Lookout Mountain

Hedge Fund

R E V I E W

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Time Capsule Opinion*

Reconsider this Script in January 2007.

by Ted Caldwell, November, 1996

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Who is the best money manager in operation today? Who are the top ten money managers in operation today?

These are sensational questions, the kind that sell a lot of magazines and sustain hours of cocktail party gab. Almost any financial industry magazine you pick up will have some kind of ranking for "the best" of some category. Performance databases and financial media lists attract customers, and can narrow the debate over who the best money managers have been, but do they point investors to the superior managers of tomorrow?

It's considerably easier to look back and pick great managers, than to look forward and pick great managers! The focus of this article is forward looking. The relevant issue for investing at any point in time is not who the best money managers have been, but rather who the best managers will be in the years to come.

The Ten Year Lock-Up

By rephrasing the question, we can redirect the discussion from sentimental reminiscing and sensational listings to a proposition that requires more forward-thinking conviction. No matter how highly you regard great money managers of the past, the following hypothetical question should give you pause.

If you were required to place all of your investment assets into a ten year, locked-up account with a single money manager, with draws limited to your basic living expenses and taxes, who would that manager be?

Thankfully, this proposition is only hypothetical, but it does impose a more somber thought process. Take a moment to ponder the answer you would give, and if you wish, write it in the space below. You may choose an individual money manager or a specific fund run by an organization, but your investment will be hypothetically "locked-up" from 1/1/97 through 12/31/06. (You may prefer to use pencil!)

Your choice: ______________________________

With thousands of mutual funds, hedge funds, commodity pool operators, and traditional money managers to choose from, several subscribers have suggested we have little to gain, and a great deal to lose by printing a single selection in indelible ink. Against their rational advice, we are going to give you the name of our hypotheti-

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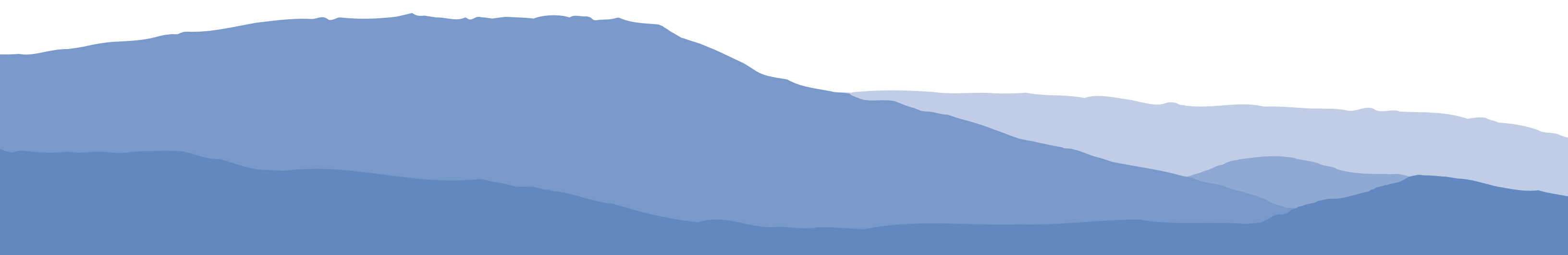

cal choice. Why? Because our answer will provide an opportunity to test some of the most important concepts we have articulated in past issues regarding *an investment system*.

The Odds

What are the odds of selecting a money manager that will turn out, a decade from now, to have been a truly great manager over the preceding ten years? Let's consider the odds from an historical perspective.

What are the odds you would have predicted the future investment supremacy of Warren Buffet in 1956, or Michael Steinhardt in 1968, or Peter Lynch in 1979 or Julian Robertson in 1982?

Step back in time and reflect on the probability of *your* correctly choosing any of the great money managers, when they had track records of only a year or two? What are the odds you would have predicted the future investment supremacy of Warren Buffet in 1956, or Michael Steinhardt in 1968, or Peter Lynch in 1979 or Julian Robertson in 1982 - given just a couple years of performance history? For that matter, what are the odds you would have predicted the *continuing* supremacy of Buffet in 1975, or Steinhardt in 1980, or Robertson in 1988, given a great deal of performance history?

The odds against predicting the future prominence of these managers was infinitesimally small during their early years, and early investors weren't remotely enlightened as to the magnitude of their future good fortune. Luck has historically dwarfed brilliance in the early selection of phenomenal money managers. Let me give you a personal example.

Luck has historically dwarfed brilliance in the early selection of phenomenal money managers.

My family began investing with Julian Robertson the day he opened his doors in 1980, hoping only to beat the S&P 500. Not only was the spectacular performance that Robertson has delivered unanticipated in 1980, it was *incomprehensible*! The actions of Tiger investors at the end of 1987 provide an even better illustration for how inadequate investors are, when it comes to anticipating a manager's extraordinary future performance.

You might expect that most Tiger investors, given eight years of distinguished history, would have foreseen Robertson's continuing excellence since the end of 1987. This was not the case. My memories of Tiger's 1987 annual partner's meeting still provoke anxiety! It was held on the Thursday following "Black Monday," and there was a pall in the Morgan Stanley conference room where the partners had gathered. At a time when even Robertson questioned how much the growth in assets under management might effect future performance, it appeared Tiger would experience its first annual loss.

Articulating various concerns, a number of investors told me they intended to reduce or withdraw their capital at the end of the year. One friend now admits that his wife has never forgiven him for withdrawing, but he was convinced a fortuitous run had come to an end. Although it may seem obvious at the end of 1996, it was by no means apparent at the end of 1987 that Robertson's performance would be so brilliant from 1988-96.

Although it may seem obvious at the end of 1996, it was by no means apparent at the end of 1987.

A decade ago, one of the more apparent responses to our hypothetical question would have been the Fidelity Magellan fund. Not only had Peter Lynch trounced the market since he started managing the fund in June of 1977, but Magellan was quite visible to the investing public. Warren Buffet's Berkshire Hathaway was a less visible choice, and the hedge funds run by Robertson, Steinhardt and Soros were still downright obscure.

Had you picked the Magellan Fund as your hypothetical choice a decade ago, performance may have been less stellar than you had hoped for. Peter Lynch left the fund in May of 1990 with annualized returns of more than 29% during his tenure. Regretfully, *after* you made your ten year commitment Lynch's returns were only 16% per year, and the fund had three different managers during the remainder of your hypothetical lock-up. Magellan still beat the market by about 1% per year during your lock-up. This was quite good, since only one equity mutual fund in five beat the market during the same period!

Had you picked the Magellan Fund as your hypothetical choice a decade ago, performance may have been less stellar than you had hoped for.

In fact, the odds in favor of picking a manager to simply outperform the Vanguard 500 index fund over the next decade are so poor that most investors are better off selecting the index fund in answer to our hypothetical question. The odds in favor of your correctly selecting a manager that will be among "the best" managers *for the decade after your choice* are negligible.

Capital Preservation

Shifting the question from "Who is the best money manager?" to "Who would you trust to manage your assets for the next ten years?" most likely shifted your focus from high performance to capital preservation. Trying to pick the highest performing manager is a reasonable goal for a dispensable portion of your assets, but a terribly misguided goal for selecting the answer to the hypothetical ten year lock-up.

"Who would you trust to manage your assets for the next ten years?" most likely shifted your focus from high performance to capital preservation.

The criteria used in answering the ten year proposition will vary from investor to investor. Some very conservative investors may choose a manager to buy and hold bonds of ten year duration. Other investors may choose a reputable balanced fund to shift allocations between stocks and bonds, depending on the chosen manager's outlook. More aggressive investors may buy an equity index fund or even select an equity fund they think can beat the index.

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Many prudent investors will choose a hedge fund. Capital preservation should still be a primary concern for these investors, and they should have a sound awareness that not all hedge funds are created equal!

Take a look at our hedge fund classification chart (Version 1.2, on page 9). There are hedge funds in almost every classification that we like and find investment worthy. The hypothetical ten year investment lock-up quickly eliminates most, because hedge funds generally warrant closer monitoring than traditionally managed investments. In fact, few hedge fund managers are able to look you in the eye, and tell you exactly how they will run their fund over the next decade. This is a prerequisite for our choice.

Time Capsule Pick

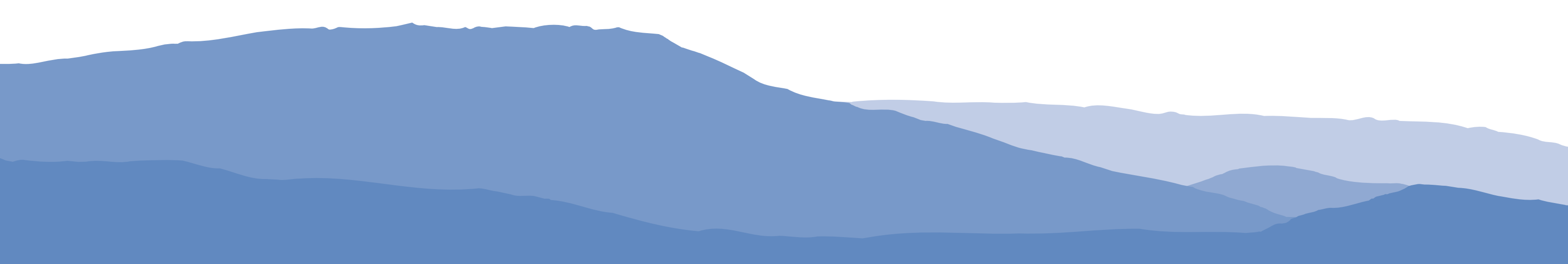
If I were required to place all of my investment assets into a ten year, locked-up account with a single money manager, I would choose Lee Ainslie to oversee my money in his Maverick Fund.

This article is calculated to encourage you to examine the most prudent of all equity investment systems - a conservative Jones model fund - in the hands of an expert for ten years. True, any number of problems can and may occur, and that is why, in reality, we would never invest in a ten year lock-up. Nonetheless, from our perspective as 1996 draws to a close, Lee Ainslie runs the best conservative Jones model fund we know of, barring none! He is the perfect choice to demonstrate over the next decade, the system we have tried to illustrate in past issues.

As 1996 draws to a close, Lee Ainslie runs the best conservative Jones model fund we know of, barring none!

We refer to Maverick as "Lee's fund," in this article, only because the conversion of Maverick to a conservative Jones model fund was brought about by Lee, and the operation of the fund will be directed by Lee. Sam Wyly brought Lee to Maverick in August of 1993, in what must be viewed as an outstanding WIN-WIN scenario. Ainslie, who fledged from Tiger Management, had the good fortune to imprint on Julian Robertson prior to leaving the nest. The importance of his three year apprenticeship under Robertson cannot be understated, although Lee's style is his own.

What Sam Wyly gave Lee should not be understated, either. Sam provided him assets to manage, a talented back office team, and the trust to permit Lee to mold the fund into something Wyly had never seen - a *pure*, conservative Jones model hedge fund. Maverick is comprised of a talented team of people, and it is their fund, but the individual that will guide Maverick through



the unknown decade ahead is Lee Ainslie.

As such, Maverick is now a misnomer. Sam Wyly is the quintessential capitalist, who can't create enough stomach acid to digest food if he doesn't have a few big bets on the table. Maverick was appropriately named when Wyly ran it, because he made calculated, directional bets. The profile we did on Maverick in 1994 was still dominated by Wyly's personality, although 70% of the assets were being run by Lee in a Jones model format. Sam had the foresight to segregate Maverick at the beginning of 1995, and to entrust the portfolio entirely to Lee. Don't let the name convey the wrong meaning to you - this is now a conservative equity fund.

Almost by decree, managers with great numbers slide into mediocrity (or worse) after investors pick them!

Our ten year choice is not based on the numbers, but on Lee's superb grasp and execution of the system we call the conservative Jones model.

Maverick's commendable performance is not revealed in this article, because past numbers are not the reason for our selection. Almost by decree, managers with great numbers slide into mediocrity (or worse) after investors pick them! Our ten year choice is not based on the numbers, but on Lee's superb grasp and execution of the *system* we call the conservative Jones model.

The major characteristic that distinguishes Lee from the overwhelming majority of hedge fund managers we evaluate, is that he grasps both the forest and the trees! Most equity hedge fund managers are practitioners, often quite good, with little hold on the fundamental principles or history of the model they use. Briefly, here are some concepts and history that will matter a great deal, if the market is less kind over the next decade than it was over the past decade.

The Forest and The Trees

In October we had the pleasure of a visit with Roy Neuberger, who turned 93 in July but goes to the office every day to oversee his investments. Alfred Jones used Neuberger & Berman as his prime broker back in the 1950's, which facilitated an interesting observation by Mr. Neuberger. Numerous investors utilize short selling and leverage, as Mr. Neuberger has since beginning his investment career in the late 1920's, but Alfred Jones was unique in the way he conceptualized an investment *system* from these tools.

Regrettably, the man who invented the system and modified it on a try-as-you-go basis, did not have the benefit of observing its flaws from a historical perspective.

Indeed he was! Jones conceptualized how two speculative tools, short selling and leverage, could be merged into a ***conservative investment system***, and then he turned the concept into an applied science. Regrettably, the man who invented the system and modified it on a try-as-you-go basis, did not have the benefit of observing its flaws from a historical perspective.

We have interviewed, and continue to interview hedge fund portfolio managers, associates and investors from 1952 through the present, in an effort to better understand what has worked, and what has not. The benefit of historical perspective led us to embark on the development of our classification system by distinguishing between the main types of equity hedge funds in the fourth quarter of 1995. Our definitions for Jones model funds vs. nominal equity hedge funds, and *aggressive* Jones model funds vs. *conservative* Jones model funds[1] are descriptive of distinctly different equity strategies that we observed to have different **risk characteristics**.

Alfred Jones's model, creates an arbitrage between a basket of long equity positions and a basket of short equity positions.

All that is necessary to be profitable within the hedge is to generate a positive spread from the arbitrage.

Under our classification system, all true hedge funds employ value added hedging to accomplish an arbitrage. The original true hedge fund, Alfred Jones's model, creates an arbitrage between a basket of long equity positions and a basket of short equity positions. Although managers seek to profit from short positions, it is not necessary for them to do so, to profit within the hedge! All that is necessary to profit within the hedge is to generate a *positive spread* from the arbitrage, with short positions rising less than long positions, or long positions declining less than short positions. Assets within the hedge are approximately market neutral (more on this later) and assets outside of the hedge comprise net market exposure.

Jones performed a cumulative attribution analysis[2] of his operation on a daily basis, using a clerical staff and no computers. He calculated the

[1] *Lookout Mountain Hedge Fund Review,* 4th Qtr. 1995, p.1.

[2] Not to be confused with multiple regression attribution or style analysis introduced by Wm. Sharpe, "Determining a Fund's Asset Mix," *Investment Management Review,* December 1988, pp. 59-69.

profits (or losses) on both the long side and the short side, and distinguished between the portion attributable to the general trend in the market from those attributable to stock selection. Jones also placed considerable value on his market timing skills, always distinguishing between profits made within the hedge and those that came from net market exposure. The latter he attributed to "market judgment."

In our opinion, Jones's Achilles heel was the over-utilization of market judgment. At times he was net short, and at times he had considerably in excess of 100% net exposure. The latter happened to be the case when the bull market turned in December of 1968, and it almost destroyed Jones's two funds. It did destroy or severely cripple most of the young hedge funds in operation at the time.

Jones's Achilles heel was the over-utilization of market judgment.

We have interviewed only two hedge fund managers that had low net exposure at the beginning of 1969. Michael Steinhardt articulated how market exposure, not leverage, was the primary determinant of his superior performance in the declining market. (An important secondary determinant was the correlation between long positions and short positions, which we will address later.)

Our definitions for conservative vs. aggressive Jones model funds center on market exposure, and do not prescribe parameters for leverage. However, there is an *inherent* distinction between how leverage is used by the two subclasses. Indeed, this distinction caused us to draw the line for market exposure between conservative and aggressive Jones model funds at 100%, rather than at some arbitrary but high exposure level, such as 95%.

In a conservative Jones model fund, any leverage used is always contained within the hedge.

Short selling and leverage can only merge to form a conservative investment system in the environment of the *conservative* Jones model.

In a conservative Jones model fund, as we define it, any leverage used is always contained within the hedge, in an environment that is approximately market neutral. On the other hand, when net market exposure exceeds 100% in an aggressive Jones model fund, leverage is employed *outside of the hedge* to make a directional market bet. There is an enormous difference in the risk characteristics associated with these different uses of leverage. In fact, as Alfred Jones demonstrated in 1969, **short selling and leverage can only merge to form a *conservative* investment system in the environment of the *conservative* Jones model**, as we have defined it.

That being said, a *value added* stock picker who fails to employ significant leverage in a conservative Jones model, while maintaining low net market exposure, is a manager that fails to properly utilize the tools of the *system* to maximize return on his investor's capital!

We have been in a bull market, with only a few brief corrections since 1981, a period that exceeds the investment careers of most investment professionals. If someone will ring a bell at the top, to tell us when the bull market is over, then these concepts are of little consequence. Bell or no bell, given a ten year lock-up, it is imperative that the manager we use understands these concepts, even if he hasn't articulated them.

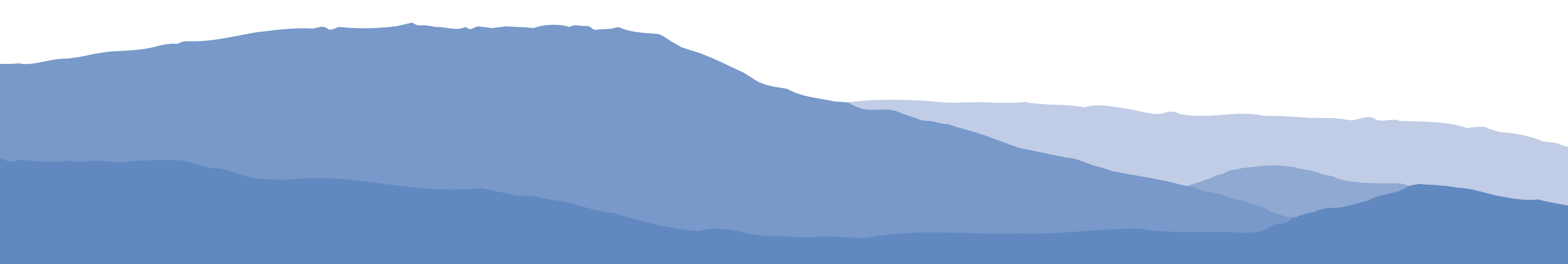
If someone will ring a bell at the top, to tell us when the bull market is over, then these concepts are of little consequence.

Lee Ainslie hasn't changed his system since we originally visited with him in the summer of 1994, more than a year before we first began to articulate the differences in strategy and risk for conservative vs. aggressive Jones model funds. In words and in practice, Lee conveys that Maverick invests in stocks only (no currencies, no commodities, no derivatives), that it uses significant leverage and short selling, and that net market exposure will range between 20% and 60%.

Maverick fits well within our definition of a conservative Jones model fund.

Ten Year Demonstration

Lee is the *only* equity hedge fund manager we have met that extensively uses attribution analysis to evaluate where and how his profits are generated. He learned this uncommon but useful



When you combine Lee's understanding of Jones's system, his ongoing attribution analyses, the strength of the Wyly organization and the skills of the Maverick team - you get superb Jones model execution!

practice from Robertson. When you combine Lee's understanding of Jones's system, his ongoing attribution analyses, the strength of the Wyly organization and the skills of the Maverick team - you get superb Jones model execution!

The utilization of capital that you can expect to observe at Maverick over the next ten years will typically look like the pie charts shown on the adjacent page. Although we normally refer to allocations and exposure relative to capital, it is useful here to view how total assets are employed.

The second biggest contributor to the dismal performance of most equity hedge funds during the 1969-70 market decline, appears to have been the poor correlation between many of the longs and shorts.

For every $100 we have invested, the Maverick team buys $115 of stocks they like, and sells short $75 of stocks they don't like. So our $100 is utilized to make $190 in total equity bets. That's what we mean by maximizing capital utilization. Now look at how risk is minimized by maintaining the overwhelming majority of total positions, and *all leverage*, within the hedge.

Look at how risk is minimized by maintaining the overwhelming majority of total positions, and all leverage, within the hedge.

The $75 of stock sold short neutralizes $75 of our long stock, with regard to trends up or down in the general market. In other words, an equal amount of long positions and short positions comprise our assets within the hedge, and are approximately market neutral. By neutralizing the market, profitability within the hedge will be determined by stock picking skills. The remaining $40 ($115 long less $75 short) accounts for our *net market exposure*, 40% of capital but only 21% of total assets, where market performance substantially influences Maverick's performance.

As employed by Maverick, all of the leverage is utilized *within the hedge* to facilitate the arbitrage between longs and shorts. When used by a manager that has consistently demonstrated value added stock selection skills on both the long side and the short side, we like to see the level of leverage that Maverick uses.

Now let's return to the correlation between longs and shorts in the Jones model arbitrage. Behind excessive market exposure, the second biggest contributor to the dismal performance of most equity hedge funds during the 1969-70 market decline, appears to have been the poor correlation between many of the longs and shorts within the hedge. Although there is no accounting for this correlation in our definition of the conservative Jones model, it is important that investors consider this relationship before allocating assets to a manager.

Some managers go to extremes seeking to achieve a perfect hedge, beta balancing industry subsections to the point of sanitizing away performance. Other managers pay no attention to the correlation between longs and shorts, at all. Lee achieves a very comfortable and productive balance that we anticipate will successfully maintain the arbitrage during market breaks.

That Lee has demonstrated his mastery of this system is not in doubt. How well he will run it as assets grow to enormous levels remains to be seen. One concern as any hedge fund grows is how well the back office can keep up. In a recent visit we focused on the back office, and we anticipate that the Wyly-Maverick back office run by Shari Robertson will adapt well.

What about capacity limits for the Jones model? As Julian Robertson has demonstrated, in the hands of some managers, the capacity limits that hinder performance as so many equity funds grow can be overcome. Although Robertson's Tiger can no longer be considered a Jones model fund, it was for much of its history, and the Jones model within continues to contribute the overwhelming majority of Tiger's profit!

The Odds Revisited

Indeed, when you look back at the list of great historical managers, you will notice a statistical aberration! The list is top heavy with managers who gained *most of their performance* over the years from the skillful operation of a relatively conservative Jones model, even if the equity

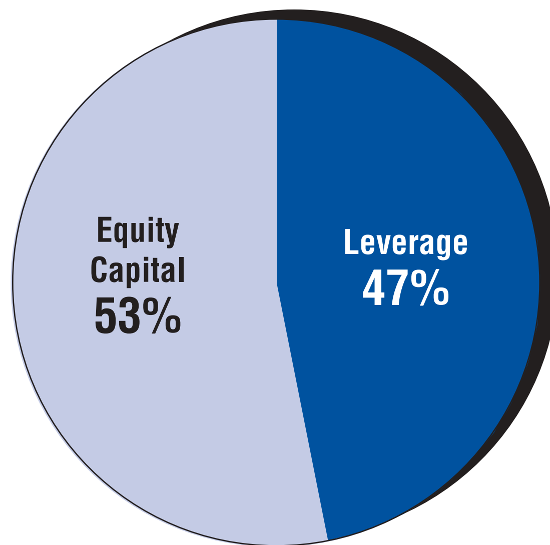
Capital Utilization by Maverick

Different Views of the Same Portfolio

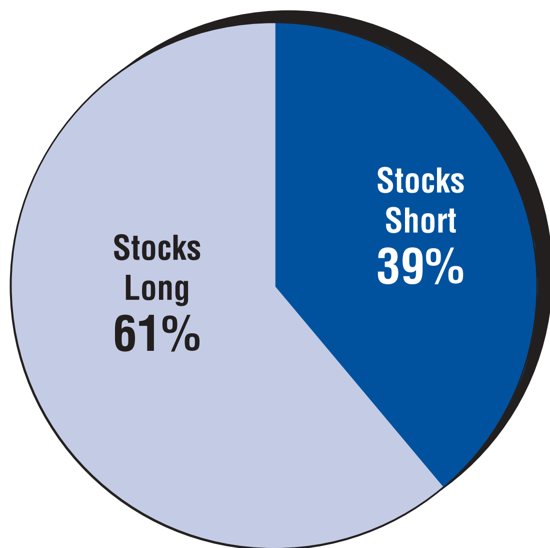
Showing how $1,000 of Capital is typically allocated into $1,900 of TOTAL EQUITY POSITIONS

Allocations:	Relative to Capital	Relative to Assets
Equity Capital	**100%**	53%
Stocks Long	115%	61%
Stocks Short	-75%	-39%
Gross Market Exposure	190%	100%
Net Market Exposure	40%	21%
Leverage	90%	47%
Positions Within the Hedge	150%	79%

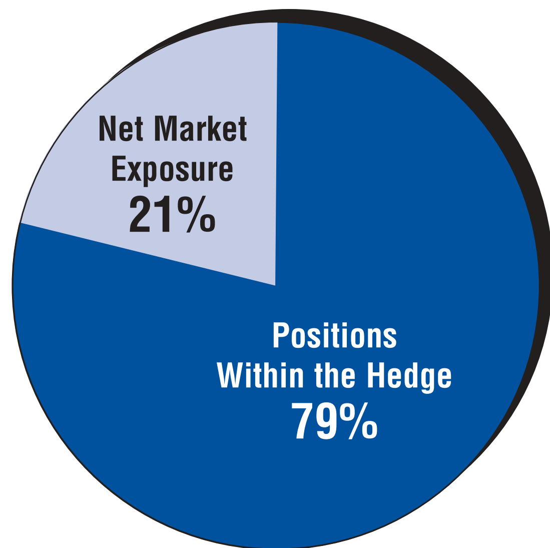
Percentages on these pie charts are relative to TOTAL ASSETS. We normally discuss exposure relative to CAPITAL. These charts are typical for Maverick.



Leverage permits higher capital utilization within the hedged structure of a Conservative Jones Model Fund.



Long stock exposure equals or exceeds short stock exposure in a Conservative Jones Model Fund.



Assets within the hedge are comprised of equal dollar amounts of stocks long and stocks short.

Any leverage is always contained within the hedge in a Conservative Jones Model Fund.

strategy has been concealed for some time under layers of more sensational strategies.

"Commingling assets with better hedge fund managers has provided immense gratification for many investors over the years. **Which managers, in retrospect, will have provided comparable gratification to investors a decade from now?** This is a challenging question. The science of investing ponders the past, while the art of investing focuses on the future. Finding good hedge funds requires a reasonable mix of both, and we should focus our attention to the areas that will help the most. In the long run, the three key variables for hedge fund performance are **motivation**, **opportunity**, and **compass**[3]." [4]

The science of investing ponders the past, while the art of investing focuses on the future.

Compass is a quality you can not measure, but we clearly see it in Lee Ainslie. Opportunity may grow thin for equity managers over the next ten years, but for a superb manager of a conservative Jones model fund, opportunity will abound. The one problem for opportunity might be asset growth, which could also pose a problem for motivation.

Opportunity may grow thin for most equity managers over the next ten year, but for a superb executioner of a conservative Jones model fund, opportunity will abound.

Whether Lee's style will accommodate asset growth as well as Robertson's style, remains to be seen. We suspect it will, but if it doesn't, continued superior returns will require the return of a portion of assets to investors. This, in turn, would depend on the nature of motivation within the Maverick organization, primarily at the top. Right now Lee's motivation is well directed, and we believe he has the character to remain properly motivated.

As is, Maverick is an odds-on favorite from among the thousands of investment managers in operation, to deliver distinctly superior performance with relatively low volatility over the next decade. However, the question of motivation leads to the one feature of Maverick we feel might be improved: the fee structure.[5]

Maverick is an odds-on favorite to deliver distinctly superior performance with relatively low volatility.

Lee understands the concept of "3rd generation fees" as we described them in the Addendum to the Primer on Hedge Funds. And because he regularly performs attribution analyses, he knows that his earnings under a 3rd generation fee structure would probably be the same over time as they would under the standard fee structure.

Converting to 3rd generation fees would assure that the motivation of Maverick's team would continue to focus on *maximizing their benefits by best serving their investors*. It would not threaten great value added managers like Julian Robertson, but it would radically alter the landscape for hoards of managers setting up funds with the hidden slogan, "Your capital is my income!" Even though the odds are against Maverick leading the industry into 3rd generation fees, the thought had to be included in this time capsule opinion.

So there you have it. Our opinion is that, a decade from now, investors who chose to commingle assets with Lee Ainslie at the beginning of 1997 will have experienced immense gratification. Since our reasoning for this opinion is indelibly based on his superb understanding and execution of the conservative Jones model, Lee's future should be instructive for us all. *12/13/96* TC

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[3] **COM•PASS** *n.* 1. the intrinsic quality that guides superior capitalists. 2. innate capitalistic genius. *Lookout Mountain Hedge Fund Review*, September 1994, p. 1.

[4] From the Introduction written by Ted Caldwell for **Hedge Funds: Investment and Portfolio Strategies for the Institutional Investor**, Irwin Publishing, 1995, Lederman & Klein, editors, page 13. This introduction, written in February 1995, was reprinted with several changes as our **Primer on Hedge Funds**, and is available upon request.

[5] At this point, Lee and the Maverick team are thinking, "Hell, Ted! Why go off and ruin such a complimentary article?" Our commentary is always intended for the benefit of hedge fund *investors*, so we couldn't let this opportunity pass.

True vs. Nominal Hedge Funds*

by Ted Caldwell

Is a large mouth bass a bass? No. Actually, the large mouth bass (Micropterus salmoides) belongs to the family of sun fish (Centrarchidae). The true bass family (Percichthyidae) includes the striped bass (Morone saxatilis). Anglers who have caught both large mouth and striped bass know the difference, but is the proper classification important? By tradition and predominant use, a large mouth bass is a bass, regardless of what biologists have to say. And frankly, as long as the fish are biting, few fishermen care!

Now consider an investment partnership that uses significant leverage to invest in technology growth stocks, occasionally sells a stock short, and pays its manager an asset fee of 1% plus 20% of profits. Is this a true hedge fund? Frankly, as long as it makes money, most investors don't care. By tradition and predominant use it's a hedge fund, but for the purposes of prudent classification, it's not. The distinction is significant, but seldom recognized. *A lot of people don't want to know what's under the hood, they just want to drive a nice car*.

When hedge funds first began to flourish in the late 1960's, a bull market was raging. Many of the new fund managers, seduced by incentive fees and daily market gains, chose to "swim naked" by omitting the "hedge" aspect of Alfred Jones's system. Investors and the media failed to differentiate between funds that hedged and those that did not, even when the bottom fell out of the market and most of the unhedged funds failed.

Since that time, the name hedge fund has been commonly applied more for the structure of a fund than for its strategy. Private partnerships investing in financial securities and paying incentive fees to managers continue to be called hedge funds, whether or not they hedge their positions. We don't presume our newsletter carries the weight to correct the nomenclature, but the difference in strategy is critical for prudent classification. In our classification system, we accept the broader, structural definition of hedge funds, but distinguish between true and nominal hedge funds.

In our classification system **True Hedge Funds** are those funds that employ *value added hedge strategies* at all times to pursue one or more arbitrage strategies. **Nominal Hedge Funds** do not maintain value added hedge strategies, but may employ insurance hedging.

Value Added vs. Insurance Hedging

Users of our system must understand the difference between value added hedging and insurance hedging. Thus we digress for a moment.

Think about your home insurance. Buying insurance simply amounts to paying someone else to assume all or part of some financial risk you don't want to retain. In the case of your home insurance, the entity that assumes the risk of loss is an insurance company that maintains sufficient reserves to cover losses that may accrue from its aggregate assumption of homeowner risk.

Can you insure against a market decline that decimates your stock portfolio? Not with a traditional insurance policy, but you can acquire portfolio insurance quite easily in the derivatives markets. You simply buy a put option on the stock index that most closely resembles your portfolio, or you can buy a customized put to replicate your portfolio. Listed and unlisted derivatives offer the holder of virtually any securities portfolio the opportunity to insure against decline in the value of those securities, while keeping the benefits of increased value.

Buying this type of portfolio insurance, like buying insurance on your home, is not a profitable venture. You are purchasing protection, and will collect only in the event of a loss, and only for the amount of loss you insured against. (The purchase of excess insurance for your home or your portfolio is not hedging, it's speculating.)

Insurance hedging is the implementation of *expensive strategies* for the protection against a decline in the market value of securities held.

Value added hedging, on the other hand, is the implementation of *profitable strategies* that provide a hedge against market decline. When reduced to their basic elements, all value added hedging strategies take the form of an arbitrage.

By tradition and predominant use, a large mouth bass is a bass, regardless of what biologists have to say.

The name hedge fund has been commonly applied more for the structure of a fund than for its strategy. We accept the broader, structural definition of hedge funds, but distinguish between true and nominal hedge funds.

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There are only three primary classes of True Hedge Funds:

1. Jones model funds
2. Arbitrage funds
3. Macro funds

Value added hedging seeks to capitalize on disparities in the values of related securities (although it may involve *baskets* of securities), regardless of the direction of the general market. *This is the defining characteristic of true hedge funds.*

Insurance hedging utilizes expensive strategies.

Value added hedging utilizes profitable strategies.

There are only three primary classes of true hedge funds: Jones model funds, arbitrage funds, and macro funds.

Jones model funds

A number of different names (traditional equity hedge funds; micro hedge funds; flexible long/short funds; etc.) have been used to describe funds based on Alfred Jones's original hedge fund model. For definitive clarity, we use "Jones model funds"[1] to describe this (numerically) largest primary class of hedge funds.

Alfred Jones was not the first to utilize a basket of stocks sold short as a hedge against a general market decline. He was, however, the first to combine this method of value added hedging with leverage in the structure of a private partnership with performance incentives for the manager. Jones's establishment of The Fully Committed Fund in 1949 provided the original model from which the hedge fund industry has evolved.

Conservative Jones model funds always *mitigate* market risk.

Aggressive Jones model funds may occasionally (or regularly) *magnify* market risk.

In addition to the characteristics common to all hedge fund classes, **Jones model funds** are 1) equity funds, that 2) maintain a substantial portion of assets within a hedged structure *at all times*, and 3) commonly employ leverage (long + short exposure) of less than 200%. Leverage is not a defining characteristic, because there are a sizable minority of funds that do not use it; a very small portion of Jones model funds exceed 200% leverage.

Assets "within the hedge" are comprised of an equal *dollar value* of long and short stock positions. Although some managers use "paired trading" within the hedge, it is more common for longs and shorts to be unpaired baskets of securities. Assets not within the hedge comprise "net market exposure," which is expressed as a percent of capital. Jones used the phrase "fully hedged" to describe his fund if, on rare occasions, all assets were within the hedge. Assets within the hedged structure are *approximately* market neutral, but the degree of neutrality varies. Jones model funds that are maintained as fully hedged funds are known as long/short funds, which we show as a subclass under arbitrage funds.

The broad parameters of the Jones model encompass a variety of subclasses and allow managers exceptional flexibility. However, there are **two major subclasses** for the Jones model, mandated by two distinctly different substrategies and risk profiles. As such, it is imperative that investors understand the difference.

Conservative Jones model funds *always mitigate market risk* by maintaining market exposure from 0% to 100%, inclusive. Although conservative managers have plenty of room to adjust market exposure for their outlook of the markets within these parameters, the greater emphasis always remains on stock picking. **Aggressive Jones model funds** may occasionally (or regularly) magnify market risk by exceeding 100% market exposure, or by going net short. Thus aggressive Jones model funds may sometimes (or regularly) emphasize market timing more than stock selection.

Consider the example of two Jones model funds, each employing leverage at 180% of capital. An aggressive fund may be 150% long and 30% short, yielding net market exposure equal to 120% of capital. A conservative fund may be 120% long and 70% short, yielding net market exposure of only 50%. Although they both employ the same amount of leverage, their relative exposure to the benefit and risk of the market is considerably different.

Distinguishing between conservative and aggressive Jones model funds is imperative if benchmarks are to reflect the different risk postures. Rarely is the distinction made in a fund's documents, *but investors who fail to distinguish between the two classes are not properly equipped to match allocations to their desired risk profiles.*

It's worth noting that many Jones model funds (conservative and aggressive) maintain very predictable levels of market exposure, and subclasses may be constructed further refining peer groups based on operating ranges for market exposure. HF

[1] *Lookout Mountain Hedge Fund Review,* 4th Quarter 1995, page 1.

Unified Hedge Fund Classification[1]

All Security Investments:

Traditional Investments

Traditional investing is characterized by the purchase, holding, or sale - but not short sale - of publicly issued securities (primarily stocks, bonds, and cash). The dominant variable in the performance of traditional investment management is the performance of the relevant market. Except in rare cases, investment skills of the portfolio manager are relegated to the pursuit of incremental performance, relative to the appropriate market benchmark. Bank trusts, insurance companies, mutual funds, pension funds, and investment advisory accounts primarily utilize traditional investment portfolios.

The primary attribute for classifying traditional investments is the asset class. The *expected return* for a traditional investment, assuming no alpha, is the return of the appropriate market index.

Non-Traditional (or Alternative) Investments

Non-traditional investments have historically been privately placed securities, but are sometimes offered publicly, today. Some major categories are: Venture Capital and Private Equity Funds, Real Estate Securities, Oil and Gas Partnerships, Commodities Trading Pools, True Hedge Funds and Nominal Hedge Funds. **The primary attributes for classifying non-traditional investments vary significantly.**

True vs. Nominal Hedge Funds

There is no *definitive* trait shared by true and nominal hedge funds. They often share structural and other characteristics customarily perceived (and frequently represented in the financial media) to be definitive for all hedge funds, but these characteristics are simply descriptive, not definitive.

True Hedge Funds

True hedge funds are diversified, managed investment pools designed to extract returns from given markets, with less risk than is inherently required of traditional investors participating in those same markets.

They achieve this by systematically employing some form of arbitrage strategy or strategies at all times, for a significant portion of assets (at least 50% of invested assets - not capital), thus creating a value-added hedge (not an insurance hedge) that considerably insulates investment skills from the gravity of markets. In doing so, they fundamentally alter the relationship between risk and return for assets invested “within the hedge”.

The primary attribute for classifying true hedge funds is strategy. The *expected return* for assets within the hedge in a true hedge fund, assuming no alpha, is zero.

Like nominal hedge funds, true hedge funds are usually offered by private placement; they usually have performance-based compensation for their fund managers; and their fund managers often have a significant personal stake in the fund… but none of these widespread characteristics are defining characteristics for true hedge funds.

There are only three major categories of true hedge funds: Jones model funds, relative value funds, and macro hedge funds.

Jones Model Funds

Jones model funds are true equity hedge funds. They are equity funds that maintain no less than 50% of invested assets within a value-added hedge structure at all times.

This original hedge fund model seeks to profit from the arbitrage between a basket of long equities and an equal value basket of short equities, maintained within the hedge at all times, but not necessarily with all assets. Any assets not within the hedge comprise “net market exposure,” which is expressed as a percent of capital.

NET MARKET EXPOSURE (%) = (Longs-Shorts)/Capital

Aggressive Jones model funds

(Alfred Jones’s original hedge fund would have been classified as aggressive, and in this peer group.)

Aggressive Jones model funds may occasionally or regularly amplify market risk by exceeding net market exposure of 100%, thus using leverage outside of the hedged structure, or by going significantly “net short” with negative net market exposure. Nonetheless, they maintain no less than 50% of invested assets within a value-added hedge structure at all times. Though uncommon today, aggressive Jones model funds should be recognized for their very different risk/return characteristics from conservative Jones model funds.

Conservative Jones model funds

MAVERICK

Conservative Jones model funds mitigate market risk at all times, by maintaining net market exposure from -20% to 100% of capital, inclusive, thus keeping leverage within the hedge at all times. This subclass allows tremendous manager flexibility, and includes numerous subclasses characterized by the use of different equity markets, sectors, regions, styles and exposure ranges.

Long/short equity funds are “fully hedged” conservative Jones model funds that hold equal dollar long and short positions with a goal of market neutrality. Some long/short funds are balanced by beta, sector and/or other variables.

GENERAL EQUITY SUBCLASSES: Whereas some of these categories are primary classes for traditional investment classification, they are secondary or lower classes under this system. These are useful subclasses for Jones model funds, as well as for nominal equity hedge funds. The subclasses listed here are neither comprehensive nor mutually exclusive, and order is a matter of preference.

Investment Style Subclasses
Growth, Value, Mixed, Trading-oriented, etc.

Market Capitalization Subclasses
Large Cap, Mid Cap, Small Cap, and Micro Cap

Geographic Subclasses
Global, International, Regional or Emerging Markets subclasses

Industry Sector Subclasses

Relative Value Funds (Market Neutral)

Relative value funds seek to fully hedge (completely neutralize) the influence of markets, through the *arbitrage* between baskets of related securities maintained within the hedge at all times. The number of subclasses utilizing such arbitrage strategies is virtually unlimited.

[1] Unified Hedge Fund Classification, *Lookout Mountain Hedge Fund Review*, 3rd Quarter 1996, © Lookout Mountain Capital, Inc. Subsequent updates to this classification system are posted at www.Jonesmodel.info. (uhfc.lmc.rev. 2002.11)

Capital Structure Arbitrage Funds

Convertible Arbitrage Funds

Convertible arbitrage funds go long convertible securities and short the underlying common stock.

Other Capital Structure Arbitrage Funds

Fixed-Income Arbitrage Funds

Fixed-income arbitrage funds exploit price differentials between related fixed-income securities and/or derivatives.

Mortgage Arbitrage Funds

Mortgage arb funds are primarily long mortgage-backed securities while hedging interest rate, volatility, and prepayment risk.

Other Fixed Income Arbitrage (non-mortgage) Funds

Merger Arbitrage Funds (Risk arb)

Merger arb funds specialize in the simultaneous purchase of stock in a company being acquired and the short sale of the acquiring company, thus making a directional bet that the deal will go through. They sometimes reverse this strategy.

Multiple Arbitrage Funds

A substantial number of funds utilize multiple relative value strategies, which may include a combination of the above and/or a variety of index or other derivative arbitrage strategies.

Macro Hedge Funds

Macro hedge funds seek to capitalize on changes in the relative values of securities, interest rates, and/or currencies affected by regional or global economic change. They tend to be aggressive asset allocators; their use of leverage and derivatives tends to be substantial; and their methods and degree of hedging may be highly concentrated or vary significantly.

Due to the directional nature of some forms of macro arbitrage, macro funds that do not utilize a significant level of other value-added hedge strategies should arguably be classified as broad mandate nominal hedge funds.

Nominal Hedge Funds

Nominal hedge funds are usually privately placed investments with performance-based fees for managers who often hold a significant personal stake in the fund. Yet, while they fit the customary description for hedge funds, **nominal hedge funds fail to employ a significant level of value-added hedging at all times.**

The primary attribute for classifying nominal hedge funds is structure, not strategy. The *expected return* for a nominal hedge fund, assuming no alpha, is the performance of the appropriate market benchmark. While nominal hedge funds often present attractive, low-correlation investment opportunities, **low correlation with traditional market benchmarks should not be confused with the lower risk characteristics of true hedge funds.**

Long-bias Equity Funds

Long-bias equity funds are structured as traditional hedge funds, and may use index options or some short selling, but they do not maintain a Jones model hedged structure.

Unleveraged Equity Funds

Leveraged Equity Funds

Short Funds

Short funds seek to profit from the short sale of securities, primarily the stock of overvalued, fundamentally flawed, or fraudulent companies.

Short-only Funds

Short-only funds focus exclusively on the short sale of securities.

Short-biased Funds

Short-biased funds seek to profit primarily from the short sale of securities, but may buy securities as a hedge.

Special Situations Funds

Distressed Securities Funds

Distressed securities funds buy, and may occasionally short, the securities of companies under bankruptcy and/or reorganization.

Opportunistic Fixed Income Funds

Opportunistic fixed income funds purchase debt securities, undervalued due to mitigating circumstances.

Activist Investing Funds

Activist investing funds seek to directly impact the value of securities held by influencing other securities holders, or by becoming activist shareholders.

Emerging Markets Funds

Emerging markets funds encompass a broad and growing classification with debt, equity, and mixed subclasses for investing, primarily long, in the securities of developing countries.

Broad Mandate Funds

Broad mandate funds are macro or mixed strategy funds that don't employ significant value added hedging at all times.

OTHER: Nominal hedge funds with unclassified strategies.

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R E V I E W

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Lookout Mountain Capital, Inc.
Old Town Hall, 610 N. Bragg Avenue
Lookout Mountain, TN 37350
Phone: (423) 821-0007

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Fax: (423) 821-9485
email: Lkt_Mtn@bellsouth.net
www.LMCapital.net

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