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Title	HEDGE FUNDS' INVESTMENTS TO DISTRESSED SECURITIES – Empirical Study Before and During the Credit Market Crisis		
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Abstract

Corporate credit spreads widened dramatically at the beginning of the financial crisis in August 2007 which drove many companies to financial distress. This created attractive investment opportunities for distressed security investors. Distressed security investing is a practice of acquiring securities of companies in financial distress. These companies may have already defaulted on their debt or may be on the edge of default. Distressed securities often trade for significant discounts, stocks at very low values and all or some proportion of unsecured debt at remarkable discount. Investors seeking to profit from the distressed securities buy the securities at a significant discount, reorganize or improve the company and exit the investment when security appreciates in value.

This thesis explores the return and risk characteristics of hedge funds described as “distressed security investing” at the same time uncovering the myriad of hedge fund style. The purpose is to find answers to the following questions:

- Which asset-based risk factors and to what extent they explain the sources of risk and return of distressed securities hedge funds?
- Do risk and return characteristics change in up and down markets?

Research data was collected from the time frame of January 1994 until December 2009. One used 73 individual hedge funds' return data and seven factors were tested. Factors tested were Barclays U.S. High Yield Index, credit spread, Russel 3000 equity index, VIX volatility index, default rate, one-month Libor and 10-year U.S. Treasury rate. Based on Sharpe's asset class factor model a multifactor model was created and regressed against fund returns.

The modeling of distressed securities' hedge fund style gave promising results. The average adjusted R<sup>2</sup> value over 73 separate regressions was 39 % using a five factor model. Barclays' high yield index had the strongest (positive) effect on returns and risk. Option adjusted spread, default rate, 10-year Treasury yield and volatility index had minor effects. However, all the factor exposures except volatility index differed significantly during up and down movements of the factors. It revealed that hedge funds investing in distressed securities are successful especially during market downturns. A widening of credit spread was clearly found to be a risk factor for distressed securities that were already on the edge of default, while narrowing spread effect seemed to be close to neutral. These results provide useful insights of risk and return characteristics of distressed securities hedge funds to asset allocation decisions, for portfolio risk managers and in fund of hedge funds construction.

Key words	distressed debt, hedge fund, bankruptcy, regression analysis
Further information	