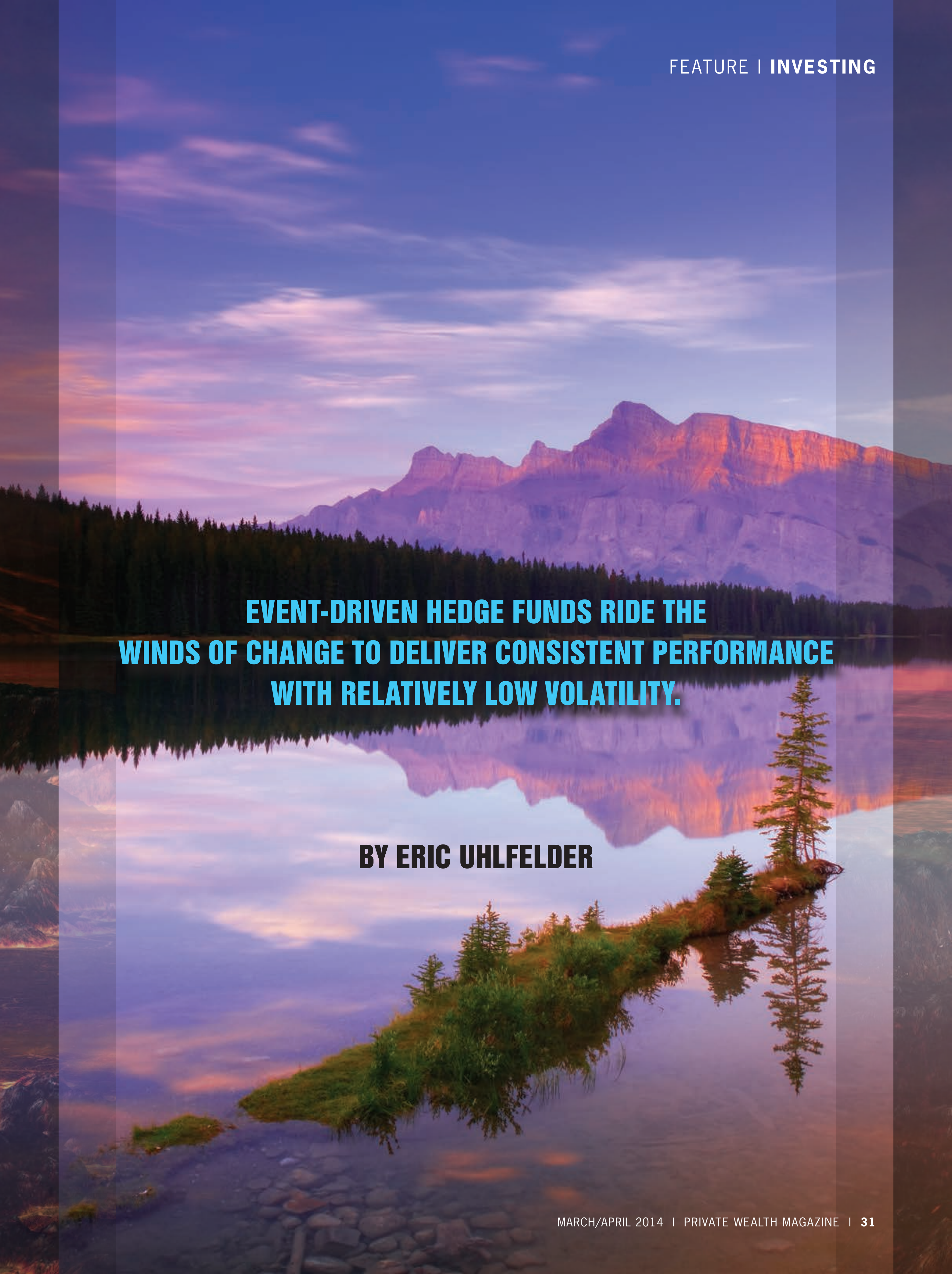
TURMOIL'S UPSIDE



EVENT-DRIVEN HEDGE FUNDS RIDE THE WINDS OF CHANGE TO DELIVER CONSISTENT PERFORMANCE WITH RELATIVELY LOW VOLATILITY.

BY ERIC UHLFELDER

WHEN THE ICELANDIC VOLCANO WITH THE UNpronounceable name Eyjafjallajökull spewed ash into the skies of Northern Europe in the spring of 2010, airline traffic came to a screeching halt, sending shares of affected carriers plummeting.

Amongst the hardest hit was discount leader Ryanair, most of whose flights ran right through the ash plume. Its shares lost nearly one quarter of their value in just two months despite no fundamental changes to the company's long-term outlook.

"The market's focus on flight suspension cut valuations from 20 times projected 2010 earnings to just 12 times, which to us made the shares a bargain," says Cliff Hoover, chief investment officer of Jersey City, N.J.-based $5.5 billion Dreman Value Management and co-manager of the Dreman International Value and Market Over-Reaction funds. Having bought Ryanair towards the bottom of the sell-off, the firm sold out just several months later when shares broke above their spring pre-eruption highs.

But the mispricing of Ryanair is a clear example of what event-driven investing—a traditional hedge fund strategy—can offer investors: low-risk, understandable investments that seek absolute returns independent of what the market is doing.

Though clearly a special opportunity, Dreman's exploitation of the 2010 eruption was not your run-of-the-mill event-driven trade. Managers in this space tend to focus on more systemic corporate changes, like bankruptcies, recapitalizations, spin-offs, asset sales, leadership transitions, litigation and regulatory changes.

"There are always events that are company specific or macro that can cause the price of a security to temporarily disconnect from its underlying value," explains Dov Gertzulin, founder and manager of DG Capital Management, an event-driven specialty shop that's delivered annualized gains of more than 21% over the past five years.

Of course it's easier for a mispriced stock or bond to move back up if it has a market tailwind. But these trades are designed to be market neutral. Historical correlation between event-driven funds and the S&P 500 is 0.65, according to the Hennessee Group, an advisor to hedge fund investors. As a portfolio diversifier, this adds to the strategy's attractiveness.

WHAT IT MEANS

When the market soars, like it did in 2013, having risen more than 30%, event-driven managers will not keep pace by the simple fact that most don't expect those kinds of gains across their portfolios.

The basic reason, explains Gertzulin, is that while managers like him may be on the right side of a trade a large percent of the time, it's the investments that don't work that keep net returns moderate. "I may stick with a trade that's moving against me because of strong conviction in a compelling thesis. I may even double down if it gets cheaper," Gertzulin explains. "But this isn't going to work all of the time because of unexpected changes in the macro picture that can challenge the thesis or its time frame, or by the occasional times that we might simply have been wrong."

Last year, the average event-driven fund rose 10.7%, according to BarclayHedge, another major industry tracker.

Still, as a group, these funds have delivered consistent, attractive returns. Since it started keeping records in 1997, BarclayHedge reports the strategy's annualized returns were pretty much the same, averaging nearly 10% through December 2013.

The same returns were also seen over the past five years, with annualized volatility of just 6.03%. And the average historical worst drawdown was less than 20%. In contrast, the S&P has turned in annualized gains of 17.6%, but with volatility of 15.7% and a worst drawdown of more than 50%.

The ability to deliver consistent returns with less risk has boosted investor interest in the strategy, especially over the past year through November, with assets having leaped 35% to $219.4 billion, according to BarclayHedge.

Growing interest is also evident in the increasing number of mutual funds that offer event-driven exposure in a package that allows for more liquidity and accessibility than hedge funds. While still small in asset terms, there are now nine event-driven mutual funds running nearly $400 million, according to Morningstar. Fidelity is the latest fund company to join in, introducing two products in December.

While mutual funds may be more advisor friendly than hedge funds because of discernable holdings and daily liquidity, they tend to give up performance by often foregoing leverage and the ability to make large bets in high-conviction trades, while working with a smaller bucket of investment tools.

The oldest mutual fund in the space is the Quaker Event Arbitrage Fund, which started up more than a decade ago. Like a hedge fund, it has exposure to merger and capital structure arbitrage, distressed securities, liquidations, proxy fights and special situations. While it can short, manager Thomas Kirchner has opted not to use leverage, which may account for its more modest returns since inception (before sales charges) of 6.46%. But over the last five years, it has generated hedge fund-like performance: annualized returns of 9.02% and standard deviation of 7.41%.

While the financial crisis inspired interest in such liquid, transparent products, the fund's assets are still modest at $92 million.

HOW IT WORKS

"Being able to gain exposure to various assets in various markets here and abroad is key to successful investing," explains Daniel Ades, founder and CIO of the $289 million Kawa Fund, a global event-driven hedge fund.

Over the past five years, Kawa has gained more than 17% annually, with annual standard deviation running 4.75%. Since starting up in the inauspicious time of September 2007, Kawa has never had a down year. Ades has largely done this not by riding the huge equity boom that followed the 2008 crash, but through his exposure to various debt instruments.

"The collapse in liquidity produced remarkable debt mispricing," he recalls, "which generated greater opportunities in fixed income for a number of years." Comparing his returns with the S&P 500 proved him right through 2012. (In 2013, Kawa was up only 5.55% because his long credit exposure saw limited returns as the price of 10-year Treasurys sold off.)

Kawa found opportunity in California as fears of municipal bond failure hit the state's troubled debt market. In June 2011, Ades built up a 4% position in a basket of out-of-favor, long-date California School District Zero-Coupon Bonds that had sold off because of a spate of negative news about the state's finances. This "event" sent effective yields soaring from 6% in October 2010 to 7.5% just before Ades started buying.

In selling off, investors ignored the fact that these bonds were issued with voter approval. They were thus ring-fenced obligations, specifically backed by district property taxing authority. When fears eased and yields fell below 6.5%, Ades sold out, delivering a 70-basis-point boost to the fund.

Delineating how hedge fund managers can reach into obscure spaces for opportunity, Dov Gertzulin ventured into Indian territory (also in California), smack in the middle of a dispute within the Chukchansi tribe, which entangled its local economic development authority and the Chukchansi Gold casino, whose revenue backed the authority's debt.

Before feathers got ruffled, the authority had restructured existing debt in a $255 million bond issue in May 2012, paying a coupon of 9.75%, and due in 2020. But this didn't stabilize the price as investors feared headwinds from the pending development of a nearby casino.

But Gertzulin felt the market was misreading the impact of this event. The new casino would not be completed for at least several years, and he saw value in the bond, whose price tumbled further below $0.60 on the dollar. So at the end of 2012, his fund established a 5.5% position in the bond, collecting an effective yield of 16.8%.

Not long after the refinancing, a second unexpected event hit. The tribal squabble resulted in the casino stopping its flow of payments to the authority, resulting in a technical default. The bond price fell further toward $0.50.

But there was legal recourse. The fund, along with several other institutional investors, convinced the bond trustee, Wells Fargo, to sue the tribe for breach of contract. A state supreme court ruling in July agreed and demanded payment of missed interest, a default penalty of 0.5%, and reimbursement of all legal fees.

By January, the bonds had rallied above $0.70. Between interest and capital gains, the investment returned nearly 40% in a year and a half. Though the fund has unwound half of its exposure, it expects to continue to profit from the bond's attractive yield and continued price appreciation.

For years, the market has been waiting for the big payday when Vodafone finally divested it's 45% holding of Verizon Wireless. In January 2013, Quaker's Kirchner went long the UK-based global telecom giant, seeing the move as a likely part of the company's ongoing rationalization to make it more European focused.

He believed the market still hadn't properly valued Vodafone's stake in the wireless enterprise (which it estimated to be worth $130 billion), including the potential for a special dividend that would distribute proceeds from the sale.

Meanwhile, Kirchner shorted Verizon—in the belief that the other owner of Verizon Wireless was already fairly valued—to partially inoculate the investment if the deal didn't work out.

By year's end, a sales agreement was in place. Vodafone's shares had soared 48% and Verizon enjoyed a modest gain of 11%. So far, the trade netted the fund 50 basis points, with potential for more via the special dividend payment due in 2014.

CHALLENGES

A key risk in event-driven investing is identifying what a meaningful event really is. The market may reward a stumbling company for replacing its CEO. But a rally may be short lived if the company's underlying problems are outside the direct control of leadership. This was aptly demonstrated by the multiple leadership changes at Eastman Kodak, which had failed to respond to the disruptive market shift from film to digital and was finally forced to declare bankruptcy.

Anne-Gaelle Pouille, an event-driven portfolio manager and partner at Paamco, the $8.8 billion funds of funds, says that a simple gauge in identifying a material event is "when one can describe with a high degree of certainty what the event is, when it's going to happen and what its impact on the corporation is likely to be."

Toward that end, she urges hedge fund investors to see their managers' "original research, their exposure to hard events, an articulated rationale as to why certain trades and sectors are favored, and [what managers deem as] acceptable liquidity."

DG's Gertzulin says the state of credit is always a potential issue. Whenever its availability is significantly altered, it can affect refinancing and leverage, which in turn impacts the outcome of many events.

Another key "X-factor" is the potential impact of government intervention and regulation. This was most evident during the financial crisis as governments aggressively intervened in markets in unprecedented ways.

There was always the potential of such risk in developing markets, explains Matteo Perruccio, the founder and former chief executive of Hermes BPK Partners, a $2.6 billion fund of hedge funds firm. But now he sees such risks in developed countries as well. This manifests itself in various forms, from quantitative easing and currency intervention to the blocking of cross-border mergers. Such uncertainties make event-driven investing harder, but Peruruccio believes "there are opportunities for people who really understand the implications of government regulation."

OUTLOOK

To little surprise, most event driven managers are optimistic about the coming year. Summing up industry sentiment, Zachary R. George, a portfolio manager at FourFront Capital Partners, an event-driven shop running $340 million and having generated 10.75% annualized returns since its inception in January 2007, thinks "low interest rates, improving U.S. growth and increased corporate merger and acquisitions [should kick] the event cycle into high gear."

He expects opportunities from continued corporate spin-offs and shareholder activism within the mid-cap and large-cap space, coupled with growing private equity activity in new investments as shops redeploy 2013 profits.

But Daniel Ades urges caution. "The market was euphoric last year, and even without cause, sentiment can quickly turn." This can play havoc with many investments, including those triggered by events, says Ades. "But it can also set up opportunities as changes in momentum produce mispricing."

FIGURE 1

Select List Of Leading Event-Driven Hedge Funds

FUNDS	INCEPTION	FUND ASSETS (MILLIONS)	1-YEAR RETURNS	3-YEAR ANNUALIZED RETURNS	5-YEAR ANNUALIZED RETURNS	ANNUALIZED RETURNS SINCE INCEPTION	1-YEAR STANDARD DEVIATION	5-YEAR ANNUALIZED STANDARD DEVIATION	5 YEAR SHARPE RATIO
Gates Capital ECF Value Fund II LP	Jan-04	1508	20.01	16.01	33.76	15.95	6.1	19.93	1.69
FrontFour Capital Partners LP	Jan-07	340	32.16	19.04	23.55	10.29	8.46	12.56	1.87
DG Value Partners LP B	Apr-07	257	28.91	13.58	22.02	7.53	4.79	10.27	2.14
JANA Nirvana Offshore Fund Ltd	Apr-07	1897	28.3	18.51	19.8	13.35	9.61	10.27	1.92
Litespeed Offshore Fund Ltd	Jul-02	1625	24.15	16.74	17.73	11.71	4.46	8.05	2.19
Kawa Offshr Feeder Fund	Sep-07	288	6.93	11.75	16.07	15.75	3.25	4.21	3.79
Beach Point Total Return Fund LP*	Jul-96	99	12.31	8.67	12.51	11.02	2.13	5.82	2.13
Moab Partners LP	Apr-06	173	20.18	8.2	12.25	9.03	5.73	7.1	1.71
Napier Park Event Driven Strategies	Jul-08	686	10.84	5.33	10.16	8.45	4.18	5.88	1.71
Twin Offshore Ltd	Sep-02	180	10.59	10.01	10.03	9.57	4.24	5.36	1.85
Barclay Event Driven Index	**Jan-97**		**11.86**	**5.38**	**10**	**9.94**	**3.72**	**6.03**	**1.64**
S&P 500 Total Return Index	**Jan-80**		**30.3**	**17.73**	**17.6**	**11.72**	**8.24**	**15.67**	**1.12**
MSCI EAFE Index (USD)	**Jan-75**		**21.42**	**7.16**	**10.09**	**8.18**	**11.86**	**19.73**	**0.51**

*Returns for Beach Point are through November 2013. Data: Through December 2013. Source: BarclayHedge