Investment Management Workshop – Subjective Takeaways

In 2005 I spent a week at Harvard Business School dissecting case studies on the money management industry. It is my hope that you will derive some value from the observations below. 95 senior investors from around the world discussed case studies on the following topics: Maverick Capital, Man Group, Sowood Capital, Harvard Management Corporation, The Hewlett Foundation, General Motors Investment Management, Dimensional Fund Advisors (DFA), TIPS and US Pension Fund Regulation. I've grouped the commentary around three themes: Hedge funds, asset allocation and investing ideas.

KEY TAKEAWAY: Money Management is an attractive business! A statement of the obvious, no doubt, but here's a simple example that reinforces it: Take, for example, the economics of a niche long-only manager, Dimensional Fund Advisors, with about $40bn in AUM: Fees are 50bp ($200M). There are 130 employees, 50 of which are professionals (50 x $1M = $50M) and 80 of which are support staff (80 x $200,000 = $16M). After fixed costs, marketing, taxes and the like*, there's at least $100M per year left over for the two owners* or for a generous employee profit-share. I use this example because it is by no means extreme for the traditional long-only institutional business. Hedge Funds with critical mass appear even better for owners and employees.

HEDGE FUNDS: *(i) fee structures are changing, (ii) business success factors are changing, (iii) there's mischief in performance measurement and (iv) the push into retail is long-term risky.*

Markets Are Not Efficient: Over the three years, *2001-2003, the top 20 hedge fund managers collected $10BN*. That equates to $50BN in Alpha accounted for by only 20 individuals. While some value is also destroyed in the industry, persistent pricing inefficiencies are fortunately a permanent feature of markets.

How Much Should Alpha Cost? There are signs, though, that Alpha may not be priced optimally. Witness the recent announcements of two industry-leading hedge funds, one in NY and the other in Boston: *NY has raised fees but offered a 'carrot' of lower management & performance fees for three- and five-year lock-ups. Further, this manager has launched a long-only product consisting of only the Longs in the long/short portfolio*. Investors can choose either a management fee with no incentive fees that starts at 2% but falls for three- and five-year commitments, or a lower flat management fee combined with an incentive fee on performance above the market benchmark that falls for longer commitments. *Boston will now not take any incentive fee for performance between zero and the risk-free rate*. For returns that fall between the risk-free rate and 500bp over, investors will pay incentive fees on a rising scale from 0 to 20%. For performance above 500bp over the risk-free rate, investors will pay 20% but not more. This gives the manager the incentive to focus on big opportunities and an investment edge vs. the competition.

Success Factors for Hedge Funds Are Changing: From a business perspective, over the long-term there really isn't any example of a sustainable successful outcome for a hedge fund (Quantum and Tiger are a few prominent casualties; who knows how the Buffett Partnership would have fared post-1969…).Vega's assets were $1.8BN two years ago, rose to $8.2BN by January 2004, peaked at $12BN a few months ago and have now fallen to $6.7BN. So what are the key factors in the future for sustainable business success? *Here's what ex-Harvard Management Corp. manager, Jeff Larson, has to say:*

You need to have a consistent philosophy, a longer-term view, the willingness to take liquidity risk, a value approach and the willingness to cap assets. If you can't hedge the position, you move on. You stick to what you know and you invest in your own fund. You need to be global instead of being constrained by geography or product. Strategically, money managers need the flexibility to move assets from one style to another, deploying resources where they can get the highest return. *Managers need to be unconstrained instead of dedicated to one strategy*. Flow of funds to a single strategy erodes alpha in that river, but the alpha just moves to another river, and managers need to be able to move along with it.

Can Performance Measurement Flatter Risk-Adjusted Returns? Smoothing, over-marking, selling out-of-the-money put options and 'incubation' can create dangerous illusions of high risk-adjusted returns, higher inflows and fees and more stable track records. For example, *the idea of risk-adjusted returns is open to more manipulation than meets the eye.* Be suspicious of very high Sharpe ratios for funds that invest in illiquid securities. Clifford Asness (academic who also runs $13bn hedge fund AQR) has convincingly shown that monthly betas and standard deviations of *illiquid* security prices can easily be smoothed to overstate Sharpe ratios. This can lead to explosive scenarios that devastate investors. Similarly, look out for risk embedded in over-marked portfolios of illiquid securities. Over-marking works great if money is flowing in, amplifying the track record, increasing fees and selling investors' funds to new entrants at higher prices, but if money flows out of the fund, the remaining investments become exponentially more over-marked. *High and unusually stable track records should put investors on alert: Is the manager selling out-of-the-money puts or instruments with similar payoffs?* This strategy can be lethal but is hard to distinguish from more conservative strategies. The paradox is that selling puts is a great strategy—selling 10% out-of-the-money puts on the S&P 500 hasn't yielded a down month in five years! But down months often precede a total loss. After infamously proclaiming in 1987 that his consistent performance was, "700 standard deviations from normal", Victor Niederhoffer suffered a 100% loss only a few months later. Lastly, *if a manager is marketing a track record, always ask how many funds have existed or been launched during the chosen period.* If many funds were launched, perhaps only those that were successfully incubated are being marketed. Is the strong track record a result of skill or chance?

Hedge Funds & Retail Investors: A Prediction: Hedge Funds for the masses are an explosive cocktail that may not end well. This is my opinion after looking at Man Group's fees on guaranteed notes for German dentists & the like. First, a quick dissection of a typical structured note: 100 of capital in a structured note typically invest in 60 of zero coupon bonds, 40 of in-house commodity fund AHL, 60 of Glenwood fund of funds and 60 of borrowings at Libor (1.6x leverage). The starting capital of AHL and Glenwood is then insured. Why do banks sell insurance for only 100bp? Because while Glenwood is illiquid, AHL can be liquidated to meet margin calls if necessary. In fact, AHL is in every structured note Man Group creates. *AHL, only 25% of group assets under management but 80% of group fees, is the anchor for the company's structured products, its revenues and its margins*. *A bet on Man Group is more explicitly a bet on AHL than I realized.* Back to the fees on AHL. Compare those for institutional clients with those for retail: Institutions pay 5% performance above a high-water mark and a 1% management fee. Retail investors pay a 3% annual management fee on gross assets, 20% performance fee taken monthly (no high-water mark), 3% sales charge, external manager fees (Glenwood, Bluecrest etc.), structuring fees and a 5% redemption fee in year one. This is a complete rip-off for retail investors; most won't understand this and the consequences for both parties will only become apparent with time. Yet this is where Man Group wants to grow because retail assets are stickier and less demanding. Man Group's biggest problem? Finding capacity to grow assets $5bn per year. Enter acquisitions. *If getting capacity were easy, why would they pay 23% of assets under management for a stake in Bluecrest when Legg Mason just paid 5% of assets for $20BN fund of funds Permal?* Is 20% of assets under management the right market valuation for Man Group?

ASSET ALLOCATION: *(i) Alpha & Beta – mix & match, (ii) what worked in the past may not in the future, (iii) watch Harvard*

Portable Alpha All The Rage: Investing skill (alpha) will increasingly be separated from asset class exposure (beta). Beta will be sourced from 'service providers', large organizations with economies of scale, brand, service and distribution. Alpha will be sourced from 'alpha factories' that suffer from diseconomies of scale yet have an edge in research, trading and structure. Compare Jeff Vinik's track record as manager of the Fidelity Magellan fund with that at Vinik Capital. Alpha factories will increasingly try to create 'brand' and service providers will increasingly distribute re-packaged alpha on behalf of the alpha factories. You can create alpha investing in bonds but your clients want to invest in stocks? Overlay your 'bond alpha' onto a stock fund through a swap. Pimco's StocksPLUS program does just this and has grown rapidly to $30bn in assets. The Hewlett foundation has doubled its exposure to 'absolute return' strategies to 20%, and borrowed 20% of fund assets to overlay equity and bond beta on top of the absolute return allocation. The foundation will invest 20% of its assets in absolute return investments and then pay Libor on that 20% but receive stock and bond beta as well. The theory is that the remaining alpha from the absolute return strategies will augment those stock and bond returns. *Bottom line: This bifurcation in the sources of alpha and beta, this concept of portable alpha (or enhanced indexing), is a secular trend if the professors at HBS are anything to go by. Question: Will there be enough alpha to go around or will flows into portable alpha strategies reduce the amount of alpha per $ of incremental beta created?*

Asset Allocation: What Is Optimal? For the last 15 years, Yale's and Harvard's endowments have achieved spectacular results. David Swensen at Yale, over the 13 years from 2001 to 2004, achieved a 16.2% annual return vs. 9.9% for the average endowment. Jack Meyer at Harvard produced a 15.1% annual return. *David Swensen's philosophy: Willingness to be different, belief that equities outperform bonds over time, diversification, avoidance of short-term market timing, external managers. Choose outside managers that are small-investor owned organizations with co-investment and that specialize in active management and have clearly articulated strategies*. Use separate accounts to protect against forced redemptions. The similarity with Harvard lies in the broad diversification into non-traditional assets as compared to the typical endowment invested in stocks, bonds and cash. The difference is that Harvard runs 65% of its assets in-house. Harvard ensures beta exposure of 1 to all asset class benchmarks through swaps and only invests internal capital in market-neutral strategies within each asset class. Performance is then measured relative to the benchmark, compensation is strictly quantitative and subject to claw back. *Suggestion: Watch what happens at Harvard after Jack Meyer's departure (any day).* Only 25% of the assets are now managed in-house and much money may seed talented managers who are spinning out of Harvard Mgmt Corp., increasing running costs. But the university has a 'clean slate' now. What worked for the past 15 years may not work in the future. Should they just index the money? Should they rebuild in-house management opportunistically and at a lower cost? Should they copy Yale and farm out all in-house money? Should they aim to find a manager with a vision of the future who would take on the challenge for reasons other than money? Should they invest in new asset classes? How the Harvard endowment is invested will be fascinating to watch in the post-Meyer world. Great minds will be put to the test finding the optimal solution.

INVESTING IDEAS: *(i) Buy forests, (ii) don't get too excited about private equity, (iii) getting a good 'price' is timeless,(iv) are long-term investing strategies capital-starved?*

Asset Classes – Best & Worst: Timber seems to have a dramatically more attractive risk-adjusted real return than any other asset class period. Don't ask me why, but *on Harvard Management Corp's plot chart showing long-term real returns vs. risk, timber is a major positive outlier.* The asset class is a significant portion of the endowment's strategic 'policy portfolio'. Conversely, according to the CIO of the $5.8BN Hewlett Foundation, *private equity returns will be weakest in the future relative to history. Why? With rampant flows into private equity, never has there been such an incentive to protect the rich fees on those assets*. Deals will be less courageous and sport lower returns. This commentary on the private equity industry is similar Warren Buffett's observation that hedge funds and private equity shops are more and more preoccupied with capturing fees than generating high returns for investors.

Attractive Investment Strategies: Value and Long-term investing were discussed and bear mention. Value: The evidence that value consistently beats growth over time is extremely convincing. *For many decades and in nearly all market environments, a simple low price/book value strategy has beaten growth by an average of 600bp annually.* Even when the valuation spread between value and growth is low (value unattractive), value *still* performs in-line with growth until the spread widens again. Proponents of behavioral finance will put this down to our 'optimism bias' and proponents of EMH will suggest that value stocks are riskier and thus deserve a higher return. Whatever the reason, the strategy works. A note on the real world though: Turnover can partially eliminate that alpha. Consider that the average institution achieves 130bp in stock picking alpha, only to offset it with 80bp in fees, 70bp in trading costs and 70bp in 'cash drag', leading to net underperformance of 90bp. Long-term Horizon: *Find where capital is most scarce and supply it. Where is capital scarce? One professor contended that capital invested on a 5-10 year horizon is still scarce. One reason may be because it is not a great business and you can't find the people.* Is lack of long-term horizon a market inefficiency today? The professor spoke of three former students who came to that conclusion. The first set out to find mutual funds with a very long horizon and effectively only found Bill Ruane's Sequoia Fund. The second works at a family office where he invests the family's wealth in only four stocks. The third now follows the so-called 'crocodile strategy', patiently waiting for big opportunities, akin to Taleb's strategy espoused in 'Fooled by Randomness'. In any case, given the above, a combination *of long-horizon* and value strategies fits perfectly with the mandate of endowments to grow real assets in perpetuity. Again, watch Harvard.

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