When It Comes to Hedge Funds, Beware of the Wolf in Sheep's Clothing, or a Bikini

Rene Levesque
Founder, Mountjoy Capital
19th Nov 2013

As written in the Christian New Testament: "Beware of false prophets, which come to you in sheep's clothing, but inwardly they are ravening wolves". Or, as in the popular text of Aesop's Fables: "Once upon a time a Wolf resolved to disguise his appearance in order to secure food more easily. Encased in the skin of a sheep, he pastured with the flock deceiving the shepherd by his costume."

The analogy of the wolf securing more food is relevant to the few hedge fund managers that are "institutionalized" for the sake of seducing investors (the shepherds) and securing more assets under management. The sheep's clothing essentially consists of impressive operational, administrative, compliance, legal and risk management infrastructures. There are no operational due diligence red flags.

Overwhelming Share

It is no secret that the overwhelming share of new hedge fund allocations has been directed towards the largest firms. The reasons are multiple and, for the most part, justifiable. Many of them offer credible strategies, are run by a deep pool of management and research talent, and operate within institutionalized operational, legal and administrative infrastructures.

Unfortunately, some successfully rely solely on an elaborate business model to attract capital while knowing very well that investors seek comfort among solid infrastructures that mitigate headline risk, reputational risk, operational risk, and - yes - career management risk.

The larger firms are well aware of this considerable competitive advantage. Examples include those from the traditional, long-only managers that leverage current infrastructure in order to repackage legacy mandates in the form of a hedge fund and raise more capital. Others have, somehow, a talent for reinventing or repackaging themselves after a major performance drawdown and fund closure. This article is in large part motivated by the new launch by such a firm. This firm is currently launching a strategy, with only very slight modifications and a reduced fee structure, that blew up in the '07-'08 era. Though the operational infrastructure would pass the most meticulous due-diligence review, all the unscrupulous and damaging elements remain in this significantly-leveraged strategy. It is as if the past is blatantly ignored because they know that most investors have not learned the lessons to be learned.

The Hedge Fund Universe

The hedge fund universe is heterogeneous in nature, both in terms of the spectrum of Assets under Management (AUM) and the degree of operational and infrastructure institutionalization. Unfortunately, too many investors associate the highest quality of institutionalization and

 2013 All Rights Reserved

AUM with the quality of the embedded or deployed strategy. Implicitly, they are "piggy-backing" on the due-diligence of others. In fact, there are both compelling and pathetic hedge fund offerings bundled in weak or average infrastructures; and, conversely, there are both impressive and weak hedge fund offerings bundled in extraordinary operational infrastructures.

For the same reason that in-depth operational due diligence may at times result in the decision to no longer pursue a relationship with a compelling hedge fund manager/strategy, in-depth investment due diligence should result in declining on some of the larger firms that offer investment strategies that are likely to bleed or blow up in market dislocations.

For some reason, the institutionalized firms that are most successful in seducing investors are those that deploy strategies that are quantitatively intensive. This quantitative attribute pertains to multiple facets of the strategy itself, including elements relating to idea generation, position sizing, portfolio construction, portfolio optimization, and the risk management overlay. The explanations may lie in the fact that most investors have deployed quantitative-centric analyses and resources to provide diagnostics on prospective hedge funds. The larger hedge fund firms are aware of this and this tendency has resulted in a mix of trends that include the "Quants impressing the Quants" and engaging in hedge fund analysis as an intellectual stimulation while testing the conventional theoretical boundaries. But when an in-depth qualitative review is undertaken on most quantitative-driven strategies, they generally turn out to rely on leveraged carry and leveraged mean-reverting algorithms that cannot sustain systemic events of much significance.

Quantitative tools do, in fact, help in building a case to justify manager selection decisions with hard data that stands up to the scrutiny of the investment committee members. The process has evolved into a culture that imposes quantitative filters on a discipline better referred to as an art rather than a science. Plainly, the justification process has somehow drifted as the core of the evaluation and decision-making process despite the two being very distinct activities. Quote: "A judicious man uses statistics, not to get knowledge, but to save himself from having ignorance foisted upon him." (Thomas Carlyle)

Quantitative Risk Management

The quantitative risk management overlays applied to these strategies are notably interesting. They state a 95% (or other), 10-day historical simulation VaR using the returns of the current portfolio positions projected back over several years as a defined comfort zone or severity of loss of capital. Isn't it the 5% that we should be worried about? Is this where we could experience a severe permanent loss of capital? Is it precisely for these occurrences that we look at hedge funds to dislocate or decorrelate the overall portfolio from broad market drawdowns?

Investors attracted to quantitative, algorithm-driven strategies to generate ideas, validate ideas, construct/optimize the portfolio, and mitigate risk, should bear the following in mind: "Statistics are like a bikini. What they reveal is suggestive, but what they conceal is vital." (Aaron Levenstein).

To avoid the wolves dressed as a sheep (or wearing bikinis), the investor must ask the following questions: Is the strategy an extension of the long-only mandate already offered? Does the strategy embed explicit and/or implicit short volatility (Vega) and short gap risk (Gamma) exposures? Does the strategy dwell on implicit or explicit carry and/or mean reversion of price patterns? Is the portfolio's key decision-maker spending much time on marketing; is he/she available at market-open for a marketing call? Is the firm's emphasis on infrastructure issues to the detriment of portfolio and market risk management issues? Are they relying on risk mitigation as a risk management framework? Is the portfolio decision-making process committee-driven, or is it nimble, dynamic and disciplined? Is the strategy pitchbook overwhelmed with analysis and presentation of performance metrics, infrastructure issues, "people" they know, "people" who know them, an elaborate advisory

 2013 All Rights Reserved

committee, and manager background and accomplishment issues?

There is a saying that "an empty barrel makes the most noise." The very same applies to hedge fund marketing materials and discussions as well as the general atmosphere conveyed during site visits.

To contact Rene Levesque, please visit www.mountjoycapital.com

 2013 All Rights Reserved