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How to launch a hedge fund – or invest in one

“We took risks. We knew we took them. Things have come out against us. We have no cause for complaint.”

- Robert Frost.

“**Never let a serious crisis go to waste.**” These words are credited to former White House Chief of Staff Rahm Emanuel in November 2008, when the banking and financial emergency (not entirely yet put to the sword) was at its most virulent. No shortage of books has tumbled out of publishing houses subsequently, exquisitely detailing the whys and wherefores of the crisis, so it was with a somewhat heavy heart that your correspondent received news of the latest book offering investment counsel, David X Martin’s ‘Risk and the Smart Investor: using the principles of de-risking to make better investment and financial decisions’ (McGraw Hill, 2010). Happily, the scepticism was unwarranted: the book is an excellent read, and refreshingly free of the risk analysis jargon that its title threatens – and which in large measure helped the crisis to vault to its giddy heights in the first place.

Mr Martin was formerly Chief Risk Officer at AllianceBernstein (\$450 billion under management) and had also held senior risk management positions at Citibank before it became a basket case. Notwithstanding these credentials there isn’t a single equation or algorithm in ‘Risk and the Smart Investor’ and if there is, I missed it. What there is in spades is the judicious anecdote, which is a lot more engaging and certainly more relevant than the pseudo-science that helped precipitate the world’s biggest financial crisis in 80 years.

If the business (art ?) of investment comes down primarily to an assessment of risk and return, the former gets a pretty poor press from the typical industry practitioner. ‘Lip service’ tends to be the traditional treatment of the prospect of (downside) risk, which is otherwise covered by bland boilerplate in the sell side marketing material; that same material tends invariably if understandably to focus on returns, whether historic, prospective or both. As Mr Martin observes, casually firing another nail into the coffin of the Efficient Market Hypothesis,

“..the notion that we rationally determine risk is just as inaccurate as the theory that the markets are rational mechanisms, moving in response to prudent decisions made by investors on the basis of information available to all participants. If the events of the past decade have taught us anything, they have taught us that this simply isn’t so.

“To begin, loss aversion describes a basic human tendency.. the willingness to forgo an opportunity for gain rather than risking a loss, or the desire to accept what you have rather than reaching for more, and perhaps ending up worse off than you were to start.”

At the risk of sounding like a broken record, we would suggest that loss aversion has never been more pertinent to the situation at hand – nor more difficult to achieve, in an environment where the prices of all financial assets and even the currencies in which they’re denominated are being either manipulated or debauched by robo-Keynesian government administration gone mad.

In the spirit of never letting crises go to waste, the last few years, particularly during the Lehman bankruptcy black comedy weekend fever pitch phase, have given investors an opportunity in real time to experience end-of-the-world-style asset pricing volatility, and therefore a rough assessment of their own tolerance for white-knuckle losses, realised or not. Since almost none of the underlying financial causes of the crisis has been sensibly addressed, while many have been perpetuated if not exacerbated, it seems plausible that at least one comparable aftershock looms.

On the topic of third party investments, Mr Martin provides a checklist that is practically worth the cover price on its own. For anyone considering investing into a fund or hedge fund, or fund of hedge funds, the checklist is invaluable (and note the emphasis on the qualitative as much as upon the quantitative):

1. Is there a free flow of information ? How often is the fund’s net asset value reported ? Traditional funds report at the end of every trading day; a good hedge fund will report its NAV at least once a month.
2. Does the hedge fund have premier suppliers (as prime broker; custodian; accountant; legal advisor) ? Brother-in-law does not meet this requirement.
3. Does the fund have the ability to stay in the game ? New hedge fund managers may find capital raising more difficult than planned, or may adopt initial strategies that imperil the fund through lack of capital.
4. What is the nature of the fund’s investor base ? Is it loyal ? Will it stay loyal when the going gets rough (which it inevitably will) ?
5. Does the fund depend on a single stock picker, or is its success based on a broader competence ? Does the fund conduct its own research or rely on data supplied to it ?
6. Does the fund have a consistent approach ? Does the fund have a track record of at least three years ? Or is performance merely pro forma, and the strategy untested in the real world ?
7. Does the fund have an exploitable niche, and if so, is that niche sustainable ?
8. Where is the firm in its growth cycle ? Look for a fund on the upswing. “If you invest in a fund at the top of its arc, you’ve got to wonder whether the managers still have the same fire in their bellies they once did..” This touches on perhaps one of the biggest and most pressing challenges, not least moral, facing fund managers: do they ultimately want to be asset managers, or asset gatherers ?

9. Does the fund's management have a good pedigree ? "Good fund managers come out of proprietary trading shops, where they learn how it's done, and just as importantly, how to put controls in place." [This may be one of the rare occasions where I reserve the right to take issue with Mr Martin – one might equally suggest "...where they learn how to gamble with other people's money and cultivate asymmetric risk / return outcomes hugely in their favour.."]
10. How large are the fund's assets under management ? Look for a fund with AUM larger than too small and smaller than too big.
11. Do the fund's managers have skin in the game ? If you feel pain, the fund's managers should feel pain too. This is one category in which hedge fund managers are likely to outshine their traditional counterparts practising lazy agency risk.
12. Does the fund's office space demonstrate a long-term commitment to the business ?
13. Do the fund managers have transparent, easily monitored control systems in place (i.e. compliance, audit, risk management..) ? Is risk management embedded in the firm, and not just a police force working on the perimeter ? Again, this is an area in which a good hedge fund is likely to be better positioned than a more typical industry chancer.
14. Are all of the fund managers and all of the fund's employees accessible ?
15. Does the fund have succession and business continuity planning in place ?
16. "Last but not least, does the fund's investment strategy *make sense* ? In addition, are its returns reasonable given the historical returns in that specific market environment ?"

Although not explicitly mentioned in this checklist, Mr Martin does not ignore the role played by integrity or reputation. (Suffice to say, anybody taking this straightforward approach would never have gone near Bernie Madoff with a bargepole.) He also cites the telling example of his own decision to launch a hedge fund after working at Citibank for more than two decades. He pitched to a close acquaintance (and billionaire) who, after 30 minutes, said the following:

"David, there is no doubt in my mind you can do this, but I wouldn't invest a nickel in your fund until you quit your job at Citibank, spend at least \$75,000 with a top-tier law firm to put together the necessary documents, and lastly, spend an entire year raising money, without any income. You have the experience and the understanding, but only if you did those last few things would I be convinced that you had the fire in your belly necessary to get this done."

There is plenty of common-sense advice in 'Risk and the Smart Investor', nicely and warmly articulated. But as Voltaire suggested, and as the last few years would tend to support, common sense is not actually so common. And a final caveat: humans have a terrible tendency toward a short memory. When Mr Martin's practical advice will prove to be most relevant, there is an awful chance that by then it will have been forgotten.

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