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# PAAMCO Perspectives

## How Macro is Your Event?

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Many institutional investors allocating to "event-driven" strategies are getting more "macro" exposure than they may have anticipated. Of course, the world has been rather macro-driven lately, which is a contributing factor. However the trend is also due to substantial style-drift, particularly at larger hedge funds (and in the long-only world). Should investors care?

*Should investors care that their allocations to event-driven strategies have more macro exposure than they may think?*

**Purist Event-Driven Investing**

Let's take hedge funds as an example. The event-driven strategy is an important component of most investment programs: about 25% of hedge fund industry assets are consistently allocated to the style, according to data from Hedge Fund Research.[1] This consistency in allocations reflects the strategy's ability to create alpha at multiple points in the economic cycle.

In its pure form, event-driven investing aims to isolate and profit from idiosyncratic events happening to specific corporate entities (i.e., companies). Examples of events include mergers, acquisitions, bankruptcies, recapitalizations, spin-offs, asset sales, leadership transitions, litigation and regulatory changes. These events may cause changes or dislocations in security prices that may be profitably exploited regardless of what happens in the broader financial markets (assuming those markets don't structurally fail as last happened in late 2008). This independence from most market risk factors is a key selling point and event-driven funds should therefore focus on getting the corporate (i.e., micro-economic) fundamentals right. In other words, bottom-up thinking should drive the P&L of an event-driven fund, not top down macro-economic calls (e.g., on broad equity markets, interest rates, currencies or commodities). This focus may work well in the long run, particularly given how costly macro bets can be especially if you are unlucky enough to mistime them.

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While event-driven funds could never afford to ignore macro drivers of markets, the historical norm has generally been to be "macro aware," not "macro obsessed" and to depend on quality fundamental research for one's edge. Similarly, while some hedge fund managers may have stretched the definition of an "event" to include almost any macro or micro occurrence, traditionally the search for market diversification has required that events be confined to idiosyncratic corporate changes. In other words, most managers appreciated how macro could affect their holdings, but the majority of their P&L was expected to come from micro, not macro. This has evolved in the past four or so years, with more event-driven funds placing increasingly large macro-driven bets. One consequence of this is increased correlation in returns between the two strategies: for example 24-month rolling correlations between the Dow Jones Credit Suisse Global Macro and Event-Driven indices have risen from about 0.4 historically to about 0.6 more recently.[2,4]

**Composition of Event-Driven Portfolios**

It is interesting to look at what is going on inside these funds. Using public regulatory filings for the first three quarters of 2011[3] and focusing on a basket of larger event-driven funds represented here by the components of the Dow Jones Credit Suisse Event-Driven index, we can look-through to selected[3] aggregated exposures of this event hedge fund group.

The largest long position in these event-driven funds held in aggregate is gold (via gold SPDRs) and this holds true for all three quarters. Other top positions among the event funds analyzed include several energy names (notably linked to oil, e.g., Transocean and Anadarko), mining names (more gold e.g., AngloGold Ashanti) and financial names (macro crisis related, e.g., Citigroup, Bank of America, Hartford Financial). These themes are remarkably static throughout 2011; in other words, the macro biases and the overweight to certain sectors appear consistent and sizeable. Although the analysis of regulatory filings does not shed light on the short side, based on our internal analysis of what we consider representative event-driven managers, we concluded that macro themes were also prominent shorts (e.g., shorting financials as well as sovereign credits through cash or synthetic instruments such as credit default swaps).

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Event-driven indices such as the Dow Jones Credit Suisse Event-Driven referred to above cannot be perfectly representative of the event-driven strategy. However, because many investors use such indices as benchmarks for their event-driven investments and focus on larger event-driven managers (with AUM above $1.5bn such as those dominating these indices), we believe it is likely that several of these macro trades are in any given investor's portfolio.

**Why It's Happening**

With the integration of global economies and various political and resource tussles, the influence of macro happenings is significant. Clearly the level of interest rates can affect companies' ability to seek financing which in turn impacts distress or expansion rates. High demand for commodities and precious metals has knock-on effects on the value chain for companies operating in those sectors and beyond. The currency intervention that governments (both developed and emerging) engage in may create winners and losers in the corporate landscape, as will political shifts such as the Euro crisis, or the upcoming elections in several G10 countries.

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There are also two somewhat less palatable reasons behind this shift to more macro. First, as hedge fund managers get larger (in Q3 2011, 90% of net inflows into hedge funds were into funds above $5 billion of AUM, according to HFR[1]), managers may struggle to find trades with sufficient investment capacity to meet their investment needs. Many of the most alpha-rich corporate event trades are in limited supply: unlike with very deep macro markets, there are only so many dollars outstanding in a particular company's capital structure to go around. Second, many hedge fund portfolio managers have a substantial amount of their liquid high net worth invested in their funds. This is clearly a positive for incentive alignment, however to the extent the manager feels the need for inflation protection (e.g., gold, commodities) or simply has strong conviction in any given macro trade, they may be tempted to shift the event-driven fund's focus to be more macro-driven than would optimally be the case for the majority of their investors.

**Why Investors Should Care**

Investors should question what the event-driven manager's edge is in placing macro bets. We believe most managers are ill-equipped to monetize macro views with the possible exception of those investing in event-driven as part of a multi-strategy approach. Few have any edge in predicting monetary or other governmental policies. Equally few are able to capitalize promptly on existing macro trends, due to the amount of detailed and specific one-off research that event-driven managers should perform on each company prior to investment. In other words, while macro dislocations frequently provide opportunities (2002, September to October 2008, May 2010, August to September 2011 for example), the true and replicable edge of the event-driven style is generally in the fundamentals-based selection of the right securities at the right companies to capitalize on these macro trends. For this reason some managers (especially smaller ones) choose to execute macro ideas exclusively in a hedging context.

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From a risk management standpoint, monitoring a macro-heavy portfolio may be different than monitoring a purely event-driven one. A portfolio with several large macro trades may be more liquid, more levered and more volatile than an aggregation of bottom-up idiosyncratic trades using corporate securities. This has investment as well as operational and legal due diligence implications. Investors need to understand all of these characteristic differences. There is no substitute to

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knowing and analyzing the actual positions in the portfolio or to performing thorough and tailored operational due diligence.

Fees are also an important consideration. On a per dollar basis (i.e., per dollar invested), macro research arguably appears cheaper than idiosyncratic event-driven research, given that larger amounts of capital can be applied per macro idea (and applied more quickly) as compared to an event-driven one. Does it make sense to pay an event-driven hedge fund manager their full fee to put on a long gold position when the same exposure could be obtained more cheaply outside of the hedge fund structure? It's true that much of the value added by a good macro hedge fund manager lies in their timing skill, but how good does this timing skill have to be to justify the higher fee structure? In other words, while a strong manager may be very valuable, ask yourself this: what exactly are you paying for?

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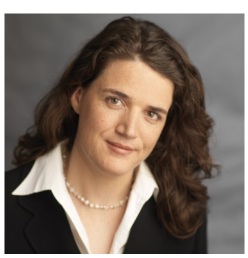
There are important differences between assessing event-driven and macro money managers (e.g., skill set, research process, risk management, fees, etc.), and there is undeniably value in both. If investors can understand the nuances between the two and the overlap with the rest of their portfolio, then they will be better equipped to answer "How Macro is my Event?" and may avoid surprises such as macro-related draw-downs.



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**ENDNOTES**

[1] Hedge Fund Research Global Hedge Fund Industry Report Q3 2011.

[2] Analysis based on monthly returns for the Dow Jones Credit Suisse Event-Driven and Global Macro indices since inception in January 1994 up to September 2011. 24-month return correlations started breaking out of historical ranges in 2007 and have remained elevated since then.

[3] Analysis based on SEC filings that were available for managers in the Dow Jones Credit Suisse Event-Driven Index for the quarters ending March 31, 2011, June 30, 2011 and September 30, 2011. These 13F filings are required to be filed by institutional investment managers (US and non-US) with investment discretion over $100m or more of "13F securities". The definition of 13F securities currently includes long (not short) equity and equity-linked positions in securities listed on US exchanges or the NASDAQ as well as certain equity derivatives and convertible securities. These filings must be filed within 45 days after each quarter end.

Specific securities presented do not represent investment recommendations of PAAMCO, and may or may not be held in the hedge fund portfolios in which PAAMCO funds invest. In the event such securities are or have been held by such hedge fund portfolios, the specific securities identified are not representative of all of the securities in PAAMCO's event-driven portfolio funds, and it should not be assumed that the investment in the securities identified was or will be profitable.

[4] The Dow Jones Credit Suisse Event-Driven Index was chosen to be representative of established and widely held event-driven hedge funds. The index is capitalization (AUM) weighted and therefore larger component funds will have an outsized impact on positions held in aggregate. Analysis using the HFR Event-Driven index would yield similar results.

The Dow Jones Credit Suisse Event-Driven Hedge Fund Index is a subset of the Dow Jones Credit Suisse Hedge Fund Index that measures the aggregate performance of event-driven funds. Event-driven funds typically invest in various asset classes and seek to profit from potential mispricing of securities related to a specific corporate or market event. Such events can include: mergers, bankruptcies, financial or operational stress, restructurings, asset sales, recapitalizations, spin-offs, litigation, regulatory and legislative changes as well as other types of corporate events. Event-driven funds can invest in equities, fixed income instruments (investment grade, high yield, bank debt, convertible debt and distressed), options and various other derivatives. Many event-driven fund managers use a combination of strategies and adjust exposures based on the opportunity sets in each subsector.

The Dow Jones Credit Suisse Global Macro Hedge Fund Index is a subset of the Dow Jones Credit Suisse Hedge Fund Index that measures the aggregate performance of global macro funds. Global macro funds typically focus on identifying extreme price valuations and leverage is often applied on the anticipated price movements in equity, currency, interest rate and commodity markets. Managers typically employ a top-down global approach to concentrate on forecasting how political trends and global macroeconomic events affect the valuation of financial instruments. Profits can be made by correctly anticipating price movements in global markets and having the flexibility to use a broad investment mandate, with the ability to hold positions in practically any market with any instrument. These approaches may be systematic trend following models, or discretionary.

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