

FIN 566

Alternative Investments: Hedge Funds & Private Equity

Instructors:	Lukas Kremens Assistant Professor of Finance
Contact Info	lkremens@uw.edu
Quarter	Spring 2020
Lecture times	Tuesday / Thursday 10:30am -12:20pm
Location	Zoom, Meeting ID 640-291-279
TA	George Nurisso
TA office hours	TBC

Course Description

What strategies do investors pursue to make returns in Alternative Investments? What are the risk profiles of these strategies and how do they fit into a broader portfolio? We will devote around half our time to Hedge Fund strategies and the other half to Private Equity.

The Hedge Fund portion of the course considers various strategies, such as Factor Investing, Carry Trades, Distressed Investing, and Merger Arbitrage. The PE part focuses on Leverage Buyouts and covers valuation techniques in the context of LBOs. We will draw a brief comparison between the investment environments of Private Equity and Venture Capital and what the differences imply for the investment process in each area. The course aims to provide students with valuable insights and skills for anyone wishing to work in Hedge Funds or Private Equity, or any institution investing in these asset classes.

Learning Objectives

Upon successful completion of the course, the students will be able to:

- Understand the risks and returns of several very different but common hedge fund strategies, and the economic mechanisms driving them
- Understand the structure and investment process of Private Equity funds
- Evaluate Private Equity investment opportunities.
- Draw distinctions between the Private Equity and Venture Capital investment environments and how those shape the respective investment processes.
- Evaluate how risk and return profiles of HF and PE strategies fit into a broader portfolio

Prerequisites

A general understanding of and interest in financial economics and investments. I will assume that you know the material covered in an introductory finance course. The overall focus of the course is qualitative rather than quantitative and relies on a conceptual understanding of the material rather than mathematical skill. The class is designed to be interactive, so the lectures (some more than others) will heavily rely on your insightful discussion of the topics at hand. This requires that you come to class prepared, that is,

having read and thought about the assigned readings. To guide your preparation, I will provide a few simple questions for each topic that you should think about answering while reading.

Office Hours

Please post questions regarding the material on the Canvas discussion board. Also feel free to discuss each other's questions there and propose answers. I will schedule a weekly office hour on Zoom during which I address those questions and your suggested answers. If you have questions you would rather discuss privately, please let me know via email.

Professionalism (not adapted to online classes)

Please refrain from use of phones during class. To get the most out of the lectures, read the assigned readings before class. Please be sure to display your name plate during class, be punctual to class, and be respectful of your fellow students. While I allow laptops, they are only to be used for classwork (and may be disallowed following use for unrelated purposes).

Form and Substance

Even though form without substance is meaningless, please remember that form still matters. You should prepare all graded materials in a form that meets professional standards.

Honor Code

I employ the principles and procedures espoused by Foster School of Business Honor System to maintain academic integrity in the course. The Honor Code of the Foster School expressly prohibits cheating, attempted cheating, plagiarism, and lying to administration or faculty as it pertains to academic work. Suspected violations of the Honor Code will be handled by referral of the matter to the Foster Honor Council.

Accommodations

Washington state law requires that UW develop a policy for accommodation of student absences or significant hardship due to reasons of faith or conscience, or for organized religious activities. The UW's policy, including more information about how to request an accommodation, is available at Religious Accommodations Policy (<https://registrar.washington.edu/staffandfaculty/religious-accommodations-policy/>). Accommodations must be requested within the first two weeks of this course using the Religious Accommodations Request form (<https://registrar.washington.edu/students/religious-accommodations-request/>).

Feedback

It is important to me to know about any concerns or questions you might have. I also appreciate any comments on the course, in particular about topics or readings that you find particularly helpful or not. Again, please feel free to stop by my office or send me an email if you would like to talk to me. The earlier you provide feedback, the more classes will remain for me to implement such feedback and improve your experience over the rest of the course.

Updates

As we go through the class, I may occasionally adjust the syllabus. Any changes will be mentioned in class and/or on Canvas.

Zoom

Meeting ID: 640-291-279. Before the first class, please register using the link below:

<https://washington.zoom.us/meeting/register/u5AtdeCprDwjBeBJXpK-7hI2tQaaRVibg>

Course Assignments and Course Grade

Reading

There is no assigned textbook. Reading assignment as indicated below for each class. Most readings will be accessible digitally through Canvas. Some classes will cover case studies published by Harvard Business Publishing. Information on how to purchase this part of the course pack will be provided on Canvas. Students are responsible for obtaining access to these materials. For readings marked with an **asterisk**, I do not expect you to read the whole article, but to understand the key message, findings, and takeaways, particularly in relation to the questions posted in the preceding class. Usually, this can be done with a careful reading (perhaps two) of the introduction.

Grading

As a faculty member, I want to make sure that I accurately assess what students have learned in my course as well as be able to stay within suggested Foster School median grade guidelines. Therefore, I grade on a curve. The “curve” refers to the bell-shaped curve in statistics which represents a normal distribution. This means most of the outcomes will be concentrated near the middle (the mean/median) with data points symmetrically distributed on either side. When calculating final grades, scores are often distributed in clear groups. I may shift grading standards slightly depending on how many scores appear in a particular grouping. If you have any concerns about your grade after a curve is in place, speak with me! I will be happy to sit with you and explain which adjustments were made and why.

The final grade will be based on the following:

- Midterm exam (35%): topics covered up to the midterm
- Final exam (50%): all topics covered in class
- Class presentation (15%): In groups of 4, you will choose an investment strategy to pitch to your peers and me during the last week of class. This can be a hedge fund strategy, a long-short stock pick, an LBO opportunity or other relevant investment proposal. You will form your own groups during the first weeks of class (I will assign members to groups that have not confirmed their group to me by the start of class 5).

Documented evidence that you were seriously ill at the scheduled time of an exam is the only valid excuse for missing an exam (final or midterm). In order to be excused from an exam, you must contact me prior to the exam and be ready to provide me with documentation after the exam.

Course Schedule (subject to change)

Each class will generally cover a different topic, but some topics may stretch across two classes, so please allow some flexibility in translating the below outline into a class schedule.

Part I: Hedge Funds

Topic 1 – Risk and Return

- Lecture: Risk, return, and the CAPM
- ✓ Readings: Provided on Canvas
 - *The Capital Asset Pricing Model*, A. Perold; JEP (2004),
 - *The Capital Asset Pricing Model: Theory and Evidence*, E. Fama & K. French; JEP (2004)

Topic 2 – Alpha versus Beta

- Lecture: Beyond the CAPM – Anomalies, Alpha, and Beta
- ✓ Readings: Provided on Canvas
 - *Value and Momentum Everywhere**, C. Asness, T. Moskowitz, L. Pedersen; JF (2013)
 - *Momentum Crashes**, K. Daniel & T. Moskowitz; JFE (2016)

Topic 3 – Risk Sharing: Hedge Funds as Insurers

- Case Study: Nephila – Innovation in Catastrophe Risk Insurance
- ✓ Readings: HBP Case Study, see Canvas for access

Topic 4 – Limits of Arbitrage

- Lecture: Lessons from Long-Term Capital Management
- ✓ Readings: Provided on Canvas
 - *Lessons from the Collapse of Hedge Fund LTCM*, D. Shirreff
 - *Risk Management Lessons from LTCM**, P. Jorion; EFM (2000)
 - *Risk and Return in Fixed-Income Arbitrage: Nickels in Front of a Steamroller?**, J. Duarte, F. Longstaff, F. Yu; RFS (2006)

Topic 5 – Distressed Investing: Sovereign Debt

- Lecture: Lessons from Argentina and Greece
- ✓ Readings: Provided on Canvas
 - *How Argentina Settled a Billion-Dollar Debt Dispute With HFs*; New York Times (2016)
 - *What the World Can Learn from Argentina's Holdout Saga*; VOX (2016)
 - *The Greek Debt Restructuring: An Autopsy*, J. Zettelmeyer, C. Trebesch, M. Gulati; (2013)
 - Optional: *Argentina Puts an End to Long Holdouts Saga*; Financial Times (2016)
 - Optional: *The Curious Case of Aurelius Capital v. Puerto Rico*; NYT Magazine (2019)
 - Optional: *How Sovereign is Sovereign Credit Risk?**, F. Longstaff et al ; AEJ (2011)

Topic 6 – Distressed Investing: Corporate Debt

- Case Study: Countrywide PLC
- ✓ Readings: HBP Case Study, see Canvas for access

Topic 7 – Merger Arbitrage

- Case Study: AT&T Canada
- ✓ Readings: HBP Case Study, see Canvas for access
 - *Characteristics of Risk and Return in Risk Arbitrage**, M. Mitchell & T. Pulvino; JF (2001)

Topic 8 – Midterm Exam

Part II: Private Equity

Topic 1 – Introduction to PE & LBO Valuation

- Lecture: Introduction to Buyout Funds – Structures, contracts, fees
- ✓ Readings: Provided on Canvas
 - *Leveraged Buyouts and Private Equity*, S. Kaplan & P. Strömberg; JEP (2009)

Topic 2 – Evaluating LBOs

- Lecture: A qualitative framework to assess LBOs
- ✓ Readings: Provided on Canvas
 - *Borrow Cheap, Buy High? The Determinants of Leverage and Pricing in Buyouts**, U. Axelson, T. Jenkinson, P. Strömberg, M. Weisbach; JF (2013)

Topic 3 – LBO I

- Case Study: Lion Capital and the Blackstone Group – The Orangina Deal
- ✓ Readings: HBP Case Study, see Canvas for access

Topic 4 – LBO II

- Case Study: Silver Lake, NASDAQ, and Instinet
- ✓ Readings: Provided on Canvas
 - *NASDAQ and Silver Lake to Buy Instinet*, Financial Times (2005)
 - *Silver Lake, Nasdaq and Instinet*, S. Kaplan, R. Jones; Chicago Booth Case Study (2012)

Topic 5 – Private Equity vs Venture Capital

- Lecture: Key differences between PE & VC and how they affect the investment process
- ✓ Readings: Provided on Canvas
 - *How do Venture Capitalists Make Decisions?**, P. Gompers, W. Gornall, S. Kaplan, I. Strebulaev; JFE (2019)
 - Optional: *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts**, S. Kaplan & P. Strömberg; RES (2009)

Topic 6 – Financial Contracts in VC

- Case Study: Metapath Software
- ✓ Readings: HBP Case Study, see Canvas for access

Topic 7 – Alternative Investments in the Portfolio

- Case Study: Yale University Investments Office
- ✓ Readings: HBP Case Study, see Canvas for access, also
 - *Private Equity Performance: Returns, Persistence, and Capital Flows**, S. Kaplan & A. Schoar; JF (2005)

Topic 8 – Class Presentations
