

## The end of an error

“It wasn’t supposed to be like this.. markets are wrong.”

- From Hugh Hendry’s September commentary to investors, announcing the closure of his Eclectica hedge fund.

“The fathomless arrogance of this guy.. his job was to surf the waves, not pick a fight with the ocean.”

- Tweet from Five Minute Macro (@5\_min\_macro) about Hugh Hendry.

**As Gordon Gekko** says in *Wall Street*, if you need a friend, get a dog. Capitalism doesn’t really *do* sympathy, so there will probably not be a Niagara of tears shed at the passing of Eclectica Asset Management and its funds. Its co-founder Hugh Hendry is unlikely to become a goodwill ambassador for the UN any time soon, as this [Greatest Hits](#) compilation suggests.

And yet the closure of Eclectica leaves us with a feeling not just of loss but a vague sense of unfinished business, of a large reckoning not yet paid out. Not having met Mr Hendry in person we can only go on the basis of his public pronouncements: combative, but also contemplative. And we share his oft-expressed scepticism about the sustainability of the central bank monetary policy that has driven the prices of so many assets to such grotesque levels. How long can this monetary absurdity last, though ? How long is a piece of string ?

The closure of Eclectica is only a small symbolic reflection of the failure of hedge funds in aggregate to deliver value to their clients over the past decade. It turns out that sheer momentum has been a far more powerful investment strategy than either portfolio hedging or outright gambling: who would have known ? It may be that Eclectica’s exit from the scene will turn out to be one of those *Road Runner* moments when Wile E. Coyote, having gone far too far over the cliff edge, finally plummets to earth with a dusty bang, along with a few trillion worth of ETF “investors” along for the ride. But it may also simply turn out to be a 1987-style blip along the course of a multi-year bull run. We don’t know. Nobody does.

But it bears repeating: to harvest a superior return from the market, you need some kind of edge. **If you do not know what your edge is, you do not have one.** For this reason, we don’t invest in global macro hedge funds. We don’t believe that markets are perfectly efficient, but we suspect they are efficient enough to leave only pitiful crumbs on the table for traders

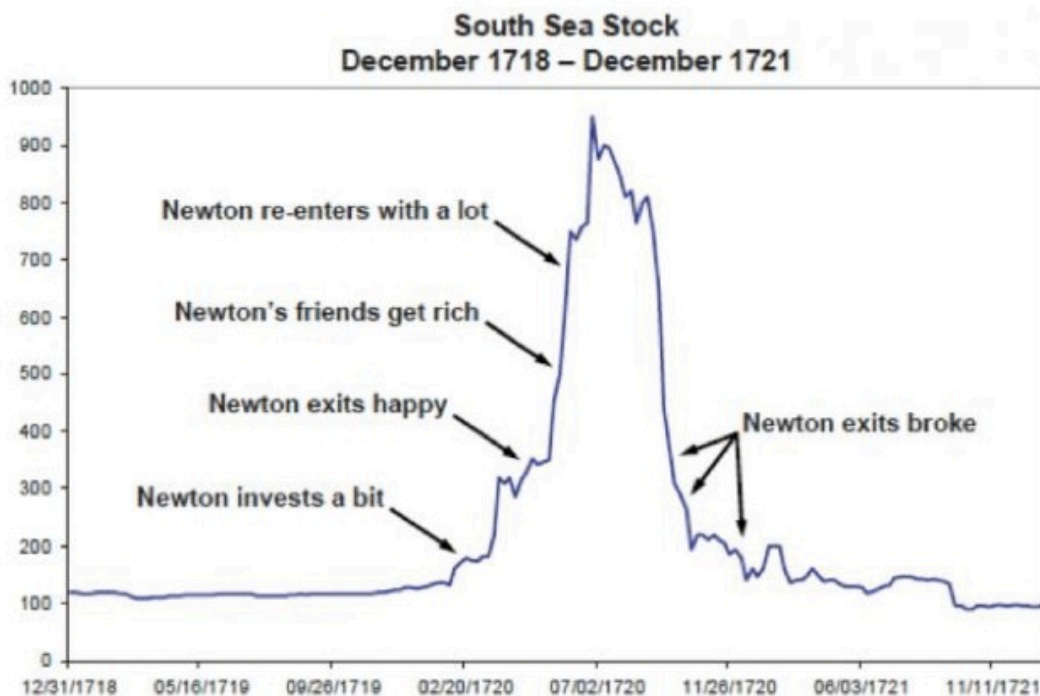
at the feast. A decade's worth of QE and ZIRP has fuelled a runaway train. Do you stand in front of the train, or do you leap aboard for some final thrills ? We prefer neither. Can we do neither ?

The example of Sir Isaac Newton may be the finest example in history of an investor being too intelligent for his own good. Britain's most celebrated scientist was not immune to the profit-making potential of the South Sea Company. In early 1720 he profited handsomely from his stake in the company.

Having cashed out, he then watched with some dismay as stock in the company continued to rise. As Lord Overstone put it,

No warning on earth can save people determined to grow suddenly rich.

Losing money is painful. Seeing one's friends making money when one is not may be even more painful. So Newton went back in. He went on to purchase South Sea Company shares at more than three times the price of his original stake. The market then collapsed, and he lost virtually all his life savings.



Source(s): Marc Faber, Jeremy Grantham, Sir Isaac Newton

The experience is said to have given rise to his bemused response:

I can calculate the movement of stars, but not the madness of men.

In his December 2013 letter to investors, Hugh Hendry wrote the following:

This is what I fear most today: being bearish and so continuing to not make any money even as the monetary authorities shower us with the ill thought-out generosity of their stance and markets melt up. Our resistance of Fed generosity has been pretty costly for all of us so far. To keep resisting could end up being unforgivably costly.

Hendry's late 2013 Damascene conversion world view could be summarised in six words:

Just be long. Pretty much anything.

Call us old-fashioned, but that doesn't sound like much of a hedging policy.

The sage investor Inspector Harry Callahan once remarked that a man needs to know his limitations. We think we know at least some of ours. We can't time markets, nor can we predict central bank activity or when it will either end or accelerate.

So we diversify as intelligently and pragmatically as we can.

Since we regard bond markets as now largely uninvestible and since we concede the vulnerability of cash, we view the fairly priced shares of profitable businesses run by principled, shareholder-friendly management as one of the least worst forms of investments. Given the enormous macro uncertainties (no macro hedge funds !), we diversify more broadly at an asset class level, favouring momentum strategies (specifically, systematic trend-following funds) but also real asset protection, notably from the monetary metals, gold and silver. As central banks have insinuated themselves fully into the workings of the free market, currency and inflation insurance should, we think, be part of any balanced portfolio. And you can then forget conventional benchmarks: the only return worth having in the future for any rational investor will be an absolute return one.

The Global Financial Crisis began roughly 10 years ago. In the time-honoured manner of regulators, they waited until the battle was largely over, then waded onto the battlefield and shot the survivors. Unprecedented monetary stimulus ever since has given rise to asset price inflation together with a Bataan death march of zombie companies and zombie banks: Japan 2.0 – but on a global scale. We have our own views as to how this crisis may play out, but our primary and most fundamental objective is keeping our clients whole.

Earlier this year my publishers, Harriman House, invited me to write the foreword to their definitive edition of [Reminiscences of a Stock Operator](#), a thinly disguised biography of the legendary trader Jesse Livermore. This book is widely and rightly regarded as an investment classic. It is also crammed with valuable observations about the practice of speculation and successful trading. Among them, the importance of not being wedded to one view:

They say there are two sides to everything. But there is only one side to the stock market; and it is not the bull side or the bear side, but the right side.

And of the merit of patience and discipline:

After spending many years in Wall Street and after making and losing millions of dollars I want to tell you this: It never was my thinking that made big money for me. It was always my sitting.

And of the essential timelessness of financial markets:

There is nothing new on Wall Street or in stock speculation. What has happened in the past will happen again, and again, and again. This is because human nature does not change, and it is human emotion, solidly build into human nature, that always gets in the way of human intelligence. Of this I am sure.

Anybody with aspirations to managing a hedge fund, and keeping it in business, would be well advised to read, and continually re-read, this remarkable book.

[www.pricevaluepartners.com](http://www.pricevaluepartners.com)



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