The Use of Exchange Traded Funds By Hedge Funds

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Assessing and Isolating Risk

Cash
  Currency Risk, Opportunity Risk

Fixed Income
  Duration Risk, Credit Risk, Interest Rate Risk

Equities
  Market Risk, Company Risk, Industry Risk

Hard Assets
  Liquidity Risk, Financing Risk, Tax Risk
Risk Isolation Techniques

- Market neutral / Pairs trading
- Macroeconomic
- Derivatives / Delta management
- Volatility / Beta management
- Tax management
Pairs Trading with ETFs: Bonds

Single-A Corporate Bond Spreads Over 10-Year Treasuries

Using ETF’s to isolate credit risk and to anticipate bond spreads narrowing:

Bought LQD, Short IEF

Sold LQD, Cover IEF

LQD: iShares Goldman Sachs InvesTop Corporate Bond Fund
IEF: iShares Lehman 7-10 Year Treasury Bond Fund
Pairs Trading with ETFs: Equity

Nvidia Corp., Oct - June, 2001

Nvidia Corp. rallies into Microsoft Xbox release

Using ETF’s to isolate company risk:
Long NVDA, Short SMH

Semiconductor HOLDRs, Oct - June, 2001

+43.44% Gain

SMH: Semiconductor HOLDR
Macroeconomic Trades Using ETFs

10 Year Treasury Yield
July 24th, 2002, 30 Min.

Asset Allocation Program
Sell Bonds to Buy Stocks
Using ETF’s to isolate macro risk:
Short IEF, Long SPY

Bonds get sold...

S&P 500
July 24th, 2002, 30 Min.

...to buy stocks

IEF: iShares 7-10 Yr T-Bond Fund
SPY: S&P 500 ETF
Delta Management with ETF's

Isolating volatility risk by buying puts and buying SPY.

Example: Purchase 100 SPX 840 Puts @ 35.90
Delta = 0.481 so put contract will move $0.48 for every 1 SPX point
For every 1 contract, must buy 481 SPY.
In order to hedge 100 puts, must currently buy 48,100 SPY
Manage delta as SPX moves and delta changes.
Beta Management with ETF’s

Using ETF’s to manage the portfolio’s beta

Monthly return expectation for buy and hold approach would be approximately 0.8% with an almost normal distribution.

Mean = 0.8%

Frequency Distribution of Monthly SPX Returns

Mean = 0.8%

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Absolute Value of Monthly Returns

Monthly return expectation capturing the absolute value of each month’s return is 3.5% with a skewed distribution.

Mean = 3.5%
Capturing The Absolute Value

Rolling Twelve Month Total Absolute Value of SPX Monthly Returns

Capturing the absolute value of each month’s return would currently result in a 71% return over the last twelve months.
In July, IWM was highly correlated with portfolio’s long exposure. Since the Russell 2000 was down in July, we traded IWM from the short side as a hedge.
Tax Management with ETFs

Situation:

- Client sold family business to ESOP plan of a public company in a 1042 Rollover transaction.
- Deferred capital gains tax if a qualified replacement asset is purchased.
- Qualified assets, in this case, were securities of domestic public companies.
- Client Concerns: Tax Deferral, Capital Preservation, Income
**Tax Management with ETFs**

Possible Solutions:

- Buy long term floating rate notes.
- Buy non-callable long-term corporate bonds and hedge interest rate risk with Fixed Income ETFs.