Book reviews

HEDGE FUND COURSE

by **Stuart McCrary**

John Wiley, Chichester, UK, 2005; ISBN 0-471-67158-4; 285 pp; paperback; \$79.95

This long-awaited book, which examines all facets of hedge funds in a concise and painless fashion, is finally out. From the simplest definition of a hedge fund to the comparison of mutual funds and hedge funds, the author traces hedge fund assets from their beginnings until the present. The hedge fund basics are explained, finally demystifying the hedge fund myths that are perceived in the industry. At the end of every chapter, questions are a welcome addition for the reader, making this book an ideal text for a course on hedge funds.

The author then classifies hedge funds into their individual categories and expands on the types of investors investing in hedge funds. He introduces ways of including hedging funds in retirement plans, including individual retirement accounts (IRAs), Keogh and 410(k) plans. The mechanics of each hedge fund strategy is discussed in layman's terms followed by various hedge fund business models. The taboo of hedge fund leverage is carefully addressed, giving the reasons, limits and impacts for the use of leverage.

Next, McCrary investigates performance measurement using ratios and various measures such as simple annualised returns, downside deviation and other methods to

evaluate the risk of hedge funds.

The hot topic of hedge fund regulation and legislation is outlined and the acts implicating hedge funds — from the Securities Act of 1933 to those as recent as the Patriot Act of 2001 — identified and discussed. The inclusion of hedge fund accounting, a subject rarely given any consideration in hedge fund textbooks, is a novelty. The chapter distinguishes the differences between traditional accounting and hedge fund accounting from a manager's point of view. Hedge fund taxation and the avoidance of US federal taxation and flow-through taxation along with their implications are carefully presented. Finally, double taxation of corporate income is addressed for C Corporations limited liability corporations (LLCs) defined under subchapter C of the Internal Revenue Service's incorporations code — LLCs and the flow-through tax treatment of sole proprietorships, partnerships and LLCs is mentioned.

Risk management and return data of hedge strategies is explored using diverse charts and tables coupled with descriptive measures of hedge fund research (HFR) into hedge fund classifications, including funds of hedge funds. McCrary also

suggests that more powerful tools to minimise risk are required today. He meticulously explains in layman's terms value-at-risk (VaR), credit risk measurement and option risk measurement.

A chapter on the marketing of hedge funds and how hedge funds perform their marketing duties in this regulated environment using third-party market business partners is seldom seen.

The penultimate chapter educates and informs the reader as to why derivatives used should be to invest in hedge funds? It includes a discussion of swaps, downside protection with zero coupon bonds and principal protected notes. Hedge fund investment through life insurance is suggested to offer a significant tax advantage over direct investment in hedge funds.

The concluding chapter elaborates on the importance of hedge funds in the market and how the hedge fund market has evolved over the years. The author further

looks at future considerations in the growth of the hedge fund industry and what lies ahead for hedge funds.

In conclusion, this book could benefit any investor intending to obtain more information on hedge funds. It can be used for a weekend course on hedge funds or simply to educate anyone interested in becoming more familiar with this rapidly growing alternative asset class. McCrary has produced a valuable handbook, which looks at every aspect of hedge fund investing. A must for academics, professional money managers, accountants, lawyers and anyone interested in this secret world of privately managed money. A job well done!

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FIXED-INCOME SECURITIES AND DERIVATIVES HANDBOOK

by Moorad Choudhry

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The book begins by a looking at the fundamentals of bond instruments and interest-rate risk. It provides a thorough view of what one needs to know to understand fixed-income securities in detail. The classic bond pricing issue is then examined in continuous time along with the mechanics of spot and forward rates. Next, the chapter on interest rate modelling examines Ito's Lemma along with one- and two-factor term structure models. Numerous two-factor interest rate models are examined, and the author guides the reader on how one should go about choosing a term structure model. The last chapter in the first section looks at yield curve smoothing by comparing parametric and non-parametric curves, which highlights how this predictor of the general economy can assist money managers to outperform and possibly predict the course of the market.

The next, and longest, section of the book examines options, forwards, futures, interest rate swaps, generic swap evaluation and an application from a corporate and an investor's point of view. The chapters explain the conceptual framework and offer insight into the impending risks and returns from typical option investing as well as offering ways, in an increasing interest rate environment, to lower the cost of borrowing money using

swaps for asset management. These chapters can provide investors with strategic information and many techniques for reducing the potential risk in managing their investment portfolios. The options chapter elaborates on option pricing using the Black–Scholes and other option models. The following chapter on measuring option risk deals with the option price behaviour of the Greeks, which can orchestrate and reduce the downside potential of traditional investment portfolios.

It is well known that there is no exact method for pricing credit derivatives yet, and numerous models are dealt with in this chapter to clarify this problem. Worldwide, the area of credit derivatives in the banking industry is growing at a fast pace, and the author takes a closer look and identifies quantitative techniques and methods by which banks, insurance companies, hedge funds and corporations can use credit derivatives to reduce their exposure to credit risk.

A different view of bonds with embedded call and put options is important to assist investors and pension funds to deal with event risk. Although complex in nature, the author provides an understanding of option elements embedded in a bond in great detail. Many models are explained in both chapters as a means of

evaluating these financial instruments, whereby investors can establish their own parameters for the options. Subsequently, the author provides his insight into inflation-indexed bonds which have offered inflation protection to investors since the 1990s and which offer added diversification to investment portfolios. The basic concepts, such as the choice of index and indexation lags, are followed by TIPS cash flow and yield calculations, and further offer the reader a choice between holding indexed or conventional bonds.

Hybrid securities combining the characteristics of both debt and stock features have been used during the past decade. Choudhry discusses floating and inverse floating rate notes along with their respective advantages and highlights the benefits to investors of synthetic convertible notes and interest differential notes.

Next, securitisation and mortgage-backed securities are examined closely by looking at the various models and patterns of cash flows of these instruments. The author then evaluates and analyses mortgage backed bonds (MBBs) and demystifies this complex subject by showing the benefits of using MBBs for interest rate hedging instruments.

The last chapter in Section 2 shows how collateralised debt obligation (CDO) structures are used to transfer credit risk. CDOs are structured fixed-income securities with cash flows linked to the performance of debt instruments. Choudhry examines the motivation behind the cutting edge area that is the exploding CDO market and structured credit products market by exploring the types of products offered and predicting the potential for

product growth and extinction. The author outlines the important factors that must be considered when evaluating and analysing or rating a CDO.

The last section of the book looks at issues relevant to players in the fixed-income markets by assessing the practical uses of redemption yield and duration. Determining strip values and strip market anomalies are examined using a small case study to shed some light on the practical use of yield and cash flow analysis for strips. The last chapter offers various approaches using screenshots of eurodollar futures trading and briefly discusses the inadequacy of using the yield curve to analyse the market.

This book is a must-read for financial professionals and practitioners interested in learning about one of the fastest growing markets on Wall Street. In conclusion, Dr Moorad Choudhry has done it once again — this is a detailed handbook for investors wanting to understand or get a deeper insight into the latest cutting edge techniques in the area of fixed-income securities and derivatives. This book should be on the shelf of hedge fund managers, academics, institutional investors, banking intermediaries, portfolio managers, high net worth individuals and others wanting to further their knowledge in this field. Congratulations on a great book!

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