THE WORRY LIST:
HEDGE FUNDS AND DERIVATIVES

Every investment manager has a horror list. There is always something to worry about. Investors need to remember that stocks, long term, have been wonderful investments. Over the last eighty years, equities have provided a compound annual rate of return of 10.4%. They have easily outperformed short-term credit instruments, long-term bonds, and inflation. Since 1926, stock returns have had 57 positive years (71%) and only 23 negative ones (29%). If you look beyond annual performance to rolling 5/10/20 year periods, the odds of a positive outcome get even better. Based on the past, the basic message is that it pays to have a bias towards stocks.

Another reason for not letting fear guide our investment judgment is that fear is fashionable. Concerns sound more erudite than optimism. A good example is how network TV and newspapers dwell on the negative.

Our last quarterly letter contained a list of the positives and negatives in the investment outlook. Such a list always exists and the trick is to pick out themes/trends that will dominate. For example, debt is a constant concern, but only the true investment guru knows when it will be important enough to impact the financial markets. It only matters when it matters and then it is everything. The trick is to anticipate the inflection point.

This letter addresses two financial instruments that have gained widespread interest and popularity and have the potential for infectious misery to the financial system. They are hedge funds and derivative contracts. One danger sign is popularity. Wall Street has a long history of backing up the dump truck to popularity. Usually these popular products are toxic to investors. A good rule is to sell popularity, buy fear. Said another way, buy when you are terrified, sell when you are satisfied.

Hedge funds have been around for a long time and come in many varieties. The modern concept was developed by Alfred Winslow Jones in the 1950s. His strategy was to buy long and short positions in different stocks so that the investor would hopefully make money no matter the direction of the market. Over the years, many so called hedge funds have strayed from a market neutral stance. They have gone into instruments other than stocks including bonds, currencies, convertibles, international securities, merger arbitrage, commodities, etc. They have increasingly used leverage, some to amazing degrees. Leverage is always dangerous. Long Term Capital Management (LTCM), a hedge fund that went bankrupt in 1998, was leveraged $100 for every $1 of invested capital. With this kind of leverage and a dose of bad markets, Humpty Dumpty, two Nobel laureates, and some of the best traders on Wall Street could not put the fund back together again. The loss, a staggering $1.2 trillion, had major repercussions in the banking and brokerage business and for the financial system as a whole. Alan Greenspan and the Federal Reserve earned a gold star containing the impact of this bankruptcy. Many hedge funds have forgotten about the “hedge” and instead make large directional bets on whether the markets they invest in will go up or down.

In 1990, there were approximately 400 hedge funds with $50 billion in equity capital. The size, scope, and popularity of the hedge fund market has blossomed. There are now an estimated 8,000 funds controlling more than $1 trillion of equity capital. Because of leverage, hedge fund buying power is significantly larger than invested capital.

Properly hedged hedge funds offer investors a way to generate positive returns in down markets. They can enhance returns and reduce risk in an overall portfolio because of their low correlation to traditional investments.

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The negatives of hedge funds are several. Regulation is minimal and fraud has been a problem. Fees are very high; typically 1 to 2% of assets plus 20% of profits. It is very profitable to manage a hedge fund, but not always great to be an investor. Some believe that hedge funds are not so much an industry as a compensation formula. Many hedge funds are traded actively with high portfolio turnover. This generates short-term capital gains that bear high tax rates for individual investors. In many cases, the use of leverage coupled with concentrated investment positions lead to significant risk. Reported performance numbers are flawed. They seldom take into consideration taxes, survivor bias is a problem (dropping the results of poor performing funds that go out of business), and the fact is that many funds simply do not publicly report performance. Liquidity is an issue for some due to long lockup periods. Finally, many funds have high minimum investment thresholds that exclude most individual investors.

In our opinion, hedge funds are not the silver bullet among investment choices for individual investors. The broader issue is that they raise the general level of risk in the financial system due primarily to leverage. Banks and brokerage firms have many billions of dollars in hedge fund debt that are at risk.

A close acquaintance ran a major Swiss bank subsidiary in the U.S. for a number of years and then was transferred to the home office to be the first American to act as the bank's chief credit officer. When asked what went bump in the night for him, he said the bank's trading in derivative securities. Derivatives are a huge market, often much larger than the underlying securities to which they benchmark. Warren Buffett called them financial weapons of mass destruction. Derivative trading in his Gen Re subsidiary has resulted in over $400 million in losses. He is closing this operation.

Derivatives were initially created as a device for hedging, but have evolved in many cases to more speculative purposes. They are often used to make bets on market direction. The classic example of derivative use is the farmer selling futures contracts on a crop to a speculator before the harvest. The farmer locks in the revenue from his farm and the speculator has the opportunity to profit if prices rise, but assumes the risk if they fall.

Derivatives are involved in many markets including interest rates, foreign exchange, commodities, stocks, energy, etc. The trading volume is huge. The Bank for International Settlements estimates that there are $370 trillion face amount of over-the-counter derivative contracts currently outstanding. There is a total of $89 trillion in U.S. exchange traded derivatives. These contracts were the cause of the high profile collapses of LTCM, Orange County, Baring Securities, and Enron. Between 2000 and 2003, government sponsored Fannie Mae had derivative losses of $25 billion. Alan Greenspan and many other economists believe there are a number of other such disasters waiting to happen. Derivatives are part of the balance sheets of many large banks and brokerage firms. They are clearly a systemic risk in our financial system.

Most hedge funds and derivative instruments focus on the short term. They encourage investors to forget that stocks represent long-term interests in discrete businesses, and to think of them as short-term trading chips. Stocks are claims to real assets: land, capital, property, ideas, trademarks, and patents, among other assets that produce goods and services. Investors in stocks share the profits of an enterprise. Stocks allow investors to jump on the back of American and foreign companies and economies and share in their progress. With proper diversification and reasonable selection, it is our opinion that stocks, as an important part of a balanced portfolio, are the best approach to wealth management.

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