

Hedge Fund

R E V I E W

“Jones Model Funds”

LMC’s Recommended Classification Name

We invite you to critically review, comment on, and hopefully adopt our definition and choice of a *new descriptive name* for traditional equity hedge funds. Why? Because segregating “Jones model funds” as a distinct classification will re-establish the clear identity that was absconded from the original and most common type of hedge fund in our industry.

“Hedged fund” (modified to “hedge fund”) was the original descriptive name for the incentive based, equity hedging investment fund developed by Alfred Jones.¹ The term was popularized by Carol Loomis² and other financial writers beginning in 1966, and was used definitively for similar funds over the next two decades. By the mid-to-late 1980’s, “hedge fund” began to be used more widely for incentive based investment pools using a broader range of non-traditional investment strategies, but it remained predominantly identified with traditional equity hedging. Today, this is no longer the case.

In the mid 1980’s a small group of the most successful equity hedge funds (most notably those run by George Soros, Julian Robertson and Michael Steinhardt) began evolving into global, multi-strategy investment organizations. Somehow perceiving these conspicuous funds to be representative, a new generation of financial journalists has conveyed to its readership that *typical* hedge funds practice a broad range of risk assumptive, highly leveraged strategies, including derivatives, currencies, foreign debt, etc. But

the “most typical” hedge fund, by our book, is still an Alfred Jones style equity hedge fund, which doesn’t remotely fit the media’s characterizations. Likewise, of the many other (non-Jones) styles we follow, very few fit the descriptions propagated by the financial press.

Adoption of our “Jones model” classification would reinstate something traditional equity hedge funds have lost: a clear identity.

Our Primary Classifications

A major historical benefit of the hedge fund industry is that it has facilitated the decentralization of investment talent, away from the constraints of large organizations and institutionalized money management. Thus, our purpose in classifying hedge funds is descriptive, not prescriptive, and we would discourage the adoption of a detailed classification system for the industry. On the other hand, more clarity for the major categories would benefit fund managers and investors.

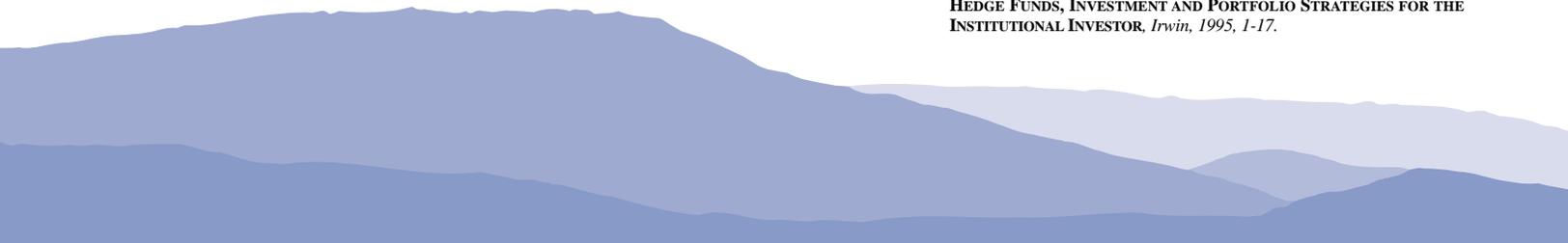
Our 1st level classification separates hedge funds into a) Jones model funds, and b) non-Jones funds. There are many excellent non-Jones strategies, and few have been accurately described in the media, but our discussion here is limited to Jones model funds. Since our use of “Jones Model” or “Jones System” began as a result of interviewing numerous people who were intimately familiar with Alfred Jones’s operation, we should briefly revisit his operation.

TABLE OF CONTENTS

- “Jones Model Funds”
Classification Definded 1
- Media Check:
An LMC Journalistic Integrity Award 3
- A Convergence of Cultures . . . 4
- Hedge Fund Profiles
- Ringoen Partners, L.P. 20
- Cambridge Energy L.P.
Cambridge International Ltd. .12
- Winston Growth Fund, L.P. . 14
- McGarr Partners, L.P.
SAM/McGarr Offshore Fund 15
- Evaluating Performance . . . 18
- Echoes from the Hedges . . . 20

¹ Carol J. Loomis, “The Jones Nobody Keeps Up With,” *Fortune*, April 1966, 237-247.

² Ted Caldwell, “Introduction: The Model For Superior Performance” **HEDGE FUNDS, INVESTMENT AND PORTFOLIO STRATEGIES FOR THE INSTITUTIONAL INVESTOR**, Irwin, 1995, 1-17.



Our secondary classification of Jones funds (conservative vs. aggressive) provides distinctly different investment alternatives.

It never ceases to amaze us, just how much flexibility both categories of Jones strategies give managers. They have, and will continue to provide good stock pickers a broad framework for achieving superior performance.

The Jones Model Revisited

There were three fundamental elements to the equity hedging system originated by Alfred Jones at mid-century. First, a significant portion of assets was maintained, *at all times*, within a hedged structure. (The portion of assets within the hedged structure was approximately market neutral, thus isolating stock picking skills from market swings.) Second, Jones felt liberated to leverage his stock picking, since market risk was eliminated within the hedged portion of assets. Third, acknowledging the dynamics of risk and reward on manager performance, Jones chose incentive remuneration based strictly on the performance he achieved for his investors, and kept all of his investment assets at risk in the fund.

This description of Jones's original equity hedging system *implies* that market risk was always mitigated for capital. In practice, this was not always the case. Thus, our secondary classifications for Jones model funds pertain to the dynamics of equity hedging as they relate to market risk. We classify Jones model funds as either a) conservative, or b) aggressive, based strictly on net market exposure for capital.

Jones's system can be used (as it was, occasionally, by Jones), to *amplify market risk* for capital, while risk continues to be mitigated within the hedge. How so? Consider an example of an aggressive Jones style manager who is 160% long and 30% short. In this case, 60% of assets are within the hedge (i.e. market neutral, where long and short exposure is equal), but with 190% total exposure, the portfolio remains 130% net long. *Thus, the exposure of capital to market risk is amplified rather than mitigated.*

Some managers argue that, in our example above, only 68% of total assets (130/190) are exposed to the market. This is true, but the argument overlooks two key points: First, investors view losses (and gains) relative to capital, not total assets. Secondly, good performance *within the hedge* is almost always outpaced by rapidly rising or falling markets. Thus in a "Black Monday scenario," we would expect a good stock picker to profit within the hedge, but not nearly enough to offset the losses incurred due to significantly leveraged net market exposure. Thus aggressive Jones model hedgers can pay a heavy price in a bear market, losing substantially more than their appropriate benchmark.

Alfred Jones's investors lost money in only 3 of his 34 years (vs. 9 down years for the S&P 500). By far the largest of Jones's 3 down years

came in the fiscal period ending 5/31/70, when he lost 35.3%, vs. 23.4% for the S&P 500. Alex Porter, one of Jones's portfolio managers at the time, confirms that their market exposure was aggressive at the time. "It was maybe 115-120%. We had been in a bull market, and it was a sum of the parts sort of thing, with the different managers in the firm wanting to make the best of the bull market." Jones's occasionally aggressive style is confirmed by other portfolio managers, Dick Radcliffe and Carl Jones (no relation). Porter also points out that conservative hedging in the down market of 1973-74 made a big difference, giving Jones positive returns.

As we have indicated in several articles, amplifying market exposure (i.e. "swimming naked") caused the demise of most of the 1st cycle hedge funds between 1969 and 1974. In 1995, some equity hedgers have leveraged into the bull market, achieving huge returns. At the other extreme, some bears have leveraged significantly net short, achieving commensurate returns.

Conservative Jones model funds *always mitigate market risk* by always maintaining net market exposure within a range from 0% to 100%, inclusive. Even at 100% net exposure, market risk is mitigated by the leveraged assets within the hedge. We expect both conservative and aggressive Jones model funds to provide superior long term performance relative to their appropriate equity benchmarks (Absolutely!). But aggressive managers have the opportunity to outperform their conservative brethren.

Our secondary classification of Jones funds (conservative vs. aggressive) is prudent because equity hedgers that will always mitigate market risk, vs. those that will sometimes employ leverage to amplify market risk provide distinctly different investment alternatives. Investors should match the style of Jones manage to their desired risk profile, and clearly understand which they are choosing!

It never ceases to amaze us, just how much flexibility both categories of Jones strategies give managers. They have, and will continue to provide good stock pickers a broad framework for achieving superior performance. This, the original and most common category of hedge fund deserves to regain the clear identity it once had.

[We encourage you to join us in adopting this descriptive classification for traditional equity hedgers, along with its two distinct subclassifications.](#)