

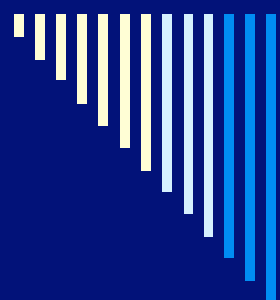
# EVOLUTION OF THE HEDGE FUND

**By: Eric M. McKenna**

President, Gables Capital Management, Inc.

General Partner, Cypress Grove Partners, L.P.

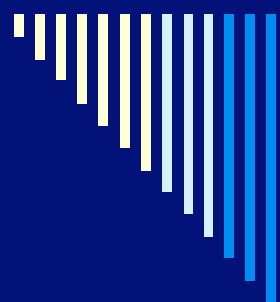
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# EVOLUTION OF THE HEDGE FUND

## OUTLINE

- Brief History
- Current Environment
- High Profile Collapses
- Terminology
- Structure of Cypress Grove Partners, L.P.
  - Market History
  - Option Strategies
  - Recent Trades



# Alfred Winslow Jones

- The Father of the Hedge Fund
- Born in Melbourne, Australia 1901 to American parents
- 1923 Graduated from Harvard
- U.S. Diplomat in Germany during the rise of Nazism
- 1941 received his doctorate in Sociology from Columbia University
- Reporter for Fortune Magazine



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## “Current Fashions in Investing and Market Forecasting”

- In researching and writing a 1948 Fortune article on the current fashions in investing, Jones came to the conclusion that he had a better system for managing money.
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# Jones Strategy

- Hedging long positions by selling short other stocks to protect against market risk
- Use of leverage (borrowed money) to enhance the potential return on the partnership's assets

**Jones called short-selling and leverage “speculative tools used for conservative purposes”.**

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# Short Selling

- Short selling is a technique used by investors who try to profit from the falling price of a stock. It entails the borrowing of a security from a broker and selling it with the understanding that it must be bought back (hopefully at a lower price) at a later date.
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# Leverage

- Investment leverage is a technique that involves accumulating debt to increase potential returns through an increase in risk. In a leveraged account, an investment manager borrows money and invests it in the funds' securities. If the securities appreciate, the upside is magnified as more money has been invested. If the securities lose value, however, investors will lose a greater percentage of their original investment.
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# The First Hedge Fund

- In 1949 Jones put his theories to practice in a general investment partnership
- He raised \$100,000 (\$40,000 of which was his own money; and represented his entire liquid net worth)
- 20% of profits incentive fee for himself as managing partner

Mr. Jones was responsible for combining short selling, leverage, incentive fees, and shared risk – the four most common characteristic of the classic hedge fund.

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# “The Jones That Nobody Can Keep Up With”

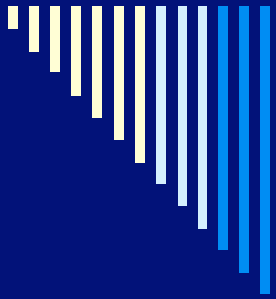
- Operating in almost absolute obscurity for 17 years, Jones’ success was finally brought to the public eye in this 1966 Fortune Magazine article written by Carol Loomis.
  - The article revealed that his partnership had outperformed the best performing mutual fund that year by 44% and the best five year performing mutual fund at the time by 85%, net of all fees.
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# Enter Today's Legends

- This article attracted the attention of both, wealthy individuals seeking better investment returns, and talented professional investors willing to sacrifice big salaries for profit participation in the portfolios they managed.
  - By 1968, there were approximately 200 hedge funds including those formed by investment industry legends George Soros, Michael Steinhardt, and Warren Buffett.
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1983: 1,000 VS 1,000

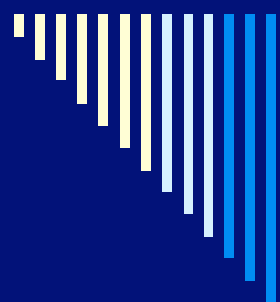
2008: 12,500 VS 145,000



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# The Dark Ages

- ❑ Shorting was difficult in the go-go markets of the mid-late 1960's and many managers stopped doing it
  - ❑ Continued to use leverage aggressively
  - ❑ This combined effect caused major bloodletting in the savage 1973-1974 bear market
  - ❑ In 1984, only 68 Funds could be identified
-

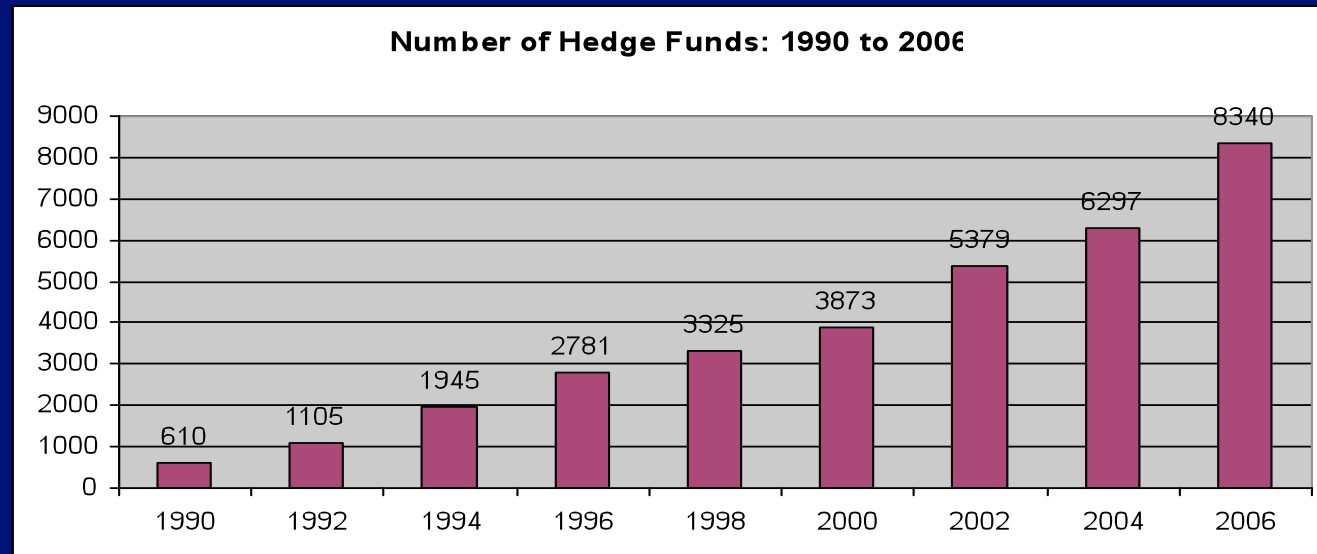


# The Renaissance

- The hedge fund industry limped along until the early 1990's, when the financial press once again began trumpeting the returns achieved by George Soros (Quantum Fund) and Julian Robertson (Tiger Fund). Many hedge funds no longer resembled the classic long/short equities model developed by Jones.
- Soros made a killing in the currency markets and Robertson employed modern financial derivatives such as futures and options.

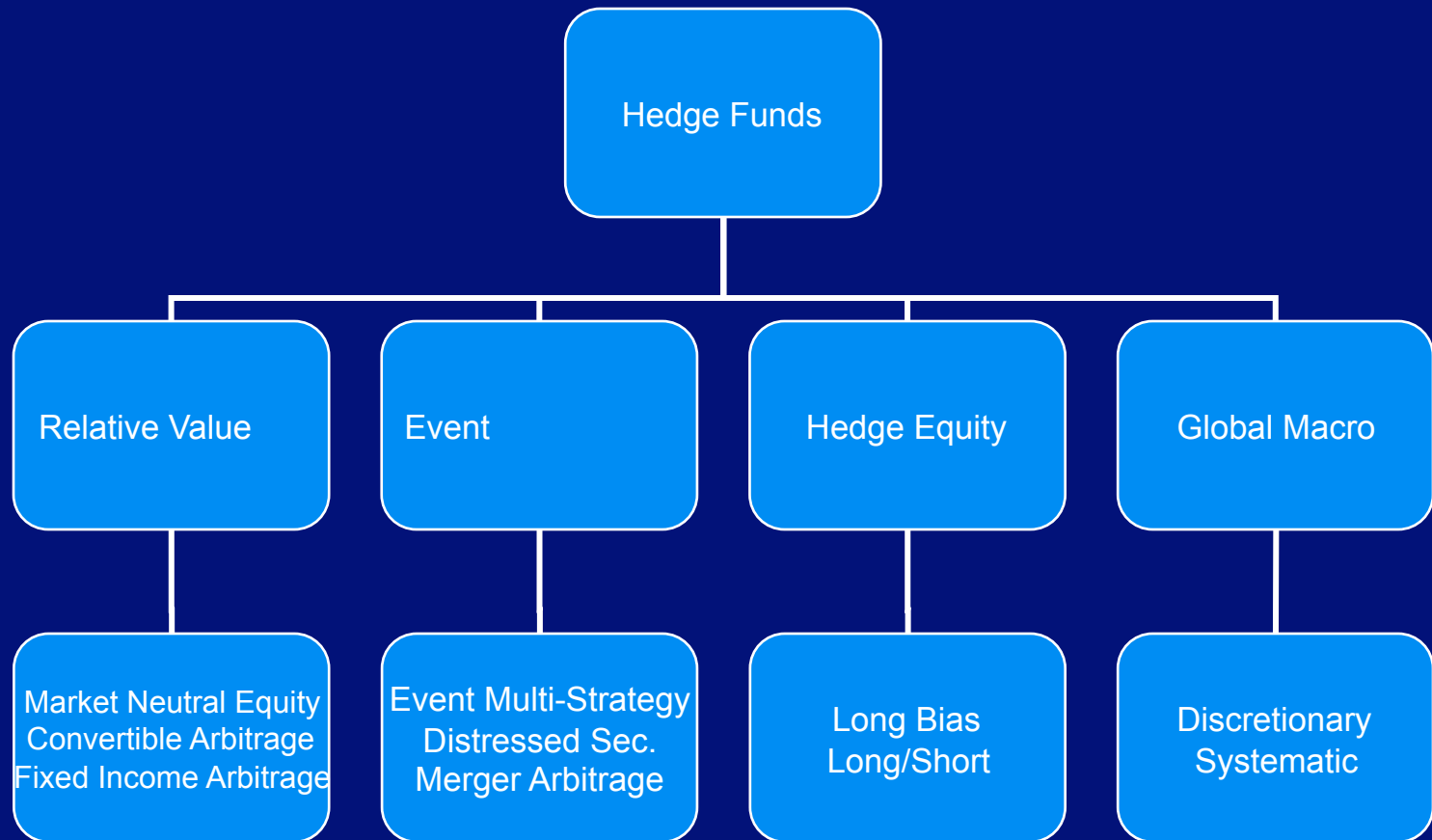
# Hedge Fund Explosion

- With lots of new hedging tools and a tide of favorable publicity, the hedge fund universe exploded.





# Types of Hedge Fund Strategies

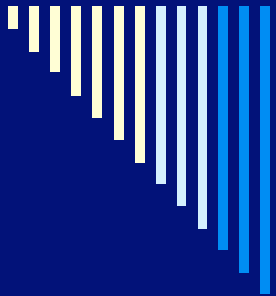




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# What are Hedge Funds?

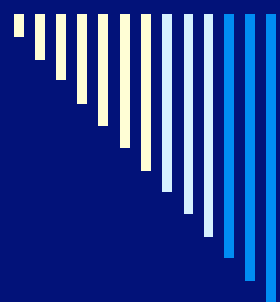
- “Hedge Fund” is a general, non-legal term that was originally used to describe a type of private and unregistered investment pool that employed sophisticated hedging and arbitrage techniques to trade in the corporate equity markets. Hedge funds have traditionally been limited to sophisticated, wealthy investors. Over time, the activities of hedge funds broadened into other financial instruments and activities. Today, the term “hedge fund” refers not so much to hedging techniques, which hedge funds may or may not employ, as it does to their status as private and unregistered pools.
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# Long-Term Capital Management

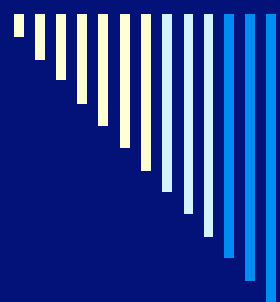
- ❑ Hedge Fund founded in 1994 by John Meriwether (former vice-chairman and head of bond trading at Salomon Brothers)
  - ❑ On its board were Myron Scholes and Robert C. Merton, who shared the 1997 Nobel Prize in Economics
  - ❑ Initially enormously successful with annualized returns of over 40% in its first years, in 1998 it lost \$4.6 billion in less than 4 months and threatened to collapse the bond market
-



# Long-Term Capital

(Cont..)

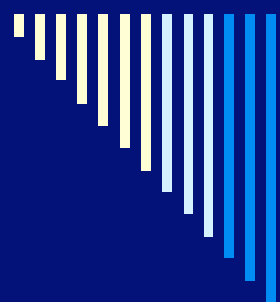
- The company had developed complex mathematical models to take advantage of fixed income arbitrage deals (convergence trades).
- Because the differences in value were minute, the Fund needed to take highly-leveraged positions to make a significant profit. At the beginning of 1998, the Fund had equity of \$4.72 billion and had borrowed over \$124.5 billion.



# Long-Term Capital

(Cont..)

- As LTCM's capital base grew, they were forced to undertake strategies outside their expertise.
- When the Russian Government defaulted on their government bonds, panicked investors sold Japanese and European Bonds to buy U.S. Treasury Bonds.



# Long-Term Capital

(Cont..)

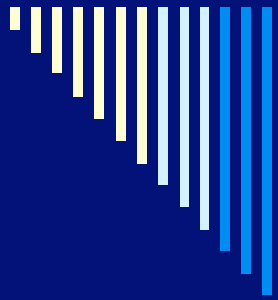
- The profits that were supposed to occur as the value of these bonds converged became huge losses as the value of the bonds diverged. Equity tumbled from \$2.3 billion to \$600 million without shrinking the portfolio, leading to a significant elevation of the already high leverage.
- The Federal Reserve Bank of NY organized a bail out of \$3.625 billion by the major creditors to avoid a wider collapse in the financial markets.



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# Amaranth Advisors LLC

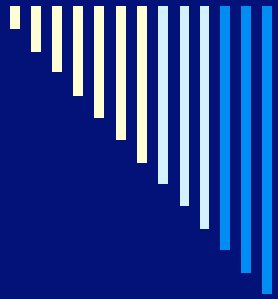
- ❑ Greenwich, Connecticut based multi strategy Hedge Fund, with \$9 billion in assets
  - ❑ Throughout much of the firm's history, convertible arbitrage was the firm's primary profit center. As more and more capital began flowing into the Fund during the early 2000s, trading opportunities became more difficult to find
  - ❑ By 2004, the firm had shifted much of its capital to energy trading under Brian Hunter
-



# Amaranth Advisors LLC

(Cont..)

- Hunter made enormous profits by placing bullish bets on natural gas in 2005, the year Hurricane Katrina severely impacted natural gas and oil production.
- Hoping for a repeat performance, Hunter wagered with 8:1 leverage, a spread trade on the March and April natural gas futures contract.



# Amaranth Advisors LLC

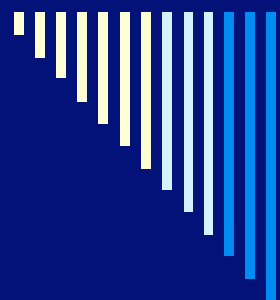
(Cont..)

- ❑ Trade went against Hunter generating a loss of \$6.5 billion in one week and resulting in the collapse of the Fund
- ❑ In 2007, Hunter founded a new hedge fund, Solengo Capital Advisors



# Bayou Group

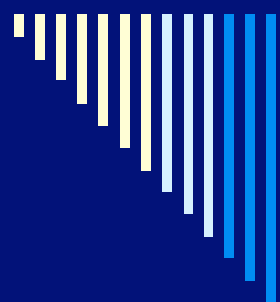
- A hedge fund company and brokerage firm run by Samuel Israel III
- \$300 million fund collapse
- Mr. Israel siphoned off most of the money to accumulate personal assets and fund his extravagant lifestyle
- Central to the Bayou story was the conflicts of interest
  - Brokerage firm
  - Referral fees



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# Hedge Fund Terms:

- Highwater Mark
  - Hurdle Rate
  - Lock-up Period
  - Feeder Fund
-



# Highwater Mark

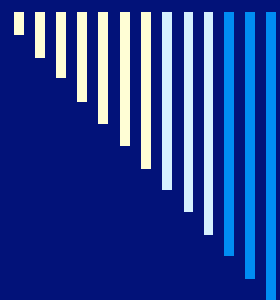
- The Manager will only receive performance fees when the investors' value is greater than its previous greatest value. Should the investment drop in value then the manager must bring it back above the previous greatest value before they can receive performance fees again.



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# Hurdle Rate

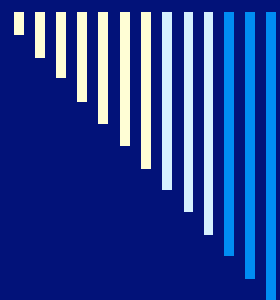
- The established minimum return an investor's investment must make prior to the application of performance/incentive fees.
-



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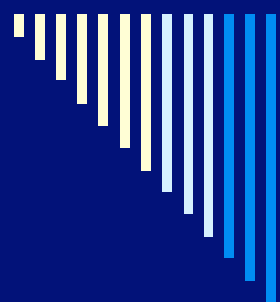
# Lock-up Period

- This is the time period that you must hold your assets within a fund before they can be removed.



# Feeder Fund

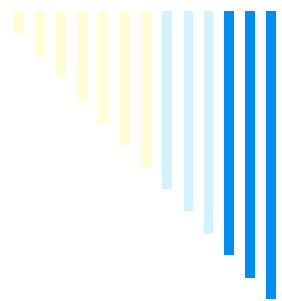
- Often, an onshore feeder fund will invest in an offshore master fund. This is done so that the foreign master fund can gain a tax advantage for the domestic investors.



# Cypress Grove Partners, L.P.

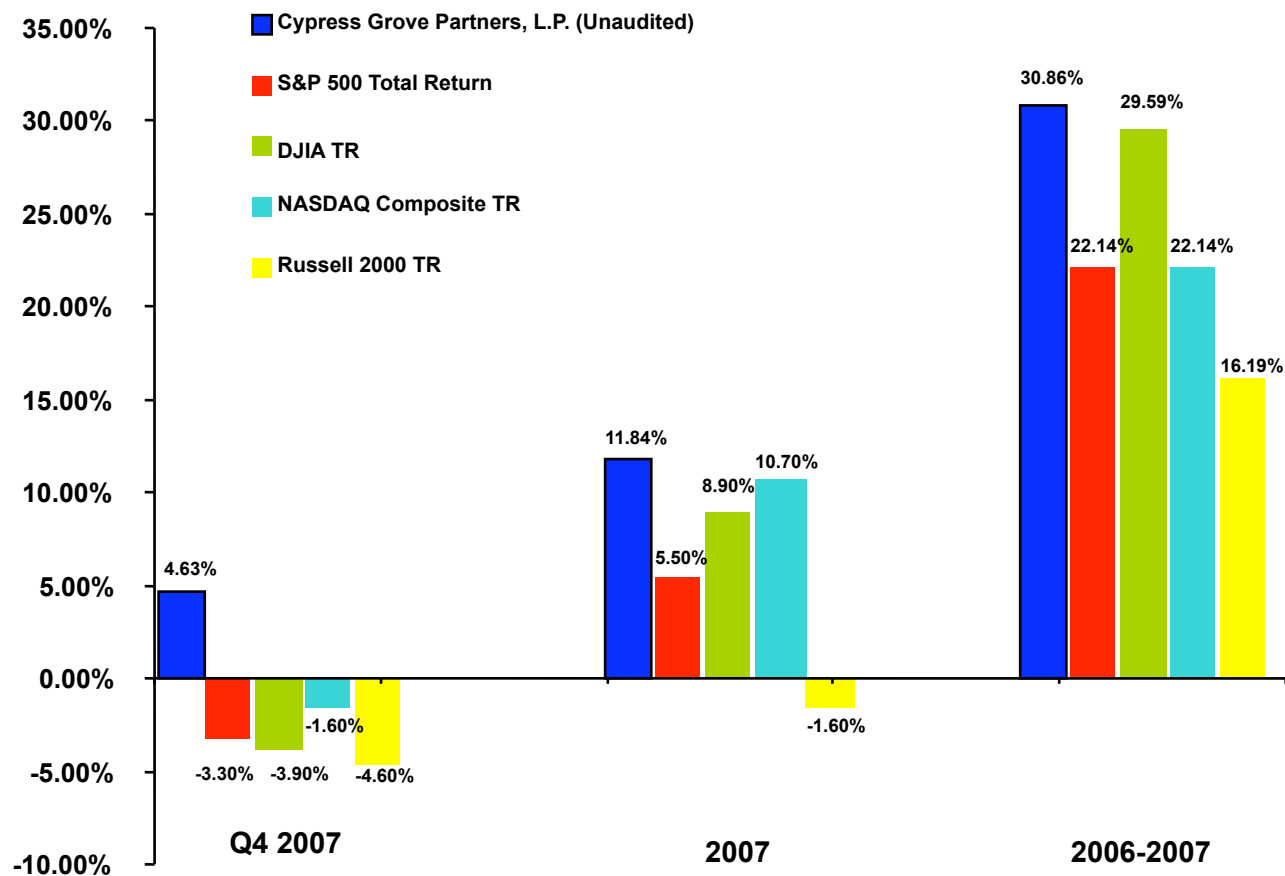
## □ Why Hedge?

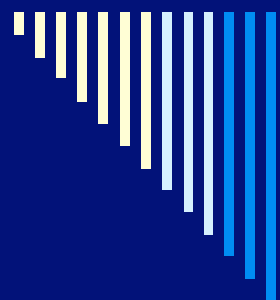
“Management strongly believes that superior long-term investment performance is achieved by avoiding substantial losses along the way; therefore, Management will utilize a disciplined strategy that seeks to control risk and minimize volatility”



# Cypress Grove Partners, L.P.

(For Presentation Purpose Only)

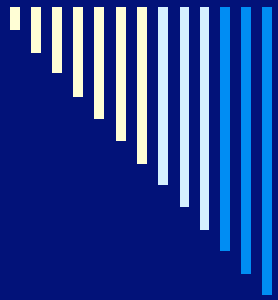




# Market History

## □ 1929 Market Crash

DOW plunges from 381.17 to 41.22 (down 90%) erasing 36 years of gains. The Index would take 22 years to surpass its previous high.

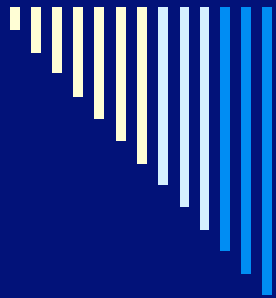


# Market History

(Cont..)

## □ 1967-1982 Bear Market

In January 1966, the DOW broke 1000 intra-day. Then it declined 26%. By December 1968, it hit 994.65. From that point to October 1974, the DOW declined 75%. The DOW continued to flirt with level 1000 back and forth until August 1982. That's merely 16 years of going nowhere.

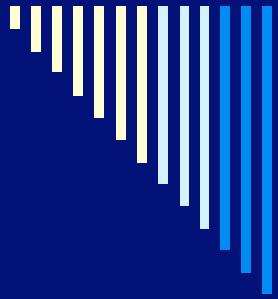


# Market History

(Cont..)

## □ October 1987

The crash on October 19, 1987 was the climatic culmination of a market decline that had begun five days before on October 14. The DOW fell 3.81% on October 14 followed by another 4.60% drop on Friday October 16. On Black Monday, the DOW plummeted 508 points, losing 22.6% of its value in one day. The crash was the greatest single-day loss that Wall Street ever suffered.



# Market History

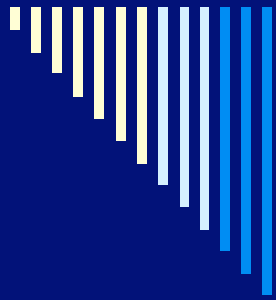
(Cont..)

## October 1987 (cont..)

Between the start of trading on October 14 to the close on October 19, the DOW lost 760 points, a decline of over 31%. The 1987 crash was a worldwide phenomenon. Out of 23 major industrial countries, 19 had a decline greater than 20%.

It took only 2 years for the DOW to recover completely.

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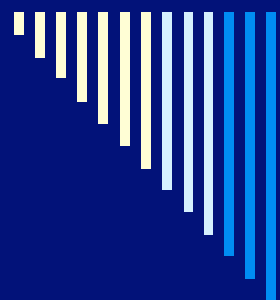


# Market History

(Cont..)

## □ 2000-2003

The DOW struggles with the 10,000 – 11,000 range for a year and then deteriorates into a panic atmosphere of severe declines punctuated by brief and violent rallies. The index hits a closing low of 7,286.27 on October 9, 2002; 38% below its highs. The records of early 2000 stand until the fourth quarter of 2006. (NASDAQ still 57% below its all time closing high)



# Option Strategies

- Covered Call
- Buy-Write
- Covered Put
- Naked Put

**“....speculative tools used for conservative purposes”.**

**A.W. Jones**



# Covered Call Writing (Selling Calls)

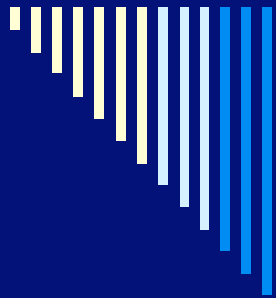
- As a call writer, you obligate yourself to sell, at the strike price, the underlying shares of stock. For assuming this obligation, you are paid a premium at the time you sell the call. Investors write covered calls primarily for the following two reasons:
  - 1. To realize additional return on the underlying stock by earning premium income; and
  - 2. To gain some protection (limited to the amount of the premium) from a decline in the stock price



# Potash Corp (POT)

- Integrated producer of fertilizer, industrial and animal feed products
- World's largest fertilizer enterprise by capacity producing the three primary plant nutrients – potash, nitrogen, and phosphate

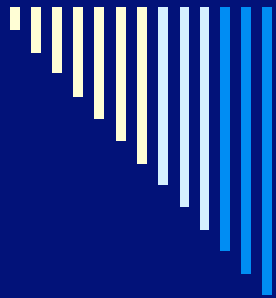
	<u>Earnings</u>		<u>Revenue</u>	
	<u>Reported</u>	<u>Street</u>	<u>Reported</u>	
01/25/07	.53	.52	\$1022.9	million
04/26/07	.62	.57	\$1154.7	million
07/26/07	.88	.80	\$1353.1	million
10/25/07	.75	.81	\$1295.0	million
01/24/08	1.11	.99	\$1431.4	million



# Potash Corp (POT)

(Cont..)

January 29, 2007	Purchased 1000 shares @ 51.50
May 3, 2007	Purchased 1000 shares @ 62.00
November 12, 2007	Purchased 500 shares @ 109.00
December 28, 2007	Wrote 5 January 145 calls for \$9.50 (out at \$154.50 7.15% 3 weeks) Closing share price \$144.19
January 9, 2008	Closing price \$138.00 Close out Jan 145 calls for \$1.45 Gain \$4,025



# Potash Corp (POT)

(Cont..)

12/31 – 1/14

S&P 500 down 3.55%  
POT up 4.28%

January 14, 2008 - 11:00 am

POT is up \$7.00 to \$145

Wrote 3 Feb 150 calls for \$8.80

2:00 p.m.

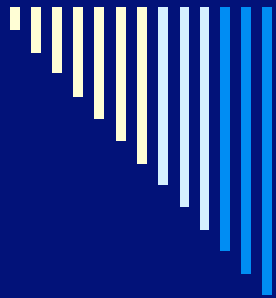
POT is up \$12.00 to \$150.00

Wrote 2 Feb 160 calls for \$6.30

Wrote 5 Feb 170 calls for \$3.80

4:00 p.m.

Share closing price \$150.12



# Potash Corp (POT)

(Cont..)

January 17, 2008 POT down \$14.40 closes at \$120.24

Day Trade

Purchased

6000 @ 119.83

Sold

6000 @ 121.07

Gain \$7,440

January 23, 2008 POT hits intraday low of \$106

Down 30% in one week

Day Trade

Purchased

4000 @ \$108.30

Sold

4000 @ 110.21

Gain \$7,640

Cover 3 Feb 150 Calls for \$1.40

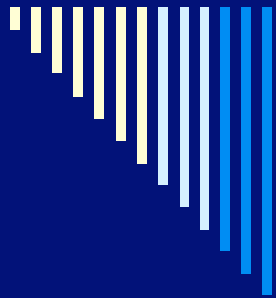
Gain \$2,200

Cover 2 Feb 160 calls for \$0.65

Gain \$1,130

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Closing share price \$120.15



# Potash Corp (POT)

(Cont..)

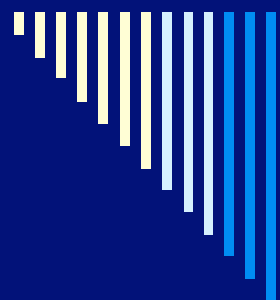
February 15, 2008      Share closing price      \$147.88

## Passive Strategy

2500 shares on 12/31/07	@ \$143.96	
2500 shares on 2/15/08	@ \$147.88	
	Gain	\$9,800
	Return	2.72%

## Active Strategy

2500 shares on 12/31/07	@ \$143.96	
2500 shares on 2/15/08	@ \$147.88	
	Gain	\$9,800
5 January 145 Calls	Gain	\$4,028
January 17 DayTrade	Gain	\$7,440
January 23 DayTrade	Gain	\$7,640
3 February 150 Calls	Gain	\$2,200
2 February 160 Calls	Gain	\$1,130
5 February 170 Calls	Gain	<u>\$1,900</u>
	Total Gain	\$34,135
	Return	9.48%



# Buy/Write

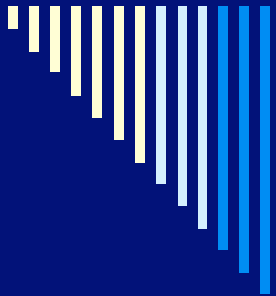
- Purchase of a stock with a simultaneous call written



# First Solar (FSLR)

- Designs and manufactures solar modules that convert solar energy into electricity. FSLR's thin film semiconductor technology has proven to be far more efficient than competing technologies and has the lowest manufacturing cost per watt in the industry
- Founded in 1999 and launched production of commercial products in 2002
- IPO November 17, 2006 @ \$20.00/share

	<u>EPS</u>		<u>Revenue Growth</u>
	<u>Reported</u>	<u>Street</u>	
02/13/07	.12	-.002	52.7 million
05/03/07	.07	-.003	66.9 million
07/31/07	.07	.02	77.2 million
11/07/07	.49	.19	159.0 million



# First Solar (FSLR)

(Cont..)

January 3, 2007 closing share price \$28.50

February 20, 2007	Purchased	2,000	\$ 48.60	
May 11, 2007	Purchased	<u>1,000</u>	<u>\$ 67.80</u>	
		3,000	\$ 55.00	\$165,000

October 1, 2007	Sold	1,000	\$125.80	
November 13, 2007	Sold	1,000	\$188.00	
November 29, 2007	Sold	500	\$236.00	
December 14, 2007	Sold	<u>500</u>	<u>\$249.00</u>	
		3,000	\$185.43	\$556,290

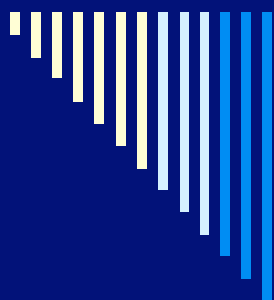
GAIN \$391,290  
237%

Contributed 1.96% of Fund's 2007 return

December 28, 2007 closing share price \$280.91 52 Week High

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December 31, 2007 closing share price \$267.14 FSLR 2007 Return 837%



# First Solar (FSLR)

(Cont..)

January 11, 2008  
January 16, 2008  
January 17, 2008

Closing share price \$221.00  
Purchased 500 shares @ \$189.41  
Closing share price \$167.20

40% off its 12/28 High

January 18, 2008

FSLR up \$8.50

Wrote 3 Feb 190 calls @ \$13.60  
Out @ \$203.60 7.50%

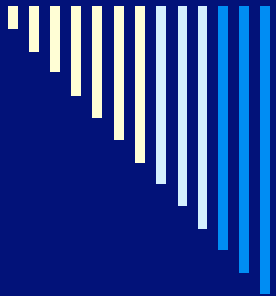
February 7, 2008  
February 11, 2008  
February 12, 2008

Purchased 500 shares @ \$165.53  
Share closing price \$189.64  
Last trading day before earnings announcement  
Investor fear leads to sell off all day

Purchased 1000 shares @ \$184.50  
Simultaneously wrote 10 February 170 calls Expire 2/15  
Premium received \$24.90  
Out @ \$194.90 gain/share \$10.40  
5.60% for 4 days over 500% annualized

~~February 12, 2008~~

~~Closing share price \$175.56~~



# First Solar (FSLR)

(Cont..)

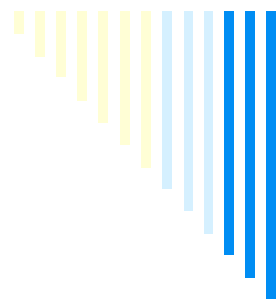
February 13 Earnings Announcement

	<u>Earnings</u>		<u>Revenue</u>	
	<u>Reported</u>	<u>Street</u>	<u>Reported</u>	<u>Street</u>
02/13/08	.77	.53	\$200.8 million	\$179 Million

Stock explodes up \$52.90 to \$228.46

February 15, 2008 Closing share price \$219.39

300 shares called @	\$203.60	gain	\$ 4,257
1000 shares called @	\$194.90	gain	\$10,400
Shares left 200	@\$189.41		
<u>500</u>	<u>@\$165.53</u>		
700	\$172.35		



# Google Option

**GOOG** US \$ ↑ **506.36** -2.64 Q C ↑506.33/506.42 Q 1x1 Equity **OMON**  
 At 10:36 Vol 1,477,775 Op 512.85 D Hi 513.21 D Lo 505.27 D ValTrd 751.256m

**GOOG US Equit.** Templates Edit Expiry Reverse Axes Option Monitor ...  
 GOOGLE INC-CL A 506.34 -2.88 506.33 / 506.42 HI 513.21 Lo 505.27 Vol 1477675  
 Center 510.00 Number of Strikes 18 or % from Center Exchange Composite

51) Calls						52) Puts					
Ticker	Strike	Bid	Ask	Last	Volm	Ticker	Strike	Bid	Ask	Last	Volm
<b>GOOG 22 MAR 2008 (Contract Size 100)</b>						<b>GOOG 22 MAR 2008 (Contract Size 100)</b>					
1) GOP+CD	420.00	88.400	88.800	90.800	32	21) GOP+OD	420.00	1.100	1.350	1.250	4
2) GOP+CF	430.00	79.000	79.400	79.300	13	22) GOP+OF	430.00	1.700	1.800	1.750	124
3) GOP+CH	440.00	69.700	70.100	70.000	50	23) GOP+OH	440.00	2.350	2.550	2.500	174
4) GOP+CJ	450.00	60.600	61.100	60.300	74	24) GOP+OJ	450.00	3.300	3.500	3.400	577
5) GOP+CL	460.00	52.100	52.500	52.300	93	25) GOP+OL	460.00	4.800	4.900	4.500	150
6) GOP+CG	470.00	43.800	44.200	44.700	220	26) GOP+OG	470.00	6.400	6.600	6.600	252
7) GOP+CI	480.00	36.300	36.500	36.700	485	27) GOP+OI	480.00	8.700	8.900	9.000	511
8) GOP+CK	490.00	29.300	29.500	29.800	369	28) GOP+OK	490.00	11.700	11.900	12.000	697
9) GOP+CO	500.00	23.100	23.200	22.800	677	29) GOP+OO	500.00	15.500	15.800	15.500	1026
10) GOP+CU	510.00	17.800	17.800	17.800	878	30) GOP+OU	510.00	20.000	20.200	20.300	752
11) GOP+CV	520.00	13.100	13.200	12.900	789	31) GOP+OV	520.00	25.500	25.600	25.500	613
12) GOP+CW	530.00	9.400	9.500	9.200	761	32) GOP+OW	530.00	31.800	32.000	32.400	442
13) GOP+CX	540.00	6.500	6.700	6.400	799	33) GOP+OX	540.00	39.000	39.100	38.700	506
14) GOP+CY	550.00	4.400	4.500	4.400	485	34) GOP+OY	550.00	46.900	47.100	46.600	289
15) GOP+CZ	560.00	2.800	3.000	2.850	725	35) GOP+OZ	560.00	55.300	55.800	56.200	135
16) GOP+CQ	570.00	1.750	1.900	1.750	233	36) GOP+OQ	570.00	64.400	64.800	64.200	92
17) GOO+CP	580.00	1.150	1.250	1.150	232	37) GOO+OP	580.00	73.800	74.300	73.800	61
18) GOO+CR	590.00	.700	.850	.750	305	38) GOO+OR	590.00	83.500	84.000	82.200	123
<b>GOOG 19 APR 2008 (Contract Size 100)</b>						<b>GOOG 19 APR 2008 (Contract Size 100)</b>					
19) GOP+DD	420.00	93.200	93.900	93.800	12	39) GOP+PD	420.00	5.000	5.300	5.000	4
20) GOP+DF	430.00	84.700	85.300	86.700	y	40) GOP+PF	430.00	6.400	6.700	6.700	27

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# Covered Put Writing (Selling Puts)

- Selling a put obligates you to buy the underlying shares of stock at the option's strike price upon assignment of an exercise notice. The writer is paid a premium when the put is written to partially compensate for assuming the risk
- A put writer is considered to be covered if he/she has a corresponding short stock position



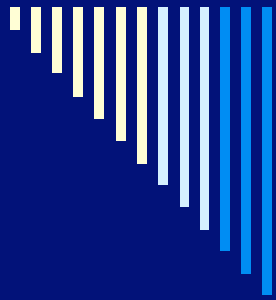
# Naked Put

- A put option whose writer does not have a short position in the stock on which he or she has written the put
  - Uncovered put writing has limited rewards (the premium received) and potentially substantial risk (if prices fall well below the strike price and you are assigned)
  - The primary motivations for most put writers are:
    - 1. To receive premium income; and
    - 2. To acquire stock at a net cost below the current market value
-



# Apple, Inc. (AAPL)

- For most of 2007 AAPL was Cypress Grove Partner's largest holding.
    - Sold all shares with the release of the I-Phone (\$168-\$182)
    - AAPL hits 52 week high on 12/28 @ \$199.83
    - AAPL up 59.55% for 2007
    - Stock slides from 12/28 high to \$155.64 in general market sell off in the first half of January
  - **January 22**
    - Reports record earnings but stock slides 12% on disappointing outlook. Stock closes at \$139.07 (chart breaks down)
    - Market continues slide and beats up tech darlings GOOG, RIMM and AAPL
-



# Apple, Inc. (AAPL)

(Cont..)

## ■ February 6

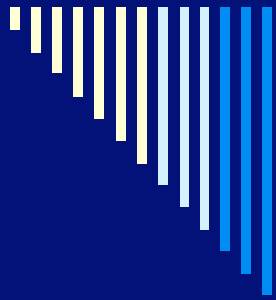
- AAPL down \$77.80/share or 40% from 12/28 high  
Stock opens at \$131.00, trades down all day

A.M. Wrote 20 AAPL Feb 120 Puts @ \$1.20

Wrote 5 AAPL Feb 125 Puts @ \$2.30

Bought 500 Shares @ \$124.50

P.M. Stock sells off into close – Closes at \$122.00



# Apple, Inc. (AAPL)

(Cont..)

## □ February 7

Cisco announces disappointing earnings

AAPL hits intraday low of \$117.27

Bought 700 shares @ \$119.80

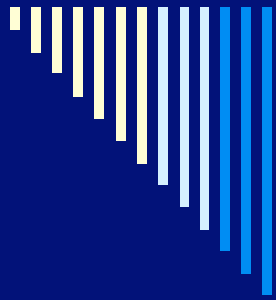
Stock closes at \$121.24 (52 week low)

## □ February 8

Snap back rally in tech

AAPL closes at \$125.48

Wrote 5 AAPL Feb 125 calls @ \$3.10



# Apple, Inc. (AAPL)

(Cont..)

## □ February 15

Stock closes at \$124.63

Result	Own	500	Shares	\$124.50
	Own	700	Shares	\$119.80
	Assigned	<u>500</u>	Shares	<u>\$122.70</u>
		1700		\$122.04

Collected Feb 120 Put Premium \$2,400

Collected Feb 125 Call Premium \$1,550

\$3,950

\$2.32/Share

Adjusted Cost \$119.72