Lookout Mountain

Hedge Fund

REVIEW

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What is a Hedge Fund? *– in 18 words*

"the *means* for greater profit with equal risk, or equal profit with less risk"

diagnostically unique

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Beginning in 1949, A.W. Jones told investors[1] what made his investing system different: This "unique hedging operation is merely the means for greater profit with equal risk, or equal profit with less risk than in conventional investment programs, not the guarantee that such profits will develop." He emphasized that "the most important of the unique features … is the lowering of risk and increase of profit potential."

Jones's design that favorably alters the risk/return profile by increasing profit potential while lowering risk is diagnostically unique.

Had Jones consistently managed his fund the way he described it, the pervasive confusion about what a hedge fund is would not endure today. However, by 1962 Jones was disregarding the "less risk" pillar of his design. Like those who began imitating his program in the early 1960's, Jones succumbed to the allure of his 20% performance fee and pursued greater profit with *greater* risk.

By magnifying rather than mitigating risk, the first generation of Jones's imitators garnered enormous envy and fees, and truly muddied the water on how to define a hedge fund. But when the market turned down in 1969, their losses were enormous and many failed. Jones survived, greatly diminished, and expressed regret for mishandling investor assets.

Attempting to define hedge funds in early 1970, Carol J. Loomis mused[2], "it would appear the key feature of a hedge fund is neither the hedge nor the leverage, but instead the method by which the general partners are compensated." Regretfully but understandably, Loomis concluded, "it seems reasonable to count as hedge funds those limited partnerships that do not necessarily hedge."

Half-a-century on, funds that do not necessarily hedge are still counted as hedge funds. Maintenance of this muddle in the roughly three trillion-dollar alternative investment industry is a real disservice to investors. How bewildering is it to define a hedge fund?

Just ask… What is a hedge fund?

You get a discussion, not an answer.

The alternative investment industry doesn't provide a valid definition. Institutional consultants who advise billions in allocations each quarter don't provide a valid definition. Nor do financial journalists or regulators. Ask Google and you encounter a tower of babble.

Performance fees remain the most common of various characteristics alluded to as definitive, but low correlation has become an industry favorite in an effort to shift the focus onto something more palatable to investors. The common denominator for these definitional ramblings is that they all cast an inclusive, wide-net. **And they all drastically fail to inform in the best interest of investors.**

A joint paper[3] by the alternative investment industry's sister organizations, AIMA and CAIA, devotes its Appendix to "What is a Hedge Fund?" It correctly concludes, "it is impossible to have a precise and yet encompassing definition of a hedge fund," and anchors that conclusion with the footnote, "no clear definition has been pronounced for hedge funds."

Indeed, none has – until now.

By dispensing with the contradictory "precise and yet encompassing" criteria, we can dispense with half-a-century of confusion. Returning to the diagnostically unique features that Alfred Jones described but neglected, here is the clear definition:

These 18 words efficiently, sufficiently & exclusively define hedge funds.

A hedge fund is an investing program designed and managed to amplify alpha while always mitigating beta risk.

This one sentence defines hedge funds efficiently, sufficiently and exclusively. It inclusively characterizes thousands of alternative investment funds in operation today while excluding thousands of others. With reasonable fees and alpha, the risk/return profiles of funds included are heavily skewed to favor investors.

Numerous alternative strategies excluded under this definition may still make attractive allocations in a portfolio mix. Yet, if they aren't designed and managed to amplify alpha while always mitigating beta risk, they are something other than hedge funds.

The discussions can now shift from ***what*** hedge funds are, to ***how*** they combine two risk assumptive strategies, leverage and short selling, into a conservative discipline.

Finally, the diagnostic design of hedge funds doesn't improve their risk/return profiles without the addition of alpha, the **superior risk adjusted performance** (**SRAP**TM) provided by a minority of managers.

tc 8/18/2018

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[1] Several of Jones's former managers and employees described his operation to me in detail, as Jones described it to investors and as he managed it. These quotes come from "A Basic Report To The Partners on THE FULLY COMMITTED FUND" from May 1961, provided to me by Dick Radcliffe, the first of many portfolio managers who worked in Jones' company.

[2] FORTUNE, January 1970, Carol J. Loomis, "Hard Times Come to Hedge Funds"

[3] HELPING TRUSTEES NAVIGATE THE HEDGE FUND SECTOR, PAPER 1: "**The way ahead**" (A joint AIMA/CAIA Association paper available at: https://www.aima.org/article/paper-1-the-way-ahead.html)

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Lookout Mountain Capital, Inc.
PO Box 4383
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