Article from:

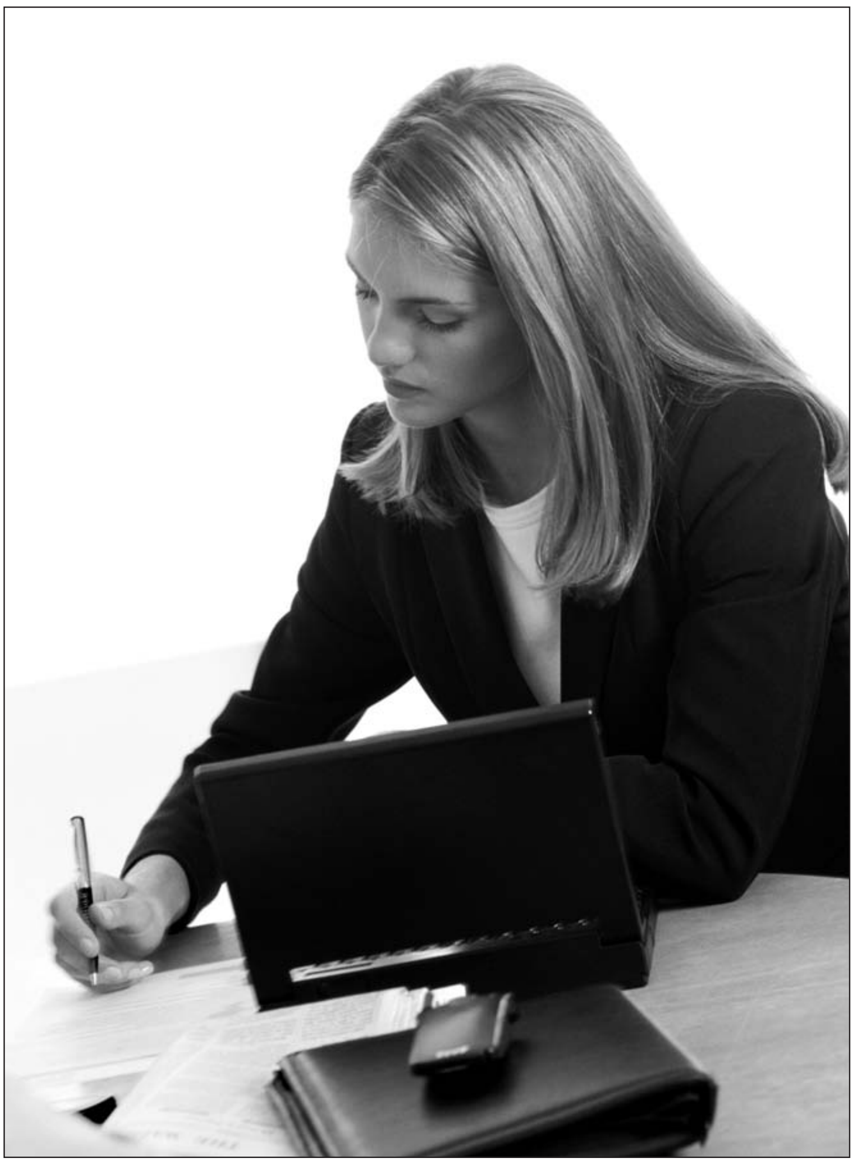
Risks and Rewards Newsletter

February 2005 – Issue No. 46

Taking Stock: Will Hedge Funds Change Investment Thinking?

by Nino A. Boezio

Hedge funds have grown tremendously over the last few years and will continue to grow, with invested assets currently being estimated at well over $1 trillion worldwide. Hedge funds often boast the ability to make money in both rising and falling markets (even though they may not always be able to do so). If equity markets continue to go sideways for the next several years, hedge funds could provide an attractive alternative to other investment strategies, or can become a good compliment to existing asset classes. But regardless of what one feels about hedge funds, what role will they ultimately play in the investment industry? How are they going to influence our views on investing as we move into the future? Have they already influenced our views on investing, perhaps inappropriately?



Traditional Investment Management

Anyone who has read traditional investment literature has been taught various principles and guidelines on investing, which may include the following:

- Abiding by an investment policy is normally the best determinant of investment performance, not stock picking;
- Diversification mitigates risk;
- Stay invested—do not go into cash for there will be times when you likely will exit the market at the wrong time;
- Market timing is virtually impossible, at least for most, and even if some claim they can do it, they cannot exercise it correctly all the time;
- Most investment managers do not necessarily have skill, but can at least achieve returns close to the benchmark. However, it is often hard to identify the skilled managers in advance, and not even the mediocre investment managers will ever admit they have no skill;
- Good prudence for a portfolio is to have one dollar of investment assets supporting each dollar invested by the client (i.e. no leverage);
- Do not short securities—this is normally a loser's game, and the gain from the downside is limited while the loss from the upside is unlimited;
- Some even discourage the use of options and other derivatives in a portfolio, feeling that it produces unnecessary risk versus the reward.

You may not agree with all of the above points, but in general, these are some of the general beliefs underlying traditional portfolio management. These also often form much of the underlying basis as to why investment policies are written the way they are, and why certain investment activities are restricted or forbidden.

Are Hedge Funds Doing Anything Special Or Just Claiming So?

Considering the traditional views of portfolio management identified above, there are a number of claims that hedge funds make, which can include one or more of the following:

- No Need for an Actual Investment Policy Statement and/or to Abide By It—some hedge funds may engage in a number of strategies at the same time, whichever strategy is felt to be most appropriate for the market conditions that are present. Hence the hedge fund may stop doing merger arbitrage and engage in shorting if the stock market turns down and the economy changes direction. A specific investment policy reduces the flexibility of a fund to take the appropriate strategy as the markets evolve and fluctuate, and due to this lack of flexibility, reduces potential return.
- Concentration—the hedge fund need not diversify as broadly, but may focus a large part of the portfolio in a few limited investments. Concentration helps achieve value-added returns, especially when the research strongly supports the current view. Diversification unfortunately can dilute investment performance to mediocrity in some cases, even if some of the bets were "very" right.
- Raising Cash—there will be times when it pays not to be invested. Hence raising cash is a viable investment strategy when either opportunities do not exist, or there is considerable market uncertainty.
- Market Timing—hedge funds claim they can alter the asset mix successfully to anticipate market conditions, which may include major tactical shifts in particular market environments
- Special Skill or Knowledge—the managers of the hedge fund have particular talent or knowledge that is inaccessible to the average portfolio manager. It may employ computer models in its analyses, which no one else has. However, there are so many hedge funds out there, you would tend to think there is a considerable amount of skill everywhere (so who is the dumb investor taking the opposite side of each of the hedge funds trades?)
- Use of Leverage—some hedge funds employ a leverage factor of as much as 1.5x invested assets, claiming that not all of the invested monies are required for the selected security positions. The hedge fund organization may use its credit standing to borrow the extra leverage. The hedge fund also requires leverage in order to promise the higher than normally expected returns suggested from traditional investment management, while at the same time possibly promising a return of principal at worst, at the end of a specified period.
- Ability to Short—Hedge funds claim they can identify overpriced securities and can short them successfully;
- Derivatives—the hedge fund will claim the ability to employ derivatives effectively and easily, to produce added value performance.

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If you notice this latter list of items, they are the opposite views of what I itemized above for traditional investment management. Which views are right?

Can A Case Be Made For Special Skill?

I had a notable conversation with a "value" portfolio manager several years ago. The Canadian tech stock darling Nortel, was trading in the $60-70 price range at the time, and it had been trading at over $100, less than six months earlier (Canadian dollars). I was not following the stock, but I figured that it might be a buying opportunity for many portfolio managers, given that it already was off quite a bit from its recent highs. However, she told me that according to her valuations, the stock was not even worth $30. I was surprised. I did not think that such a widely followed and well-publicized stock could be so grossly mispriced. Of course, I never looked at the financial statements and never tried to do my own valuation.

Now in hindsight, as we know, this portfolio manager was right. The stock had tumbled to trade well under $1 per share, and has now rebounded to trade at about $5 (Canadian). However, this portfolio manager, with all her wisdom (and she was a 1st quartile manager, achieving positive returns during the market decline of 2000-2002) did not even make a penny on her insight. She could only buy stocks "long" in her portfolio, and thus could not profit from her knowledge that a certain stock was grossly overvalued. She could not short, since that was against her investment mandate and the investment policy guidelines.

So a case can be made that some of the ideas supporting traditional investment management are flawed, given that various restrictions are placed on investment managers, and whether through

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investment policy or regulation, an investment manager is inhibited from making additional choices. However, I do think traditional investment management has got it right—there may be a few portfolio managers out there who have the skill, wisdom and the foresight to enhance returns if they were not too unduly restricted, but in the main, relaxing such restrictions may help some achieve better returns while allowing most others to mess it up—now finding more ways to get it wrong and destroy a portfolio's performance. I have noted from my own experiences that skill exists among the few, not the many, even though the many will claim they have the skill. What may help some investment managers to improve performance will hurt most investment managers who now will try to do more things, and will even become more distracted from what they are able to do best, simply because they may want to compete with hedge funds. I also do not believe too many hedge funds in general have got the skilled management to produce the returns they promised, even though they all claim to do so. Interestingly, many hedge funds do not last two years, while the good ones tend to close since they get too much money, which is an admission that the hedge fund label does not imply that skill commonly exists. But as it was with Internet stocks not too long ago, some see the hedge fund label as a new strategy (or should I say new fad) to get additional returns.

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Hedge Funds Will Put Pressure on Traditional Investment Management

Regardless of my comments above, as long as hedge funds continue to dominate the investment marketplace and continue to take in substantial inflows of cash, and as this cash continues to be drained away from traditional investment managers, there will be pressure on certain traditional investment managers to ask their clients to relax any restrictions they are now operating under. For some managers this may be a good thing, but for most if they also get such relief, it could be a bad thing—and they may just be asking for this relaxation simply in order to try and play on a level playing field with hedge funds. I feel that hedge funds are doing a disservice to the investment industry in general (unless the investment public becomes well-educated on the matter, which normally never happens) as certain hedge funds appear to suggest that they can generate returns under all market conditions.

Hedge funds have been opening the door for those without skill to endeavour at selling services and strategies that they are not capable of adding value in, and such people are also being lured by the glitzy image that hedge funds have these days, and the promises of higher compensation than is otherwise available through traditional investment management. We therefore have to be wary that the common sense and perhaps conservatively drafted principles of traditional investment management are still sound and valid principles of prudence have been time tested and still have not been proven wrong. Traditional investment management may seem boring, its returns considered more subdued, and its returns will still have its ups and down, but at the same time such principles cannot be abandoned for the "free lunch" sometimes implied by hedge funds. Hedge funds do provide a good diversification tool and do allow certain pools such as pension funds to get into strategies and markets that they otherwise may not have gotten into before, but at the same time, hedge funds have to be analyzed carefully.

I do strongly believe that the contradictory philosophies of traditional investment management versus hedge funds have to be carefully considered, reflected upon and evaluated, since they form important determinants in the returns that will ultimately be achieved, and will provide useful questions that need to be addressed in assessing the various skill sets and novel techniques that hedge funds claim to have and are employing. Only then should you be able to sleep at night knowing that your portfolio is positioned in such a way that it would not get killed by some unforeseen investment twist—we may not always have a little dog named Toto to pull the drapes away for us, from the venerable Wizard of Oz who is trying to dazzle with his gadgetry—so we have to do our own homework, and not believe what we hear or see is what we really will get.