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Hedge fund investing: a private family perspective

Jeffrey Tarrant
Arista Group, Inc.

In the 1970s computers were used in portfolio management and the concept of indexation was introduced. With all the trends pointing away from human judgment and towards lower fees, it seemed an odd time for hedge funds to emerge, because, as we know, a typical hedge fund is generally long on both. But the industry took root, and particularly in the late 1970s and through the 1980s grew and thrived.

As an active investor in hedge funds for more than a decade, I have witnessed their evolution and believe they are here to stay. However, in one respect hedge funds have yet to prove their staying power; apart from a few sector and regional crises, most hedge fund managers have not yet experienced a protracted bear cycle.

Value of hedge funds to the traditional portfolio

It should be emphasized that our private family group invests in many other classes of assets as well as hedge funds. We have substantial investments in traditional, long only equity and fixed-income portfolios as well as non-traditional investments outside the hedge fund universe. I do know some investors that have embraced the hedge fund concept so completely that they have shifted most, if not all, assets into hedge funds. This is not the case for us. We invest in hedge funds and are willing to pay the relatively higher fees, since certain hedge funds add value at the margin to the base traditional portfolio already in place. For us the hedge fund portfolio has, in fact, increased the overall portfolio performance.

Hindsight is 20-20 vision and who knows what the future holds, but we continue to invest in hedge funs for the following simple reason: they are run by some of the best and brightest specialists in the investment industry.

Hedge funds – home of the brightest

We pay our hedge fund managers premium rates for their services – not only management fees but incentive fees as well. To some extent we have to. It is obvious that a successful investment manager can earn a very large amount of money. This being the case, traditional money management firms find it very difficult to keep their brightest managers when the economics of leaving are so compelling. Not every manager can develop or maintain his contacts and resources once outside the traditional firm, but the brightest managers will usually manage to do so.

Some traditional money management firms are beginning to offer hedge fund products in order to retain their best managers. It is too early to determine whether these firms will succeed in retaining their top performers or even if the traditional firms can cross over successfully into the hedged product arena. Of course the hedge fund structure does not ensure the most able investment managers will be at the helm. With the proliferation of hedge funds there are probably as many mediocre managers and hucksters as there are truly bright investors. It is our job to try to distinguish the wheat from the chaff before investing.

The search for specialists

In searching for specialists I am looking for someone with an ‘edge’ or advantage over other investors. The specialists usually fall into one of three categories:

1. Regional specialists. These managers specialize either in regions, such as Asia, Latin America and Europe, or specific countries. Our simple philosophy is that we live in a big and fairly complex world and are more comfortable with investment managers that focus their energies in an area with which there are familiar. Preferably they live (or have lived) in the region and understand the local cultures and languages. More importantly, they understand the nuances of the local capital markets.
2. Style specialist. These managers specialize in the different styles of investing. Styles include: value, small cap, emerging market, convertible bond arbitrage, fixed income arbitrage, and short selling or short-term trading. Although these styles probably do not seem to have any similar characteristics, the managers apply a specific trading or valuation style across sectors or regions. By focusing on a particular style, the manager can have an edge.
3. Sector specialists. These managers focus on specific sectors such as banking, technology, natural resources, and others. The reason for hiring specialist or niche manages is that the specialist knows his territory better than the generalist. As the capital from asset allocators or generalists is put into or taken out of the specific sector, the sector specialist should have an advantage over the non-specialist. As long as the specialist has the flexibility to be long or short his specialty sector, his edge should ensure his survival.

Capital constraints and specialized styles

The downside of investing with specialized money managers is that generally there are limitations to the amount of capital under management they can efficiently control. Most money managers know what that limitation is. Whether they tell us, the investors, is a different story, but it is important to find this out. Some ‘micro’ –cap (smaller than small-cap) hedge fund managers will run into capital limitations with as little as US$25 million under management. The usual threshold of concern is between US$100 million and US$250 million, depending on the liquidity, style and markets in which the manager operates.

Assuming liquidity is less of an issue, the next threshold of concern in my view is reached at a level between US$500million and US$750 million of assets under management. At US$1 billion under management, any specialty manager will have problems of excess capital. Remember, we are talking about specialty hedge fund managers, not traditional long-only managers. Capital under management is much less of an issue for the good traditional manager, in my view.

It is useful here to look at the specialty manager model and what can happen once that manager reaches his capital constraint. There are basically three scenarios:

1. If the manager adds more positions to accommodate the capital, returns drop as sub-optimal investments in the sector are made.
2. If the manager adds to his current positions, the fund's capital becomes increasingly less liquid as he becomes one of the bigger players in the sector.
3. If the manager adds new strategies, the specialization is diluted. If the manager does not test the new strategy before investing, the fund's capital is funding research and development.

In any of these situations, there is a potential for the returns to fall as the risk increases.

This leads me to the last category of the hedge fund managers we use: macro investors. These are the managers that were originally specialists in a certain area or industry, but for various reasons have managed to make money outside their original area of focus. They are the managers everyone knows and whose assets under management are counted in billions. They make 'macro' bets on the direction of security and currency prices while trying to stay in markets sufficiently liquid to handle their capital and, sometimes, egos. Although such individuals handle a decreasing percentage of our portfolio (as we reinvest earnings to more specialized managers) I believe that as long as the primary founder of the money management firm is sufficiently driven, the portfolio of these macro funds should be in good hands.

There are only a few great macro hedge funds and most of those stumbled in 1994. Funds of funds with heavy macro exposure suffered as well. Fortunately, we survived that year without problems because our exposure was more concentrated in smaller niche managers than in the large macro funds. It is interesting to note that some of the macro players have now reached the same conclusions as we have, and are seeking specialized niche teams to manage a portion of their fund's capital.

As discussed, specialty hedge fund managers have limits on capital under management. These limits can sometimes be reached and exceeded with incredible speed. A rapid inflow of capital early on has been the demise of many bright managers.

When capital corrupts

If capital can corrupt a good money management strategy, why do specialty managers take in too much money? I do not believe it is necessarily to make more money. Assuming even marginal positive returns, a hedge fund manager with US$250 million under management can make a nice living from the typical 20 per cent performance fee. Rather than money, managers can be driven by ego and the urge to be bigger and better. Another reason a manager raises his level of capital is to diversify into new strategies (sometimes because he has lost confidence in his primary strategy). Increasing capital for any of these reasons could be in conflict with my objectives as an investor.

Modern Portfolio Theory compounds the capital

Markowitz's Modern Portfolio Theory (MPT) was formulated decades ago but has only been influential since the mid-1980s. At that time, Markowitz's optimization algorithms started to appear on desktop computers, and consultants and investors began to use them to apply his securities theory to the selection and allocation of assets to money managers. Whether this was appropriate or not, since the mid-1980s more money has been allocated according to this theory. Not surprisingly, a surge in the use of hedge fund managers corresponded with the use of optimization models based on Markowitz's theory.

The theory is based on the premise that all investors want to optimize portfolios by selecting a combination of assets that yield the highest expected return for a given level of risk. Risk is defined as volatility of returns over defined period. That defined period can be years, quarters, months or days, whichever is considered relevant to the investor's investment horizon. One conclusion of the theory is that in order to reduce risk it is best to hold those non-correlated assets that in combination yield the highest expected return.

The application of MPT set into motion the search for non-correlated asset classes. The ultimate combination of assets is two perfectly negatively correlated assets that each yield a positive expected return. This combination, according to the theory, would be a 'risk-free' investment. Unfortunately, the common asset classes such as growth equities, value equities and bonds are correlated to some extent, so that risk is only moderately mitigated by combinations. As hedge funds can sell assets short and potentially achieve portfolio Nirvana – higher returns with negative or non-correlation to the traditional portfolio - the interest in these funds has exploded.

These days, the theory, or the thinking behind it, is familiar to the average investor – which is precisely my point. Portfolio managers embraced this new asset class with unbridled enthusiasm. The unfortunate consequences read like a chapter from George Soros' book *The Alchemy of Finance* regarding the theory of reflexivity. Investors armed with optimization programs searched for the investment managers that would push their portfolio's mean-variance characteristics into the 'Northwest Quadrant', the upper left quadrant of the mean return, mean variance (risk) matrix. Given the size of the hedge fund universe at the time, the demand for the few with the performance characteristics that were negatively correlated to the traditional portfolio was significant.

Money will chase good opportunities until opportunities become less attractive. In this case, anyone with a computer and a hedge fund database probably arrive at the same conclusion about the same or similar money managers. To the uninitiated, investment research begins and ends with the MPT mean/variance analysis and optimization. I believe the analysis just begins with the quantitative work. Rather than accept the allocations of an optimization program, I find myself asking these questions: What is the effect of the influx of money to this manager or style? Who is a candidate for a future member of the Northwest Quadrant? Often the answer is a manager not even listed in the standard databases.

Reduced volatility = lost opportunity?

The problem with MPT optimization models is not only that their widespread use can affect the money manager, but that they seem to focus the investors' attention on volatility management rather than investment management. We all know that many of the historic investment opportunities have occurred during periods of crisis and volatility. A portfolio manager focusing on volatility management might miss opportunities either through early redemption or under-allocation.

MPT does not take into consideration any valuation measurements. The inputs to the optimization model are simply the patterns of periodic returns for an asset class or sector. Therefore it is possible for the portfolio, according to MPT, to contain significant allocation to asset classes or sectors that might be overvalued. Take, for example, real estate in the early to mid-1980s. Just as MPT was becoming more influential in asset allocation, more research paper (both academic and private) were recommending greater allocations to real estate. I remember reading many of these reports in the mid-1980s. Oblivious to any valuation consideration, investors ploughed capital into this overvalued sector and by the late 1980s owned much more real estate than they wanted.

The more investors allocated assets according to MPT, the more money will flow to yesterday's story. Those investors that understand value will probably avoid this danger and welcome volatility as an opportunity to invest away from the crowd. One day the investment world will wake up and realize that managing portfolio volatility according to MPT has significant risks in itself.

Hedge fund manager life cycle

At business school, we learned about business cycles, product life cycles and corporate life cycles. All these affect the growth cycle of a company's stock price. If we truly believe in these cycles, then shouldn't we try to understand a money management firm's own life cycle?

The potential profitability of the hedge fund business is so high that the manager can retire early while quite wealthy. Often, it is unfortunately the case that your hedge fund manager has, in effect, retired while still 'managing' your money. Keeping an investment edge is grueling work, and the trappings of success can be distracting.

I believe there is a life cycle to a money management firm and to the managers in that firm. As a private family investor, I want:

- to invest with the manager during the growth phase of the cycle;
- the manager to make a lot of money with me; and
- the manager to have the chance to consider early retirement and be honest with himself (and with me) as to whether he is, in fact, already retired.

Peter Lynch summed it up well in the preface of his book *Beating the Street.* He retired in 1990 after 13 years at the helm of the Magellan Fund. Having achieved one of Wall Street's best performance records, he decided to devote more time to his private life. After his announcement he was offered several attractive offers to stay in the business and he noted that one offer in particular was a very 'tempting proposition'. He declined the offer when he realized that there is no such thing as a part-time investment manager position, nor could he delegate the responsibility of the portfolio. He remained honest with himself, as described in his book:

> "There were only two problems with this arrangement. The first was that my tolerance for lagging the market is far exceeded by a desire to outperform it. The second was that I've always believed that fund managers should pick their own stocks. Once again, I'd be back where I started, stuck in the office on Saturdays, lost in the piles of annual reports, a man with a thicker bankroll but just as time-poor as ever." (Peter Lynch, *Beating The Street,* p. 8. Simon & Schuster, New York, 1994.)

Lynch was honest with himself and his investors. He either offered his all and suffered the consequences in his private life or checked out completely.

But a few legends just keep going and going like the Energizer Battery Bunny. People believe that the manager who is motivated by ego to grow assets to huge levels may manage to keep it all together with the strength of that same ego. Unfortunately these cases are the exception and not the rule. More specialty managers eventually 'hit the wall' or burn out. If you are not convinced, just read the preface to Peter Lynch's book.

Selecting specialty hedge fund managers

We have concluded that in order to invest successfully we must remain active trying to find the next bright, motivated specialist. Often we are led to small emerging managers but this does not worry us because we have proved to ourselves that we can grow with the managers. The process of specialty hedge fund money management is dynamic. The seasoned investor accepts the fact that capital flows affect investments and investment managers. The problem for the gatekeeper, such as myself, is making the people I work for understand the philosophy.

Unfortunately, emerging hedge fund specialists do not generally have a long-term established track record to present to the investment committee. I feel fortunate that the investors I serve trust the process I have used to identify the best manager. Most funds of funds or institutional investors are in a different position and are generally more interested in presenting to their committees and clients those names that are more recognizable because:

- the name is easier to sell to the ultimate client or investment committee;
- no in-depth analysis is required; and
- as all the consultants are recommending the same managers, if the end result is disappointing, the misery will be shared in good company.

This means that much of the big capital with a large constituency of investors or a 'conservative' investment committee will not be 'early' and will most likely be 'late' when selecting managers.

Information is critical

Although the smaller specialized hedge fund managers have a somewhat myopic view of the world, I find that I value the information I receive from them. They tend to have more time for discussion than most money managers do and the information is not filtered through a 'relationship' or marketing person. Also, the information, even if it is anecdotal, gives me a good feel for valuations and capital flows from a bottom-up viewpoint. A strong network of specialty managers gives me a better feel of how I want to position the total portfolio for the future.

Quantitative versus qualitative information

Ten years ago information about the private world of hedge funds was generally the exclusive province of family offices and industry insiders. Over 10 years, though, the numbers of hedge funds has increased from perhaps 300 to over 3,000. The task of maintaining quantitative information on such numbers of managers has become a daunting task that even the most initiated and well-financed groups have not been able to keep up. In order to cope more effectively with this volume of data, private Internet-based hedge fund information and reporting systems have been developed. As founder of Altvest, I was part of a group of investors that were able to convince hedge funds that it is in everyone's best interest for the managers to report information themselves over the Altvest system to ensure data integrity and timeliness. This has dramatically reduced the time an investor must spend to collect and compare data on hedge funds. It has also reduced, if not eliminated, the back-office communications expense for the hedge fund manager and administrator.

Does Altvest, or similar systems, diminish the value of the intermediary or consultant? I believe the answer depends on what is provided by the consultant. If the consultant's value is largely quantitative, then the answer is yes. If the consultant tries to differentiate himself by collecting data and quantitatively slicing and dicing it, then there is a possibility that a well-designed system such as Altvest can undermine his business model.

The by-product of the information revolution is that we have not only more information at our fingertips, but also too much information to process. In this era of information 'over-load', the value of the true 'editor' of information increases rather than declines. The trained and experienced consultants will be the highly valued 'editors' of the hedge fund information overload. Think about the following analogy. Hedge fund managers have extensive quantitative information at their fingertips (Reuters and Bloomberg) but that does not mean their value added is reduced. We pay these people for their qualitative judgment of the information. Likewise, manager-of-manager consultants who thrive in the future will learn to hone their qualitative judgment skill. The quantitative component of the services, although still important, will not be the competitive advantage of tomorrow's successful consultant.

Choose with care

The hedge fund industry has grown and evolved significantly in the past decade. These changes have required the astute hedge fund investor to modify the allocation process since the effect of capital flows into the strategy has been considerable. The blind use of MPT optimization models in the allocation of assets to money managers has created new concerns for the hedge fund industry. Money management firms are as dynamic as the markets they trade, so it behooves the investor to pay attention to qualitative issues such as the position of the firm in its life cycle. The firm occupying the optimal mean/variance Northwest Quadrant might not be the hedge fund manager to invest with for the future.