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How to generate returns when the markets won't do it for you

Like a surfer unsure of his chances of catching another wave as he is swept out to sea in a rapidly moving current, investors are questioning their investment strategies now more than at any other time in modern history.

By Craig A. Machel

The rapid declines in the global stock markets have had a dramatic impact on the majority of investor portfolios. Why? Because the average investor is dependent upon the upward movement of the stock markets in order to make money.

This reliance on market movement for investment gain is commonplace, but not commonsense. Markets have no predestined path. Despite what financial models want us to believe, the markets weren't designed to generate returns of eight to 10 per cent annually. And they haven't always done so.

Let's look at the facts, using the Dow Jones Industrial Average (DJIA) as the proxy for U.S. economic and market growth. From 1900-2008, the DJIA averaged a return of 7.2 per cent per year. Not bad. But consider that this is an index return: it does not include dividends, fees, or taxes or reflect inflation — all of which are major factors on an investor's return experience. Also consider that most of us don't have the luxury of a century to invest, during which the law of averages can smooth out the rocky years.

Being a bit more realistic with our data, if we dissect the DJIA into 20-year time frames (a more reasonable time period to reflect saving for retirement), we reveal a much different scenario than positive annual returns at over seven per cent. Starting from 1900 again, we can look at 88 rolling time periods of 20 years. In only nine of those periods — just nine times in over 100 years — the DJIA produced a compounded annual average return of 9.6 per cent or more. Moreover, in all but one of those nine years, the returns corresponded with what led to the technology bubble of the late 1990s. So, over the course of 100 years, the strongest average annual returns preceded one of the worst bubbles that effectively erased most investment gains for those



participating in the markets at the time. What history actually shows us is that there is no reason why the market must provide a certain return over a select period of time. They are, have been, and will likely remain unpredictable.

So why do so many investors put themselves at the mercy of market movements? I believe it is because they don't know they have another option. They are unaware of the fact that there is another way to participate in the equity markets that is not dependent on positive market returns for growth. This enhanced, non-correlated approach to equity investing is called a hedge strategy.



Long-term strategy

In 1949, A.W. Jones, credited as the father of the hedge fund industry, presented this innovative alternative to traditional equity market investments. He realized that markets are unpredictable, and thus, developed a strategy that didn't rely on predicting market movements to succeed. In an annual letter to partners in the fund, he described his approach: "Such a fund, being fully hedged, has a market risk of zero and all net gains or losses will be attributable to good or bad stock selection, none to the action of the market."

Hedge solutions have been helping affluent investors make money in all market conditions for decades. These days, there are many different types of hedge fund strategies. My focus for this column will be Jones's original approach: the long-short strategy.

The goal of any authentic long-short strategy is to generate returns and minimize losses regardless of the direction of the market. This is achieved by constructing a portfolio that holds both attractive investments poised to grow (long positions) and unattractive yet overvalued investments likely to drop in value (short positions). By holding similar numbers of long and short positions, the hedge fund manager is able to provide more positive returns and fewer and smaller negative returns than those of the broad market. It makes sense if you think about it: whether the market goes up or down, half of a long-short portfolio is likely to benefit. So it truly doesn't matter what the market does. This is why most long-short managers have been riding recent market volatility quite well (not to mention posting strong performance in more positive markets).

With hedge funds, the markets don't matter, but your portfolio manager does. The performance of a long-short strategy is dependent on the manager's ability to be tactile and select the right stocks. Not all long-short funds are created equal. Fortunately, it is easy to sort through this asset class and find an authentic hedge strategy by examining five key factors:

Fund structure: The first thing you want to look at in any hedge fund is its structure. Does it have independent relationships with partners integral to its operation and security? Is this structure properly documented? Basically, you're looking for outside party oversight of the fund's operations. The lack of an independent and accountable fund structure

behind the scenes raises a red flag as to the integrity and security of the firm, and is the root of the problems with recent high profile hedge fund frauds.

Investment process: The second aspect you should examine in any hedge fund is its investment approach. What parameters are set out by the fund's investment managers? Will they manage a true long-short fund or is there potential for digression? And, finally, consider whether the investment process is consistently adhered to: was there ever a large bet or one-time bias, or has the long-short style continued since inception?

Leverage level: What is the leverage range limit set for this fund? How is leverage being employed—and when? Long-short funds normally set leverage limits to a 2:1 ratio. (As a point of reference, a typical first-time homebuyer applies leverage at a 4:1 ratio.) While some leverage is necessary to implement this strategy, consider a fund with a lower leverage level.

Capacity limit: Total assets in a fund can impact the success of any strategy. Will the fund limit capacity to ensure it remains nimble enough to execute its strategy? Hedge funds act proactively in order to lock in gains and protect capital. A fund with billions in assets simply can't move between positions quickly enough without hurting its own return. What you're looking for is a fund that has set a reasonable capacity limit in order to continue to be effective.

Manager incentive: Finally, you want to consider portfolio manager incentives. Does the fund offer compensation linked to positive fund performance? Equally as important, do the managers and principals have their own skin in the game? The incentive to work hard in order to limit losses and produce gains is significant if the portfolio managers themselves are amongst the largest unit holders.

During this continued state of uncertainty, it is prudent for investors to be exploring less volatile solutions in order to protect their savings. We don't have to be captive to the markets in order to save for our retirement. Jones figured this out over 60 years ago. He developed a strategy that diminishes the risks associated with the uncertainty of the markets and can grow capital without relying on market movements to generate returns. It worked then—and it's still working now.

An authentic long-short hedge fund can enhance the risk/return profile of your portfolio. In fact, true hedge strategies are an important element in any properly diversified portfolio. Armed with the five key factors to assessing hedge funds, you can now enter this asset class and make a good selection for yourself. Making this choice can help you ride a more consistent and predictable investment wave, giving you a clearer view towards your future lifestyle and retirement plans. ■

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The opinions contained in this article are those of the author and are not necessarily those of Blackmont Capital Inc.