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THE RULES OF THE LONG-TERM GAME

By Craig Reeves, Platinum Capital Management

Short-termism, as all but a few dedicated speculators know, is the scourge of the investor seeking significant and durable returns. To be fair, some members of the traditional equity investment community learned this key message a long time ago. Speaking in the 1920s, for example, the notorious stock operator Jesse Livermore commented that: "It was never my thinking that made me money but my sitting tight". Seventy years later, the now legendary former head of Fidelity's Magellan Fund, Peter Lynch, said of skittish investors: "The key to knowing when to sell is knowing why you bought it in the first place".

Unfortunately, many hedge fund investors have yet to learn these lessons. Sometimes it's difficult to convince investors to stay in a fund experiencing short-term problems, despite the fact the investment will or should have been sold as a long-term plan. This sort of investor nervousness is often the fault of the management group, which can benefit from some simple 'rules' which will help to establish a core group of informed and stable investors.

Transparency

Nothing is more likely to send investors scampering towards the door than rumours of there being "something nasty in the woodshed" and such rumours are most likely to occur when the manager's organisation and/or general strategy are more or less opaque.

There are at least two examples in the past couple of years where assets under management at separate managers have been decimated by, in one case, a regulatory investigation (in the USA) which found nothing, and in the other, a clash of personalities at the top of a fund which led, on the back of some spicy and probably false allegations, to the resignation of one of the principals.

With hindsight, both these events could and should have been managed with greater efficiency, replacing rumours with appropriate and informative statements. I do not say this approach would have stopped the outflows of capital but it would certainly have built some dams along the stream.

A parallel area where greater transparency reduces uncertainty is when a manager finds himself with a poorly performing fund among a portfolio where the other funds are either doing well or, at least, acceptably. In such circumstances there's an understandable tendency to keep quiet about the poor performer and trumpet the merits of the strong.

There's nothing wrong with this approach until or unless information begins to leak about the poor performer. If there's little external understanding of the structures within the fund management company - the different teams running different portfolios, the presence of segregated accounts, the segmentation of the investment systems, that sort of thing - commentators and investors may be forgiven for worrying about cross infection (the bad apple in the barrel).

There was, for example, a recent incident, driven by relatively uninformed coverage in the UK national press, where a poorly performing fund (now closed) led to serious and negative speculation about the overall condition of one of the big and usually well-considered management groups.

Absolute relativism

The second rule requires the manager, or at least his salespeople and marketers, to ensure investors clearly understand the likely returns of the investment strategy during different turns of the economic cycle and/or different stock and bond market conditions.

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When the vogue for hedge fund investment began to gather pace in the late 1980s and 1990s, the original star names - Soros, Robertson, Steinhart and a few others - appeared to be able to make money, a great deal of money, in virtually all market and economic conditions (at least, until early 1994 when the US bond-crisis hurt many and stopped Steinhart].

These famous names in many ways set the style for the newer alternative investment groups, and the message that a hedge fund investor could expect high absolute returns in all market conditions was born.

The trumpeters of this message - the new band of marketers - failed, however, to take two things into account. The first was that the 1990s (early 1994 and late 1998 excepting) were a decade of unprecedented equity market growth. During those ten years, the Dow Jones Industrial Average rose from 2,810 to 11,497 - an increase of almost 310%. Nothing had been seen like that since the boom years of the later 1920s and it was therefore hardly surprising that many managers were able to ride the wave and, with a bit of gearing, produce eye-wateringly impressive results.

The second point was that none of the original stars was a straightforward long/short equity investor and yet the majority of the start-ups in the late '90s and early '00s were just that. And long/short equity investment is axiomatically a relative return strategy, whereas global macro as practised by George Soros, for example, is as near an absolute return strategy as exists.

Given these two issues, the downturn in the majority of alternative investment returns from the beginning of the millennium was hardly surprising but, at the time, it gave rise to comment that hedge fund investment was necessarily a short-lived phenomenon and that it was tantamount to impossible to beat the markets for any length of time. A little management of expectations would have gone a long way to handling such negative reports.

Do unto others...

Hedge fund managers who want investors (correctly) to take the long-term view should, I would argue, take the long-term view themselves (*Rule Three*). Of course the rewards to a successful manager are enormous. On conventional fees of 2% management and 20% performance, a group managing \$3 billion with a performance of +10% in a 12 month period would earn in excess of \$120m (gross), and hedge fund operations are rarely very large in terms of personnel so there need not be a lot of sharing.

Over the years, that sort of income has led a number of managers to give up the chase earlier than their investors might have either hoped or expected. But these swift departures send the wrong message to the investment community as a whole.

The answer here is about succession. Too many boutique managers depend for their profitable continuity on only one or two key individuals. If the investment process is systematic and computer-driven then this fact should be clearly communicated to investors who should come to understand that to continuity of the machine is more important than the continuity of the individuals.

If, on the other hand, investment decisions are taken on a more personal basis, management groups reaching any sort of size should be thinking about consistently introducing new talent and, equally as importantly, incentivising such talent to a level that discourages break outs when sufficient experience has been acquired.

It is worth adding that establishing a known, public succession also goes a long way to negate investor jitters about the "key man being run over by a bus". And while, until now, hedge funds have tended to be a one generation business, there are successful examples of

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transfer and continuity such as the transmogrification of Trout Trading (run by Monroe Trout) to Tewksbury Capital Management (run by Matthew Tewksbury, Trout's former CEO) in 2002 after Trout Trading had made a gain of 13.6% in 2001.

Compound interest

The formula for compound interest is $FV = P(1 + r)^n$ where FV is Final Value, P is the Principal, r is rate of return (expressed in decimals so if the interest rate is 5%, r is 0.05) and n is number of years.

Using this calculation, we find that a principal of \$100 invested at 8% compound over 10 years becomes \$215.89, and over 30 years, grows more than ten-fold.

The reason for this diversion into relatively elementary arithmetic is to encourage managers, marketers and salesmen to ensure, as far as possible, that their investors understand the enormous growth potential contained in apparently low compound rates of growth [*Rule Four*].

I mentioned above that during the 1990s, the Dow Jones Index grew meteorically (at an average of 15% compound per annum), but over the longer-term (in this case a 35 year run), the Dow's growth has been a little under 7.7% compound per annum (see Figure 1) and yet few investors would deny that the results were at the same time impressive and acceptable.

Figure 1: Dow Jones Industrial Average - closing prices for the first trading day of the year, each five years since 1970.

2/1/1970	2/1/1975	2/1/1980	2/1/1985	2/1/1990	2/1/1995	2/1/2000	2/1/2005
809.20	632.04	824.56	1,196.88	2,810.15	3,834.44	11,497.12	10,783.01

Over 35 years the Dow has grown at a tad less than 7.7% compound pa

Of course, this is basic stuff and to that extent needs to be conveyed with a fair degree of subtlety for fear of being patronising. But it is also important stuff and often misunderstood or misinterpreted in the press.

The key, I believe, is keeping the investment process on track for consistent, durable performance and ensuring investors understand that this will, over time, ring up very desirable returns. It is commonplace today for potential investors to be told that volatility is their enemy, and yet there is something seductive about an investment portfolio that has a chance of 'shooting the lights out' in any one year even though performance in other years may be dire.

And actually, the press often doesn't help explain the fallacies contained in this view. I can hardly count the number of times I have been informed, in apparently informed articles, that an investment that halves in value - falling, for example, 50% from \$150 to \$75 - is going to take five years at 10% per annum to recover. No it isn't. To recapture a 50% loss one needs a 100% gain. This is hardly rocket science.

Conclusion

I will leave the last words to Niccolo Machiavelli, the 16th century Florentine political philosopher: "All this can affect changes in wealth in the same fashion, for one can make a fortune if his administration is cautious and patient and converges with the spirit of the time ..."

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