

# 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: \_\_\_\_\_

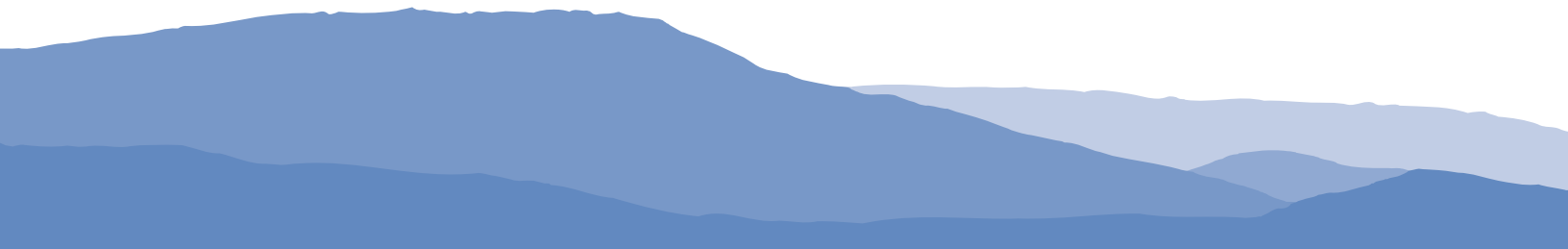
With thousands of mutual funds, hedge funds, commodity pool operators, and traditional money managers to choose from, several subscribers have suggested we have little to gain, and a great deal to lose by printing a single selection in indelible ink. Against their rational advice, we are going to give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

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\* Reprinted from Lookout Mountain Hedge Fund Review, 4th Qtr. 1996



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.

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.

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.

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!

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**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?**

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



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.

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.

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.

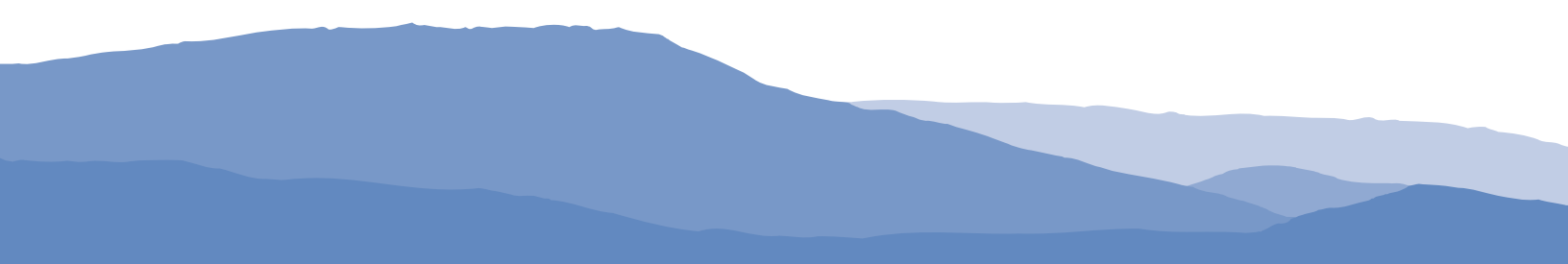
We refer to Maverick as “Lee’s fund,” in this article, only because the conversion of Maverick to a conservative Jones model fund was brought about by Lee, and the operation of the fund will be directed by Lee. Sam Wyly brought Lee to Maverick in August of 1993, in what must be viewed as an outstanding 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

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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.

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.

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<sup>1</sup> are descriptive of distinctly different equity strategies that we observed to have different **risk characteristics**.

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<sup>2</sup> of his operation on a daily basis, using a clerical staff and no computers. He calculated the

<sup>1</sup>Lookout Mountain Hedge Fund Review, 4th Qtr. 1995, p.1.

<sup>2</sup>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.

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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.

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, 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.

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.

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

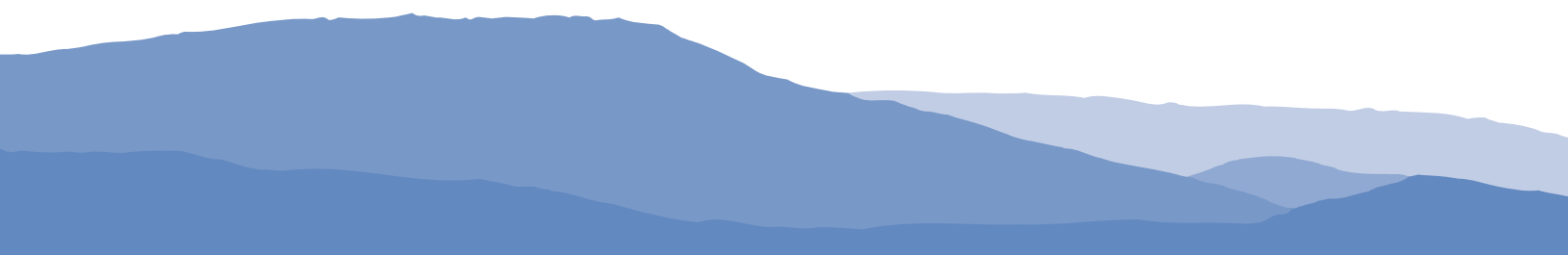
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### ***Ten Year Demonstration***

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



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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.

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.

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

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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

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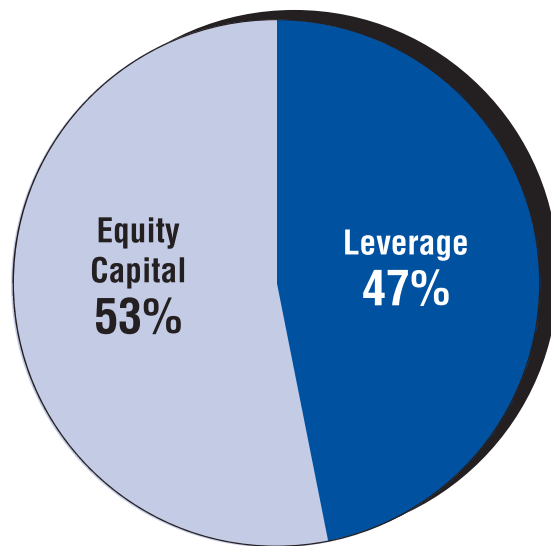


# Capital Utilization by Maverick

## Different Views of the Same Portfolio

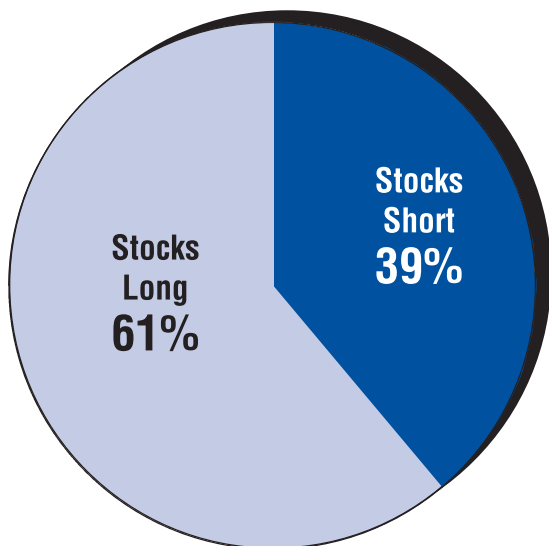
Showing how \$1,000 of Capital is typically allocated into \$1,900 of TOTAL EQUITY POSITIONS

Allocations:	Relative to Capital	Relative to Assets
<b>Equity Capital</b>	<b>100%</b>	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%

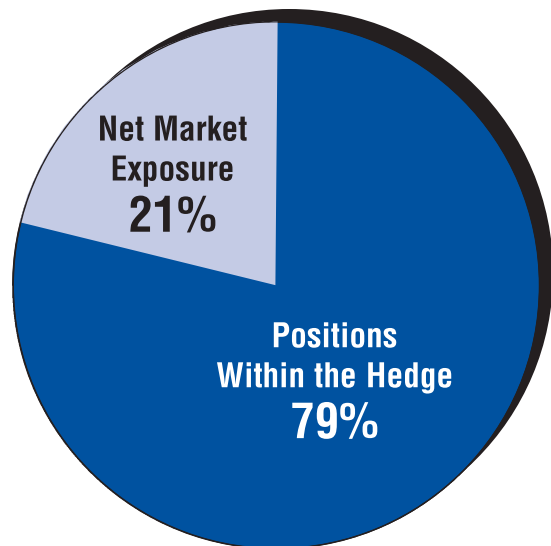


Percentages on these pie charts are relative to TOTAL ASSETS. We normally discuss exposure relative to CAPITAL. These charts are typical for Maverick.

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

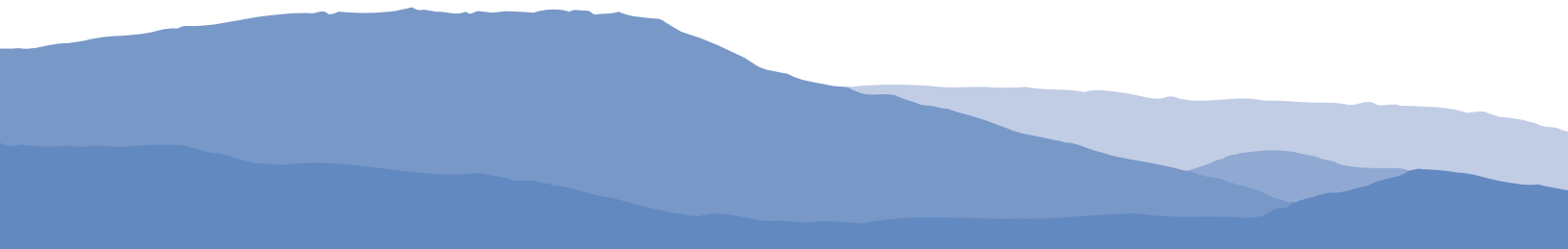


Long stock exposure equals or exceeds short stock exposure in a Conservative Jones Model Fund.



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.



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

“Commingle 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**.<sup>3</sup>”<sup>4</sup>

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.

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

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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.<sup>5</sup>

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**

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

<sup>4</sup> 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.

<sup>5</sup> 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.