Back Down the New Haven Line

It is within the philosophy adopted by the proprietary trading desk that lays the methodology vital to the effective evaluation of hedge funds.

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This article seeks to explore some of the shortcomings in the proper analysis and evaluation of hedge funds. The evolution of events and developments relating to this industry as seen through the headlines seem to suggest that perhaps we have forgotten where the approach to absolute return strategies comes from, and therefore not allocated the adequate resources to evaluate hedge fund managers.

Historical Perspective

It is no accident that the New Haven Line is well populated with hedge fund managers. This landscape is a revelation of what, for the most part, hedge funds around the globe represent.

It perhaps all started with the concept of asset-liability management within the large banks, followed by taking increasing amounts of market risk in comparison to the legacy business of undertaking credit risks. These banks' proprietary trading desk adopted a "make money but do not lose any" attitude; thus the implementation of absolute return and protection of the capital philosophy within the larger and regulated institutions.

Hedge Funds represent the dis-intermediation between the bank and the proprietary trader who has now become an entrepreneur. The trader, now labeled as "hedge fund manager" still makes use of the bank's balance sheet to execute the strategy through the negotiation of a "prime brokerage agreement". This dis-intermediation has resulted in a whole new industry increasingly taking its place in the investment policies of institutional investors around the globe. These investors now have access to a pool of talent that was traditionally contained within the walls of the major investment banks.

By now, many of these 'traders' are remaining up the New Haven Line. They have setup their own shops, lured by the concept of independence, proximity and freely expressing their talent while keeping all the upside in the form of an attractive and overlaid fee structure. Evidently, these fee structures not only attracted the "talent", but also the neophyte and (unfortunately) the fraudsters.

The independent risk oversight and infrastructure is very much a current issue. The reader is already well aware of the unfortunate circumstances of unreasonable losses and fraud that are somehow more prevalent in volatile and dislocated markets.

The industry is presently showing signs of maturity. The concepts of "managed account platform" and "transparency" are now more widely used.

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An elaboration on the foregoing, although very important, is beyond the scope of this article whose objective is to focus your attention on the pieces that were left behind on the demand side, i.e. those who analyze and evaluate the managers to obtain absolute returns and protection of capital.

The pieces left behind, on the demand side:

On the proprietary desk (or down the New Haven Line) much of the trading talent was (and still is) evaluated and screened by heads of proprietary desks, heads of capital markets divisions, and heads treasuries; all with trading experience, and most still managing a "book" (what investors call a portfolio).

At the opposite, up the New Haven Line, the resources that hedge fund investors have deployed to evaluate and screen throughout this universe of talent are for the most part young investment professionals with little or no experience, and indeed the actuaries; but worse, none with trading experience. These relatively inexperienced professionals were understandably lured by the neophyte, and the fraudsters who are calculated, smart and articulate.

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The unfortunate fact that has transpired on the demand side reveals that the hedge fund investor community has deployed an inexperienced scouting pool that has far too often and grossly mistaken eloquence for competence. This has resulted in high rates of false-positive and false-negative diagnostics of hedge funds thus ensuing with the unfortunate headlines plaguing this industry.

More to do with trading than investment

The one issue that hedge fund investors must realize is that hedge fund strategies are much more about "trading" than "investment". It is that simple. Ask any proprietary trader how much he made last month and you will get the answer in the form of a dollar amount, not in the form of a percentage. This is a reflection of the mindset of proprietary traders who do more than manage portfolios. They constantly manage risk, deploying precious capital within very strict guidelines and under the watchful eyes of the risk managers, the middle office, and their boss who decides between the bonus and the door.

Perhaps a clarification of the terms is in order. "Trading", as in what proprietary traders do, represents the allocation of capital in an array of risks and dynamically managing these risks (positions) with discipline to better the chances of deriving positive returns. This is different from "investing" capital based on researched ideas, undertaking active risks to derive active returns relative to a benchmark. There are, of course, some similarities but many differences. For the purpose of this article, one should not confuse trading with the term "day-trading" that consist to getting in and out of positions within the trading session.

The "disintermediation" referred to earlier in this article makes rather obvious the set of criteria that one should use in the evaluation of a hedge fund manager. The following formula shall set the basis of the analysis framework:

Hedge Fund Manager = Analyst + Portfolio Manager + Execution Trader + Risk Manager + Entrepreneur + Business Manager

All above elements should be integrated in a proper analysis of a hedge fund manager. However, it seems that the investors have unfortunately overweighed some elements at the expense of others. The term "Trader" referred rather often in this article combine three elements of the above formula. They are: Portfolio Manager, Execution Trader and Risk Manager.

An analysis on the background and interrogation of the key individual(s) will reveal some of the strengths and weaknesses within the key elements of the above formula. First, the fact that the individual was a proprietary trader, and second, their tenure as a proprietary trader offer perhaps the best indicators. Nobody makes it into the proprietary trading business for an extended amount of time losing money. Anybody who remains as proprietary trader for three or more years, and preferably one who survives a tough market environment, has likely proven himself as a "money-maker", at least for that period and deserves to be investigated further. The longer the tenure, the higher the conviction level in the evaluation.

For those who were never traders, but rather an analyst or traditional long-only manager, one should then ask the question "how do you manage risk in your portfolio?" For some reason, several will take us back to the "Analyst" part of the equation with the answer: "we manage our risk through deep due diligence research". RED FLAG!!

The market is a collective perception of reality. It is this "collective perception" (and its behavior) that will prove you right or wrong, and thus allow you to make or lose money, not the truth!! Capital is much too precious to be allocated into positions waiting for the market to realize that you are right. Successful traders (or hedge fund managers) have within them the ability and discipline to implement and dynamically size individual positions and portfolio exposures coherently with the collective perception. They also have the discipline to admit when they are wrong, cut positions and move on with the next idea, even though they may eventually be proven right.

The distinction between "investing" and "trading" cannot be over-emphasized. Investing, or the buying and holding of positions until the markets confirm the value realization is not the recipe for absolute return and protection of capital. Far too many things can happen to these individual positions and far too many things can happen to the market before the portfolio manager can be proven right within the intended holding period. The proper application of dynamically sizing positions and exposures is the appropriate recipe while accelerating the alpha generation process. These are the tools available to the hedge fund manager that allow him to navigate through all market conditions and derive absolute returns.

The dynamic calibration of positions and exposures

While the eternal debate of what constitutes alpha and beta still rages on, one can safely admit that "the deliberate, dynamic and tactical exposures, long and short, among an array of betas is a source of alpha".

The dynamic and proper calibration of individual positions allows the manager to manage the risks associated with that particular position. This can be accomplished in a number of ways, i.e. through selective entry points and grossing-up as the market confirm the underlying thesis. Entry points are sometimes through the use of options and following up with the underlying security position as conviction is confirmed. The manager should also realize that as the thesis become increasingly widespread within the community that the trade becomes increasingly crowded. Crowded trades are prone to gap risk and this is when exit points are contemplated to monetize gains and reduce the implied gap risk.

The dynamic and proper calibration of net and gross portfolio exposures allows the manager to navigate though the systematic risks associated with the underlying relevant markets. Net exposure calibration is usually associated with the manager's conviction on the direction of the overall underlying market. Gross exposure is usually associated with the summation of the underlying position conviction levels and the degree to which the current environment is fertile in terms of opportunities. Capital is much too precious to be allocated to ideas without conviction. As well, when the markets are most volatile, the gross exposures tend to be taken down.

It is not the intention of this article to undermine the very important task of fundamental research and due diligence, but the trading talent of a hedge fund manager remains the key element in the evaluation and screening process. The proof, in part, lies in the fact that very sophisticated trading systems have been developed specifically to replicate the thought process of a talented trader, and with absolutely no consideration to the data points resulting from the fundamental research and due diligence. Many of these systems have proven themselves successful in all market environments.

In summary, it is within the philosophy adopted by the proprietary trading desk that lays the methodology vital to the effective evaluation of hedge funds. It is only when the investors start deploying the resources that truly understand the core mechanics allowing the generation of absolute returns that their objectives will be met, and thus effectively screen throughout the universe of hedge fund and obtain absolute returns, protection of the capital, and de-correlation from broad equity draw-downs. *

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