

# STANDARD DEVIATIONS

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## HEDGE FUND INVESTING - THE MOVIE

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**As the numbers for hedge fund performance in 2005 slowly arrive, the meager returns will no doubt fuel even more speculation that active investment management is on the decline. At Ferrell Capital Management, we have always considered our role as a trading manager to be challenging. Where asset allocators tend to draw pictures of their portfolio investments, we see the risk allocation process as always in motion - more like a movie. After all, the nature of risks and their correlations in liquid markets are constantly changing and we recognize that our job is to use our risk management tool kit, our large pipeline of managers and above all, our experience and judgment to produce attractive returns for our investors. This piece will identify some of the concerns in the marketplace and provide our response to the business opportunities ahead.**

Now that the truth about the source of returns for many of the world's top investors like Harvard, Yale and Duke is common knowledge, there is an avalanche of investment cascading into the hedge fund space. At the same time, there are skeptics posing good questions about the ability of hedge funds to produce the glimmering results that match the past. People are concerned about the effect of regulation, the effect of the new money flows, the ease with which traders can open thousands of new funds as well as the value of fund of funds managers in the hot "asset class." These questions and others are worth answering. The answers won't please everyone, particularly those ill-equipped to play the game.

The barrier to entry to open a hedge fund is virtually meaningless. Almost anyone without a criminal record can set up a prime brokerage account and launch a fund at insignificant cost. Attractive fee structures and gullible investors have created thousands more hedge funds than necessary and as they quickly proliferate they will disappear after taking fees from their customers and losing capital. Newly imposed regulation will not prevent losses or inept managers from raising money. Those of us who participated in the trading business before taped conversations, e-mail and electronic execution remember that even in the wildest markets of the 70's and 80's, the number of disputed transactions per year were a meaningless factor in a business where many billions changed hands on a daily basis. The

industry regulates itself well by virtue of counterparties relying on their own evaluation of risk rather than an overseer telling them with whom to deal. There will always be mistakes. Regulators will rarely discover them first.

Funds of hedge funds should be key in providing the kind of trading strategy evaluation and risk allocation that makes them invaluable to investors and worth their fees. But instead, the growing trend is for the fund of funds to package terrific track records, periodically send people with clipboards out to ask annoying questions of their managers and watch their own performance drift down to LIBOR or in some cases, less. Why? Because it requires a lot of work and a risk management tool kit to actively manage a portfolio of hedge funds and most investors are ill-equipped. Moreover, hedge fund investments are not as easy to get into and out of as stocks and bonds. The subscription and redemption process is cumbersome. If an investor expects to actively subscribe and redeem managers, they also need a "deep bench" of new managers. The liquidity and profit forecast for various strategies requires a profound understanding of the markets and their correlations and risk factors that few of the "Packagers" in the industry possess. Just as there is a small universe of exceptional traders in a growing pool of traders, similarly there are few trading managers that know how to manage portfolios of proprietary traders. Why? Because portfolio construction is a complex combination of top down risk allocation and bottom up manager selection

and few have all the resources necessary to measure, analyze and make capital allocation decisions to run trading portfolios. It is also why many funds of funds are so reluctant to admit that they have taken off their asset management hats after the first experience of good performance and become pure asset gatherers. Many fund of hedge fund managers are unsure about how to allocate their investors' capital because they know little about the risk allocation process and even less about the issues facing their underlying investments.

#### HEDGE FUND VALUE PROPOSITION

So with all the legitimate issues about the industry on the table, where is the value proposition for hedge fund investing going forward?

First of all, hedge funds are absolutely *not* an asset class. They are proprietary trading accounts that actively deal in many asset classes. Unlike equity investments, they do not benefit from the underlying growth of economies, population and wealth that raise the value of equity investments over time. If there is a major disruption in the world, you can count on the mutual fund managers, whose goal is to stay somewhere near their passive benchmark, to do little, if anything. You can count on hedge fund managers, at least the good ones, to burn the midnight oil putting on trades that will benefit from the disruption. So, the first point is that equity performance depends on growth plus marginal Alpha creation by adept managers. Trading depends on pure intelligence of the manager to take advantage of market inefficiencies, buying and selling cash flows, rising and falling volatility and a myriad of idiosyncratic alignments of market prices. Hedge fund specialists use their ability to exploit security and commodity values before the market players generally discover the appropriate value to generate profit.

The key distinguishing factor that separates traders from passive managers is that the risk that defines the range of outcomes of the trader's return can be accurately measured and managed by those who understand and use the appropriate tools. Investment professionals wishing to maximize the benefit of investing in trading need a completely different tool kit from those operating in "Beta" space. The risk tools and knowledge of trading strategies requires a special set of background and judgment not always found in the universe of hedge fund investors but rather by the major investment banks that trade their own accounts. This mismatch of investment and experience is the fundamental reason behind the growth of ill-conceived and poorly managed schemes that attract money regardless of their efficacy.

Secondly, active investment management that can add uncorrelated Alpha to make investment portfolios more dependable for investment return will never go away. Diversification is too powerful and the value of compounding absolute yields from financial assets is not simply a point of view: it is a mathematical fact.

The point that Tom Friedman made last year in his popular book *The World is Flat* is less about outsourcing and insourcing and more about the second derivative of capital allocation, i.e. that the rate of change is rising at an unprecedented pace. We are changing the way we look at under-developed economies so that instead of providing the world with commodities and inexpensive blue collar labor, they are being utilized for their intellectual capital as well. What we know about just about everything is influenced by a continually broadening set of criteria. Hedge funds provide an exciting window to the shifts in the marketplace that impact the way we live. Unlike the past several decades when western investors waited impatiently for Lesser Developed Countries to develop, there is now real opportunity for many poorly developed economies to become global players.

At Ferrell Capital, we are very bullish about the business because our risk management heritage is on the front page and we have built the platform to grow. While far too much money is chasing the traditional spreads in the industry, there are new opportunities opening on a continuing basis. The value proposition for many hedge funds is a fleeting dependence on a handful of profit opportunities in the marketplace. The fact is that the high level of profit opportunity for the hedge fund managers often ultimately works against them. They make a lot of money and become complacent. Over a period of time, others figure out the dependent profit patterns and they vanish. That is when it's time to move on to fresh approaches. Many active investment managers run more money than they deserve and will probably be figured out at some future point when investors tire of poor performance. These changing risk/reward patterns will continue to evolve requiring managers to constantly improve measurement and analytic tools for ongoing risk allocation.

At Ferrell Capital, we will continue to rely on our ability to source an ever-growing pipeline of high quality hedge fund managers who have demonstrated their ability to adapt to the vagaries of the marketplace. We will maintain an appropriate level of supervision over our investments because we never want the fate of our franchise to be threatened by factors of which we are unaware.

At the end of the day, we realize that the risk we need to be concerned about over all else is not equally weighted with a bureaucratic checklist. Our franchise is based on our ability to continually allocate the risk capital entrusted by our investors to the most reliable sources of absolute return we can find. We will continue to conduct research on Portable Alpha, play our “Where’s Waldo” game to find sources of Beta correlations and exponentially decay return streams analyzed in our proprietary Heat Map<sup>SM</sup> and Marginal Sharpe<sup>SM</sup> calculations. Most importantly, we will attract investments based on our “Ferrell Investment Relevance Analysis” that shows potential clients the impact they can expect from an allocation to our Ferrell Concert Fund. We are uniquely qualified to run client portfolios through our risk analytics, identify risk allocation mismatches and opportunities and harness our strategy to improve performance.

In conclusion, Alpha is hard to find but still available. The choices for Alpha seekers are clear. Either invest in staff, risk allocation tools and buy hedge funds directly or invest with a fund of funds manager with trading management skill and experience. In any case, they should be certain that they pay professionals that have the right tool kit for risk allocation and have the experience and the judgment to make qualified decisions. Alpha space is different and in many ways more predictable than Beta based investments.

There will always be price movements in markets suitably liquid for our consideration. We believe it is a challenging and intellectually satisfying business to participate in the movie that separates our management style and performance from competitors still focused on last year’s picture.

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