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Finance 630: MSF Capstone Course

Hedge Funds (& Other Vehicles): Structure & Strategies

Term: *Spring Quarter 2015*

Location & Time: *Saturdays from 10:00 am – 1:00 pm in Corboy #421 (25 E. Pearson)*

Prerequisite: *6 courses in finance*

Course Description

This course is designed to help MSF students connect most major areas of finance, synthesize knowledge acquired in earlier finance courses, and apply them to an area that they are perhaps less familiar with but is of extreme importance in modern finance: hedge funds. After an introduction to the hedge fund industry, we will delve deeply into various hedge fund strategies including convertible arbitrage, risk arbitrage, and hedge fund activism. We will also focus on what distinguishes hedge funds from other investment vehicles: short-selling, leverage, and the use of alternative asset classes like derivatives. As such, the course will re-enforce concepts from corporate finance, risk management, and asset management, for students focusing in those areas, and necessarily expose students focusing in one area (e.g., risk management) to other areas (e.g., corporate finance & asset management).

Nature of the Course

This is a quantitatively-oriented course with many opportunities to work on problem sets and class examples. The course will combine some lectures with lots of discussions and hands on analysis. We will go through many real-world cases that showcase different hedge fund strategies and organizational issues. Some of these cases will be used as examples for learning purposes, some will serve as the basis for a moderate level of quantitative analysis, and others will require detailed student analysis with a sizeable quantitative component.

Course Objectives and Learning Outcomes

- 1) To synthesize the quantitative and financial skills developed in earlier classes and apply them to new learning situations
- 2) To develop students' critical thinking skills in the area of investment, risk management, and corporate financial strategy
- 3) To develop the ability to integrate knowledge from finance, economics, and mathematics/statistics
- 4) Students will learn the basics of hedge funds and related entities, as well as delve into detailed analysis of arbitrage and related strategies
- 5) Students will have the opportunity to simultaneously broaden their finance knowledge, as well as to deepen their understanding in their chosen area of interest
- 6) Outcomes will be assessed using homework, cases, class discussion, and a final exam

Required Materials

- 1) A Packet of Harvard Cases which can be purchased online at the following URL:
<https://cb.hbsp.harvard.edu/cbmp/access/35255000>
- 2) In addition to the case packet, I will post material on Sakai that you may be required to read

Course Requirements and Grading Criteria

Your grade will be computed and assigned according to the following formula:

1-pagers (4)	8%	90+	A
Case assignments (4)	16%	80-89	B
Cypress Case	10%	70-79	C
GGP or 130/30	20%	60-69	D
Participation	16%	Below 60	F
<u>Final Exam</u>	<u>30%</u>		
Total	100%		

Class Policies, Procedures, and Prerequisites:

1. There will be 4 *individual* case assignments (basically like homework) that you will be asked to turn in through the class page on Sakai. Solutions will be posted promptly on Sakai. Note: **NO LATE CASE ASSIGNMENTS WILL BE ACCEPTED, NO EXCEPTIONS.** The cases in this category are Green Mountain Coffee, Leman, Boston Properties, and Dynamis Fund, and will involve limited calculations. These will count a total of 16% of your grade (4% each). There will also be four other case assignments based on the cases Man Financial, ETF at Vanguard, and Opportunity Partners, as well as one additional case to be determined. In these cases, I will ask you to individually answer a few questions to insure that you've read the case prior to class. These will not involve calculations and will each count as 2% of your final grade, and will be used as in-class examples.
2. Note: this is a very advanced course. I will assume that all students are very familiar with portfolio mathematics & statistics, bond mathematics, derivative securities (especially options and forwards), as well as basic tenets from corporate finance (M&A, restructuring, free cash flow valuation, multiples valuation, etc.). I will try to briefly review these when I use them, but can't afford to spend a lot of time on these topics.
3. Be aware that once you've taken the final exam, the class is over. No one will be allowed to retake tests and no incompletes will be granted at that point. During the course of the quarter, students wishing incompletes will be considered on an individual basis, though it is unlikely an incomplete will be granted without extenuating circumstances that warrant such an outcome.
4. **Participation:** You will learn a lot more - and the class will be much more interesting -if you have read the day's material before class, *especially when we are discussing a case.* Hopefully there will be days when the class is more discussion oriented. For an added incentive, participation will be 16% of your grade. I take participation seriously. **Note: *This doesn't mean just showing up!***
5. **Cases:** In addition to the more moderate case assignments discussed in (1) above, for two cases, a) Cypress and Sun Power, and b) either Martingale Asset Management or General Growth Properties, your case group will be asked to do a detailed analysis and write up your thoughts and calculations in a paper *not exceeding 5 pages* (the first case (Cypress) is worth 10%, the second is worth 20%). Note: you will need to turn in using the "TurnItIn" facility on Blackboard.
6. **Group Work:** Note that your case write-ups are to be completed in groups. The groups should consist of 3-4 people. Try to self-select into groups where there are numerous common times that you can meet. You will have the opportunity at the end of the course to grade your fellow group members. Unless I get considerable feedback to the contrary, I will assume that all group members contributed equally to the group work and will give everyone the same grade. If there is a consensus that one or more group members either significantly out-performed or under-performed everyone else, I will adjust their grades accordingly. I will base these decisions on your evaluations of each other, but I reserve the right to make the ultimate call on how grades should be allocated.

7. Please get to class on time. Late arrivals are very disruptive. You are not allowed to come and go during the class (including during exams) so plan ahead. If you need to leave class early (or come late) for a particular reason please let me know in advance, and please sit in a location that limits disruption.
8. You will need a calculator for this course. I recommend a scientific calculator (a \$10 TI-30 will do just fine!), but business calculators are also fine (make sure it has exponentials and logs). **You will NOT be permitted to use cell phones as calculators. No exceptions.**

Academic Integrity

All members of the Quinlan School shall refrain from academic dishonesty and misconduct in all forms, including plagiarism, cheating, misrepresentation, fabrication, and falsehood...Plagiarism or cheating on the part of the student in individual or group academic work or in examination behavior will result minimally in the instructor assigning the grade of "F" for the assignment or examination. In addition, all instances of academic dishonesty must be reported to the chairperson of the department involved.

For further information about expectations for academic integrity and sanctions for violations, consult the complete Quinlan School of Business Honor Code and Statement of Academic Integrity on the Quinlan website:

<http://www.luc.edu/media/lucedu/quinlanschoolofbusiness/pdfs/Honor-Code-Quinlan-July2012.pdf>

Relevant References in the Academic Literature

Open-End Funds, Closed-End Funds, ETFs, and Hedge Funds

- (1) Agarwal, V., N. Boyson, and N. Naik, 2009, “**Hedge Funds For Retail Investors? An Examination of Hedged Mutual Funds**”, *Journal of Financial and Quantitative Analysis* 44, 273-305.
- (2) Stein, J., 2005, “**Why Are Most Funds Open-End?**”, *Quarterly Journal of Economics* 120, 247-272.
- (3) Whaley, R., 2013, “**Trading Volatility: At What Cost?**”, *Journal of Portfolio Management*, forthcoming.
- (4) Pontiff, J. 1996, “**Costly Arbitrage: Evidence From Closed-End Funds**”, *Quarterly Journal of Economics* 111, 1135-1151.
- (5) Petajisto, A., 2013, “**Inefficiencies in the Pricing of Exchange-Traded Funds**”, working paper, NYU.

Risk Arbitrage

- (6) Mitchell, Mark and Todd Pulvino. “**Characteristics of Risk and Return in Risk Arbitrage.**” *Journal of Finance* 56 (2001): 2135-2175.
- (7) Mitchell, Mark, Todd Pulvino and Erik Stafford. “**Limited Arbitrage in Equity Markets.**” *Journal of Finance* 57 (2002): 551-584.
- (8) Lamont, Owen and Richard Thaler. “**Can the Market Add and Subtract? Mispricing in Tech Stock Carveouts.**” *Journal of Political Economy* 111, no. 2 (2003): 227-268.
- (9) Brunnermeier, M. and L. Pedersen, 2009, “**Market Liquidity and Funding Liquidity**”, *Review of Financial Studies* 22, 2201-2238.
- (10) Mitchell, M., L. Pedersen, and T. Pulvino, 2007, “**Slow Moving Capital**”, *American Economic Review* 97, 215-220.

Hedge Funds and Fund-of-Funds

- (11) Brown, S., Goetzman, W., and B. Liang, 2004, “Fees on Fees in Funds of funds“, *Journal of Investment Management* 2, 39-56.
- (12) Frazzini, A. and L. Pedersen, 2014, “Betting Against Beta”, *Journal of Financial Economics*, forthcoming.
- (13) Agarwal, V. and N. Naik, 2004, “Risks and Portfolio Decisions Involving Hedge Funds”, *Review of Financial Studies* 17, 63-98.
- (14) Brunnermeier, M. and S. Nagel, 2004, “Hedge Funds and the Technology Bubble”, *Journal of Finance* 59, 2013-2040.
- (15) Fung, W. and D. Hsieh, 2004, “Hedge Fund Benchmarks: A Risk-Based Approach“, *Financial Analysts Journal* 60, 65-80.

Hedge Fund Activism

- (16) Becht, Marco, Julian Franks, Colin Mayer, and Stefano Rossi, 2009, “Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes UK Focus Fund”, *Review of Financial Studies* 22:8, 3093-3129.
- (17) Bradley, Michael, Alon Brav, Itay Goldstein, and Wei Jiang, 2010, “Activist Arbitrage: A Study of Open-ending Attempts of Closed-end Funds”, *Journal of Financial Economics*, 95:1, 1-19.
- (18) Brav, Alon, Wei Jiang, Frank Partnoy, and Randall Thomas, 2008, “Hedge Fund Activism, Corporate Governance, and Firm Performance”, *Journal of Finance* 63:4, 1729-1775.
- (19) Greenwood, Robin and Michael Schor, 2009, “Hedge Fund Investor Activism and Takeovers”, *Journal of Financial Economics* 92:3 362-375.
- (20) Klein, April and Emanuel Zur, 2009, “Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors”, *Journal of Finance* 64:1 187-229.

Tentative Syllabus

<u>Date</u>	<u>Topic</u>	<u>Reading Assignment</u>
2/21	Introduction & Hedge Fund Overview, Short-Selling, Leverage, Arbitrage	-Intro to Short-Selling
2/28	Funds vs. Funds of Funds Case: Man Financial Case: Green Mountain Coffee **** Green Mountain Assignment **** Man Financial 1-Pager	Case: Shorting Green Mountain Coffee Case: Man Financial Due **** Due ****
3/7	***** No Class: Spring Break *****	
3/14	Hedge Fund Fraud Risk/Event/Convertible Arbitrage **** Leman Assignment Due ****	-A Note on Risk Arb -Disclosure, Regulation & Taxation of Hedge Funds Case: Leman
3/21	ETF vs CEF vs OEF vs HFs Case: ETFs at Vanguard **** Boston Properties Assignment **** ETFs at Vanguard 1-Pager	Case: ETFs at Vanguard Due **** Due ****
3/28	Case: Cypress and Sun Power **** * Case Write-ups Due *** (In Class)	Cypress & Sun Power
4/4	***** No Class: Easter Holiday *****	
4/11	Activism/CEF Activism Case: Opportunity Partners **** Opportunity Partners 1-Pager	Case: Opportunity Partners Due ****
4/18	Long/Short Equity	Handout

<u>Date</u>	<u>Topic</u>	<u>Reading Assignment</u>
4/25	Case: Dynamis Fund	Case: Dynamis
	Guest Speaker: Phillip Torres, Founding Partner, Harbert Macro Fund (Tentative)	
	**** Dynamis Assignment	Due ****
5/2	Case: 130/30 Funds: Mutual Funds Move Towards Hedge Funds	Case: Martingale
	Case: General Growth Properties	Case: GGP
	**** Case Write-ups Due *****	(In Class)
	Either	a) Martingale + GGP 1-pager
	or	b) GGP + Martingale 1-pager
5/9	*****	Final Exam (comprehensive) *****

Please note: This class may occasionally deviate from the course outline above. I reserve the right to make minor changes as needed to the course syllabus, but I will try to minimize this and give advanced notice when possible.