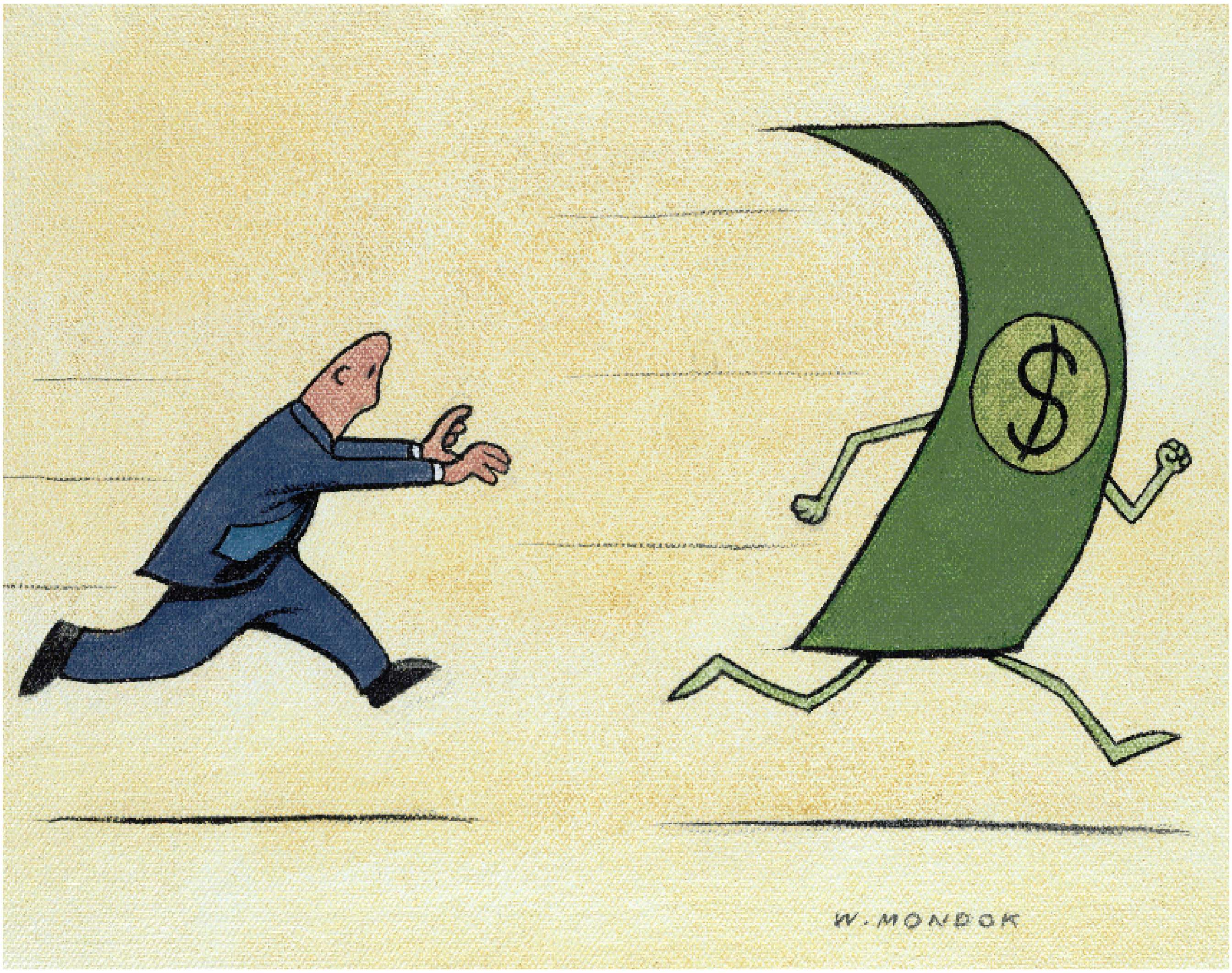
Event-driven is one of the oldest and most successful hedge fund strategies. By Zaki Abushal

The managers who wait for something to happen



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According to a recent study conducted by Hedge Fund Research, 14% of all hedge fund assets are allocated to event-driven styles (excluding distressed securities) and most of these fall into the special situations bucket.

It's a loose term to describe one of the most uncorrelated and innovative strategies around. The strategy is driven by the quality of the managers and their ability to pick the right stocks. This may sound like a fund manager's Holy Grail, but in the special situation environment, stock-picking is vital. For these hedge fund managers, 30% to 40% of the portfolio tends to be made up of about five positions. Among their peers, event-driven strategies are performing well, up more than 12% annualised for the year according to Eurekahedge's event-driven index.

Part of the reason behind the sector's strong performance is the amount of mergers and acquisition activity taking place. It is something carefully monitored by special situation

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>
> **Sean Ewing, Absolute Capital Management**

managers. The value of M&A transactions had reached over $2.5trn by the end of September – already in excess of last year's figures. This phenomenal growth is down to the combination of strong stock markets, low credit spreads, low interest rates and a pretty solid macro environment, as well as a generally more positive sentiment around corporates, which has seen a shift from cost cutting to growth opportunities.

Over the past 12months there has been a lot of talk about exchange consolidation, which offers a number of synergies through horizontal integration. The recent CBOT/CME merger created a US behemoth. However, there's been even more excitement about the European markets, starting with last year's failed takeover of the LSE by Deutsche Börse and the expectation that by year end we would see perhaps two or three dominant stock exchanges in Europe. This is yet to happen, but those in the event driven environment are confident the move isn't far off.

Twin Securities founder David J Simon has been managing a wide array of special situation investments for over 20 years. Operating out of New York, his fund is predominantly interested in equity event-driven strategies – a purely bottom up approach.

The fund focuses on merger arbitrage, special situations and deep value stocks, each situation relying on a deep understanding of the targeted company history and a visible catalyst to release the embedded value. In this way, Simon feels the best approach to take advantage of special situations is through a modified long/short equity strategy.

Twin Securities looks for equity-based investment opportunities in the US, Canada and Europe, preferring to take advantage of its experience and expertise. The fund manages around $150m but has capacity of between $400m to $500m. "We will stick to what we know and remain flexible in our tactics. Our smaller size provides better agility and permits us to consider a wider array of situations," says Simon. "It is a focused long/short equity portfolio with almost zero correlation to the larger equity markets. We concentrate on events that simply aren't as affected by market direction." When Simon considers an opportunity, he favours those industries with

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serious barriers to entry. For instance, the healthcare market appears ripe for a period of consolidation following years of largely organic growth.

"There is plenty of anecdotal evidence that the drug pipelines for these firms are running dry, which will mean some of the big drug companies will have to look at each other. Apples-to-apples mergers buy management three more years to establish real growth in earnings," he says

In the last couple of years, there has been a lot of irrational behaviour in hugely volatile sectors of the market. Unmoved, Twin Securities has continued to apply its craft in a methodical fashion. "We are not about to drink the Kool-Aid at this point," says Simon. "It's very tempting for less-experienced event-driven managers to chase big momentum trends like commodities and irrational sector valuations. At some point, there is usually a tragic headline."

Simon hasn't built the firm's reputation on future performance. It has returned around 21% per year since 1995.

Unlike other special situation funds, Twin Securities stays well away from anything that's remotely volatile, and prefers to do business in geographic markets it knows well. He's not alone in taking this approach. Sean Ewing, CEO of Absolute Capital Management, the activist hedge fund that also runs the event-driven European Catalyst Fund, predominantly stays within the safe havens of Western Europe. Absolute Capital is also hopeful of some activity in the healthcare market, so much so that it has just beefed up its healthcare team by hiring Tim Franklin, a pharmaceutical and biotech analyst. This will make up a small portion of the 80 or so positions the Catalyst fund holds at any one time – a relatively large number for an event-driven fund.

All Absolute Capital's funds were up between 1% and 3% in October – the month is shaping up to be a good one for most event-driven funds – and the firm now holds well in excess of $1.25bn in assets under management, according to Ewing.

However, he isn't too convinced by the recent equity market rally. "We're currently seeing the market becoming over-exuberant, which is similar to what happened in February, March and April of this year," Ewing says. Though Absolute Capital is bearish for the rest of 2006 the company has been taking positions and making profits in the meantime.

"We made money on the consolidation in the Italian banking industry and we've made a little money in some of the exchange derivative markets," Ewing confides. This has all contributed to Absolute Capital's strong performance in October. But the firm certainly isn't excited about the markets prospects for the rest of the year. "Our exposure is the lowest its been in the last 16-18 months," says Ewing. ■

OCT 2006 PERFORMANCE LEAGUE – EVENT-DRIVEN FUNDS

	AUM ($m)	Oct 06 return	06 YTD return
KAYNE ANDERSON MLP FUND LP	494	4.97	20.55
JANA OFFSHORE PARTNERS LTD	Not disclosed	2.90	11.17
ORE HILL INTERNATIONAL FUND LTD	1470	2.87	10.74
ORE HILL FUND LP	420	2.03	10.75
GLAZER OFFSHORE FUND LTD	46	1.40	10.83
BAREP ACHILLEA MULTI EQUITY FUND	132	1.28	8.14
TROPHY HUNTER INVESTMENTS LTD	168	1.13	35.79
BAREP PROTEA M&A EURO FUND	84	0.91	5.99
BAY HARBOUR PARTNERS LTD	374	0.52	41.28
BAY HARBOUR 90-1 LTD	343	0.45	38.54