

Alternative to What?

There is the bucket, and then there is what is inside the bucket.

For millennia, people have debated the distinction between substance and form, reality and perception. If you think such philosophical musing is not related to our daily affairs, consider the new mania in the financial services industry for alternative investments (or, more colloquially, “hedge funds.”)

Did 6,000 investment geniuses suddenly materialize because there was a need for hedge fund managers?

If you do not know what hedge funds are, consider yourself lucky – or perhaps you should take offense that you are not considered well heeled enough to be pitched one. There are now more than

6,000 hedge funds with more than \$500 billion in assets, with much of the growth in the past couple years.

Investments are packaged in various “buckets.” One bucket is a brokerage account, with your broker recommending the purchase of various securities. Another popular bucket is a mutual fund, a diversified portfolio of stocks or bonds of a particular type with a hired investment manager. The hedge fund bucket is similar to a mutual fund, except the hired manager can invest in just about anything, use borrowed money to make the potential risks and returns of an investment greater and, most explanatory of their recent popularity, make bets on the market going down by “selling short.” A hedge fund is like a less-regulated mutual fund with less disclosure, less reporting and less liquidity. They are more risky (through leverage) than most other investments. There are no limits on what the manager may do. Investors pay expenses far more than for a mutual fund, plus a large chunk of any profits earned.

Studies of hedge fund performance over multi-year periods indicate that, as a group, they have not done nearly as well as broad market indexes. With their typical extensive use of leverage, they also do not last long. Professor William Goetzmann at Yale has estimated the probability of a hedge fund or hedge fund manager surviving for seven years is less than 20 percent. To top it all off, the Securities and Exchange Commission has begun to warn investors of a rising tide of hedge fund fraud.

So why would anybody want to invest in alternative investments? The answer is psychological. Burned by the crash of the technology boom, many investors feel they need to follow a different course, ideally something that, at least theoretically, can make money when the market declines. The financial services industry needs something to make their customers forget that they were recommending all those high-flying technology stocks and something to get their

sales people on the phone again, earning commissions and fees. Voila – the hedge fund craze!

Of course, the reality is that the bucket is not important, only what is inside of the bucket. There are good and bad brokers, good and bad mutual fund managers, and good and bad hedge fund managers. The primary sales appeal of hedge funds, however, is the “bucket.” Hedge funds have traditionally been the province of the very wealthy, so owning a hedge fund makes you a “player.” Hedge funds claim to be managed by geniuses who can make money even if the stock market goes down, but where did the 6,000 managers come from? Did they suddenly materialize when there was a need for investment geniuses to pilot hedge funds? In most cases, the managers were managing money in a different format. Putting them in the hedge fund “bucket” does not make them better managers; it just adds cachet and mystique.

When everyone is flogging an investment product, it is a metaphysical certainty that the timing is poor.

Ask the new hedge fund managers how they make money, and you are likely to hear about “black box” quantitative methods, “macro” forecasting models and the like. Ask the same question of a demonstrably good investment manager, legends such as Warren Buffett, Peter Lynch and John Templeton, and they can hardly be more simple and clear. Their methods may be hard to replicate, but they are easy to understand. They may bore you to death by telling you about inventory levels of some obscure company, but you do not have to worry about your portfolio suddenly “blowing up” from an ill-timed bet on the Thai currency because of a flawed quantitative model. Good managers typically know exactly what they do best, specialize in that, and have no problem in being limited to doing that. They don’t need broader than normal discretion, substantial bets on market direction, the use of extreme leverage, an outsized portion of the profits and the ability to speculate in commodities as well as currencies as well as restricted securities as well as stocks.

The sad thing is we have seen it all before. While the first modern hedge fund dates from the late 1940’s, the idea was never very popular in the long bull market of the 1950’s and 1960’s, since selling short did not generally work. People began paying attention in the late 1960’s and the early 1970’s after the long bull market ended. When the market started going down, the number of hedge funds surged, mirroring recent experience. The vast majority of the new hedge funds were failures, however, and the hedge fund idea became dormant again until a new generation of investors could be attracted by the “new” shiny bucket of alternative investments.

Sigma allocates client money to what we believe are superior managers, regardless of the “bucket.” We can allocate money to hedge funds and keep an open mind on the topic. When every bank and broker is pushing a particular product, however, it is almost a metaphysical certainty that the timing for that investment is poor. Contact us if you want your portfolio driven by reality, not the current marketing pitch from the “financial products” industry.