e.g., most mutual funds, hardly beat the market. There are lots of sophisticated money managers with large amounts of capital who compete vigorously to achieve the best investment performance, and they make markets more efficient when they buy low and sell high.

I believe that the truth lies somewhere in between these extremes, but not just in some arbitrary middle ground. The truth is equally well-defined: the truth is that markets are efficiently inefficient.

Prices are pushed away from their fundamental values because of a variety of demand pressures and institutional frictions, and, although prices are kept in check by intense competition among money managers, this process leads the market to become inefficient to an efficient extent: just inefficient enough that active investors and their money managers can be compensated for their costs and risks through superior performance and just efficient enough that the rewards to money management after all costs do not encourage entry of new managers or additional investor capital.

In an efficiently inefficient market, money managers are compensated for providing a service to the market, namely providing liquidity—just like burger bars are compensated for the service of combining meat, salad, and buns and delivering a burger in a convenient location. Burger bars’ profits reflect their efficiently inefficient competition in light of their costs, just like the money managers’ outperformance reflects the efficiently inefficient price of liquidity in light of their costs and risks. The outperformance that money managers deliver to their investors after fees reflects the efficiently inefficient market for money management.

Liquidity is the ability to transact, so when money managers “provide liquidity,” it means that they help other investors transact by taking the other side of their trades. Money managers profit because demanders of liquidity value the opportunity to transact at prices that are not exactly equal to fundamental values (just like you are willing to buy a burger for more than the value of the ingredients). For example, some investors trade when they need to reduce risk (e.g., hedging by commodity producers such as farmers or commodity consumers such as airlines); others need to raise money or invest it (e.g., you sell bonds to raise cash for a wedding and later invest money you received as a wedding gift, or a mutual fund needs to rebalance its portfolio because of inflows or outflows of capital); many investors desire to sell stocks going through mergers to avoid event risk; pension funds may trade to comply with regulation; banks may prefer certain securities over other similar ones because of differential capital requirements; many investors prefer not to hold illiquid securities that are difficult to trade; and some investors prefer more speculative securities that have a chance of a large return. Money managers are compensated for taking the other side of these trades and, although their fierce competition can drive the compensation close to zero, competition doesn’t drive the price of liquidity all the way to zero since these trades involve risk. Active managers are also compensated for collecting and processing information about security valuations. For example, if
money managers discover that a pharmaceutical firm is making particularly useful medicines, they will buy the stock. As the stock price is bid up, the pharmaceutical firm’s cost of capital is lowered, allowing the firm to increase the scale of its operations. Hence, when money managers incorporate new information into prices (i.e., improve market efficiency), this process helps the real economy.

Money managers can only operate if they attract capital from investors. Naturally, investors benefit if money managers can select good securities with high returns, but investors must be aware of several costs. First, money managers charge fees for their efforts, skills, and internal operating costs (e.g., salaries to traders, computers, rent, legal fees, and auditors). Second, money managers incur transaction costs that further lower the returns received by their investors. Investors should only bear these costs and fees when they are outweighed by the profits that the manager is expected to extract from the efficiently inefficient market.

How close are prices and returns to their fully efficient values in an efficiently inefficient market? Well, because of competition, securities’ returns net of all the relevant market frictions—transaction costs, liquidity risk, and funding costs—are very close to their fully efficient levels in the sense that consistently beating the market is extremely difficult. However, despite returns being nearly efficient, prices can deviate substantially from the present value of future cash flows. To understand this apparent paradox, note that the return to buying a cheap stock, say, depends both on the price today and the price tomorrow. If the price tomorrow can be even further from its efficient level and if liquidity costs are large, then the expected return may not be very attractive even if the price deviates significantly from its efficient level.

Markets constantly evolve and gravitate toward an efficient level of inefficiency, just as nature evolves according to Darwin’s principle of natural selection, also called survival of the fittest. The traditional economic notion of perfect market efficiency corresponds to a view that nature reaches an equilibrium of “perfectly fit” species that cease to evolve. However, in nature there is not a single life form that is the fittest, nor is every life form that has survived to date “perfectly fit.” Similarly in financial markets, there are several types of investors and strategies that survive and, while market forces tend to push prices toward their efficient levels, market conditions continually evolve as news arrives and supply-and-demand shocks continue to affect prices.

As in nature, many social dynamics inside and outside financial markets entail an efficient level of inefficiency. For instance, the political process can be inefficient, yet politicians have an incentive to appear efficient relative to their competition. However, the competitive forces in the political system do not make the process fully efficient because of the friction caused by voters’ ability to monitor their representatives (corresponding to the frictions in financial markets). Similarly, traffic dynamics can be efficiently inefficient. For example, consider what happens when you drive on a busy highway. Each lane moves approximately equally fast because lane-switchers ensure a relatively even number of cars in each lane. However, the lanes don’t move exactly equally fast because of the “cost” of
switching lanes and the evolving traffic situation. Lane speeds probably tend to reach an efficiently inefficient level where switching lanes hardly helps, but doing so still makes sense for those with comparative advantages in lane switching—although frequent lane switching and high speed increase the risk of driving, just as frequent trading and high leverage increase the risk in financial markets.

The economic mechanisms of an efficiently inefficient market are fundamentally different from those of neoclassical economics, as seen in table I.1. The neoclassical principles continue to be taught ubiquitously at global universities as they constitute the fundamental pillars for our understanding of economics. While economic thinking is almost always seen in reference to these neoclassical benchmarks, the belief that these pillars constitute an accurate description of the real world has been shaken by the global financial crisis that started in 2007, by earlier liquidity crises, and by decades of research. In contrast to the Modigliani–Miller Theorem, corporations trade off the benefits of debt against the costs of financial distress, and, during liquidity crises, corporations strapped for cash must change their investment policy. While the Two-Fund Separation Theorem stipulates that all investors should hold the market portfolio in combination with cash or leverage, most real-world investors hold different portfolios, where some avoid leverage and instead concentrate in risky securities, whereas others (such as Warren Buffett) leverage safer securities. Asset returns are not just influenced by their market risk (as in the CAPM); they are also influenced by market and funding liquidity risk since investors want to be compensated for holding securities that are difficult to finance or entail the risk of high transaction costs. The Law of One Price breaks down when arbitrage opportunities arise in currency markets (defying the covered interest rate parity), credit markets (the CDS-bond basis), convertible bond markets, equity markets (Siamese twin stock spreads), and option markets. Investors exercise call options and convert convertible bonds before maturity and dividend payments when they need to free up cash or face large short sale costs (defying Merton’s Rule). The financial market frictions influence the real economy, and unconventional monetary policy, such as central banks’ lending facility, can be important in addressing liquidity draughts.4

4 Modigliani–Miller breaks down due to financial distress costs, taxes, and behavioral effects, see Baker and Wurgler (2012) and references therein. Calvet, Campbell, and Sodini (2007) and Frazzini and Pedersen (2014) document systematic deviations from Two-Fund Separation, where constrained individuals and mutual funds hold riskier stocks, and leveraged buyout (LBO) firms and Warren Buffett apply leverage to safer stocks. Theory and evidence suggest that required returns are influenced by transaction costs (Amihud and Mendelson 1986), market liquidity risk (Acharya and Pedersen 2005), and funding liquidity constraints (Gärleanu and Pedersen 2011). Arbitrage opportunities arise due to the limits of arbitrage (Shleifer and Vishny 1997), and specific examples are referenced throughout the book. Deviations from Merton’s Rule are documented by Jensen and Pedersen (2016). Credit cycles (Kiyotaki and Moore 1997, Geanakoplos 2010) and liquidity spirals (Brunnermeier and Pedersen 2009) arise due to leverage and funding frictions. For the theoretical and empirical case for two monetary tools, see Ashcraft, Gärleanu, and Pedersen (2010) and references therein.
II. GLOBAL TRADING STRATEGIES: OVERVIEW OF THE BOOK

Exploiting inefficiencies is challenging in an efficiently inefficient market. It requires hard work, thorough analysis, costs in setting up trading infrastructure, and opportunity costs of highly skilled people. Hence, to be a successful active investor requires specialization and often scale, so money management is usually done by managers who run pools of money such as mutual funds, hedge funds, pension funds, proprietary traders, and insurance companies. The first part of the book explains the main tools for active investment. As seen in figure I.1, we learn how to evaluate, find, optimize, and execute trading strategies.

TABLE I.1. PRINCIPLES OF NEOCLASSICAL FINANCE AND ECONOMICS VS. THOSE IN AN EFFICIENTLY INEFFICIENT MARKET

<table>
<thead>
<tr>
<th>Neoclassical Finance and Economics</th>
<th>Efficiently Inefficient Markets</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Modigliani–Miller</strong></td>
<td><strong>Capital structure matters</strong></td>
</tr>
<tr>
<td>Irrelevance of capital structure</td>
<td></td>
</tr>
<tr>
<td><strong>Two-Fund Separation</strong></td>
<td><strong>Investors choose different portfolios</strong></td>
</tr>
<tr>
<td>Everyone buys portfolios of market and cash</td>
<td></td>
</tr>
<tr>
<td><strong>Capital Asset Pricing Model</strong></td>
<td><strong>Liquidity risk and funding constraints</strong></td>
</tr>
<tr>
<td>Expected return proportional to market risk</td>
<td></td>
</tr>
<tr>
<td><strong>Law of One Price and Black–Scholes</strong></td>
<td><strong>Arbitrage opportunities</strong></td>
</tr>
<tr>
<td>No arbitrage, implied derivative prices</td>
<td></td>
</tr>
<tr>
<td><strong>Merton’s Rule</strong></td>
<td><strong>Optimal early exercise and conversion</strong></td>
</tr>
<tr>
<td>Never exercise a call option and never convert a convertible, except at maturity/dividends</td>
<td></td>
</tr>
<tr>
<td><strong>Real Business Cycles and Ricardian Equivalence</strong></td>
<td><strong>Credit cycles and liquidity spirals</strong></td>
</tr>
<tr>
<td>Macroeconomic irrelevance of policy and finance</td>
<td></td>
</tr>
<tr>
<td><strong>Taylor Rule</strong></td>
<td><strong>Two monetary tools</strong></td>
</tr>
<tr>
<td>Monetary focus on interest rate policy</td>
<td></td>
</tr>
</tbody>
</table>
The most unrestricted and sophisticated investors tend to be the hedge funds, so I focus on hedge fund strategies. While I focus on hedge funds, the strategies in the book are also the core strategies for most other active investors. One difference is that whereas hedge funds can both invest long (i.e., bet that a security increases in value) and sell short (i.e., bet that a security decreases in value), most other investors only invest long. However, the difference is smaller than you may think. A hedge fund strategy that invests in IBM and short-sells CISCO corresponds to a mutual fund that overweights its allocation to IBM (relative to the benchmark) and underweights CISCO.

At a high level, I distinguish between equity strategies, macro strategies, and arbitrage strategies. Equity hedge funds invest primarily in stocks, macro hedge funds invest primarily in overall markets (e.g., currencies, bonds, equity indices, and commodities), and arbitrage funds primarily make relative-value bets across pairs of related securities. I subdivide these three broad types of trading strategies, as seen in figure I.2, which also shows the structure of the
Each chapter is self-contained and can be read independently. For instance, readers most interested in event-driven investment can jump directly to chapter 16 (and use the fundamental chapters 1–5 as a reference).

Equity Strategies

I subdivide equity strategies into discretionary long–short equity, dedicated short bias, and quant equity. Discretionary long–short equity managers typically go long or short stocks based on a fundamental analysis of the value of each company, comparing its profitability to its valuation and studying its growth prospects. These fund managers also analyze the quality of the company’s management, traveling to meet managers and see businesses. Furthermore, they study the accounting numbers, trying to assess their reliability and to estimate future cash flows. Equity long–short managers mostly bet on specific companies, but they can also take views on whole industries.

Some equity managers, called value investors, focus on buying undervalued companies and holding these stocks for the long term. Warren Buffett is a good example of a value investor. Implementing this trading strategy often requires being contrarian, since companies only become cheap when other investors abandon them. Hence, cheap stocks are often out of favor or bought during times when others panic. Going against the norm is harder than it sounds, as traders say:

It’s easy to be a contrarian, except when it’s profitable.

Another approach is to try to exploit shorter term opportunities, for example, to try to predict a company’s next earnings announcement better than the rest of the market. If you think the earnings will come out higher than others expect, you buy before the announcement and sell after the announcement. More generally, such opportunistic traders try to put on a position before something is broadly known and unwind the position when the information gets incorporated into the price based on the motto:

Buy on rumors, sell on news.

If you know a rumor to be true, then you could be engaging in illegal insider trading (as Gordon Gekko, played by Michael Douglas, in the movie Wall Street).

Whereas equity long–short managers often have more long positions than short, the reverse is true for dedicated short-bias managers. They use similar

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5 There are many ways to classify hedge funds, varying across hedge fund indices and databases. My classification of substrategies is similar to that of the Credit Suisse Hedge Fund Indexes, and it also shares similarities with most other classifications.
techniques as equity long–short managers, but they focus on finding companies to sell short. Short-selling means taking a bet that the share price will go down. Just like buying a stock means that you profit if the stock price goes up, taking a short position means that you profit if the price goes down. In practice, short-selling is implemented by borrowing a share and selling it for its current price, say, $100. At a later time, say, the next day, you must buy back the share and return it to the lender. If the stock price has gone down to $90, you buy it back cheaper than you sold it and earn the difference, $10 in this example. If the price has gone up, you lose money.

Dedicated short-bias managers look for companies that are going down, searching for hotels where all the rooms are empty, pharmaceutical companies with drugs that no doctors prescribe (or with new risks), or companies based on fraud or misrepresented accounting. Since stocks go up more often than they go down (called the equity risk premium), dedicated short-bias managers are fighting against the general uptrend in markets, and, perhaps for this reason, they comprise a very small group of hedge funds (anecdotally consisting of pessimistic managers).

Almost all equity long–short hedge funds and dedicated short-bias hedge funds (and most hedge funds in general) engage in discretionary trading, meaning that the decision to buy or sell is at the trader’s discretion, given an overall assessment based on experience, various kinds of information, intuition, and so forth. This traditional form of trading can be viewed in contrast to quantitative investment, or “quant” for short. Quants define their trading rules explicitly and build systems that implement them systematically. They try to develop a small edge on each of many small diversified trades using sophisticated processing of ideas that cannot be easily processed using non-quantitative methods. To do this, they use tools and insights from economics, finance, statistics, mathematics, computer science, and engineering, combined with lots of data to identify relations that market participants may not have immediately fully incorporated in the price. Quants build computer systems that generate trading signals based on these relations, carry out portfolio optimization in light of trading costs, and trade using automated execution schemes that route hundreds of orders every few seconds. In other words, trading is done by feeding data into computers that run various programs with human oversight.

Some quants focus on high-frequency trading, where they exit a trade within milliseconds or minutes after it was entered. Others focus on statistical arbitrage, that is, trading at a daily frequency based on statistical patterns. Yet others focus on lower frequency trades called fundamental quant (or equity market neutral) investing. Fundamental quant investing considers many of the same factors as discretionary traders, seeking to buy cheap stocks and short sell expensive ones, but the difference is that fundamental quants do so systematically using computer systems.
While discretionary trading has the advantages of a tailored analysis of each trade and the use of soft information such as private conversations, its labor-intensive method implies that only a limited number of securities can be analyzed in depth, and the discretion exposes the trader to psychological biases. Quantitative trading has the advantage of being able to apply a trading idea to thousands of securities around the globe, benefiting from significant diversification. Furthermore, quants can apply their trading ideas with the discipline of a robot. Discipline is important for all traders, but as the saying goes, 

**Have a rule. Always follow the rule, but know when to break it.**

Even quants sometimes need to “break the rule,” for example, if they realize that there are problems in the data feed or if sudden important events happen that are outside the realm of the models, such as the failure of the investment bank Lehman Brothers in 2008.

Quants also have the advantage of efficient portfolio construction and the ability to “backtest” strategies, meaning that one can simulate how well one would have done by following such a strategy in the past. Of course, past success does not guarantee future success, but at least it eliminates using rules that never worked. Furthermore, systematic investment reduces the effects of psychological biases, at least to a degree. The quant method’s disadvantage is its reliance on hard data and the computer program’s limited ability to incorporate real-time human judgment.

Whether using discretionary trading or quant methods, learning the analytical tools is useful, and this book aims to provide such tools. Full disclosure: I am a quant. That said, I believe that the methods described in this book are essential for all managers, whether discretionary or quantitative. Indeed, many serious discretionary traders often analyze the historical performance of a trading idea before implementing it in large size. For example, in my interview with Lee Ainslie, he told me how his Maverick Capital has built a quantitative system that informs their fundamental process and helps manage the risk.

**Macro Strategies**

If Gordon Gekko was an equity trader in the movie *Wall Street*, the Duke brothers and Eddie Murphy were macro traders in the movie *Trading Places*, using futures markets to bet on the direction of orange juice prices. I divide macro strategies into *global macro* and *managed futures*. Global macro traders bet on economy-wide phenomena around the world. They take the view that the overall stock market will go up or down, that inflation will lead to a spike in gold prices, or that emerging-market currencies will rise or collapse. Some global macro traders take large positions, as is clear from the following quote from Stanley Druckenmiller, who learned it from Georges Soros (Schwager 2008):
When you have tremendous conviction on a trade, you have to go for the jugular. It takes courage to be a pig.

Others go for a more diversified and risk-managed approach, arguing instead,

Bulls get rich, bears get rich, but pigs get slaughtered.

According to this saying, you can make money taking long positions (bulls) or taking short positions (bears), but if you don’t control your risk (pigs), you end up going out of business. In my interview with George Soros, he explains that he too puts significant emphasis on risk management, but he feels that one should go for the jugular in the rare cases when the upside is large and the downside is limited.

The differences between these sayings reflect the great variation across global macro traders. They come from a variety of backgrounds, ranging from traders with little formal training in economics to former central bank economists. They apply a range of different approaches, some analyzing data, others following every move of central banks, yet others traveling the world for global trading ideas. Some global macro funds are thematic traders, meaning that they focus on a few themes and express each theme in terms of various trades. For instance, one theme might be that China will continue to grow at an explosive rate, and the global macro trader might express this view by buying Chinese stocks or commodities imported by China or companies or industries selling to China.

Though global macro traders are very different from one another, there are similarities. For instance, macro traders often like to express their views in a way that earns a positive carry, meaning that they earn income even if nothing changes. Hence, whether they do so intentionally or not, they often have exposure to so-called carry trades, in particular the currency carry trade. The currency carry trade involves investing in currencies with high interest rates while shorting currencies with low interest rates. This strategy earns an interest rate differential, essentially borrowing one currency at low interest and investing in another currency with a higher interest rate, but it is exposed to the risk that the relative values of the currencies can change.

Managed futures investors (also called commodity trading advisors, CTAs) trade many of the same securities as global macro traders: bond futures, equity index futures, currency forwards, and commodity futures. Managed futures investors often focus on finding price trends, buying instruments that are trending up, and shorting instruments that are trending down. For instance, if gold prices have been rising, a managed futures hedge fund may buy gold futures, betting that the price will continue to rise, relying on the maxim that

The trend is your friend.

Managed futures hedge funds focus on price data, using statistical methods (managed futures quants) or using rules of thumb (technical analysis) more
than they look at fundamental data. Managed futures investors then try to identify trending markets, trends that have become overextended, or snapbacks caused by counterrtrends. The philosophy is that trends start as people under-react to news. By the time prices catch up to fundamentals, they have been moving in the same direction for a while, and other traders may start herding into the position, leading to a delayed overreaction followed by an eventual reversion. Rather than following the news, managed futures investors focus on prices and go by the saying,

Show me the charts, I’ll tell you the news.

Risk management is central for managed futures investors, who apply a very different philosophy than the global macro view expressed by George Soros above. When managed futures investors lose money, it is often because the trend is switching direction and, in this case, they flip their position and get ready to ride the new trend.

**Arbitrage Strategies**

Turning to arbitrage strategies, these consist of fixed-income arbitrage, convertible bond arbitrage, and event-driven investment. Fixed-income arbitrage is based on a number of so-called convergence trades. In a convergence trade, you look for similar securities with different prices; then you buy low, sell high, and hope for convergence. Since fixed-income securities usually have a finite maturity, convergence must eventually happen, but the sooner it happens, the more profitable the trade. The biggest risk in convergence trades is that the trader is forced to unwind the trade when the price gap widens and the trade loses money. As the saying goes:

The markets can remain irrational longer than you can remain solvent.

Typical examples of fixed-income arbitrage trades include on-the-run versus off-the-run Treasury bonds, yield curve trading, betting on swap spreads, mortgage trades, futures-bond basis trades, and trades on the basis between bonds and credit default swaps (CDS).

Another classic arbitrage trade is convertible bond arbitrage.Convertible bonds are corporate bonds that can be converted into stock at a prespecified conversion ratio. A convertible bond can be viewed as a package of a straight corporate bond and a call option on the company’s stock. Using option pricing techniques, the convertible bond value can be computed as a function of the company’s stock price and volatility. This theoretical value of the convertible bond tends to be above the market price because convertible bonds can be very hard to sell quickly and therefore investors need to be compensated for the inherent liquidity risk. Convertible bond arbitrage consists of buying cheap
convertible bonds and hedging the risk by shorting stocks and possibly using additional hedges.

Finally, event-driven hedge funds try to exploit opportunities that arise around corporate events. The classic trade is merger arbitrage (also called risk arbitrage). In a corporate takeover, the acquirer makes a bid for the target stock above the current price to get investors to tender their shares. The stock price shoots up on the announcement but usually not all the way to the bid price. The difference reflects the risk of deal failure, but it also reflects that many investors sell their shares shortly after the announcement. Merger arbitrage managers buy the target company, typically after the announcement and after the initial price jump (unless they had the insight that this was a likely merger target in advance) and hope to earn the difference between the target stock price and the merger offer. The opposite corporate event of a merger is a spin-off or a split-off, where one company becomes two. This event also presents opportunities for event managers. Event managers trade a variety of corporate securities, not just stocks, but also corporate bonds and loans, for instance. Relative value trades across different securities issued by the same company are called capital structure arbitrage. Some event managers focus on distressed companies and may play an active role on the company’s creditor committee, trying to turn the company around.

III. INVESTMENT STYLES AND FACTOR INVESTING

Although the different investment strategies are pursued in disperse asset classes by different types of managers, I nevertheless argue that there exist some pervasive investment “styles” that transcend these boundaries. I define an investment style as a method for deciding on what to buy and what to sell that can be applied broadly across asset classes and markets, as seen in Overview Table III.

The broad applicability of style investment means that it can be implemented systematically, which is called “factor investing.” For instance, we study investment factors such as the value factor and the momentum factor. Whereas style investment lends itself well to factor investment, we shall see that there are many approaches—factor based and discretionary—to earning their rewards.

As a case in point, most of the managers whom I interviewed for this book use some version of value investing (buying cheap securities and selling expensive ones) and momentum investing (buying securities whose price has been rising while selling falling ones). Table I.2 includes brief quotes from each of my interviews related to value and momentum, although each of the hedge fund gurus calls it different things. As Asness’s quote shows, value and momentum are clearly central in his investment strategy, and he had the insight
that value and momentum strategies can be applied everywhere: in any asset class, you buy cheap assets that are trending up and short expensive assets that are coming down.\(^6\) Soros focuses on boom–bust cycles, but, when he rides a bubble, this is essentially momentum trading, and when he decides that a bubble is bursting as the economy moves closer to equilibrium, he is a value

\(^6\) See Asness, Moskowitz, and Pedersen (2013).

<table>
<thead>
<tr>
<th>Expert Interviewed in This Book</th>
<th>Quotes Related to Value and Momentum</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lee Ainslie</td>
<td>The most common valuation metric at Maverick is the comparison of sustainable free cash flow to enterprise value [. . .] It’s certainly important to be attuned to short-term expectations as well.</td>
</tr>
<tr>
<td>James Chanos</td>
<td>Kynikos Associates specializes in short selling, an investment technique that profits in finding fundamentally overvalued securities that are poised to fall in price. [. . .] Even if we love a position, if it’s going against us, we’ll trim it back.</td>
</tr>
<tr>
<td>Cliff Asness</td>
<td>We’re looking for cheap stocks that are getting better, the academic ideas of value and momentum, and to short the opposite, expensive stocks that are getting worse.</td>
</tr>
<tr>
<td>George Soros</td>
<td>I developed this boom/bust theory [. . .] A bubble is when a situation moves from near-equilibrium to far-from-equilibrium. So, you’ve got these two strange attractors where the whole thing is an interplay between perceptions and the actual state of affairs.</td>
</tr>
<tr>
<td>David Harding</td>
<td>Trends are what you’re looking for.</td>
</tr>
<tr>
<td>Myron Scholes</td>
<td>Most of the fixed-income business is a negative-feedback-type business unless you’re directional, which is positive feedback, or trend following.</td>
</tr>
<tr>
<td>Ken Griffin</td>
<td>I started to view the markets through the lens of relative value trading.</td>
</tr>
<tr>
<td>John Paulson</td>
<td>The target stock runs up close to the offer price but trades at somewhat of a discount to the offer price because of the risks of failure of deal completion.</td>
</tr>
</tbody>
</table>

investor. Scholes talks about how fixed-income arbitrage is often based on negative-feedback trading, where one bets on mean reversion, i.e., a form of value investing, complemented by positive-feedback trading, betting on trend continuation. Ainslie and Chanos focus on fundamental value investing, but also consider short-term dynamics, which are often momentum based. Harding is one of the original systematic trend followers in the futures markets, whereas Griffin and Paulson look for relative value opportunities.

Another investment style (as seen in Overview Table III) is liquidity provision, meaning buying securities with high liquidity risk or securities being sold by other investors who demand liquidity. This investment style comes in many shapes and forms, from Griffin buying illiquid convertible bonds to earn a liquidity risk premium, to Paulson buying merger targets being dumped by investors who demand liquidity for fear of event risk, to Soros riding a credit cycle, to Asness providing liquidity through statistical arbitrage trades.

Carry trading is the investment style of buying securities with high “carry,” that is, securities that will have a high return if market conditions stay the same (e.g., if prices do not change). For instance, global macro investors are known to pursue the currency carry trade where they invest in currencies with high interest rates, bond traders often prefer high-yielding bonds, equity investors like stocks with high dividend yields, and commodity traders like commodity futures with positive “roll return.”

Low-risk investing is the style of exploiting the high risk-adjusted returns of safe securities. This investment style is done in several different ways across various markets. Low-risk investing can be done as a long–short equity strategy, buying safe stocks with leverage while shorting risky ones, also called “betting against beta.” Low-risk investing can also be done as a long-only equity strategy, buying a portfolio of relatively safe stocks, also called defensive equity. Low-risk investing can also be applied as an asset allocation strategy called risk parity investing, and has also worked in fixed-income markets.

Lastly, quality investing is the style of buying high-quality securities, for instance, profitable, stable, growing, and well-managed companies, while shorting low-quality securities. High-quality securities naturally have higher average prices than corresponding low-quality ones, so quality investment goes hand-in-hand with value investing as investors seek securities that are cheap relative to their quality.
Index

A page number followed by f refers to a figure and a page number followed by t indicates a table.

3Com/Palm carve-out, 310, 310f
10-K filings, 125, 126, 128
10-Q filings, 125, 126
13D filing, 107
60/40 portfolio, 167, 169–70, 211
144a securities, 270

absolute return benchmark, 21
accounting practices: dedicated short bias managers and, 115; quality of reported earnings and, 101–2
accredited investors, 20
accruals, 101
acquisitions. See mergers and acquisitions
active investment: basic concept of, vii; limited need for, 20, 20n; long history of, 20; producing market efficiency, 3; transaction costs of, 63–64; types of investors involved in, 19. See also hedge funds
active investment strategies. See hedge fund strategies
active risk, 22
activist investing, 102, 106–7; distressed firms and, 291, 311
Adam Harding and Lueck (AHL), 225 administrator of hedge fund, 26
aggregate demand, 193f, 194; shocks to, 195–96, 195f, 195t
aggregate supply, 192–93, 193f; shocks to, 195–96, 195t
AIG, 78
Ainslie, Lee S., III, viii, 1, 11, 15t, 16; interview with, 108–14; resizing positions and, 55
alpha, 27–29; in convertible bond arbitrage, 281–82; risk-adjusted, 30; in three-factor regression model, 29
alpha-to-margin (AM) ratio, 31
Amaranth, 24
American depositary receipts (ADRs), 151, 152f
America Online, 130, 131
Apple Computer, 314
AQR Capital Management, xi–xii, xiii, 158
arbitrage: defined, 233; as disproof of frictionless efficient markets, 3n2; general framework for, 234–35; Law of One Price and, 6, 7t; limits of, 41–42; option pricing and, 235–40; overview of strategies for, 8, 13–14. See also capital structure arbitrage; convertible bond arbitrage; fixed-income arbitrage; merger arbitrage; relative-value trades; statistical arbitrage
arbitrage pricing, 234–40
Arcata Corp., 298–300
arithmetic average, 32–33, 34
Arthur Andersen, and Enron failure, 124
ask price, 63. See also bid–ask spreads
Asness, Cliff, viii, 1, 1n, 14–15, 15t, 16; on good quant investment managers, 133; interview with, 158–64; on nature of hedge funds, 19; portfolio optimization and, 56, 133
asset allocation: Harding on, 229; introduction to, 167–68; by large institutional investors, 168–69; strategic, 167, 168–72, 211; tactical, 167, 175–76, 185 (see also market timing). See also portfolio construction
assets under management (AUM), 74–75
AT&T, 319
auditors, 26
BAB. See betting against beta (BAB)
backfill bias, 23
backtests of strategies, 2, 38, 47–50; adjusting for trading costs, 50, 69; Asness on, 163; biases affecting, 48–50; in fixed-income arbitrage, 252; for market timing, 174–75, 174t; out-of-sample performance in, 175; procedure for, 47–48; in quantitative equity investing, 133, 134t, 135
balance sheet of hedge fund, 74–76, 76f
Balassa–Samuelson effect, 197n
Baldwin United, 127
banking system, Soros on evolution of, 205
bank loans or credit lines, as leverage, 76
Bank of England, Soros’s famous trade involving, viii, 1, 187, 204, 320
bankruptcy investing, 291, 311–12, 314; Paulson on, 319–20
bank stocks, concerns about short-selling of, 123–24
bargain-hunting investors, 99, 103–4, 103f
Baruch, Bernard, 123
basis points (bps), 70
basis trades, 264
bear or bull markets, time series momentum strategies in, 209; 220–21, 220f
Bear Stearns: failure of, 24, 78; risk arbitrage at, 313, 314
beating the market, 3–4, 5, 19, 21, 22. See also alpha
behavioral biases: Asness on successful strategies and, 164; demand pressures created by, 46; overcome by quantitative modeling, 133; pushing prices away from fundamentals, 3, 41; systematic portfolio construction and, 57; trend-following strategies and, 209. See also overreaction/underreaction
benchmark, 21; information ratio and, 30
benchmark portfolio, 167, 168. See also strategic asset allocation
Berkshire Hathaway, 104–6, 160. See also Buffett, Warren
Bernanke, Ben, 191
beta, 27–29; benchmark and, 30; capital asset pricing model and, 140–41, 140f. See also betting against beta (BAB); market exposure (beta risk)
betting against beta (BAB), ix, 16, 140–44, 142f, 143f
bid–ask spreads: defined, 63; effective cost and, 68; market makers’ profits due to, 154; optimal trading and, 64, 65, 67
bid price, 63
binomial option pricing, 236–38, 237f, 237n; in convertible bond valuation, 272
BlackBerry, 115
Black–Scholes–Merton formula, 7t, 238–40; convertible bond valuation using, 272; foreshadowed by Thorp and Kassouf, 270; Griffin on his early use of, 288; Nobel Prize for, 262; Scholes’s interest in fixed-income arbitrage and, 263
Blackstone Group, 320
Boesky, Ivan, 233
bond carry, defined, 255
bond carry trades, 16, 187, 188t; 255–56, 257
bond futures, 241, 262; for government bonds, 209; hedging interest-rate risk with, 283; Scholes on, 264–65; in time series momentum strategy, 213, 214–17f, 220
bond returns, 179–80, 179n, 243–44, 245f; carry and, 255–56, 256f; convexity and, 246–47; on leveraged bond, 246, 248, 249, 249n. See also bond yields
bonds: central bank actions and, 190; economic environment and, 191–92, 191t; leveraged, 241, 244–46, 248–49, 249n; on-the-run versus off-the-run, 241, 257, 258f, 259; prices of, 242, 243, 244, 246; specialness of, 245–46, 245f; strategic asset allocation and, 168. See also convertible bonds; corporate bonds; fixed-income arbitrage; government bonds
bond value trade, global, 197, 198, 198f
bond yields, 179–80, 242–43, 243f; determinants of, 248–49; earnings yield compared to, 179; on leveraged bonds, 244–46, 245f, 248; real, 197. See also bond returns; yield curve
bonuses, performance-based, 21
book-to-market ratio (B/M), 29, 136, 137
book value of a stock, 92–93
boom/bust cycles: Soros on, 15, 15t, 200–204, 202f, 205–6, 207. See also bubbles
break-even inflation trading, 262
break-even rates (forward rates), 247–48; bond carry as, 255n6
breakout, 48
broker/dealers, 25
BTOB 50, 221, 222t
bubbles: greater fool theory and, 107, 120; mitigated by short-selling, 121; Paulson on subprime mortgage securities and, 321; riding rather than trading against, 41–42, 107; Soros and, 15, 41, 201–4, 202f, 205–6, 207. See also conglomerate boom of late 1960s; Internet bubble of late 1990s; subprime credit crisis
Buffett, Warren: on arbitrage, 233; on diversification in arbitrage, 292; on holding periods, 105–6, 111; on intrinsic value, 87, 88, 89, 90; leverage used by, 105; leveraging safer securities, 6, 141; on merger arbitrage, 298–300, 304; Sharpe ratio achieved by, 104–5, 160; as value and quality investor, 9, 99, 104–5
busted convertible bonds, 282–83, 282f, 284, 285f
butterfly trades, 241, 251–55, 252f, 253f, 254f
buy in, 118
callable convertible bonds, 269, 272
call options: convertible bonds and, 13, 269, 272; defined, 235; Merton’s Rule and, 6, 7t. See also options
call protection, 269
capacity: of hedge fund, 72, 73f; of trading strategy, 72, 73f
CAPE (cyclically adjusted price earnings) ratio, 179
capital: aggregate supply and, 192–93; supply shocks arising from changes in, 196
capital asset pricing model (CAPM): liquidity-adjusted, 43–44; margin requirement and, 45; market portfolio and, 169; merger arbitrage and, 306; predicting alpha equal to zero, 28, 29; required rate of return and, 90; security market line and, 140–41, 140f; statement of, 6, 7t, 140
capital flows, 199
capital structure: in efficiently inefficient markets, 7t; in neoclassical finance, 7t; Scholes on fixed-income arbitrage and, 268
capital structure arbitrage, 14, 261, 291, 312
capital structure changes, arbitrage related to, 291, 312
carry, defined, 187
carry-trade unwinds, 186
carry trading, ix, 16, 185–88; of bonds, 16, 187, 188t, 255–56, 257; of currencies, 12, 16, 185–87, 186f, 188t; exposure of macro traders to, 12; performance across global markets, 188, 188t
carve-outs, 291, 307–8, 308f; trading on, 308–11, 310t, 310f
catalysts, 106–7; Asness on, 162; starting a trend, 210, 210f
CDS-bond basis, 6, 13, 261
CDSs. See credit default swaps (CDSs)
CDX credit index, 260–61, 283
Centerbridge Partners, 320
central banks: bond yields and, 248–49; carry trades and, 186–87; economic environment and, 191–92; Federal Reserve, 189–91, 205, 206; general collateral repo rate and, 245; macro traders’ monitoring of, 189–91, 250; trend-following strategies and, 209, 211. See also exchange rates; interest rates; monetary policy; Taylor rule
CFTC (Commodities and Futures Trading Commission), 156–57
Chanos, James, viii, 1, 15t, 16; on Enron, 124–27, 128, 129; interview with, 127–32; on Murphy’s Law, 115; position limits of, 55
China: Harding’s agnostic view of, 229; trading themes involving, 12, 200
Citadel, 286–87, 290
clean surplus accounting relation, 92, 178 clearing, 25–26
Clear Wireless, 319
closed-end funds: event opportunities related to, 313; statistical arbitrage involving, 153
Cohen, Abby, 160
collar stock deals, 293, 301–3, 302f
collateral: as cash provided by short seller, 116, 118; in efficiently inefficient markets, 7t; in financing by prime brokers or repo lenders, 26, 76, 80; on hedge fund balance sheet, 76. See also margin requirements commissions, 63, 64, 65
Commodities and Futures Trading Commission (CFTC), 156–57
commodity carry trade, 187–88, 188t
commodity futures: carry of, 16, 187–88; in time series momentum strategies, 209, 213, 214, 214–17f, 218t
commodity markets: demand pressures in, 46; stagnation and, 192
commodity trading advisors (CTAs), 208; Adam Harding and Lueck as, 225; diversification from investing with, 228; fees of,
commodity trading advisors (continued)  
223; tail hedging and, 228; trading rules of, 48. See also managed futures investing commodity value trade, 197–98, 198f computer models. See quantitative equity investing confirmation bias, 212 conglomerate boom of late 1960s, 201–2, 203 constant rebalanced asset allocation, 169–70. See also rebalancing of portfolio contrarian trading strategies: providing liquidity to demand pressure, 45–46; value investing as, 9 convergence time, natural, 235 convergence trades, 13. See also fixed-income arbitrage conversion price, 269 conversion ratio, 13, 269 convertible bond arbitrage, viii, 13–14, 233; Griffin on, 286–90; hedge ratio in, 275, 275f, 283; life of a trade in, 270–72, 271f; liquidity crises and, 283–85, 284f, 285f, 286f; profits and losses in, 277–82, 278f, 279t, 280f, 281f convertible bonds: basic features of, 13–14, 269–70; hedgeable and unhedgeable risks for portfolio of, 283–86; hedging of, 270, 275, 275f; leveraged with prime brokers, 80, 284, 284f; liquidity discount of, 281–82, 281f; liquidity risk of, 14, 43, 270, 271, 281, 283–85; Merton’s Rule and, 6, 7t; types of, 282–83, 282f; valuation of, 13–14, 272–73, 273f, 274f; when to convert, 275–76, 276n. See also convertible bond arbitrage convexity, 246–47 convexity trading, 247, 277, 279; in mortgage markets, 265–66; Scholes on, 263, 264, 265–66; takeovers and, 285 corporate bonds: arbitrage trades involving, 260–61 (see also capital structure arbitrage); bankruptcy and, 319; with embedded options, 180n; hedging interest-rate risk with, 283; loss rate in case of default on, 260, 260m; market for, 241; in overheated economy, 191; returns on, 179–81; strategic asset allocation and, 168. See also bonds; convertible bonds corporate events: risk to convertible bonds from, 283. See also event-driven investment corporate hedging activity, in line with trends, 212 correlations across assets: liquidity spirals and, 82; in portfolio construction, 55, 57; portfolio volatility and, 58 costs of implementing a strategy, 63–64. See also funding costs; transaction costs coupons: bond prices and, 242; bond returns and, 180, 243; of convertible bonds, 269, 270, 271, 277, 283, 287, 288; inflation and, 179; reinvestment of, 179n crash risk, 31–32; implied volatility and, 239; liquidity spiral and, 82; volatility and, 58 credit carry trades, 188 credit cycles, 7t, 16 credit default swap index, 283 credit default swaps (CDSs), 241; capital structure arbitrage with, 312; credit return and, 180; fixed income arbitrage involving, 13, 260–61; to hedge convertible bond default risk, 283; in overheated economy, 191 credit returns, 180–81 credit risk, 260; of convertible bonds, 283; of credit carry strategy, 188; in event-driven investment, 292; Scholes on, 264 credit risk premium, 168, 260 credit spread, 180–81, 260; of distressed firms, 311; in overheated economy, 191 crises. See global financial crisis of 2007–2009; liquidity crises cross-margining, 80 cross-sectional regression, and security selection, 51, 52–53 CTAs. See commodity trading advisors (CTAs) currency carry trades, 11–12, 16, 185–87, 186f, 188t currency crisis, of 1992 in U.K., 187, 204 currency forwards: macro traders using, 187; in time series momentum strategies, 209, 212–13, 214, 214–17f, 218t currency markets: arbitrage opportunities in, 6; central bank activities in, 190, 211; Soros on fixed currency system and, 206–7; Soros on reflexivity in, 203. See also foreign exchange markets currency returns, 182–83 currency value trade, 197, 198, 198f curve flattener, 250–51 curve steepener, 250–51 curve trades, Scholes on, 264–65 custody, 25–26 cyclically adjusted price earnings (CAPE) ratio, 179
databases listing hedge funds, 23
data mining biases, 49
data vendors, 26
DD. See drawdown (DD)
deal risk, 233; in merger arbitrage, 294–96, 304–5, 308
deal spread in merger arbitrage, 294–96, 297, 300, 304; for failed deals versus successful deals, 297–98, 298f; Paulson on, 316
dedicated short bias hedge funds, viii, 9–10, 87–88, 115–24; basic focus of, 115–16; controversy about benefits of, 122–24; difficulties of, 117–18; how short-selling works for, 116–17; overvaluation of companies and, 119–21. See also Chanos, James; Enron; short-selling
deep value investors, 99, 103
defensive equity investing, 16
delta. See hedge ratio (delta, $\Delta$)
demand pressure: bond yields and, 252; derivative prices and, 7t; need to identify source of, 266; option prices and, 46, 240; providing liquidity to, 45–46
demand shift, as catalyst of trend, 210
demand shocks, 5, 194–96, 195f, 195t
derivatives: binomial model for value of, 236–38, 237f, 237n; Black–Scholes–Merton formula for value of, 7t, 238–40, 262, 263, 270, 272, 288; defined, 235; in efficiently inefficient markets, 7t; exchange-traded, 80; key markets for, 241; leverage achieved with, 74, 76, 80; in neoclassical finance, 7t; over-the-counter (OTC), 80; prime brokerage of, 80; volatility trades with, 262. See also futures; options; subprime credit crisis; swaps
derivatives clearing merchants, 26
directional volatility trades, 262
discounted cash flow model. See dividend discount model
discount rate, 89–90, 100, 102
discretionary equity investing, viii, 9, 10, 11, 87–88, 95–108; Asness on quantitative investing versus, 162–63. See also Ainslie, Lee S., III; dedicated short bias hedge funds; fundamental analysis; quality investing; value investing
discretionary macro hedge funds, 185
Dish Network, 318
disposition effect, 106
distressed convertible bonds, 282f, 283

distressed investments, 14, 291, 311–12; Paulson on, 319–20

diversification: beta risk and, 28; of carry trades, 188, 188t; of convertible bond portfolio, 283; CTA investments as source of, 228; in event-driven investment, 292; as form of risk management, 59; hedge funds as source of, 26; by market neutral hedge fund, 21, 28; in merger arbitrage, 295, 303–4, 306, 317–18; portfolio optimization and, 55, 57; in quantitative equity investing, 133, 134, 144, 162; of time series momentum strategy, 209

dividend discount model, 89–92; fundamental analysis using, 97; margin of safety and, 98; quality and, 100; residual income model derived from, 92

dividend growth, 176, 177, 178

dividends: book value and, 92; early conversion of bond and, 276; in merger arbitrage, 296; recapitalization and, 314; on short equity position in convertible bond arbitrage, 277. See also dividend discount model

dividend yield, 176–77, 176n; as carry of an equity, 188; historical average, 178; market timing based on, 172–75, 174f, 174t

DJCS Managed Futures Index, 221, 222t
Donchian, Richard, 208
downside risk, 32
drawdown (DD), 35, 36f
drawdown control, 54, 59, 60–62; by managed futures managers, 225
Drexel Burnham Lambert, 129
Druckenniller, Stanley, 11
dual-listed stocks, 149–50, 149f, 151, 152f, 235
duration, 244; modified, 180, 181, 244, 246, 251, 253, 254, 255
Dutch disease, 199
dynamic hedging strategy, 234, 235, 237–38, 240
earnings, as net income, 92, 178–79
earnings manipulation, 121
earnings quality, 101–2
earnings restatements, 121
earnings yield, 178–79, 178n6
economic capital, 32
economic environments, 191–92, 191t; shocks leading to, 195t, 196
effective cost, 67–68
efficiency of markets: enhanced by hedge funds, 26; enhanced by short-selling, 123; enhanced by value investors, 89; Scholes on fixed-income arbitrage and, 263
efficiently inefficient markets: arbitrage in, 151, 233, 235, 241; for convertible bonds, 271; defined, vii; dynamics of, 3–6; equity markets as, 88–89; information in, 40–41; limited amount of profit for active investment in, 20; liquidity risk in, 42; merger arbitrage and, 295; for money management, 3n3; versus neoclassical finance and economics, 6, 7t; option prices in, 240; price discrepancies between bonds in, 241; Scholes on, 265; short-selling and, 119
efficient market hypothesis, vii, 3; Harding on, 227, 228; liquidity spiral theory versus, xiii; paradox of, 3n3; Soros on, 201, 203; tests of, 3, 3n3
“Egyptian” collar deal, 302, 302f
embedded options: convertible bonds with, 281; corporate bonds with, 180n; Scholes on, 263
emerging markets: bonds in, 262; global macro traders and, 12; Soros on, 205, 207
e-mini S&P 500 futures, and flash crash of 2010, 155–57, 156f
endowments, 43, 149, 168, 170
enter–exit trading rule, 48
enterprise valuation, 93–94
equalization agreement, 149
equity capital in a hedge fund, 74–75, 76f; daily change in, 78
equity carry trade, 188, 188t
equity index futures: e-mini S&P 500 futures, 155–57, 156f; in time series momentum strategies, 209, 213, 214, 214–17f, 218t
equity market neutral investing. See fundamental-quantitative investing
equity returns, 176–79; historical, 178, 179
equity risk premium, 42, 89, 177–78, 178n5; short-selling against headwind of, 10, 124; strategic asset allocation and, 168
feedback: in liquidity spiral, 81; Scholes on fixed-income arbitrage and, 15t, 16, 264, 266, 267; Soros on, 201, 203
feedback trading, extending a trend, 211–12
feeder fund, 24, 25f
fees of hedge funds, 21–22, 38; managed futures, 223
financial crises. See global financial crisis of 2007–2009; liquidity crises financing for hedge funds. See “funding” entries; leverage financing spread, 78–79
fire sale: avoiding redemptions and, 75; in fixed-income arbitrage, 241; funding
ES (expected shortfall), 59
ETFs. See exchange traded funds (ETFs)
European Central Bank, 190
European options, 235, 236, 239–40. See also options
event-driven investment, viii, 2, 13, 14, 233; classes of, 291–92; demand pressure and, 46; portfolio construction in, 292. See also capital structure arbitrage; capital structure changes; merger arbitrage; Paulson, John A.
equity risk premium, 42, 89, 177–78, 178n5; short-selling against headwind of, 10, 124; strategic asset allocation and, 168
embedded options: convertible bonds with, 281; corporate bonds with, 180n; Scholes on, 263
endowments, 43, 149, 168, 170
enter–exit trading rule, 48
enterprise valuation, 93–94
equalization agreement, 149
equity capital in a hedge fund, 74–75, 76f; daily change in, 78
equity carry trade, 188, 188t
equity index futures: e-mini S&P 500 futures, 155–57, 156f; in time series momentum strategies, 209, 213, 214, 214–17f, 218t
equity market neutral investing. See fundamental-quantitative investing
equity returns, 176–79; historical, 178, 179
equity risk premium, 42, 89, 177–78, 178n5; short-selling against headwind of, 10, 124; strategic asset allocation and, 168
feedback: in liquidity spiral, 81; Scholes on fixed-income arbitrage and, 15t, 16, 264, 266, 267; Soros on, 201, 203
feedback trading, extending a trend, 211–12
feeder fund, 24, 25f
fees of hedge funds, 21–22, 38; managed futures, 223
financial crises. See global financial crisis of 2007–2009; liquidity crises financing for hedge funds. See “funding” entries; leverage financing spread, 78–79
fire sale: avoiding redemptions and, 75; in fixed-income arbitrage, 241; funding

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liquidity risk and, 63; liquidity spiral and, 82, 83f
firm value, 93–94
First Executive, 129
fixed exchange ratio stock deal, 293, 300, 301f, 303
fixed-income arbitrage, viii, 13, 233, 241–42; basic concepts of, 241; fundamental bond concepts underlying, 242–48; leverage in, 241, 244–46, 248–49, 249n; liquidity risk premiums earned by, 44; with on-the-run versus off-the-run Treasuries, 13, 257, 258f, 259; Scholes on, 15t, 16, 263–68; trading on dimensions of the term structure, 250–55; typical trades in, 13, 241 (see also specific trades)
fixed-income futures, in time series momentum strategies, 214, 214–17f, 218t
fixed-income markets, 241; central bank activities in, 211; low-risk investing in, 16. See also bonds; derivatives
flash crash of 2010, 155–57, 156f
floating exchange ratio stock deal, 293, 301, 302f, 303f
FOMC (Federal Open Market Committee), 191
foreign direct investment (FDI), 196
foreign exchange markets: central bank intervention in, 190; forward contracts in, 187. See also currency markets
forward-interest-rate markets, 190
forward rates, 247–48; bond carry as, 255n6 forwards. See currency forwards
fraud: of Baldwin United, 127; by companies hostile to short-selling, 123; Enron and, 129; investigating possibility of, 115; spreading false stories about a company as, 132; uncovered by short sellers, 132. See also insider trading
French, Kenneth: Asness as student of, 158, 159. See also Fama–French three-factor model
frictions: in arbitrage trading, 235; carry trading and, ix; demand pressures created by, 46; early conversion of bond and, 276; funding frictions, 7t; market frictions, 5; short sales and, 119–21; supply shocks arising from, 196; trend-following strategies and, 209, 211
front-running, 107
fundamental analysis, 41, 88, 97–98; Ainslie’s orientation toward, 110, 111; dedicated short bias managers using, 115; fundamental quant and, 134
fundamental quantitative investing, 11, 134, 134t, 135–49; Ainslie on incorporation of approaches from, 110; betting against beta (BAB) in, ix, 16, 140–44, 142f, 143f; factors considered in, 135–36; momentum investing in, 138–39, 138f, 144, 146, 148, 149; portfolio construction in, 144–45; quality investing in, 139–40; quant event of 2007 and, 144, 145–49; value investing in, 136–38, 137f, 144, 145–46, 146f, 147–48
fundamental risk: in arbitrage, 41; in value investing, 89
fundamentals, Soros on, 201
fundamental value, 89; from arbitrage pricing, 234, 235; Harding on, 228. See also intrinsic value
funding costs, 63–64
funding liquidity risk, 45, 63, 80–81; of convertible bonds, 281, 283; to short seller, 118. See also liquidity risk
funding of a portfolio, 74, 77–79. See also leverage
funds of funds, and quant event of 2007, 145
futures: demand pressures associated with expiration of, 46; interest rate futures, 190; leverage through, 80; market exposure of, 28; mortgage-backed securities and, 261; statistical arbitrage involving, 153; in time series momentum strategies, 213, 214, 214–17f, 218t. See also bond futures; commodity futures; equity index futures; managed futures investing
futures commission merchants (FCMs), 26, 80, 225
gain-on-sale accounting, 124–25
gambler’s ruin, 80–81
gamma, 277, 279
GARP (growth at a reasonable price) investing, 104
gates, 75
GDP (gross domestic product), 192–93; output gap and, 189
general collateral (GC) repo rate, 245, 245f
geometric average, 32–33, 34
GlaxoSmithKline, 290
global bond value trade, 197, 198, 198f
global equity index value trade, 197, 198, 198f
global financial crisis of 2007–2009: banned short-selling of financial stocks during, 117; as challenge to neoclassical economics, 6; convertible bond markets in, 284; falling bond yields in, 192; on-the-run/off-the-run spread during, 257, 258f; Soros on, 203, 204, 205; spreading from subprime market to other markets, 83, 84f; yield curve during, 257, 258f. See also subprime credit crisis

global macro investing, viii, 11–12, 184–85; carry trades in, 185–88, 188f (see also bond carry trades; currency carry trades); central bank monitoring in, 189–91, 250; economic developments affecting, 191–96, 191t, 195f, 195t; key trades of, 196–200, 198f; Paulson’s “greatest trade ever” classified as, 292; Scholes on futures contracts and, 264–65; Scholes on segmented views of yield curve and, 263; thematic, 200. See also Soros, George

global tactical asset allocation (GTAA), 176, 185

global trade flows, 199

global warming, 199

Goldilocks economy, 191t, 192, 196

Goldman, Sachs & Co.: Asness at, 158, 159, 161; Long-Term Capital Management and, 84; risk arbitrage at, 313–14

gold prices, 11–12, 48, 192, 200

Gordon’s growth model, 90–91, 100
government bonds: market for, 241; repo rate for, 245; short-selling, 260, 261; spread trades involving, 264; strategic asset allocation and, 168. See also bonds; Treasury bonds

Graham and Dodd, 95, 96, 98, 139
greater fool theory, 107, 120
“greatest trade ever,” 2, 292, 313, 320–22


Greenlight Capital, 122

Greenspan, Alan, 190–91, 203, 206

Griffin, Kenneth C., viii, 2, 15t, 16; interview with, 286–90
gross domestic product (GDP), 192–93; output gap and, 189
gross leverage, 74
growth: bad forms of, 101, 102; economic environment and, 191–92, 191t; factors affecting, 193; quality investing and, 100–102, 103–4; supply or demand shocks and, 195t; trading on direction of interest rates and, 250
growth at a reasonable price (GARP) investing, 104
growth banks, 205
growth investors, 103–4, 103f
growth stocks, 100–101, 104
Gruss Partners, 313

GTAA (global tactical asset allocation), 176, 185

haircut, 77, 80. See also margin requirements

Hansen, Lars, 3

Harding, David W., viii, 1–2, 15t, 16; interview with, 225–29

Harvard Management, 43

hedge fund managers, viii, 1–2. See also specific managers

hedge funds: balance sheet of, 74–76, 76f; capacity of, 72, 73f; defined, 19; fees of, 21–22, 38; high attrition rate of, 24; history of, 20; limited need for, 20; limited regulation of, 20, 23; objectives of, 21; organization of, 24–26, 25f; performance measures of, 27–38; performance of, 22–24; role in the economy, 26; total assets under management by, 20; withdrawals from, 75

hedge fund strategies, viii, 7–14, 8f; asset pricing theories and, 2–3; capacity of, 72, 73f; performance measures of, 27–38; predictive regressions of, 50–53; profit sources of, 39–46, 40f. See also backtests of strategies; investment styles; specific strategies

hedge ratio (delta, Δ): in binomial option pricing model, 237; in convertible bond arbitrage, 275, 275f, 283; to make a strategy market neutral, 28; in slope trade, 251

hedging: as benefit of short-selling, 123; of convertible bonds versus straight bonds, 270; defined, 19; dynamic, 234, 235, 237–38, 240; in fixed-income arbitrage, 241; Scholes on broker-dealers and, 267; tail hedging, 59, 228

Heisenberg uncertainty principle of finance, 135

herding, 209, 210, 211–12

high-conviction trades: going for the jugular with, 12, 321; portfolio construction and, 55, 57

high-frequency trading (HFT), 10, 134, 134f, 135, 153–57; flash crash of 2010 and, 156–57; as market making, 44–45, 153–55
high-minus-low (HML) factor, 29, 137, 137n
high-moneyness convertible bonds, 282, 282f, 284, 284f
high water mark (HWM), 21–22, 35, 36f
holding periods, 105–6; at Maverick Capital, 111–12
hurdle rate, 21
Huygens, Christiaan, 81
hybrid convertible bonds, 282, 282f
idiosyncratic risk, 27–28; in information ratio, 30; washed out in quant investing, 144
illiquid assets, in asset allocation, 168, 170
illiquidity premium, 43
illiquid securities, defined, 63
IMA (investment management agreement), 25
immunization, 246, 251
implementation costs, 63–64. See also funding costs; transaction costs
implementation shortfall (IS), 70–72, 73f
implied cost of capital, 93
implied expected returns, 93
implied volatility, 239, 262
index arbitrage, 153
index funds, 28
index options: demand pressure for, 46; implied volatilities of, 239
index weightings, Maverick’s indifference to, 111
industry-neutral portfolio construction, 144; quant event of 2007 and, 146
industry rotation, 98
inefficient markets: Asness on successful strategies and, 164; defined, vii. See also efficiently inefficient markets
inflation: aggregate demand and, 193f, 194; aggregate supply and, 193, 193f; bond returns and, 180; central bank policies and, 189–90; currency returns and, 182–83; economic environment and, 191–92, 191t; employment and, 193; equity returns and, 178–79; Federal Reserve policy and, 189–90; interest rates and, 189–90, 194, 250; supply or demand shocks and, 195t inflation risk premium, 196
information: efficient market hypothesis and, 201, 227; short sellers as providers of, 132; as source of profits, 39, 40–42, 40f information ratio (IR), 30, 31; adjusted for stale prices, 37
in-sample backtests, 50, 53
insider selling, 125, 128
insider trading, 9, 40–41, 294, 318
Integrated Resources, 129
interest rate futures, 190
interest-rate risk: in convertible bond arbitrage, 283; in event-driven investment, 292
interest rates: aggregate demand and, 194; in efficiently inefficient markets, 7t; inflation and, 189–90, 194, 250; in neoclassical finance, 7t; option instruments related to, 262; overnight, central banks and, 248–49. See also central banks; risk-free interest rate; Taylor rule; term structure of interest rates
interest-rate swaps, 259–60; in convexity trading, 266; in curve trading, 265; in hedging portfolio of convertibles, 283; margin requirements for, 80; market for, 241; in mortgage trading, 261; in spread trades, 264, 265; swaptions and, 241, 262; in volatility trading, 262
Internet bubble of late 1990s: Asness on, 161–62; carve-outs during, 309–10, 310f; greater fool theory and, 107; low dividend yield during, 174; Soros and, 41, 203, 206
Internet stocks, demand pressures for, 46 intrinsic value: Ainslie on, 109; Buffett on, 87, 88, 89, 90; dividend discount model and, 89–92, 97, 98, 100; fundamental analysis and, 97; quality characteristics and, 100; residual income model and, 92–93, 92n, 97; value investing and, 88–89, 96, 97, 98–99, 98f; value investor versus growth investor and, 103–4, 103f. See also fundamental value; value investing
inventory risk, 155, 156
investment banks: prime brokerage service of, 80; risk arbitrage and, 314
investment management agreement (IMA), 25
investment–saving (IS) curve, 194, 194n
investment styles, ix, 2, 14–16. See also specific styles
iPhone, 115
IR. See information ratio (IR)
irrational exuberance, 203
IS (implementation shortfall), 70–72, 73f
IS-MP model, 194n
iTraxx, 283
JOBS (Jumpstart Our Business Startups) Act, 20
Jones, Alfred Winslow, 20
Jones, Paul Tudor, 184
junk bond companies, 129
Kabiller, David, 161
Keynes, John Maynard, 119, 137, 204
Keynesian Beauty Contest, 119–20
Kohlberg, Kravis, Roberts & Co. (KKR), 298–99
Krail, Bob, 161
Krispy Kreme, 46
Kynikos Associates, 15t, 127; Kynikos Opportunity Fund, 131. See also Chanos, James

Law of One Price, 6, 7t
LBO. See leveraged buyout (LBO) investors
Leap Wireless, 319
Leasco Systems and Research Corporation, 202
legal advisors, 26
Lehman Brothers, failure of: convertible bond market and, 284, 285; liquidity crisis unfolding around, 149; management’s efforts to distract from, 122; recession following, 319; stress tests and, 59; as sudden event, not in models, 11; unable to fund their positions, 78
leverage: alpha-to-margin (AM) ratio and, 31; betting against beta and, ix, 16, 141; bubbles based on, 203; Buffett’s use of, 105; in convertible bond arbitrage, 271, 277, 284, 284f; defined, 74; embedded in derivatives, 80; embedded in options, 236, 240; in fixed-income arbitrage, 241, 244–46, 248–49, 249n; funding costs and, 63–64; market timing with, 174–75; measures of, 74; overall economics of, 77–80; preference for risky securities instead of, ix, 45, 141; provided by prime brokers, 26; quant event of 2007 and, 145, 148; reactive risk management and, 61; riding out a drawdown and, 54; in risk parity investing, 171–72; Scholes on, 268; Soros on, 201, 203; sources of, 74–76, 76f. See also margin requirements
leveraged buyout (LBO) investors: acquisitions by, 293; applying leverage to safer stocks, 141; failure rate of, 304; KKR deal for Arcata Corp., 298–300; quant event of 2007 and, 145
leverage risk premium, ix
Levy, Gustave, 313, 314 LIBOR rate, interest-rate swaps and, 259–60
Liew, John, 161
limit orders, 135, 154, 155; flash crash of 2010 and, 155, 157
Lipper/Tass database, managed futures funds in, 221, 222t
liquidity: enhanced by short-selling, 123; Keynes on preference for, 204; limited demand for, 20; on-the-run/off-the-run spread and, 257, 259
liquidity-based asset allocation, 170
liquidity crises: in convertible bond markets, 283–85; in flash crash of 2010, 157; neoclassical economics and, 6; on-the-run/off-the-run spread during, 257, 259; risks associated with, 44; systemic, in September 2008, 149. See also liquidity spirals
liquidity management, 59
liquidity provision, ix, 4; by high-frequency traders, 153, 154, 155, 156, 157; as investment style, 16; by market makers, 123, 153–54; useful for the economy, 26
liquidity risk: arbitrage and, 42, 151, 233; capital asset pricing model and, 6, 7t, 43–44; compensation for, 39, 40f, 42–46; components of, 42–46, 63; of convertible bonds, 14, 43, 270, 271, 281, 283–85; defined, 5; funding crisis and, 80–81; to funding of short seller, 118; of mortgage-backed securities, 261; in value investing, 89
liquidity risk premium, 42, 44; asset allocation and, 168, 170; convertible bond arbitrage and, 270, 281; investment style based on, ix, 16
liquidity spirals, 7t, 81–83, 82f, 83f; alternatives for dealing with, 148; buying securities during, 44; in carry-trade unwinds, 186; cause of, ix; in convertible bond market, 283; drawdown policy for dealing with, 61; in quant event of 2007, xii–xiii, 144, 147, 148; stress tests and, 59. See also liquidity crises
liquid securities, defined, 63
Livermore, Jesse, 208
loan fee, 117, 118; decision not to lend shares and, 124; stock valuation and, 121
lock-up provisions, 75
London Financial Futures Exchange, 225
long–short equity funds, 95–96
Long-Term Capital Management (LTCM): among other troubled hedge funds in 1998,
161; bailout of 1998 for, 205; convertible bond market and, 285; counterparties’ behavior toward, 84; failure of, 24; on-the-run/off-the-run spread and, 257; Scholes at, 262, 268; stress tests using, 59
loss, time horizon for observing, 33t, 34–35
lost decade, 191t, 192; demand shocks and, 196
low-risk investing, ix, 16, 140–44, 142f, 143f
Lynch, Peter, 106
macroeconomics, 191–96, 191t, 195t
macro strategies, 8, 11–13; asset allocation for, 167–68. See also global macro investing; managed futures investing
MADD (maximum acceptable drawdown), 60–61
managed futures indices, 221, 222t, 223
managed futures investing, viii, 11, 12–13, 208–10; explaining the returns of, 221, 222t, 223; implementation of, 224–25; Scholes on, 264–65; surprises and, 227–28. See also commodity trading advisors (CTAs); Harding, David W.; time series momentum strategies; trend-following investing
managed futures quants, 13
management company, 25, 25f
management departures, 127, 128
management fee, 21, 38
management quality, 102, 104; Ainslie on, 108, 110, 112, 113
Man Group, 225
Manufacturers Hanover Trust Company, 202
MAR (minimum acceptable return), 32
margin calls, 79, 118; liquidity spiral and, 148
margin loans, 75–76, 76f
margin of safety, in value investing, 89, 98–99, 98f
margin requirements, 77–80; alpha-to-margin ratio and, 31; in arbitrage trading, 233; in convertible bond trading, 281, 284; defined, 77; on hedge fund balance sheet, 75–76, 76f; liquidity spiral and, 82, 148; in managed futures strategies, 225; in options trading, 238; for short seller, 116, 118; for swaps, 259; for time series momentum strategy, 225. See also collateral
Market Break of May 1962, 157
market dislocations, event opportunities in, 313
market exposure (beta risk), 28, 29, 42; of merger arbitrage portfolio, 305–7; quality and, 102; quant portfolio construction and, 144
market impact, market makers’ profits due to, 154
market impact costs, 63, 64–65, 66f; effective cost and, 68
market liquidity risk, 42–45, 63; of convertible bonds, 281, 283. See also liquidity risk market makers, 44–45; basic economics of, 153–55; failure of liquidity provision by, 157; liquidity provision by, 123, 153–54
market-neutral excess return, 28
market-neutral hedge funds, 21, 28; asset allocation by, 167, 169; quantitative equity investing by, 133, 135, 144
market portfolio, 169
market price: discrepancy between theoretical value and, 2–3; versus intrinsic value, 89, 98–99, 98f; Soros on distortions of, 200–201
market timing strategy, 51–52, 53, 167, 172–75
mark to market profit and loss, 78
master–feeder hedge fund structure, 24–26, 25f
master fund, 24–25, 25f
Maverick Capital Management, 11, 15t, 108. See also Ainslie, Lee S., III
maximum acceptable drawdown (MADD), 60–61
maximum drawdown (MDD), 35, 36f
McDonough, Bill, 205
mean–variance portfolio optimization, 56–57
Mendillo, Jane, 43
merger, early conversion of bond prior to, 276
merger arbitrage, 14, 291, 292–307; acquirers talking up their stock price and, 303; basic concept of, 294–96; demand pressure and, 46; determining the hedge in, 300–303, 301f, 302f; historical return of, 295, 305–7, 306f; life of a trade in, 296–300, 297f, 298f; Paulson on, 2, 15t, 16, 296, 314–16; portfolio construction and, 303–4; portfolio-level hedges for, 307–8; risk in, 304–5; types of deals involved in, 292–94, 293f
mergers and acquisitions: available universe of, 303; bad growth involving, 101, 102; convertible bonds and, 285; failure rate of, 304; types of, 293–94, 293f. See also merger arbitrage
Merton model, and corporate default, 261
Merton’s Rule, 6, 7t
MetroPCS, 319
Meyer, Frank, 290
minimum acceptable return (MAR), 32
mispricing: exploited by high-frequency traders, 155; in flash crash of 2010, 157; persistence of, 41–42; statistical arbitrage and, 134, 135. See also arbitrage
modified duration, 180, 181, 244, 246, 251, 253, 254, 255
Modigliani, Franco, 263
Modigliani–Miller Theorem, 6, 7t
momentum investing, 14–16, 138–39; Asness on, 15t, 158–59, 161, 162; initial underreaction/delayed overreaction and, 41, 139; quant portfolio construction and, 144; Scholes on, 266–67; value performance compared to, 138, 138f, 158. See also time series momentum strategies; trend-following investing
momentum/value investing, 139; Asness on, 161, 162; global, 196–99, 198f; quant equity performance during 2008, 149; quant event of 2007 and, 146, 146f, 148
momentum/value/quality investing, 140
monetary policy, 6, 7t. See also central banks; exchange rates; interest rates
monetary transmission mechanism, 248
money management, market for, 3n3, 4–5
mortgage-backed securities, 261; commercial, 261; credit returns of, 180n. See also subprime credit crisis
mortgage basis trade, 261
mortgage bonds, market for, 241
mortgage pools, 261, 321–22
mortgage refinancing waves, 265–66
mortgage servicers, 266
mortgage trading, 13, 241, 261; Scholes on, 265–66
municipal bond spreads, 262
mutual funds: active, discretionary equity investing by, 96; difference between hedge funds and, 8; hardly beating the market, 4; management fees of, 21; market index as benchmark of, 21, 22; required to report geometric averages, 32n; trading skill in, 23
NASDAQ, crises affecting, 157
natural convergence time, 235
natural rate of unemployment (NAIRU), 189n
neoclassical finance and economics, 6, 7t
NeoStar, 113
net asset value (NAV), 74–75, 76f
net income (NI), 92; earnings yield and, 178–79, 178n6
net leverage, 74
no-arbitrage condition, 234
noise trader risk, 41, 42
Nokia, 115
non-solicitation requirement, for hedge funds, 20
Norges Bank Investment Management, 167
Ogden Corporation, 202
Okun’s law, 189n
on-the-run versus off-the-run Treasuries, 13, 241, 257, 258f, 259
opportunity cost, of trading pattern, 71–72
options: American-type, 235, 237n, 276; arbitrage pricing of, 235–40; basic concept of, 235–36; binomial model of, 236–38, 237f, 237n; Black–Scholes–Merton formula for, 7t, 238–40, 262, 263, 270, 272, 288; on bond futures, 262; convertible bond pricing and, 270, 272; demand-based pricing of, 46, 240; embedded, 180n, 263, 281; exchange-traded, 80; interest-rate related, 241, 262; in-the-money versus out-of-the-money, 58, 235–36, 239; leverage embedded in, 236, 240; markets for, 241; risk associated with, 236. See also derivatives
order flow, trading on, 107
out-of-sample backtests, 50, 53
output gap, 189, 189n, 190
output of a country, 192–93, 193f
overheated economy, 191, 191t; demand shocks and, 196
overreaction/underreaction, ix, 41, 139, 209, 210–12, 210f
overstated earnings, 115
over-the-counter (OTC) markets: dealers in, 25; derivatives in, 80; market makers’ withdrawal during crises affecting, 157; transaction costs in, 65, 66f, 67
overvaluation of stock prices, 119–21. See also bubbles
pairs trading, 152
parity conversion value, 269
par value, of convertible bond, 269
passive asset allocation, 169
Index

passive investing, vii
Paulson, John A., viii; “greatest trade ever,” 2, 292, 313, 320–22; interview with, 313–22; on merger arbitrage, 2, 15t, 16, 296, 314–16; Soros’s influence on, 206, 320, 321 Paulson & Co. Inc., 313 payout ratio, and quality investing, 100, 104 PBs. See prime brokers (PBs) pegged currencies, 186–87, 190 pension funds: asset allocation by, 168, 169–70; demand pressure on bonds due to, 249, 252, 255; discretionary equity investing by, 96; Scholes on, 263, 265 performance attribution, 37–38 performance fee, 21–22, 38 performance measures, 27–38; adjusting for illiquidity and stale prices, 36–37; annualizing, 33–34; estimating, 32–33; gross versus net of transaction costs and fees, 38; introduction to, 27–29; risk–reward ratios, 29–32; time horizons and, 33–35, 33t. See also return; Sharpe ratio (SR) performance of hedge funds, 22–24 peso problem, 186–87 Phillips curve, 193 PIPEs (private investments in public equity), 291, 313 P&L. See profits and losses (P&L) Platinum Grove Asset Management, 262, 268 policy portfolio, 167, 168. See also strategic asset allocation political events: global macro developments and, 199–200; Soros on importance of, 204 portfolio, replicating, 234–35, 237, 239–40 portfolio construction, 54–57; Ainslie on, 110; Asness on, 113, 160; Chanos on, 131; components of, 167; in event-driven investment, 292; in fundamental quantitative investing, 144–45; industry-neutral, 144; in merger arbitrage, 303–4; in quantitative investing, 133. See also asset allocation portfolio insurance, trends and, 212 portfolio optimization, 56–57; Asness on, 164; Harding on, 229 portfolio rebalance rule, 47–48, 50. See also rebalancing of portfolio portfolio sort, as predictive regression, 51–53 position limits, 55, 60 post–earnings-announcement drift, 41 PPP. See purchasing power parity (PPP) predatory trading, 83–84 predictive regression, 50–53 preferred habitat theory, 249 present value model. See dividend discount model price. See market price price-dividend ratio, 176–78 price manipulation, 108, 123 price surplus, 178, 178n6, 179 price-to-book (P/B) value, 99, 104, 139; for overall market, 197 pricing period, of floating exchange ratio stock deal, 301, 302f prime brokers (PBs), 25f, 26; of cash instruments, 80; hedge fund balance sheet and, 76; margin call from, 79; of OTC derivatives, 80; predatory trading by, 84; profit earned by, 78–79 Prince, Chuck, 201 private equity, 293; illiquidity of investments in, 170. See also leveraged buyout (LBO) investors private investments in public equity (PIPEs), 291, 313 production function, 192 profitability: measures of, 101; quality investing and, 100, 101–2, 104 profits and losses (P&L): mark to market, 78; time horizon for observing, 33t, 34–35 profit sources, from trading strategies, 39–46, 40f proportional transaction costs, 65 “pump and dump” schemes, 107–8, 123 purchasing power parity (PPP), 182–83; trading based on, 197, 197n put-call parity, 236, 236n2 put options, 235–36; demand pressure for, 46, 240; implied volatilities of, 239. See also options qualified institutional buyers (QIBs), 270 quality at a reasonable price (QARP) investing, 100, 104, 140 quality investing, ix, 16, 100–104; Ainslie on, 108–9; value investing combined with, 16, 100, 103–5, 139–40 quant event of 2007, xii–xiii, 144, 145–49, 146f quantitative easing, 189 quantitative equity investing, viii, 10–11, 88, 133–35; advantages and disadvantages of, 133–34; Ainslie on incorporation of approaches from, 11, 110; Asness on, 162–64;
quantitative equity investing (continued)
types of, 134–35, 134t. See also fundamental quantitative investing; high-frequency trading; statistical arbitrage
quantitative global macro investing, 185
random walk hypothesis, 173
RAROC (risk-adjusted return on capital), 31–32
reactive risk management. See drawdown control
real assets, in strategic asset allocation, 168, 171
real bond yield, 197
real business cycles, 7t
real estate boom, 203
real estate investment trusts (REITs), 261
realized average return, 32
realized cost, 67, 68
reallocation. See tactical asset allocation
rebalancing of portfolio, 169–70; in managed futures strategy, 224, 224f, 225; in time series momentum strategy, 213; trading against trends, 211. See also portfolio rebalance rule
rebate rate, 79, 117
recall risk, 117–18
recovery rate in case of default, 260, 260n
redemption notice periods, 75
reflexivity, Soros on, 200–204, 202f, 206
regressions: estimating, 32–33; predictive, 50–53
Regulation FD (Fair Disclosure), 129
relative valuation, 93
relative-value trades, 8; across asset classes, 261; on cross-country interest rate differences, 250; Griffin on, 287; mortgage-related, 261; on volatility, 262. See also arbitrage
Renaissance Technologies, 23
replicating portfolio, 234–35, 237, 239–40
repo (repurchase agreement), 80
repo lenders, 76
repo rate, 80, 245–46, 245f, 248; general collateral (GC), 245, 245f; interest-rate swaps and, 259–60
required rate of return (discount rate), 89–90, 100, 102
residual income (RI), 92–93
residual income model, 92–93, 92n, 97
residual reversal strategies, 153
return, 27–29; Chanos on shorting opportunities and, 128; of highly shorted stocks, 121; of major asset classes, 176–83. See also performance measures
return drivers of investment styles, ix
returns of hedge funds, 22–24. See also performance measures
reversal strategies, 152–53; Asness on, 158, 159
RI (residual income), 92–93
Ricardian equivalence, 7t
Ricardo, David, 208
risk: measurement of, 57–59; Soros on, 204, 206–7. See also liquidity risk; market exposure (beta risk); value-at-risk (VaR); volatility
risk-adjusted alpha, 30
risk-adjusted return, 29–31. See also Sharpe ratio (SR)
risk-adjusted return on capital (RAROC), 31–32
risk arbitrage, 14, 314. See also merger arbitrage
risk aversion coefficient, 56, 171
risk-based asset allocation, 170–71
risk-free interest rate: bond prices and, 241; bond yields and, 248–49; return of a trading strategy and, 27–28
risk limits, 59–60
risk management, 54; drawdown control in, 54, 59, 60–62, 225; in line with trends, 212; in managed futures investing, 225; versus predatory trading, 84; prospective, 59–60; trader’s emotions and, 61
risk neutral probability, 238
risk parity investing, 16, 45, 171
risk premium: Asness on successful strategies and, 164; bond yield and, 248–49; carry trading and, ix; corporate credit and, 168, 260; inflation and, 196; leverage and, ix; liquidity-adjusted CAPM and, 43; option value and, 238; strategic asset allocation and, 168; value investing and, ix. See also equity risk premium; liquidity risk premium
risk–reward ratios, 29–32; Soros on, 206–7
Robertson, Julian, 1, 108
roll-down return, 180, 255–56, 256f
Rubin, Robert, 313–14
Sabre Fund Management, 226
safety: margin of, in value investing, 89, 98–99, 98f; quality investing and, 100, 102, 104
Salomon Brothers, 262, 263, 268
Scholes, Myron, vii, 2, 15t, 16; interview with, 262–68
sector rotation, 98
Securities and Exchange Commission (SEC):
convertible bonds and, 270; count of hedge funds in 1968, 20; Enron and, 125;
firms having enforcement actions by, 121, 122–23; flash crash of 2010 and, 156–57;
Market Break of May 1962 and, 157
securities lender (sec-lender), 79
security market line (SML), 140–41, 140f, 141n
security selection, 167–68; cross-sectional regression strategy for, 51, 52–53; global
tactical asset allocation and, 176
self-financing trading strategy. See dynamic hedging strategy
sell-side quants, 88n
share buybacks or issuances, 312
share classes, arbitrage trading on, 150–51, 150f
shareholder lawsuits, short interest in firms having, 121
shareholder value, 102; Ainslie on, 108. See also dividends
Sharpe ratio (SR), 29, 30–31; annualizing, 34;
of betting against beta portfolios, 141–42, 142f, 143f, 144; of carry trades, 188, 188t;
of global value and momentum trades, 198, 198f; of high-minus-low (HML) factor, 137;
in low-risk investing, 141, 142, 142f, 143f;
of managed futures funds and indices, 221, 222t; market timing strategy and, 175;
of merger arbitrage, 305; portfolio risk and, 171; rebalancing a portfolio according to, 48;
of security selection strategy, 52–53; of short-term bonds, 249n; Sortino ratio compared to, 32; time horizon and, 33, 33t, 34;
of time series momentum strategies, 209, 214, 214–17f, 218, 218t, 219, 223, 224; of Warren Buffett, 104–5, 160
Shiller, Robert, 3, 179
shocks: to capital flows and trade flows, 199;
Scholes on, 268; supply and demand, 5, 194–96, 195f, 195t
short-selling: Ainslie on, 109–10; banned for financial stocks during some crises, 117, 123–24; basic concept of, 10; benefits of, 123–24; in convertible bond arbitrage, 270, 277, 283; creating a catalyst for,
short squeezes, 118; predatory trading and, 84
Siamese twin stocks, 6, 149–50, 149f
side pockets, 75
size risk, 29
Skilling, Jeff, 127
small-minus-big (SMB) factor, 29
smile, of time series momentum, 220–21, 220f
smirk, of implied volatility, 239
SML (security market line), 140–41, 140f, 141n
SoftBank, 318, 319
Soros, George, viii, 1, 11, 13, 15–16, 15t;
famous trade by, shorting the pound, viii, 1, 187, 204, 320; on going for the jugular, 11–12, 321; Internet bubble and, 41, 203, 206; interview with, 204–7; Paulson’s learning from, 206, 320, 321; Scholes on, 264; theory developed by, 15t, 200–204
Soros Fund Management, 204
Sortino ratio, 32
sovereign bonds, 260
sovereign credit risk, 200
sovereign wealth funds, 96, 167
specialness, 245–46, 245f
special purpose acquisition companies (SPACs), 313
special security structures, 313
spin-offs, 14, 291, 307–9, 308f; Paulson on, 314, 316
split-offs, 14, 307–9, 308f
spreads: widening during periods of stress, 267–68. See also bid–ask spreads; credit spread; deal spread in merger arbitrage spread trades, Scholes on, 264, 265
Sprint, 318, 319
SR. See Sharpe ratio (SR)
stagflation, 191t, 192; supply shocks and, 196
stale prices, 36–37
standard deviation (σ): annualized, 34; estimating, 33; of excess return (volatility), 30, 57–58; in risk–reward ratios, 29–32. See also volatility
Standard & Poor’s 500 (S&P 500): flash crash of 2010 and, 155, 156f, 157; mutual funds benchmarked to, 21; versus time series momentum strategy, 219, 219f, 220, 220f; trades related to inclusion in or exclusion from, 292
Standard & Poor’s GSCI index, 46; versus time series momentum strategy, 220
statistical arbitrage (stat arb), 10, 16, 134, 134t, 135, 149–53; Asness on, 158; quant event of 2007 and, 146
stock indices: commodity trading advisors trading in, 228; excess demand for put options on, 240; price change around inclusion or deletion date and, 313. See also Standard & Poor’s 500 (S&P 500)
stock market crash of 1987: Griffin on, 288; withdrawal of market makers during, 157
stocks: arbitrage trading on share classes, 150–51, 150f; capital structure arbitrage and, 261, 312; economic environment and, 191–92; leverage for, 80; Soros on rebound after crisis abates, 204; twin stocks, 6, 149–50, 149f, 151, 152f, 235. See also “equity” entries
stock selection strategies. See equity strategies stop-loss orders: predatory trading and, 84; trends and, 212
strategic asset allocation, 167, 168–72; trading against trends, 211
strategic risk target, 60
strategies of hedge funds. See hedge fund strategies
stress loss, 59
stress tests, 32, 59; margin requirements and, 77
strike price, 235–36
structured credit, 262
stub, 309–11, 310t, 310f
style drift, 72, 73f
styles of investment, ix, 2, 14–16. See also specific styles
subprime credit crisis, xii; “greatest trade ever” in, 2, 292, 313, 320–22; ripple effects on banks and hedge funds, 145; spreading to other markets, 83, 84f. See also global financial crisis of 2007–2009
subsidiaries. See carve-outs; spin-offs; split-offs
supply shocks, 5, 194–96, 195t; as catalyst of trend, 210 survivalist bias, 23
suspending redemptions, 75
swap contracts, margin requirements for, 80
swap rate, 259
swaps. See credit default swaps (CDSs); interest-rate swaps
swap spreads, 13, 241, 259–60
swap spread tighter, 259–60
swaptions, 241, 262
systematic global tactical asset allocation funds, 185
systematic macro hedge funds, 185
systematic risk. See beta
tactical asset allocation, 167, 175–76; global macro funds using, 176, 185. See also market timing strategy
tactical risk target, 60
tail hedging: commodity trading advisors and, 228; via options, 59
takeovers, 14; convertible bonds and, 283, 285–86. See also merger arbitrage
Taylor principle, 189
Taylor rule, 7t, 189–90, 189n, 191, 194; monetary easing and, 195
technology bubble. See Internet bubble of late 1990s
telecom mergers, 318–19
term loan, 118
term premium, 168, 249, 249n
terms of trade, 199
term structure of interest rates, 242–43, 243f, 250; trading on the curvature of, 251–55, 252f, 253f, 254f; trading on the level of, 250; trading on the slope of, 250–51. See also yield curve
TFP (total factor productivity), 192
thematic global macro traders, 12, 200
theta, 280, 280f
Tiger Cub funds, 108
Tiger Management Corporation, 1, 108
time decay, in convertible bond arbitrage, 280, 280f
time lags, in backtesting, 47
time series momentum strategies, 209–10; margin requirements for, 225; position sizing in, 213, 213n, 214, 219–20, 225; single-assets example (1985 to 2012), 212–14, 214–17f. See also managed futures investing
time series momentum strategies, diversified: example of (1985 to 2012), 214, 218–19,
218t; explanation of returns from, 219–21, 220f; hypothetical fee for, 223, 224; managed futures fund returns and, 221, 222t, 223; versus S&P 500, 219, 219f, 220, 220f
time series regression, 51–52, 53
TIPS (Treasury inflation-protected securities), 192
T-Mobile, 319
total factor productivity (TFP), 192
tracking error, 22, 30
tracking error risk, 30
track record of hedge fund, 38
trading rules: broad classes of, 47–48; defined, 47; implementation costs and, 64
trading signals, 47; multivariate regression on, 51, 53
trading strategies. See hedge fund strategies
transaction costs, 63–64; adjusting backtests for, 50; of arbitrage trades, 235; Asness on, 160, 163; estimating expected values of, 69–70; implementation shortfall and, 70–72; liquidity of securities and, 63; of managed futures strategies, 224–25; market liquidity risk and, 42–45, 63; as market makers’ profit, 154; measuring, 67–69; optimal trading in light of, 64–67, 66f; in portfolio optimization, 57; reduced by short-selling, 123; sources of, 63
“Travolta” collar deal, 302, 302f
Treasury bonds: hedging interest-rate risk with, 283; on-the-run versus off-the-run, 13, 241, 257, 258f, 259; swaps and, 259, 260. See also government bonds
Treasury inflation-protected securities (TIPS), 192
trend-following investing, ix, 12–13, 15t, 16, 208–10; Harding on, 226, 227–28, 229; initial underreaction/delayed overreaction and, ix, 41, 209, 210–12, 210f; rationale underlying, 210–12, 210f; Scholes on, 266, 267. See also commodity trading advisors (CTAs); managed futures investing; time series momentum strategies
r-statistic: of alpha estimate, 28–29; of alpha for time series momentum strategies, 218t, 219; security selection strategy and, 52–53
twin stocks, 6, 149–50, 149f, 151, 152f, 235
Two-Fund Separation Theorem, 6, 7t
uncovered interest rate parity (UIP), 182n, 185
underlying of a derivative, 235
underreaction/overreaction, ix, 41, 139, 209, 210–12, 210f
unemployment: aggregate supply and, 193; Federal Reserve policy and, 189–90; natural rate of (NAIRU), 189n; supply shocks and, 196
Unilever, 149–50, 149f, 151, 152f, 235
valuation. See arbitrage pricing; convertible bonds: valuation of; equity valuation; intrinsic value
value-at-risk (VaR), 58–59; drawdown control and, 60–61; economic capital and, 32; margin requirements and, 77
value investing, ix, 9, 14–16, 15t, 88–89, 96–99; Asness on, 15t, 158, 161, 162, 163; deep value investors and, 99, 103; efficiently inefficient equity market and, 88–89; fundamental analysis in, 97–98; in global markets, 196–99, 198f; holding periods in, 105–6, 111–12; margin of safety in, 89, 98–99, 98f; negative-feedback trading as form of, 16; quality investing combined with, 16, 100, 103–5, 139–40; quant event of 2007 and, 145–46, 146f, 147–48; quantitative, 136–38, 137f, 144; 60/40 portfolio and, 169–70. See also Buffett, Warren; intrinsic value; momentum/value investing
value risk, 29
value trap, 99
variance: annualized, 34; estimation of, 33
Verizon, 319
volatility: of Berkshire Hathaway, 105; of bond yields, 251; of deviation from benchmark, 22; directional trades on, 262; implied, 239, 262; option prices and, 239; position sizes in time series momentum strategies and, 213, 213n, 214, 219–20, 225; quality and, 102; relative-value trades on, 262; as risk measure, 57–58, 59; Soros on, 204; of stock price underlying convertible bonds, 280–81, 282; strategic risk target measured as, 60. See also standard deviation (σ)
volatility trades, fixed-income, 241, 262
Volcker, Paul, 206
Volcker Rule, 314
volume-weighted average price (VWAP), 67, 68–69
Waddell & Reed Financial, Inc., 155, 156f
warrant, 269
Weil, Jonathan, 124
Whitehead, John, 313
Winton Capital Management, 225
Wood Mackenzie, 225

yield curve, 242–43, 243f; bond returns and, 245f (see also bond returns); hedging the risk of parallel moves in, 246; in overheated economy, 191; preferred habitat theory of, 249; Scholes on segmented clienteles concerned with, 263; speculating on the slope of, 190. See also bond yields; term structure of interest rates yield-curve carry trade, 187
yield curve trading, 13, 241, 264–65
yield to maturity (YTM), 179–80, 242, 243f; of corporate bond, 260; determinants of, 248–49; of swap, 259. See also yield curve
zero-coupon bond yields, 242–43, 244, 247