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## **Why Hedge Funds Fail**

Hedge funds have grown tremendously popular since the late 1980's. While Alfred Jones has been credited with setting up the first such fund in 1949, it wasn't until Institutional Investor wrote about the incredible performance of Julian Robertson, in 1986, that the industry began its rise to prominence. Then, after the Dot.Com bubble began its burst in the spring of 2000, the popularity and resulting proliferation of hedge funds really took hold and became main-stream. It is clear to many that we are now in a more mature stage of the industry; a stage where hedge funds are not only accepted but esteemed.

An analysis by Bernstein Wealth Management Research reports that, as of the end of 2005, there are some "8,200 funds representing more than \$1.1 trillion in net assets" and according to Hedgefund.net "total hedge fund asset levels increased from \$1.725 to \$1.786 trillion during the third quarter of 2006". They are attractive, not only to ultra wealthy individuals, but institutional investors such as pension funds, endowments, corporations, banks, family offices and the like have appreciated their advantages and have turned a greater proportion of their assets over to hedge fund managers in the search for alpha. As defined by the Global Custodian Institute (GCI), "Alpha is the difference between the risk adjusted return of a given portfolio and the return of its benchmark." It is the difference generated by a smart person executing smart strategies using research, skill and experience to generate stronger than expected returns.

Smart institutional investors, broad strategies and the flexibility to exploit market inefficiencies on a global scale have led the way for a lot of people to embrace hedge funds as vehicles to grow their wealth. Yet, the Global Custodian Institute provides us some statistics reflecting that roughly 15% of hedge funds fail each year. Among the surviving funds, performance often starts out strong only to ebb dramatically in a few years. In other noteworthy funds, as in the case of recently failed Amaranth LLC, there have been spectacular blowups where billions of dollars of wealth suddenly disappeared. We thought that, given this popularity, many of our readers would be curious to know why hedge funds fail and desire some indicators that might shed light upon the stability of a fund you may be looking at.

In a white paper published in 2005 by the Eagle Rock Diversified Fund, "There are lots of reasons why hedge funds fail, in almost all cases it comes down to poor performance resulting from inadequate people managing the funds." In other words, operational problems and poor execution can damn good strategies.

As readers of our newsletter well know, wealth management is the ultimate goal of all that we do at Hoffman, White and Kaelber. Yes, we promote our services; yet, you will find that we always seek to present thought provoking topics that are relevant to our wide audience.

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In a collaborative effort by Dr. Dan Elash and Henry Kaelber, this month's newsletter will discuss the issues and behaviors that lead to failures in the hedge fund industry. Whether you represent an institutional investor or have an individual interest in hedge funds, you will want to look over this prospective of the sexy world of hedge funds. Once you've read this enlightening piece, please be sure to spend some time looking over our market comment and performance for the month past. It will be well worth the investment.

## **Why Strategies Fail**

We might do well to think of this section as looking at "what happens when great ideas are paired with poor execution." All investing activities require making commitments based upon expected and probable future outcomes. The strategies that drive these commitments don't just operate in vacuums. A strategy that sounds great in the abstract is always going to have to be tested in the "fog of war."

In the hedge fund arena, it is not uncommon to see new ideas and strategies developed and funded by eager investors. However, an investment idea that looks good on paper is not always successful when the manager lacks the ability to execute it well. This concept is well known in the investment banking industry. Investment bankers, for instance, are often very imaginative in constructing financial arrangements but often move on after the transaction is done and never experience the pitfalls of maintaining the complexities of what they've constructed or the relationships they've created. This can cause considerable loss to clients down the road.

Strategies arise in the minds of human beings, people with various strengths and weaknesses. These human factors become the filters through which strategies are executed. As with any human endeavor, they can impact an individual's performance and that of the organization itself. These risks are unavoidable; they can only be managed more or less effectively. How does the manager or the investment team recognize threats and opportunities in the face of unexpected events? In the competitive arena of the hedge fund world, how is the stress of short-term mediocre results handled? What does the portfolio manager do to minimize fund defections or the loss of key talent?

Different human vulnerabilities can arise and be tested in a number of circumstances throughout the life cycle of a fund. Good strategies fail when these vulnerabilities affect best execution in ways that are both obvious and subtle. We will consider some of these factors below.

- An inadequate breadth of experience can lead to errors in judgment and poor decision making under pressure. Managers whose expertise is deep within a particular sector can be vulnerable to events affecting that sector and are often more at risk as their fund assets grow in size. They have problems resulting from:
  - Concentrating too many of their proverbial eggs in one basket.
  - Failure to recognize the ebb and flow of their strategies.
  - Having too many dollars chasing too few opportunities.
- Other issues arise when they start easing strategic discipline by failing to balance their risks in relation to their disclosed promises.

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- They can wind up evolving toward taking more concentrated risks or drifting to a less familiar strategy in pursuit of alpha.
- They can lack an effective conflict resolution processes on the investment team, often resulting in the most dominant personality trumping the best thinking and causing defections or sabotage from within.

### **Operational Challenges Experienced By New Funds**

Structuring a management company requires successfully addressing the challenges associated with every new business. A fund manager may be deeply experienced in his or her area of investment expertise but a well managed fund also needs the “know-how” to manage the business side of the equation. Often, new fund managers come out of big investment houses and lack an appreciation for the operational processes required to support their earlier success. That is, they lack organizational insight to recognize the infrastructure needed to support their strategy. Most never had to learn or appreciate how everything else worked. These managers must attend to the requirements of a start-up fund and a fledgling business. They must effectively manage the human and intellectual capital as well as the financial capital entrusted to them. These challenges are often greater than anticipated and they lead to poor decisions and inadequate execution. Problems can also arise when they don’t adequately handle one or more of the challenges listed below.

- Having less than full understanding of all facets involved in executing their strategy.
- Lacking experience to effectively manage the fund's knowledge assets, including creating research, marketing and operational infrastructure.
- Lacking an understanding of the complex management issues that can arise in-house as well as from an over reliance on outside service providers.
- Lacking the maturity and the knowledge required to run a business.
- Coping with the challenges of trying to get a group of smart people to think well together.
- Setting appropriate expectations, focus and incentives that foster a common definition of success across all parts of the organization and with clients.

### **Operational Challenges Experienced By Mature Funds**

Mature or rapidly growing funds can face a different set of challenges. As success occurs, the operations of the management company become more complex. One threat that often gets highlighted in the media is the threat of a “rogue trader.” When a fund or trading desk blows up there is often a scapegoat identified as a rogue. A rogue is often characterized as someone who has been either loosely managed or operating in secret, who has gotten into trouble on a couple of trades or is otherwise underperforming, and then works a highly risky strategy in an effort to recoup his or her losses. The root cause of such problems however comes not from the rogue, but from a breakdown of internal transparency and a lack of discipline and management practices needed to prevent roguish behavior in the first place.

It is one thing to find and develop good investment ideas; it is another to execute those ideas well and yet another to manage the risks of the company itself. Rogue traders can blow up a company; poor client communications or miscommunications can blow things up; poor trade

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execution, poor coordination of outsourced or in-house support systems; poor allocation of human resources, etc.

Past or prolonged success can produce overall underperformance and “botch things up” as well. Success can corrupt the focus of key decision-makers and, in turn, can foster damaging behavior that is often less obvious to investors. Some of these trends are noted below as:

- Egos, fed by success can begin to cancel out human capital. Arrogance and poor people skills often become more pronounced within the leadership team. This can easily lead to defections or internal sabotage.
- Portfolio managers can become more conservative, holding too tightly to yesterday’s winning formula in a rapidly changing world causing diminishing returns and poor overall performance.
- Success leads to people enjoying their wealth and diluting their focus on the business. Fed by success, they become less hungry and performance suffers.
- Internal transparency and other checks and balances can falter as the management company grows and becomes more complex. This elevates the potential for big losses to occur as investment risks start becoming mismanaged.
- There is a lack of adequate succession planning. Key players become uneager to groom their successors and stifle talent. This can also lead to poor communication of ideas, defections or internal sabotage.

## **In Conclusion**

Hedge funds can be powerful engines for producing wealth as evidenced by their rise in popularity in recent years. However, for a hedge fund to achieve and then sustain top performance, much more than an effective strategy is required. Broad overarching strategies often require an uncommon breadth of experience on the investment team. This implies that the organization is prepared to act as a highly disciplined think tank. It is also a complex business endeavor that requires significant business skills to manage as it starts up and then grows more complex with success. Finally, hedge funds are run by people, people with faults and flaws. Unless appropriate checks and balances are put into place, the challenges of handling the human and intellectual capital are sufficient to sink an otherwise good strategy. In this newsletter we have tried to identify, for you how many of these problems can surface and sink a good fund strategy or fail to grow an inadequate one.

## **Hoffman, White & Kaelber Financial Services Investment Performance Update**

During October, the residential housing starts and permits numbers were reported for September. While starts reflected a rebound, permits were down better than 6% which marked the 8<sup>th</sup> straight monthly decline. And, as should be logical, permits are a leading indicator of housing starts. If the permits numbers prove to be accurate, the South could experience a much slower pace of starts in coming months. Also, it is important to note that the starts numbers are generally more volatile (erratic), on a month over month, basis than the permits numbers. The impact of this will be a continued drag on the economy.

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But despite this, much of the third quarter earnings reports came in quite strong with approximately 75% posting positive earnings surprises. While housing markets pulled us out of the last economic decline, perhaps this weakening of housing won't spread out to the rest of the economy. Especially with oil prices becoming an easing concern of late. Economic indicators like unemployment, capacity utilization and consumer confidence all seem to be telling us that the Fed has successfully orchestrated a soft landing. This could bode well for world markets as well. However, recently, China came out to state publicly that they are looking to diversify away from their significant US dollar based reserve holdings. We'll all have to watch how that scenario plays out at home and in the global marketplace. Does danger lurk in the wings? There is never a dull moment in this business.

For the month ended October 31, 2006, our one-month performance is up 0.48%, our one-year return is up 6.15%, our three-year return is up 4.90% and our average annualized return since inception is up 7.75%. Our since inception risk measures edged downwards to remain very conservative at +/- 5.75% (+/- 6.25% and +/- 5.80% for one-year and three-year measures, respectively) and our Sharpe Ratio (reward for risk taken) remains very respectable at 0.89. [For more performance information, please see our web site for details.](#)

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