The Dilemma of Hedging

Assuming you're not the type of investor whose mood is synchronized with the daily gyrations of the stock market, October has been an interesting month. Although it's not over yet so of course anything can happen, to this point October looks like a big, short-lived margin call. Leveraged investors and those who like to hedge their downside have had a torrid time and many must regard their recent activity wondering how so much frenetic portfolio adjusting could have been so harmful.

It will be especially interesting to see how hedge funds finish the month. Industry apologists long ago perfected shifting the goalposts of performance. What was once the Absolute Return industry moved to generating attractive relative returns, later supplanted by uncorrelated returns as each description of the performance objective was found to be at odds with the empirical results. Nowadays sophisticated hedge fund consultants promote downside protection as the raison d'etre of a hedge fund allocation.

So what to make of the way October is shaping up? Through yesterday, the S&P500 was down 1.6% for the month, an innocuous result that scarcely describes the wealth adjustment that was inflicted earlier. MLPs, in which we have more than a passing interest, were at one point down 14% before the V-shaped market move thankfully began its ascent.

Hedge funds, as defined by the HFRX Global Hedge Fund Index, are currently estimated to be down 2.5%. Many hedge funds, particularly those focused on equities, have done far worse. Stocks may of course spend the rest of the month falling, but assuming they don't one imagines there will be some uncomfortable conversations as investors contemplate the value destruction that's possible when hedged strategies test the market timing skills of their practitioners beyond the level

of their ability.

It’s a fair question to ask that, in a market environment characterized by a sharp trip down followed by an equally fast return, what exactly should a hedged strategy return? Presumably, if a hedge fund maintains constant exposure, the round trip ought not to be much different than for the long only investor. But it’s looking very much as if the risk management being practiced is of the “dynamic” variety, which is to say highly responsive to market moves, or perhaps less generously, prone to sell low and buy high.

It reminded me a little of the crash of October 1987, whose 27th anniversary of course just passed on Monday. Not nearly as traumatic of course, and spread over a longer period of days, but what both events have in common is the use of hedging strategies that rely on risk reduction in response to falling prices. In 1987 it was called Portfolio Insurance. Its 2014 version has more complexity and variety of implementation, but thematically is another version of taking more risk when prices are rising and less when they’re not. There are other ways to grow your savings.

CalPERS Has Enough of Hedge Funds

The California Public Employee Retirement System (CalPERS)

recently announced they were closing down their $4.1 billion hedge fund program. I don't know if they read *The Hedge Fund Mirage*. It might have saved them some time.

The New York Times has an interesting perspective.

CalPERS Hedge Funds; No Fee Break Here

CalPERS' $4 billion hedge fund portfolio will cause barely a ripple in the $2.5 trillion hedge fund industry as it's redeemed over the next several quarters. Some speculate that their decision will cause other public pension funds to re-examine their commitment to hedge funds, although you're unlikely to find a public pension trustee who will admit to being a follower.

What struck me most about this news though was the fees CalPERS paid. They disclosed a 7.1% net return on their $4 billion portfolio during their last fiscal year, as well as $135 million in fees. In recent years there's been some anecdotal evidence that the ubiquitous "2 & 20" (2% management fee and 20% profit share) was coming down. That may be so, but you wouldn't know it from CalPERS' experience.

They don't disclose their actual fee structure, but an educated guess is possible. Given the information provided (investment size, net return and fee expense) 1.9 and 19 (i.e. a 1.9% management fee and 19% incentive fee) would make the numbers add up. 2 and 18.5 also works. Given that CalPERS has a reputation as one of the most aggressive negotiators of investment terms, it's surprising that their realized fees during their last fiscal year were so close to the traditional

2 & 20.

Now, it’s possible that some of their funds lost money, which doesn’t alter their effective fee but could mean that they’d negotiated lower incentive fees but had failed to benefit. There are no negative incentive fees. And CalPERS does include funds of hedge funds in their portfolio so that again may understate the fee savings they negotiated with individual managers.

Nonetheless, it still adds up to $1 of fees for every $2 in investment return. Nice business for some.

The Alpha Rich List Got 15% of Everything

There’s been plenty of press coverage of the Top 25 hedge fund earners recently, of David Tepper’s $3.5 billion haul and so on. But it’s probably even more striking to estimate what portion of total hedge fund returns these guys took home. It goes like this:

Last year the industry began with $1.8 trillion in AUM and finished with $2 trillion (BarclayHedge), so that’s $1.9 trillion in average assets under management (AUM) for the year; the 5.5% net return to investors (HFRX) was worth $103 billion. The Alpha 25 made their money both from fees and their own investments in their funds. Let’s make the generous and simplifying assumption that average hedge fund fees are 2% with no incentive fee. Fees were therefore $38 billion. So gross hedge fund investment profits (i.e. before fees) were $141 billion.

The Top 25 retained about 15% of the entire industry's gross profits. What a fantastic haul! That leaves the other 85% for the investors who provided most of the capital, not including of course the cut for the rest of the hedge fund industry that's not actually in the Top 25. It's a great business.

Nice New Yorker piece about Hedge Funds

http://www.newyorker.com/online/blogs/johncassidy/2014/05/how-hedge-funds-get-away-with-it.html

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The Power of the MLP GP

Yesterday was Williams Companies' (WMB) Analyst Day. The company gave a strong presentation across each of their divisions. It highlighted the many opportunities to build new infrastructure in response to the shale developments, especially in the Marcellus. WMB's dividend yield is 3.3% but such is the earning power of the assets they control that management extended their dividend growth forecast of 20% out to 2016 (from 2015) with further strong performance expected beyond that. Much of this is driven by assets held at WMB's MLP, Williams Partners (WPZ), since WMB owns the General Partner are therefore receives 50% of each additional dollar of distributable cashflow.

WMB controls Transco, a pipeline network that runs from the NE

U.S. down to Texas. One of the more memorable pieces of information came when Rory Miller, SVP of the Atlantic-Gulf Operating Area, noted that he’d once asked his team to estimate the cost of rebuilding the Transco system and the figure they came up with was $100 billion (for comparison, WPZ’s enterprise value is $33 billion). This pipeline was first laid 60 years ago, and decades of population growth and development all along the route make the cost of building something similar today prohibitive.

Interestingly, today Goldman upgraded Kinder Morgan (KMI) from Buy to Conviction Buy. Kevin Kaiser of Hedgeye, a small research firm in Connecticut, has been a long-time critic of MLPs and the Kinder complex in particular. KMI owns the GP for Kinder Morgan Partners (KMP) and El Paso (EPB) and while it doesn’t sport the type of growth prospects of WMB we think it’s a similarly attractive security leveraged to the continued development of energy infrastructure in the U.S. Kaiser has long argued that firms such as KMI skimp on maintenance, something not supported by metrics such as operating performance or accident statistics. But the Transco example above suggests that in at least some cases MLPs own assets that are substantially undervalued, at least on a replacement basis.

KMI has been a weak performer over the past year or so, providing at least some vindication for Kaiser (although their business performance has been fine and his negative call on MLPs as a whole has been dead wrong). For our part, we think both companies are very well positioned and are long both WMB and KMI.

Too Many Quant Hedge Funds

The Economist turned its critical eye at quantitative hedge funds recently, noting the poor performance of such “black box” strategies since the 2008 Financial Crisis. The article’s headline (“Computer Says No”) is a wry reference to a British sitcom called Little Britain, a humorous touch that will have been missed by many U.S. readers.

Quant practitioners predictably note the absence of rational markets (isn’t that ALWAYS why managers lose money) and place the blame squarely at policymakers and artificially low interest rates as the reason their models can no longer make reliably profitable predictions. It may also be that this sector of the hedge fund business is overcapitalized, with assets having grown from $91 billion to $215 billion in four years. While the underlying markets such as equities and bonds offerplenty of liquidity, perhaps the inefficiencies such algorithms are meant to identify are being competed away, at least by the big ones.

Another Short Aims at Joseph A Banks

This morning I noticed an article on Seeking Alpha by Alan Ginsburg making the case for shorting Joseph A Banks (JOSB). The writer makes a good case that the company’s financial statements are untrue and that a conflict-driven management team has at times “looted” the company. We have no position in JOSB and no plans to take one. I was simply reminded of Marc

Cohodes, a passionate short seller (they usually are) who in early 2008 made the case at a presentation I attended that JOSB was a sham and was going to collapse. Marc was similarly convincing and had evidently done his homework. Sadly, though, in 2008 his short positions blew up on him during Lehman's bankruptcy (you may recall a temporary ban on shorting financials at that time which caused a brief but sharp rally). It should have been his year, of all years. But it wasn't.

Early last year I noted that Marc Cohodes had turned his back on Wall Street to run a chicken farm. It was one of the less likely outcomes of the 2008 Crash. We certainly wouldn't own JOSB, and we don't short individual stocks so my only involvement with JOSB will be to occasionally buy a pair of socks there. I haven't so far been seduced by the "Buy One, Get Two Free" pitch for their suits. But if they do eventually collapse and Alan Ginsburg is right, someone else was on to the story already, if rather too early.

Bloomberg Businessweek Offers a View on Hedge Funds

Bloomberg Businessweek, July 2013

Simon Lack, December 2011

Obviously, I was too kind. What does the hedge fund industry's chief lobbying group AIMA (Alternative Investment Managers Association) have to say?

Cooper Union Learns An Expensive Lesson About Hedge Funds

The New York Times has a story highlighting what can happen when well-intentioned but financially unsophisticated trustees of a college endowment interact with the wrong kind of financial advisors. It's a sorry tale of poor portfolio construction and imprudent debt capped off with a Hail Mary

type lunge for hedge funds that it was hoped would solve their problems with 10% returns. Regrettably, a desired return is no substitute for a realistic expectation of one, and the consequences are now being felt widely within the school. Where are the consultants today who advised Cooper Union to expect a 10% return from hedge funds? They're probably investing the fees they earned in something more reliable – perhaps even back in to their consulting business.