Passive Capital Management

Manager Selection Risk & Fortune-Telling

It remains very difficult to separate the skillful manager from the lucky manager and over 30 years of data are needed before you know with any degree of certainty. If 8,000 people flipped coins ten times in a row, a few of them would flip all heads; this is *luck*, not skill! Hedge fund and mutual fund managers would have you believe that they are very talented coin-flippers (stock pickers) and, therefore, you should pay them a high fee to flip coins (pick stocks) on your behalf. Even if a manager had the ability to consistently predict the future, it only helps those investors who identify this ability *in advance*. This article discusses manager selection risk within the hedge fund industry and outlines why the flaw of averages can be detrimental to your portfolio.

A presentation by Charles Schwab & Company [1] provides some interesting insights into the variability of manager returns within specific styles of hedge funds. The data is summarized below:

Manager Style	*Range of manager returns around that of the median manager after excluding the best and worst 5% over the ten-year period ending June 30,2002*	
Large cap long only equity managers	-3%	+3%
Long/short equities	-32%	+32%
Merger arbitrage	-21%	+11%
Short selling	-28%	+8%
Relative value	-11%	+11%
Distressed securities	-10%	+12%
Opportunistic	-20%	+42%

Because large cap long-only managers have a relatively narrow investment mandate, there is clearly less variability in returns and less differentiation amongst individual managers. On the other hand, hedge fund managers generally have tremendous latitude to pursue investment gains so it is no surprise that some managers successfully generate impressive returns while others fail miserably. Since there is huge positive and negative variability around each style's median performance, the challenge to investors is to *find the skillful manager in advance*. As this data illustrates, choosing the "wrong" manager can be detrimental to your portfolio.

Of course there are consultants and other investment professionals who claim *they*, of course, can identify the skillful managers in advance…if only you pay them a generous fee for their knowledge. A recent article in *The Wall Street Journal* by Leah Goodman and Matt Chambers[2] gives a good example of how difficult (or impossible) it is to find the good managers in advance. Their article explains how MotherRock, a hedge fund that specialized in trading natural-gas futures, suffered massive losses in June and July and had to shut down the fund after reaching $430 million in assets in May. Now that's specialized, alright! What's interesting is that this fund was established by former executives of the New York Mercantile Exchange who supposedly had skill at trading energy futures. They obviously did not want to fail miserably, but the market is driven by random events that, by definition, are not predictable. So investors paid them lucrative management fees and few quarters of incentive fees in order to take what they thought was calculated-risk. While this is only one example of horrendous performance, it is important to realize that approximately 1,000 hedge funds closed in 2005 (while another 2,000 were launched!). In recent academic research[3], Burton Malkiel and Atanu Saha found that of the 331 hedge funds reporting to the Tremont Capital Management database in 1996, only 58 (18%) were *still in existence* in 2004!

So if your primary concern is maximizing risk-adjusted returns for your institutional portfolio, allocating funds to a hedge fund manager can be more risky than it first appears. Additionally, if you allocate the funds to many hedge fund managers in order to mitigate the manager-selection risk, then you may be left with a high-cost portfolio that is highly correlated to the S&P 500 and traditional asset classes (but the correlation of hedge fund returns are a topic for another newsletter). Unless you're confident that you or someone else can consistently predict the future, it is best to control what you *can* control (for example, fees, diversification and asset allocation) and to not spend a lot of time or money on things that you *cannot* control (market fluctuations and the future).

The team at Passive Capital Management understands how results are generated and structures institutional portfolios that capture returns from various risk factors in a cost-effective, tax-efficient manner.

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[1] Data is from a Charles Schwab & Company presentation that acknowledged that the long-only data is from Mobius M-Search and the hedge fund strategy

[2] Matt Chambers and Leah Goodman, "New York Energy Hedge Fund to Close After Big Natural-Gas Losses," *The Wall Street Journal*, Page C-3, August 4, 2006

[3] Burton G. Malkiel and Atanu Saha, "Hedge Funds: Risk and Return," *Financial Analysts Journal*, Volume 61, Number 6, November/December 2005

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