

## A Goofy Idea?

My six-year-old daughter recently asked “Daddy, if Goofy and Pluto are both dogs, why does Goofy walk on two legs, speak English and is Mickey’s friend while Pluto walks on four legs, cannot speak and has to live in a dog house?” I gave her my stock answer (“Quiet, and finish your vegetables”), but I admit I am haunted by the question. I considered denying that Goofy is really a dog, but a check of the Disney web site verifies he is.

My daughter’s question got me to thinking about similar category confusions existing outside cartoons. For example, hedge funds, once an obscure, secretive sideline just a few years ago, have grown to more than 7,000 in number, with just under a trillion dollars invested and an army of salespeople foraging for new prospects. But what, *exactly*, is a hedge fund? Just as with the Goofy/Pluto question, I have yet to get a very satisfactory answer.

Hedge fund managers can invest in just about anything, use borrowed money to increase potential returns (and risks) and make bets on the market going down by “selling short.” Investors pay the manager a fee plus a percentage of the profits. Investors have limited liquidity. The funds typically do not register with the SEC.

In sharp contrast, mutual fund managers can invest in just about anything, use borrowed money to increase potential returns (and risks) and can make bets on the market going down by “selling short.” Investors pay the manager a fee (typically smaller than that charged by a hedge fund) and do *not* share profits with the manager. Mutual fund investors can take out their money any time. The funds always register their shares with the SEC. In other words, a hedge fund is like a mutual fund, except with less disclosure, less liquidity, less regulation and much higher fees. Who could resist that?

In logic, classification involves sorting things into categories. You divide the genus, a broad group with generally similar characteristics, into smaller subcategories or species. You identify species by focusing on how their essential attributes are different from those of other species.

This was my daughter's confusion with Goofy and Pluto. Within the genus of cartoon animal, you define the species dog by essential attributes such as walking on four legs, wearing a collar and living in a dog house. Goofy breaks the rules, calling into question the concept of "dog" in the world of animation. With hedge funds, the genus is investment vehicle, but what are the essential attributes? They appear to be exorbitant fees, poor disclosure to investors, lack of regulation and lack of liquidity.

Much of the investment world seems to persist in treating hedge funds as an "asset class," despite many dozens of fundamentally different investment strategies, with widely varying risk/return characteristics, pursued by hedge fund managers. In the February 19 issue of *The Economist*, a "phrase of the moment" characterizes hedge funds as "a compensation scheme masquerading as an asset class." Exactly so. The high fees attract bad managers as readily as good managers. Ironically, part of impetus behind the rush to hedge funds has been recent scandals relating to the misleading disclosure, high fees and breaches of fiduciary duty at a few mutual funds. So the response is to rush to an investment vehicle with virtually no disclosure, even higher fees and no defined fiduciary notion?

*Hedge funds are "a compensation scheme masquerading as an asset class"*

*- The Economist,  
February 19, 2005*

Information regarding hedge fund performance is misleading due to self-selection, with managers not reporting returns until they are good, and stopping reporting just as they enter their final swoon. Even with these "advantages," you cannot accuse hedge fund investors of chasing recent excellent performance. *The Wall Street Journal* daily publishes six hedge fund indexes, and only one has double digit returns over the past 12

months. We believe many investors are interested in hedge funds because they now mistakenly consider hedge funds to be an asset class, something in which they *have* to invest.

Some credit conservative hedge funds with saving their portfolio during the bear market a few years ago, but plain-vanilla bonds outperformed many of those conservative hedge funds. The problem most investors had then was not an under-commitment to hedge funds; it was an over-commitment to speculative stocks at the top of the bull market. They could have "saved" their portfolio just as well by selling the speculative stocks and stuffing the proceeds in their mattress, and yet nobody thinks to praise the brilliance and fiduciary sense of their mattress or characterize mattresses as an asset class.

In the western farce *Blazing Saddles*, the new sheriff hears of the bizarre villain Mongo, asks who he is and is told "Well, Mongo ain't exactly a 'who,' he's more of a 'what.'" For us, the category confusion with hedge funds is the mirror image of the Mongo description. We do not think of a hedge fund as a "what," but a "who." Tell us who the managers are and the investment style and process they follow, and we will be happy to evaluate them, regardless of whether the "what" is a hedge fund, mutual fund, separate account or Luxembourg trust.

So hedge funds still confuse us. Maybe we're just a little slow - after all, I even have trouble with the questions my kids ask me. If you would like to focus on a rational investment plan that avoids Mickey Mouse investment fads, however, call us at 503-419-3938 or check us on the web at [www.sigmainvestment.com](http://www.sigmainvestment.com).

- Bill Berg