New opportunities

Ever the innovators, hedge funds are increasingly using exchange-traded funds to gain access to equity, and fixed income, in preference to futures or other derivatives. Elise Coroneos looks at the new opportunities on the horizon

Since the first exchange-traded fund (ETF), the Spider, began trading on American Stock Exchange in 1993, hedge funds have been a significant and growing user of the products.

The ability to trade an entire index in a single trade – whether it be a broad-based or industry specific index – provided hedge funds with even greater trading flexibility and speed, characteristics for which they were already well known.

Over the last decade, both the hedge fund and ETF industries have gone from relatively small time players in the financial markets to becoming mainstays, both with burgeoning assets.

It has become common place for hedge funds engaging in a long/short strategy to short a stock and then hedge that position by going long that stock's industry sector using an ETF. Or conversely, a hedge fund that is positive on a specific stock may choose to go long that same stock's industry sector using an ETF.

Despite hedge funds' use of equity based ETFs, their use of fixed income ETFs has not grown with the same tenacity.

ETFs with the highest levels of short interest are overwhelmingly equity-based. The level of short interest, which indicates the shares outstanding that have been sold short on an ETF, is generally accepted as a gauge of an ETFs' use by the hedge fund community.

The only fixed income ETF with any significant short interest percentage is the iShares Lehman 20+ Year Treasury Bond Fund from Barclays Global Investors (BGI), which, over the past year, has steadily found acclaim as the hedge fund industry's favourite way to short the fixed income market.

Why the TLT?

Despite the proliferation of ETF products listed on stock exchanges around the world, only a handful are actually based on fixed income. As an example of the dominance of equity based ETFs, BGI, one of the largest provider of ETFs, has over 100 funds in the market, only six of which are based on fixed income; one of which is the TLT.

In addition to the TLT, BGI has another three iShares based on varying durations of the US Treasury market: the iShares Lehman 1-3 Year Treasury Bond Fund, the iShares Lehman 7-10 Year Treasury Bond Fund and the iShares Lehman TIPS Bond Fund.

BGI also offers the iShares Lehman Aggregate Bond Fund, based on the broad US bond market, and the iShares GS dollar InvesTop Corporate Bond Fund, based on the Goldman Sachs InvesTop Index.

According to Matthew Tucker, who is head of enhanced and indexed fixed income strategies at BGI, the TLT, which was launched in July 2002, is popular among hedge funds first and foremost because it is the longest duration fixed income ETF on the market.

"Because the TLT provides exposure to the 20 plus Treasury market, it shows the most price volatility and response to interest rate changes, so it has the most bang-for-your-buck if you will," says Tucker.

This is appealing to hedge funds that are looking for leverage in order to maximise their level of exposure and hence the potential return they can generate on a position.

"So having the highest duration product provides them with the highest return if their view on rates is correct," says Tucker.

And hedge funds' favour of TLT as a way of shorting the fixed income market is only likely to grow as many experts continue to predict further hikes in interest rates by the US Federal Reserve.

When BGI launched the TLT in 2002, there was much talk in the US about the low level of interest rates and speculation about when they would rise. As a result, BGI expected the trading volume and assets under management in the fund to exceed what in fact eventuated.

"Ironically, long-term interest rates went lower, not higher, since we launched the product. So the increase in rates expected over the next 12 months should see the TLT reach assets more like what we expected at launch," says Tucker.

Now, however, Tucker believes that the TLT's time has come at last.

"We've seen this product getting pretty heavily shorted by investors who are betting that interest rates are going to be rising, a vast number of which we know are hedge funds," says Tucker.

This is evident because TLT's assets under management fluctuate wildly with changes in interest rates. "When there are large shift in interest rates, we tend to see people moving into or out of the funds," says Tucker.

"Just within 2005, we've seen the TLT's assets under management fluctuate from a peak of $1 billion in early March to less than $200m in early June. Hedge funds, because they are so dynamic, account for a lot of the fluctuation we have seen in the size of the fund," says Tucker.

In practice

Hedge funds using the TLT include New York-based Para Advisors, an event driven hedge fund firm founded by Ned Sadaka in 1991. Para tipped the

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scales above $1bn in assets under management just under a year ago.

Over the years, open-ended structuring spin offs have taken a higher prevalence in the firm's portfolio. Today, just over 70% of Para's portfolio is in restructurings and value opportunities such as capital structure type of names and holding company arbitrage. About 15% is in distressed situations and the remaining 10-12% in merger arbitrage.

"We are short TLT at the moment to hedge the bond market risk and interest rate exposure in the portfolio," says David Braille, Para Advisor's COO.

"This is to offset the interest rate risk in the portfolio which comes from bonds that pay cash interest and may go lower to the extent that interest rates go higher," adds Braille.

In addition to shorting the TLT, Para trades numerous industry specific ETFs that hedge different positions or groups of positions in its portfolio.

Another hedge fund currently using the TLT as a hedge against interest rates is New York-based Metropolitan Capital Advisors, an event driven operation co-founded by Jeffrey Schwarz and Karen Finerman in 1992.

The firm employs a range of event driven hedge fund strategies including distressed securities, risk arbitrage, value-with-a-catalyst and special situations. The weight of the firm's allocation to any one event driven sub-strategy depends on the opportunity set presented by the markets.

According to David Fried, an MD at Metropolitan, the firm is currently short TLT as a hedge against bank stocks it is holding long. "We think that if interest rates go up, these bank stocks might not do as well," says Fried. "It is an interesting hedge."

Specialist ETF hedge funds

In addition to larger hedge funds such as Para Advisors and Metropolitan Capital Advisors, there are a number of smaller hedge funds emerging for which the use of ETFs is an intrinsic part of their strategy, which include fixed income ETFs.

One such smaller hedge fund manager is GNI Capital, which has offices in New York and Greenville South Carolina. According to Allen Gillespie, GNI's principal, the firm was an early adopter of ETFs.

GNI has a hedge fund that trades indices, primarily the S&P 500, long and short in the futures and the ETF market. While GNI's hedge fund only manages a couple of million at this time, the firm manages over $40m across its funds and separately managed accounts from clients in the US and Europe.

Gillespie cites a number of uses of fixed income ETFs, one being to isolate macroeconomic risk by countering the impact of interest rates upon the valuation of stocks.

Fixed income ETFs, says Gillespie, are also especially useful when it comes to pairs trading in an effort to isolate credit risk in anticipation of bond spreads widening. This can be achieved by buying the iShares Lehman 7-10 Year Treasury Bond Fund and selling a credit related ETF such as the iShares Goldman Sachs InvesTop Corporate Bond Fund, according to Gillespie.

"Ironically, while many are anticipating bond spreads widening and are using fixed income ETFs to take advantage, my take is that credit spreads may stay tighter than people expect, making it difficult for those wanting to short the TLT," says Gillespie.

There have been a couple of times over the past year when Gillespie has been unable to borrow on TLT. "Nevertheless, because it is an ETF they can theoretically create more, from a borrowing perspective it has been very, very tight," says Gillespie.

While shorting the TLT is a valid way to hedge interest rates and inflation risk, says Gillespie, due to the difficulty in borrowing the ETF, he will sometimes use streetTRACKS Gold ETF as an alternative.

"Although using the GLD is not a pure fixed income play, we think it is important to look at that along with our fixed income ETFs," says Gillespie.

Another small hedge fund firm with an emphasis on using ETFs is New York-based New Millennium Advisors. Michael Carty, the firm's founder and chief investment officer was formerly a senior portfolio manager and associate research chairman at Value Line, where he managed $650m in assets, including the Value Line Centurion Fund.

"We had for years been working on long only strategies using standard equities, and we did equity balanced accounts using a growth-at-a-reasonable-price strategy. We have since converted over to using ETFs and more specifically recently developed a hedge fund which uses ETFs exclusively," says Carty.

The New Millennium Long Short ETF Strategy Fund currently has around $2m in assets. It has been in beta test mode since 1 March this year.

Carty is aiming to have around $5-10m by the time the fund is out of testing and ready for launch. "We expect assets to rise fairly quickly," says Carty, who chose to focus the hedge fund on ETFs in order to make it fully scalable.

The strategy of the fund uses a number criterion to establish whether to buy into or sell out of a particular ETF and the best entry or exit point at which to do so. It currently invests across 150 different ETFs, including five of BGI's fixed income iShares.

According to Carty, fixed income ETFs play a specific role in the fund. "If the Fed continues to increase interest rates in the way it is doing, ETFs such as the TLT are poised to reflect these movements," says Carty.

"The only problem is that as interest rates rise, TLT is likely to go down and, as a result, may be a little bit harder to borrow than you would like it to be," he adds.

Another small hedge fund with an emphasis on ETFs is Skyhawk Management, a market neutral hedged portfolio able to go long and short the S&P 400, S&P 500 and S&P 600 value indices in equal dollar amounts. Launched about three months ago, the fund currently has assets of around $1m.

"We basically try to select ETFs that are more attractive on average to be long and less attractive on average to be short," says Gary Gastineau, a managing partner of the hedge fund.

Gastineau is also a founder of New Jersey-based ETF Consultants through which he works on a number of ETF consulting and licensing projects. Gastineau organised the company in May 2003 to provide specialised exchange-traded fund consulting services to ETF issuers, exchanges and other markets, market makers, research organisations and investors. Gastineau was previously an MD for ETF product development at Nuveen Investments, before which he directed product development at American Stock Exchange for approximately five years.

"Fixed income ETFs are receiving a lot of interest from hedge funds that are expecting higher interest rates," says Gastineau, who is currently consulting to a firm with proposals filed with the US Securities & Exchange Commission for actively managed ETFs.

"In the TLT, the short interest percentage, that is the percentage of shares outstanding that have been sold short, has frequently been extraordinarily high. For the month of August it was down to a mere 135%, but there have been times it has been over 600%, which means that people are borrowing and lending and selling short and re-lending in a kind of round robin way," says Gastineau.

Room to grow

The advent of fixed income ETFs has provided equity traders such as hedge funds with access to the fixed income market; however, many industry participants believe there are still a number of product gaps to be filled.

In terms of the availability of fixed income ETFs, all the existing US funds are based on either Treasuries or investment grade bonds. There are currently no fixed income ETFs based on high yield bonds, international bonds or sovereign debt, whether it be regional, broad based or international.

"There is are lot of empty spaces and room for growth," says Jim Ross, co-head of Boston-based State Street Global Advisor (SSgA)'s adviser strategies group, which is responsible for the firm's ETF business.

SSgA, a major player in the US ETF market with 23 funds with over $70bn in assets, is yet to enter the fixed income arena in the US. So far it has only brought to market an Asian fixed income ETF domiciled outside the US, however, the word on the street is that this may be about to change.

"It is definitely an area we are evaluating," says Ross. "If you look at the fixed income area in the US right now, there are six fixed income ETFs. Should there be more? There is a belief by many that there should be. There are a total of 173 ETFs in the US, so clearly there is room for additional fixed income products."

Gastineau agrees that there is much room for growth in the fixed income area. "A lot of people want to see high yield and municipal bond ETFs," says Gastineau. "However, it seems the SEC has been reluctant to approve anything that goes beyond investment grade so it is not clear what will happen or how long it will take."

Whatever the shape the fixed income ETF market takes, industry participants agree that hedge funds will continue to keenly look to gain exposure to the fixed income market, especially as interest rate and inflation risk continues to heighten in the coming 12 months. And ETFs are uniquely positioned to cater to hedge funds because they provide fixed income exposure in an equity style package.

"Hedge funds are evaluating all the available tools out there to get fixed income exposure and, for many, ETFs are better tools to use than a future or some other type of derivative product," concludes Gastineau. "They are saying this is a vehicle I can use because I can buy and sell it like an equity." ❑