

# FIN 566

## Alternative Investments: Hedge Funds & Private Equity

Instructors:	Lukas Kremens Assistant Professor of Finance
Contact Info	lkremens@uw.edu
Quarter	Winter 2021
Lecture times	Thursday 6:00-9:30pm
Location	Zoom, details on Canvas
TA	Claire Xu
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 Quantitative Factor Investing, Distressed Investing, and Merger Arbitrage. The PE part focuses on Leveraged 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. **This course is qualitative** and relies on a conceptual understanding of the material rather than mathematical skill. As the range of topics is broad and the quarter is short, some students may benefit from prior exposure to other investments classes. However, I will provide background materials for some of the topics that are typically covered with more technical detail, as this may help some students with the more conceptual level targeted in 566.

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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. In exchange for thorough preparation for class discussion, there will not be any written weekly assignments.

### **Office Hours**

Please post questions regarding the material on the Canvas discussion board. These can be as vague as “I did not quite understand what you said about XYZ in yesterday’s lecture, could you elaborate on this?”. 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 there are no questions on the Canvas discussion board, I will assume that there is no need for an office hour. If you have questions you would rather discuss privately, feel free to email me directly.

### **Professionalism in an online class**

I expect everyone to attend the Zoom meetings on time, with your camera on. Ideally, you should attend the Zoom classes in a quiet environment to allow you to unmute and participate, and follow the discussion without unnecessary distraction. Name your Zoom account is appropriately (with your first and last name).

### **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.

### **FERPA**

This course is scheduled to run synchronously at your scheduled class time via Zoom. These Zoom class sessions will be recorded. The recording will capture the presenter’s audio, video and computer screen. Student audio and video will be recorded if they share their computer audio and video during the recorded session. The recordings will only be accessible to students enrolled in the course to review materials. These recordings will not be shared with or accessible to the public. The University and Zoom have FERPA-compliant agreements in place to protect the security and privacy of UW Zoom accounts. For more information about the University’s FERPA policy, please visit the Office of the University Registrar’s Page.

### **Learning Remotely in 2020-2021: Facts and Information**

The move to remote instruction in autumn/winter quarters 2020/21 is a way to protect the health of our community while mitigating the effects of the COVID-19 public health crisis on students’ academic progress. The Office of the Provost is providing answers to frequently asked questions at <https://www.washington.edu/coronavirus/autumnquarter/>.

### **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.

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## **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.

## **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 previous 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. This means most of the outcomes will be concentrated near the middle (the mean/median) with data points distributed roughly symmetrically 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 1-5, held in week 5, between topics 5 and 6.
  - Final exam (35%): topics 6-9, held in finals week, March 2021
  - Class presentation (20%): More info below, presentations will be held in week 10.
  - Class participation (10%): For regular/relevant participation in class discussion, quality>quantity.
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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.

### Presentations

In groups of around 4 students, 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, such as long-short particular stocks, sectors, commodities, etc., 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). These presentations are an opportunity for you to dig deeper into a topic you found interesting. Last year's presentations generally reached a very high standard and helped both the presenting groups as well as the audience appreciate new facets of and perspectives on the materials covered in class. You should expect to spend a considerable amount of time on this project during the second half of the course. All group members will receive the same grade for the project. In the event that you believe a group member is not pulling their weight, please alert me (and, of course, the group member in question, first) to this *during the preparation of the presentation* rather than afterwards.

### 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, Alpha versus Beta

- Lecture: The CAPM and beyond; Anomalies, Alpha, and Beta
- ✓ Readings: Provided on Canvas
  - *The Capital Asset Pricing Model*, A. Perold; JEP (2004),
  - Background notes on Factor Models (if needed)
  - *\*Momentum Crashes*, K. Daniel & T. Moskowitz; JFE (2016)

##### Topic 2 – Risk Sharing: Hedge Funds as Insurers

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

##### Topic 3 – 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)

##### Topic 4 – 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)
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### 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)

### Part II: Private Equity

### Topic 6 – Distressed Investing: Corporate Debt

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

### Topic 7 – Introduction to PE & LBO Valuation

- Lecture: Introduction to Buyout Funds – Structures, contracts, fees, and qualitative framework
- Case Study: Lion Capital and the Blackstone Group – The Orangina Deal
- ✓ Readings: Provided on Canvas
  - *Leveraged Buyouts and Private Equity*, S. Kaplan & P. Strömberg; JEP (2009)
  - HBP Case Study, see Canvas for access

### Topic 8 – Private Equity vs Venture Capital

- Lecture: Key differences between PE & VC and how they affect the investment process
- Case Study: Metapath Software
- ✓ Readings: Provided on Canvas
  - HBP Case Study, see Canvas for access
  - *\*How do Venture Capitalists Make Decisions?*, P. Gompers, W. Gornall, S. Kaplan, I. Strebulaev; JFE (2019)

### Topic 9 – 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 10 – Class Presentations

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