

## Absolute Madness, or Relative Idiocy?

The Guru smiles, knowing he has an attention-grabber for today's television show. He clutches a bundle of balloons; printed on each is the name of a professor who recently warned of the imminent bursting of a real estate bubble. Brandishing a needle, he pops the balloons as he recites information about the returns on real estate, real estate investment trusts and homebuilding stocks, ridiculing anyone daring to doubt the investment potential of real estate.

Writing a column the next day, the Guru admits there probably is a real estate bubble that eventually will burst. But "eventually" is not now, and the Guru believes you cannot "afford" the opportunity cost of missing the tripling of the stocks of homebuilding companies. It does not matter how richly the stocks are priced compared to underlying business fundamentals – the Guru says you *have* to play the game because you will never make up that missed chance by trading slower-moving stocks like Pfizer or Intel.

We will not opine here on the real estate bubble, although we think it a bit weird to get several emails a day from "Frank," to whom we have not been properly introduced, offering us half-million dollar mortgages at low rates. Instead, we will consider the concept of opportunity cost, of having to chase a particular investment or industry, no matter the price, because it would be too painful to miss a possible gain. Fear of opportunity cost drove many speculators during the technology boom of the late 1990s. The Guru took a similar tack back then – you "couldn't afford" to miss the last 100 points of Infospace (or other hot Internet stock) if your competition was in on the game. Implicit in the concept of opportunity cost is that you are competing against others; you have no goal for yourself other than beating "them." Well, each to his or her own. We were able to miss the last 100 points of Infospace with equanimity then. Sure, we occasionally would get heartburn imagining the vacation home we could have bought with that last 100 points in Infospace, but we lead full lives and can get heartburn from all kinds of regrets.

Many lacked equanimity in the 1990s, though – they played the game suggested by the Guru and got burned. Their subsequent search for a better approach gave rise to the growth in hedge funds, sometimes euphemistically called “alternative assets” or even more euphemistically “absolute return management.” Acting as if they are presenting us with the invention of the wheel, the new breed managers assure us they are seeking substantial gains while avoiding losses. (You can imagine our joy at this conceptual breakthrough). Absolute return managers contrast themselves with traditional pension and mutual fund managers who are happy if they beat their peer competition, even if it means they lost less.

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But the Guru’s observation on opportunity cost demonstrates that absolute return managers are really playing a relative return game anyway. Seeking absolute returns only works in the real world if you are operating in a vacuum, never compared to peers. A true absolute

return manager should be happy to miss the homebuilder stock boom if she thinks it is stupid, waiting on the sidelines until she gets an opportunity that makes sense to her. But if she loses all her investors to the competition because her performance falls behind that of other absolute return managers, then relative returns are all that matter. She has to worry about short-term results if her clients are comparing her short-term results to those of her competitors. In many hedge funds, clients have only once a year when they may withdraw their investment, so the hedge fund managers do not have the advantage of inertia created by daily liquidity – investors will consider withdrawal once a year. An investment manager can be “absolute” in her investment focus, but unless she is “relatively” good in the performance sweepstakes, she will have no money left to manage due to the behavior of her clients, something she cannot control. Investment wise man Jeremy Grantham points out that for every decision an investment manager makes, he has to weigh both investment risk and career risk.

The absolute return craze is a phenomenon of the recent bear market; the risk of loss is (temporarily) foremost in the minds of prospects. This was not the case in the late 1990s, when many value-oriented managers had very good returns but lost clients to growth managers who were (temporarily) performing better. The oft-quoted long-run return on stocks is somewhere in the 9 to 11 percent range. Imagine that we offered you an investment that returned 12 percent every year, with the proviso that once you sold it, you could not buy it back. This is a great investment, but how many investors would happily have held it during the 1990s, when the broad U.S. stock market returned 18 percent per year and many growth managers boasted even higher returns? Imagine hearing your dim-witted neighbor chiding you for your conservatism, bragging about his technology stocks.

Investors have an asymmetry in how they view performance. They cherish absolute returns (not losing money) in bear markets, but relative returns (doing better than that neighbor) in bull markets. Wall Street can create all the absolute return “product” it wants, but little of it will survive a period when many are experiencing higher returns. The very popularity of hedge funds has led to much more performance analysis against peers; this relative performance comparison will tend to destroy the more conservative “absolute” nature of the returns sought. Managers will assume more risks to keep up in the performance sweepstakes. Investments change, but human nature seems constant. The next time someone tells you it is too costly to be bearish on a particular investment, that the train is leaving the station and this is your last chance to hop on, stop. Forget about the train, decide you want a rational investment policy, and call us at (503) 419-3938.