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Hugs for the hedged investor

In the year to date, the S&P 500 has risen by 11%, the average hedge fund hardly at all. Since the end of 2008, the S&P has climbed by 153%, the average hedge fund (specifically, the average equity-focused hedge fund) by only 41%. No wonder, as Bloomberg reports, that private investment partnerships are closing at the fastest rate since 2009, or that money continues to pour into Vanguard's low-cost (virtually no-cost) index funds. Hedged investing is the subject at hand. It's due for its own bull market, we are about to conclude.

To begin at the beginning, a definition: "To hedge" is to withhold. It's to keep something back from the long side of the market, either in cash or through the technique of short selling. It's to give financial expression to the adage, "you never know," and likewise to deny the modern adage that, because markets are efficient and information is ubiquitous, the deciding variable in investment success is the investor's cost of investing.

Seth Klarman, president of the Baupost Group, observes that one's choices in markets resemble one's choices in life. Yes, you could invest everything in today's markets at today's fancy prices; in so doing, you would be acting on the implied belief that today's opportunities are the best you'll see. And, yes, you could have married at the age of 18, having reasoned that, really, you'd never meet anyone more suitable than the people with whom you studied geometry. It's only common sense not to bet everything on the opportunities in front of your eyes. Time opens doors.

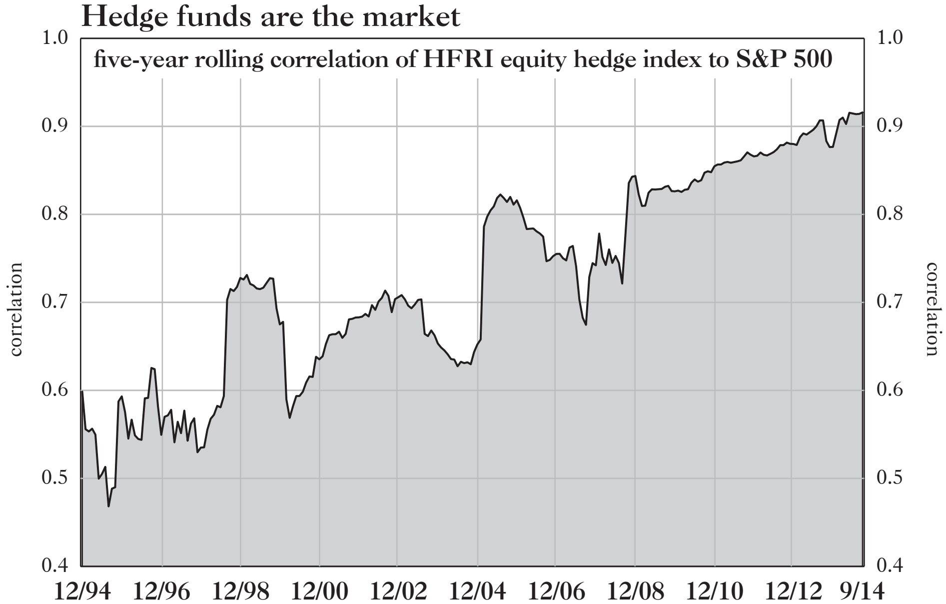
Probably 99 professional investors out of 100 would agree with Klarman's proposition—and probably almost as many would say they couldn't hold a job while implementing it. Yes, life may be uncertain, but one must bow to the imperatives of the moment. As for this moment on Wall Street, price volatility is low, the dispersion of returns among asset classes, ditto. Central banks continue to stimulate, asset prices to levitate. Indexed investing is the 2014 public securities' market category killer. Ergo, to hedge is to lose.

Or rather, to hedge *has been* to lose. It has been a losing proposition in much the same way as the purchase of homeowner's insurance is ordinarily a losing proposition. You send thousands of dollars to Allstate, yet your house is still standing. Of course, the analogy is not quite apt. A homeowner doesn't lose his or her portfolio manager's job because he or she bought too much fire insurance.

The late Alex Porter, an alumnus of A.W. Jones & Co. and a founding partner of what is today Amici Capital, used to make the case for hedged investing in this way: "One of these days, you're going to wake up in the morning, open the newspaper and find out that China has lobbed a nuclear missile into Pakistan. And it's going to be a good day to be hedged." For us, the missiles to worry about are the ones that central banks shoot off. A peculiar kind of ordnance, they seem packed with gifts, not high explosives. They blow up with a kind of long-delayed fuse.

We build this argument on top of our

Hedge funds are the market



source: Hedge Fund Research

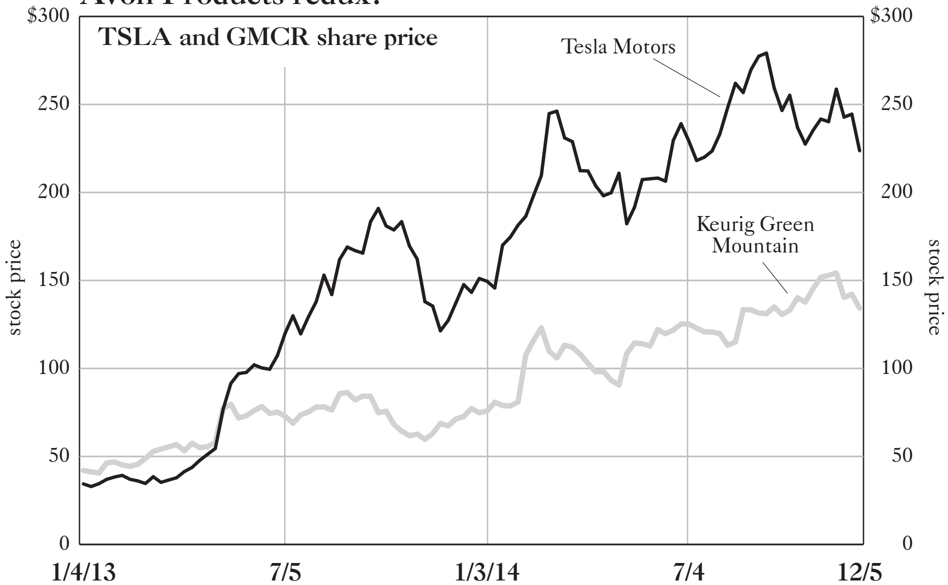
previously constructed brief for active investing (*Grant's*, Nov. 14). Concerning the case for not only opening the 10-K report, but also reading the footnotes thereto, and—where indicated—turning that information to constructive use, John C. Bogle, founder of Vanguard, has produced a five-page rebuttal that we post on the *Grant's* Web site. The case for hedged investing is more than twice as controversial as that for delegating the art of securities' selection to Standard & Poor's. While all active investors profess to believe in active investing, only a portion of that beleaguered cohort (and not necessarily a majority) chooses to hedge their long positions with short sales or cash.

Reasons not to sell short abound. Thus, in no particular order, you earn no interest on the cash balances you generate from selling short but can pay a pretty penny to borrow the shares with which to be short. The "best" short ideas are overcrowded. Activist investors are prone to buy the shares of the very under-performing businesses that short sellers sell. Finally, the big, highly valued, index-dominating stocks that would seem to cry out for a bear's attention are the same stocks that the index funds are buying. All of this undermines the efficacy of the long-short hedge fund model that Alfred W. Jones originated in the 1950s. A Jones' style fund is built to be leveraged; margin debt finances the short book, a.k.a. the hedge. Trouble on the short side spells trouble for the business model.

"While the market is not in risk-off mode, which it hasn't been except intermittently for years now, sitting in shorts is just deadly," relates a portfolio manager we know (he asks to go nameless). "It just eats at returns. It provides no income like it used to. . . . If you're 120% long and 70% short, and you're earning 4% on that short, you can afford to sit on it if it goes against you a little bit. If you're paying 3% to sit in that short, and sometimes 20% or 30% to sit in the best ideas, it's just working against you on time. You want time to be your friend. To me, that's always been one of the main points of the A.W. Jones model—that time is your friend. It's not really your friend now if that is the set-up you've got. One always has to be tactical with shorts, trying to size and time them correctly, but the pressure to get that right increases in this environment."

No surprise, then, that hedge funds more and more resemble the stock market they are supposed to hedge against. Over the past five years, the HFRI Equity Hedge index and the S&P 500 have exhibited a steadily rising correlation; in September, it reached 0.92. According to the Nov. 20 issue of Goldman Sachs' "Hedge Fund Trend Monitor," the funds' net long exposure reached a new record high on the eve of the Oct. 15 bond-market flash crash. The case against short selling is so seemingly obvious that—as a contrarian might reckon the odds—it must be wrong. Easy to say, of course. For many a practitioner, there's no choice but to fall in step with the bull market. A fund without investors is even less viable than a fund without a hedge.

Avon Products redux?



source: The Bloomberg

Scopia Capital, which manages $5 billion, sets itself the difficult task of delivering absolute returns uncorrelated with the broad market. It has succeeded in this work, not least in 2008 when it was up by 1.8%, as against a plunge in the S&P 500 of 37%. Since inception in 2001, Scopia has compounded its capital at an annual average rate of 9.5%, net of fees, compared to 7.9% for the S&P. It hasn't been easy. "We've been fully hedged, with relatively little index or ETF exposure, for 13 years," Jeremy Mindich, co-founder and managing partner, tells colleague David Peligal. "I would say that we are considered among the best short-selling hedge funds around. And we've made no money on the short side. Our rate of return on shorts since inception, including borrow costs, is 1%. Fully burdened with research and overhead costs, it's slightly negative. The market is up 8% annually over that same period, so we have created a ton of alpha on our shorts. But the bottom line is that we've lost money shorting for 13 years. A sane hedge-fund manager can rationally say, 'Why in the world would I devote all the time that it takes to come up with really good short ideas—and then not to make any money from it?' It's preposterous on some level, except that it allows you to create the kind of uncorrelated returns that attracted people to hedge funds in the first place—and why they were willing to pay the fees that hedge funds command."

It's interesting that Mindich should put the matter just this way—in the context of the origin of the hedge fund—because we happen to hold in our hands a relevant ancient text. It's a 1970 *Fortune* article by Carol Loomis headed, "Hard Times Come to the Hedge Funds." Allegedly hedged, the funds had flunked the test of the 1969 bear market. They had suffered devastating losses on the long side without offsetting gains on the short side (or, worse, with contributing losses on the short side). Through October 1969, the biggest funds were down between 30% and 40% as against a 13% decline for the New York Stock Exchange composite index.

Jones was famously averse to publicity but he spoke to Loomis. "The trouble began, he [said], in the 1966-68 period when the craze for performance swept the investment world and when all sorts of money managers, including those in his own shop, got overconfident. . . ," the reporter wrote. "Jones's record for this period was excellent: during his three fiscal years ending May 31, 1966, through 1968, the limited partnerships in A.W. Jones & Co. realized gains—after deduction of the general partners' 20% of profits—of 29%, 22% and 45%. In all these years, these gains (as well as those recorded by Jones's other partnership) were far superior to those made by the broad market averages. As the new fiscal year began in mid-1968, the profits continued to build.

"Even Jones himself," Loomis continued, "despite his 69 years, was caught up in what he describes as the 'euphoria' of the times. He says he began to wonder—for him, the very thought was heretical—whether his hedging strategies, which had always been aimed at softening the effects of a potential market decline and which had therefore held back his gains in bull markets, might not have been misguided; perhaps it would have been smarter, he told himself, to have run at full risk all the time, thus taking maximum advantage of the general upward trend of the market."

By the time the market had rolled over, as Jones related his sad story, his funds' rush to reduce exposure and to build up short positions was "too little, too late." Then, too, as Loomis pointed out, not every short sale was profitable, even in a falling market. For their failure to execute, hedge fund managers assigned blame to, among other things, the existence of an uptick rule (you couldn't hammer a falling stock), the chaos in Wall Street back offices that made borrowing shares difficult, and one with a particularly contemporary ring, "the existence of too many hedge funds looking for shorts." They might have mentioned poor securities' selection. The short sellers of 1969 fatally favored high-multiple growth stocks, e.g., IBM, Xerox and Burroughs. Like the Teslas and Keurig Green Mountains of 2014, the glamour stocks of Jones's era were exceptionally versatile investments. Favored short-sale candidates, they did double duty as profitable longs.

In 1969, by Loomis's tally, 150 hedge funds managed $1 billion; public mutual funds held $50 billion. You look at these figures and wonder where the commas and zeroes went. It was just 45 years ago, after all. Could American finance have really been so tiny (can ours really be so outsized)?

Today's world might be unrecognizable to the practitioners of Jones's generation. Derivatives, nonstop digital media, governmentally administered bull markets, and a gold-free monetary system would have seemed odd, if not inconceivable, in the first full year of the Nixon administration. Today, some 8,000 hedge funds manage $2.8 trillion against the $12 trillion in the hands of mutual funds.

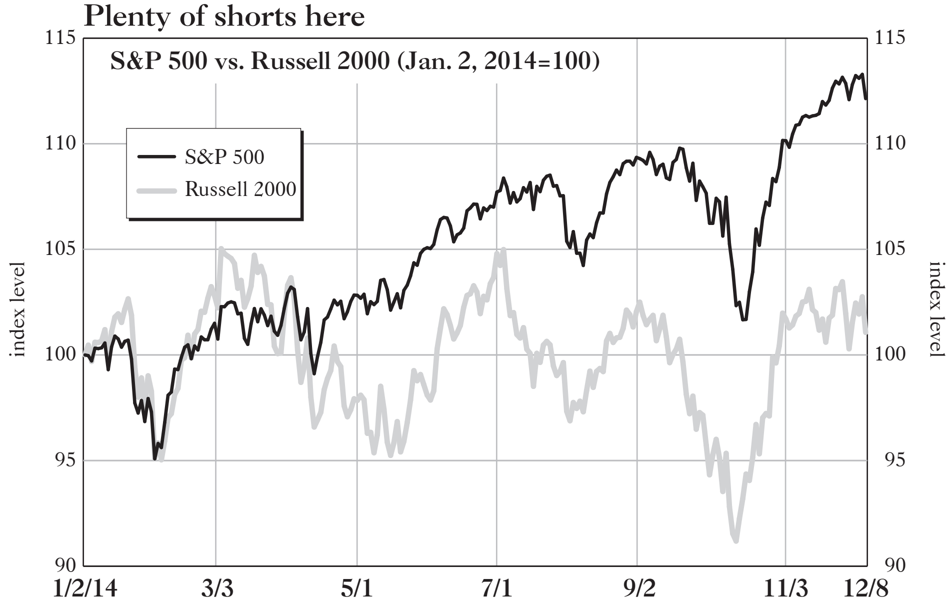
As hedge funds loom proportionately larger in the world of finance than they did 45 years ago, so does the typical hedge-fund personality make a deeper financial imprint than it formerly did. Almost by definition, the average hedgie is inclined to take a nonconsensus view. His or her mind-set is the "yes, but" kind. Our composite hedge fund G.P. is no dummy, as he or she is all too well aware. It's a personality type not necessarily destined to succeed in the average too-big-to-fail bank or during a central-bank-administered market updraft.

"Of course," Peligal observes, "just because the dispersion between the best-performing and worst-performing stocks in the S&P 500 is low doesn't mean that it's been impossible to succeed on the short side. The Russell 2000 is up 2% for the year in the face of a double-digit rise in the S&P. *Some* stocks went down. But the reality is that when you talk to hedge-fund guys for ideas, they're always giving you the funky, out-of-consensus, illiquid name to be long and, as perhaps as a hedge, a large cap name to short. As an example, let's say Eli Lilly & Co. is that large cap name. For the most part, nobody is pitching you to be long Eli Lilly, an $80 billion market-cap company, up 42% year to date, that trades at 22 times the projected consensus sell-side earnings estimate for 2015. Maybe they should, maybe they shouldn't, but the average hedge-fund manager isn't thinking about being long Eli Lilly."

If Jack Bogle is right, the investment question is settled science. Costs alone are dispositive, and we should wire our funds to Valley Forge, Pa. If Bogle is only partially correct, the world is not so cut and dried. Asset prices will continue to overshoot both to the upside and the downside. Deep on the downside, what will matter most is not the cost of investing but having the funds with which to invest—and the courage to call the broker to utter the word "buy." It's to capture those recurrent opportunities that hedge funds, some of them, hedge.

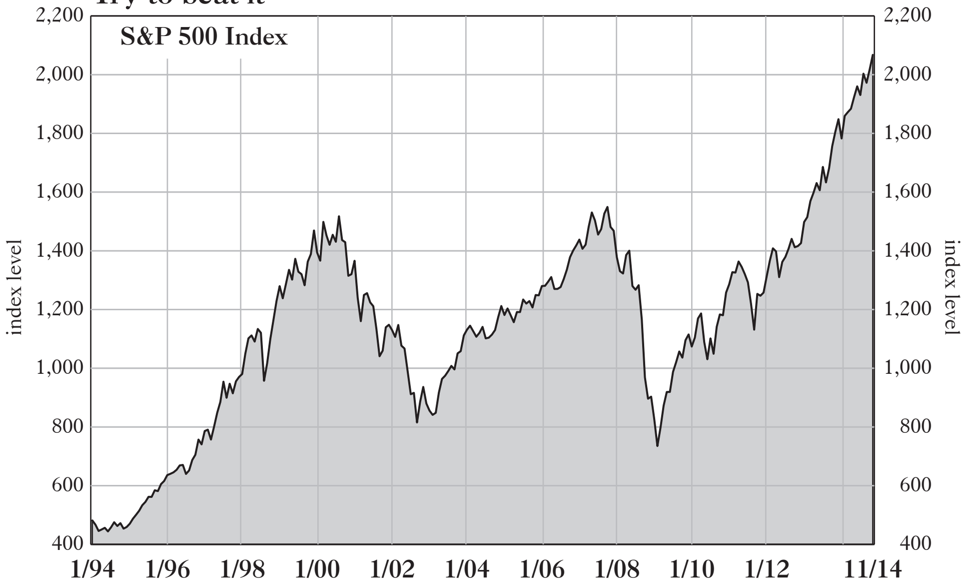
Within two years of the publication of Loomis's article in January 1970, the Nixon administration had cut the dollar loose from its $35 ounce gold mooring and implemented wage and price controls. By October 1974, the S&P 500 had fallen by 32% from its 1969 close. Within weeks of the market's low ebb, Benjamin Graham delivered a talk to the Institute of Chartered Financial Analysts in New York, which *Barron's* excerpted under the fitting headline, "The Renaissance of

Plenty of shorts here



source: The Bloomberg

Try to beat it



source: The Bloomberg

Value."

Graham spoke as the doctrine of the efficient market was coming to the fore. The 80-year-old author of "Security Analysis" didn't buy it, and he played to an audience of research analysts—the "slide-rule boys," *Barron's* styled them—that was also predisposed to doubt. Exponents of the strong case of market efficiency held that stock prices fully reflect all knowable, relevant facts, from which it followed that only a rare analytical talent could hope to add meaningful value. "I disagree completely with this viewpoint," Graham announced. "To establish the right price for a stock the market must have adequate information, but it by no means follows that if the market has this information, it will thereupon establish the right price. The market's evaluation of the same data can vary over a wide range, dependent on bullish enthusiasm, concentrated speculative interest and similar influences, or bearish disillusionment. Knowledge is only one ingredient in arriving at a stock's proper price. The other ingredient, fully as important as information, is sound judgment."

To illustrate his point, Graham invoked the astounding rise and fall of Avon Products. The shares had sold for $140 each, for a market cap of $8 billion, during the reign of the so-called Nifty Fifty only a year before. They had recently changed hands at less than $20, for a market cap of only $1.2 billion. Was the market efficient at the high or efficient at the low?

Coincident with the fall of the "one-decision stock" was the rise of the net-net. Perhaps 200 public companies were valued in the market at less than net cash per share. "Is the market 'efficient' in maintaining these 'fire-sale' price levels?" Graham wondered aloud. "Surely it does not lack the essential information about companies. What it does lack is judgment, courage and patience. In situations of this kind lie the best opportunities for financial analysts to prove their mettle."

"We have many complaints," the eminence wound up, "that institutional dominance of the stock market has put the small investor at a disadvantage because he can't compete with the trust companies' huge resources, etc. The facts are quite the opposite. . . . I am convinced that an individual *investor* with sound principles and soundly advised, can do distinctly better over the long pull than a large institution. Where the trust company may have to confine its operations to 300 concerns or less, the individual has up to 3,000 issues for his investigations and choice. Many true bargains are not available in large blocks; by this very fact the institutions are well-nigh eliminated as competitors of the bargain hunter."

Reading the words of Jones and Graham, we see more similarities than differences in the markets of the Go-Go era and those of today. Structures change, investing techniques change and dollars proliferate, but we humans remain the same. Herding creatures, we buy high and sell low. We mean to do better the next time—"I'll be brave in the next bear market!"—but we can't seem to help ourselves.

There will be another bear market, of course. For a finely reasoned speculation on the possible outlines of this coming event, the third-quarter letter of Elliott Management Corp. makes essential reading. It's the quality and quantity of financial market liquidity that may matter most in the next slump, Singer ventures. The Volcker Rule, which prohibits big banks from proprietary trading, along with various regulatory strictures concerning executive salaries and capital adequacy, have combined "to create spookily diminished liquidity in a variety of fixed-income markets," Singer relates. "Our traders already see the impact of this diminished liquidity in both initiating and unwinding positions. This factor will, of course, be orders of magnitude more impactful in the midst of significant market turmoil."

"It's only a paper moon," says Singer in so many words about the cosmetic good health of American finance ("fake growth, fake money, fake financial stability. . ." was the passage that brought the lefty blogosphere down on his head). Yet the author of those dogmatic words is equally the author of an undogmatic investing style (one that has succeeded in delivering compound annual returns of 13.9% from 1977 to date). Permanently hedged is the way Singer operates his money-management business, a conflation of activities (as he enumerates them) including "distressed securities, performing debt, equity-oriented trades (including real estate securities), related securities arbitrage, portfolio protection trades related to currencies and commodities' hedging and trading."

It's the hedged investor, not the dogmatist, who writes, "One of the main challenges of a long career in money management is that the distance (in terms of time and cost) between an intelligent conclusion that prices are massively wrong in either direction, and the actual reversal of valuations toward the range of 'reasonableness,' can sometimes be too long to bear. One could easily [have] become stridently bearish on stocks in 1995 (as we did), when in America equity prices passed all-time highs by nearly every measure, selling at 22 times' earnings, a level that was previously reached in only September 1929 and March 1972 (both serious peaks). But they did not top out until *early 2000 at 40 times earnings*."

It would be nice if the simple model of the bell-shaped curve were a guide to survival on Wall Street, Singer adds, but—alas!—it's not: "[M]oves away from the mean in securities markets are frequently self-reinforcing, not random or mean-reverting, because participants are involuntarily (either by direct order from their bosses or clients or by compulsion arising from performance/career challenges) trading when they do not expect or desire to be trading."

So much of what happens when the market's open is what one hadn't expected. To be long *and* short; to be steadfast and humble; to be patient and wary; and to be hedged—there are worse ways to wake up in the morning, to steal a line from the departed Mr. Porter.

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