Hedge Funds

COMSTOCK

By Stephen C. Browne, CFA, Chief Investment Officer

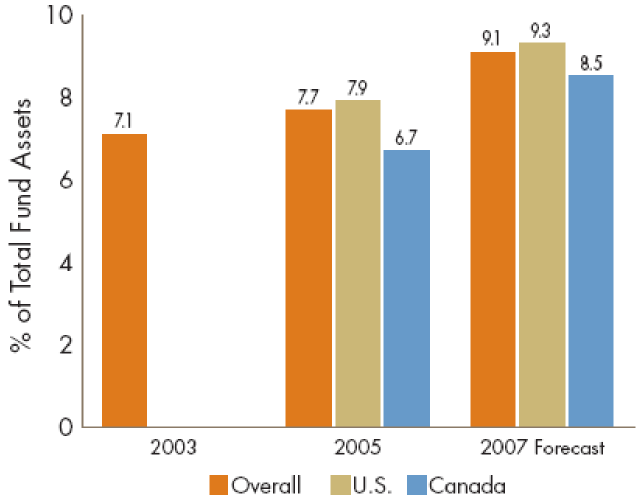
Despite a growing number of articles in the financial press about small cap and foreign equities ceding their market leadership to large cap US companies, these two sectors blew the doors off in the first quarter. The MSCI EAFE index of international stocks returned 9.47% while small caps, represented by the Russell 2000 returned 13.94%. The S&P 500, by comparison, returned a respectable but relatively paltry 4.21%. Within the US market low quality stocks outperformed high quality by a large margin - A rated stocks returned 3.7% compared to 7.8% for B and over 10.0% for C and D stocks. Value beat growth in the large cap space but growth dominated among small cap stocks. The emerging markets continue to outperform. The MSCI emerging market index returned 12.0% for the quarter. The hot BRIC countries (they are so hot they have become a new acronym pronounced "brick" that stands for Brazil, Russia, India and China) have returned 22.7% so far this year. These markets have been the recipient of large flows of capital in recent months, and likely these numbers will attract even more "hot money" chasing this performance. Perhaps one can appreciate the irony of the acronym in advance of a potential future decline of these markets should the flow of capital reverse directions. After a lackluster 2005, hedge funds came back to life in the first quarter with the HFR Fund of Funds index returning 4.81% for the quarter.

The bear market of 2000-2002 brought home to most investors the reality that they would be facing a lower return environment than they had experienced in the 1980's and 1990's. Faced with this, investors have two basic responses:

1. Reduce performance and perhaps spending expectations to conform to the new environment or
2. Increase risk to maintain the same return levels as investors were accustomed to in the 1980's & 1990's

Most people would rather not have to face this choice. Recognizing this, the investment industry has offered a third option which is, to paraphrase Warren Buffet's latest annual shareholder letter, to pay more management fees. As one might expect, the industry has another name for it – absolute return investing. What they are saying is that everyone can climb on board with the best and brightest hedge fund managers and not worry anymore about benchmarks, bear markets or betas. Of course, the best and brightest cost more than your traditional money managers and to justify the higher fees the industry touts the very successful investment records of innovative large endowments such as that of Yale University who have relied heavily on alternative investments over the years.

But can everyone be a Yale Endowment? Is this a model that Wall Street, particularly the brokerage houses, can successfully deliver to the broad public? Yale and others were successful not only due to their large allocations to alternative investments; they have also had a keen insight into the investment industry and an ability to discern where inefficiencies might lie and a willingness to invest capital in unconventional areas. Empirical studies have shown that in most categories of alternative investments, only the top quartile of managers have added substantial value over traditional investment categories. The amount of money in hedge funds has doubled since 2000 to over $1 trillion dollars currently. A recent survey of institutional investors by Frank Russell & Co. shows that these flows can be expected to continue, with a 20% increase in hedge fund allocations forecast by 2007:



This does not mean that one should avoid hedge funds or other alternative investments. Hedge funds are an investment structure that offers many interesting opportunities that can add substantial value to a portfolio. Higher fee structures than for traditional investments are justified for many hedge fund strategies. Investors however should be wary as what was once a vehicle for relatively small, entrepreneurial pools of capital becomes an institutionalized “asset class”. If the returns of diversified pools of hedge funds are largely attributable to superior manager skills (i.e. “alpha”) why do all the primary metrics of hedge fund and fund of fund performance correlate with one another on a monthly basis? According to a recent article in the Financial Analyst’s Journal by Burton G. Malkiel and Atanu Saha, the average annual dispersion in returns between the universe of hedge fund of funds is slightly less than the 3.34% average difference between mutual funds of all categories. In the less volatile non-correlated strategies such as fixed income arbitrage, convertible arbitrage and equity market neutral the average annual performance difference among funds in the category was between 2 and 3 percentage points. What this indicates are underlying common risk factors (otherwise known as betas) that drive a significant portion of hedge fund returns.

Quantifying the specific risk factors is a subject of debate, but an analogy for many hedge fund strategies can be made to an insurance model. When, for example, a stock for stock merger is announced with a substantial premium offered over the current price of the acquired company, the stock usually responds by appreciating sharply if the market believes there is a reasonable chance the merger will be consummated. Most of the current holders of the stock are motivated to sell as the possibility of an additional small gain is outweighed by the possibility of losing all their gains if the merger fails. Nor does the investor want to follow the legalities of anti-trust approval and shareholder proxy votes. Here is where the hedge fund has traditionally stepped in. By purchasing the stock of the acquired company and selling short the stock of the acquirer the fund stands to make a modest gain when and if the merger closes. While a disproportionate loss is possible should the merger fail, the hedge fund owns a broadly diversified portfolio of similar merger trades. As with any insurance model, the long term success depends on the pricing of the premiums relative to the risk being assumed. With record institutional flows into hedge funds and market volatility at historically low levels, it is not an unreasonable assumption that market “insurance premiums” are cheap today.

Many popular hedge fund strategies, such as long-short equity, macro and distressed investing do not fit this profile. They are a more straightforward, zero-sum competition among active managers to obtain excess return (active management is zero-sum because in the aggregate all the dollars earned by active investors must equal the return of the market less fees). There are highly motivated, skilled managers out there who have developed a sustainable advantage in the competition for alpha. However, investors must ask themselves how they can distinguish these skilled managers from the lucky ones.

Despite talk in the press of a “hedge fund bubble” no direct comparison with the tech stock bubble of the 1990’s is applicable. Hedge fund investors simple do not stand to lose 70% of their aggregate investments in some catastrophic blow-out as was the case for the NASDAQ. However sub-par returns for an extended period with implosions of some more aggressive or esoteric funds are very possible.

For successful investing there are no real alternatives to knowing what you own and why you own it. Select hedge fund strategies within this context can add substantial value to a portfolio. However the industry also promotes a gunslinger mentality that anoints top performing managers with an aura of invincibility when in fact it is extremely difficult to identify top performers ex ante. The one thing Wall Street can be trusted to do is to take a good idea and push more money, more risk and more fees into it than it can handle. This was true of LBO’s in the 1980’s, technology stocks in the 1990’s and railroad stocks in the 1890’s. Whether it is true today of hedge funds only time will tell.

Paul Comstock Partners
6363 Woodway Suite 620, Houston, TX 77057 ▪ Main (713) 977 2694 Fax (713) 877 1363 ▪ www.paulcomstockpartners.com