

Act III

Life Is Like a Box of Chocolates

Alexander Ineichen

December 2009

Once upon a time, not so long ago, there was a bear named Winnie-the-Bear who lived in the Trillion Acre Wood. On some level, he was a silly old bear. Nevertheless, he was wondering what the fuss about hedge funds was all about. He invited his two best friends, George Jones, the famous hedge fund manager, and Ben Put, the famous academic and central banker since the 1980s, to the Trillion Acre Wood for a third chat on hedge funds.¹

Winnie-the-Bear Thanks again for joining me. Hedge funds were unduly demonized. I think I got that. But what really is a hedge fund?

Ben Put Hedge funds are mysterious investment pools for well-heeled investors, who seek very high returns by taking very great risks. Hedge funds are run by sinister men who go around kicking dogs, taking candy from babies, and making massively leveraged bets in the equity markets.

Winnie-the-Bear This is utter nonsense, right?

George Jones Of course. A hedge fund is a money manager who manages risk actively.

Winnie-the-Bear ... That's it?

George Jones That's it. You see, Winnie, in traditional money management the risk of the portfolio is determined by the benchmark, not the skill of the

¹ *LaRasmussteinmontians in Yellowstone Park, Act II, November 2009; A Green Pig Down Wall Street, Act I, October 2009*

manager. The so-called long-only, buy-and-hold investment approach does not allow the manager to materially control for risk where risk is defined as losing money. The safety of principal is not the manager's responsibility. That's why the traditional long-only approach is sometimes referred to as a buy-and-*hope* strategy.

Winnie-the-Bear

Hope? ... Sounds presidential.

Ben Put

Hedge funds are short-term traders, not long-term investors. They're speculators.

Winnie-the-Bear

Is that so? I heard that *more money is lost by people who attempt to invest their money conservatively and sanely, but ignorantly, than is lost by those who enter into frank speculations.*

George Jones

The reason why hedge funds are perceived as short-termist is because they are not indifferent to financial losses. To them, a Green Pig—which I was told is sometimes also referred to as a Black Turkey—could be just around the corner. They do not use a long-term investment horizon as an excuse for screwing up in the short-term.

Winnie-the-Bear

Yes. As the famous Überphilosopher once said: *Life is like a box of chocolates, you never know what you're gonna get.* Everyone knows that.

George Jones

Exactly. *Active risk management* means you need to respond to changing circumstances.

Winnie-the-Bear

Sounds reasonable. *When circumstances change, I change my view. What do you do Ben?*

George Jones

To absolute return cognoscenti Keynes' statement is rather obvious: If circumstances change you need to do something about it rather than hug your arbitrary benchmark. If accidents happen in the short-term, one might not live long enough to experience the long-term.

Winnie-the-Bear

As in the long-term, we're all dead. I understand that. *Time is the greatest teacher. Unfortunately, it kills all of its pupils.*

George Jones

Of course. Or as Mark Twain put it: *Good things arrive unto them that wait – and don't die in the meantime.* After all, the long-term is nothing else than many short-term periods adjoined together. If the models at

CERN are as good as the models in high finance, you really need not worry about the long-term anyway.

Winnie-the-Bear

Funny, isn't it. *People sometimes have the attitude that 'Gaia will look after us'. But that's wrong. If the concept means anything at all, Gaia will look after herself. And the best way for her to do that might well be to get rid of us.*

George Jones

There is still a lot of myth with respect to hedge funds. Much of it is built on misleading anecdotal evidence, oversimplification, overgeneralization, myopia or simply a misrepresentation of facts.

Winnie-the-Bear

Human nature, isn't it? *Men occasionally stumble over the truth, but most of them pick themselves up and hurry off as if nothing had happened.*

George Jones

Exactly. Although hedge funds are often branded as a separate asset class, a point can be made that hedge funds are simply asset managers executing other strategies than those used by their long-only brethren. The major difference between the two is the definition of their return objective: Hedge funds aim for *absolute returns* by balancing investment opportunities and risk of financial loss. Long-only managers, by contrast, define their return objective in relative terms. They try to beat a moving target, their benchmark. The funny thing is, with their own money *relative return* managers care about *absolute returns* too.

Winnie-the-Bear

Absolute returns? Sounds interesting. Someone should write a book on this. But hold on, if you hedge all the risk, don't you also hedge away the return?

George Jones

Yes. You need to strike a balance between taking risk and controlling it. It's like car racing. You need both, torque and brakes.

Winnie-the-Bear

Take calculated risks. That is quite different from being rash. I think I understand. So hedge funds are not perfectly hedged at all times. I'm not sure everyone knows that. Makes sense though. *A ship in port is safe, but that's not what ships are built for.*

George Jones

Yes. A hedge fund is trying to find a balance between seeking and exploiting opportunities in an entrepreneurial fashion while continuously controlling risk of substantial depreciation of principal. It's all about

braking sharply immediately ahead of the curve and accelerating smoothly but decisively coming out of the curve.

Winnie-the-Bear

One could easily argue that this is what investing has been about all along, no?

George Jones

Yes, one could; easily. Benjamin Graham—arguably an authority on the subject—was quoted saying: *The essence of investment management is the management of risks, not the management of returns*. The torque is required to generate the positive returns in a competitive environment whereas the risk management bit—the brakes—is for controlling the losses and staying alive. If all goes well, the end result is an *asymmetric return profile*, that is, the positive compounding of capital over time.

Winnie-the-Bear

Asymmetric returns? Sounds interesting. Another book topic, I'm sure.

George Jones

The word *active* in *active risk management* is rather important. The reason for the word *active* in *active risk management* being rather important is that circumstances always change. Risk is really *exposure to change*. Everything ends eventually. *Civilization is an interlude between ice ages*. Extinction is common in business and in life. 99.99% of all biological species that have ever existed are now extinct. On a somewhat shorter timescale, most businesses fail. Even large, successful, monopolistic corporations are not secure.

Winnie-the-Bear

As we now know.

George Jones

Not only species and corporations fail; policies and governments fail too. This is referred to as the *Iron Law of Failure*.

Ben Put

I've never thought about it like that.

George Jones

I know. The parallels between species, people, firms, governments and, of course, hedge funds are striking in terms of failure. They are all complex entities that try to survive in dynamic environments which evolve over time but eventually fail. Despite striking parallels between the social and economic world and the world of biology, there is a fundamental difference between the two: the process of evolution in biological species cannot be planned. In contrast, in human society, individuals, firms and governments all strive consciously to devise

successful strategies for survival. They adapt these strategies over time and alter their plans as circumstances change.

Winnie-the-Bear Got that. *It is not the strongest of the species that survive, nor the most intelligent, but the one most responsive to change.* And you call the *adaptive* bit *active risk management*?

George Jones Yes. Responding to change as opposed to ignoring it. Going uphill you need more torque and less brakes. In long-only asset management you only have torque but no brakes. However, what goes up can fall too. Going downhill you need more brakes and less torque.

Winnie-the-Bear Believe it or not, I actually knew that. *When you are finished changing, you're finished.* However, hasn't the risk management profession lost a little bit of its credibility during the past crisis? I understand that some banks in the US and elsewhere had thousands of risk managers on their payroll.

George Jones Well, yes and no. It is actually true that some banks had thousands of FRMs on their payroll....

Winnie-the-Bear FRM as in *Flying Ravioli Monster*?

George Jones No. FRM as in *Financial Risk Manager*. There is a parallel between finance and *Pastafarianism*, but trust me, you don't want me going there.

Winnie-the-Bear I know, I know. *People readily believe what they want to believe.* You people are weird. When three million people are starved and murdered in the Congo, most people can't be bothered. When a princess dies in a car accident, however, a quarter of the earth's population falls prostrate with grief.

Ben Put That was weird, wasn't it? Guess that the models that assume we've descended from homo oeconomicus weren't the pinnacle of wisdom after all.

George Jones The reason for the risk management profession's failure is that the profession confused risk *measurement* with risk *management*. All the books in Ben's library which claim to be on the topic of risk management are in fact about how you *measure* risk. Since risk is measureable and uncertainty is not, and it is the latter that gets you killed, the literature is

not only useless; but also dangerous, as it gives market participants a false sense of security.

Winnie-the-Bear I think I understand that. *Not everything that can be counted counts, and not everything that counts can be counted.*

Ben Put I've never thought about it like that.

Winnie-the-Bear I know. *Thinking is to humans what swimming is to cats – something we can do if absolutely necessary, but we'd really rather not.*

George Jones In addition to misleading literature, the advent of the computer and its ever increasing power has done some real damage too. Many investors thought that it replaced *reasoning* when making forecasts. *I am not computer sophisticated enough to make complex, elegant models to produce a forecast. I shall leave that to the likes of LTCM's Nobel laureates... oh, wait, they've blown up, depending upon their computer models. Oh, ok then, we'll leave that to the good folks at Lehman Brothers' economics department with their sophisticated computer models. Oh, wait, they've blown up too, as their models went awry? Then surely Bear Stearns widely acclaimed mortgage backed operation will have the models and sophistication necessary to make an elegant and reliable forecast, won't they? Oh, they're gone also? Darn! Well then, perhaps the Ph.D dominated economic forecasting prowess of the IMF can be drawn upon? Oh, wait! They...*

Winnie-the-Bear I think you made your point. *Science gives us knowledge, but only philosophy can give us wisdom.* Move on please.

George Jones The debate between risk management and measurement is somewhat a contrast between science and street-smartness, i.e., the ability to *read* one's market and gain insight and understanding from observing what is going on *pragmatically*. It's the difference between knowledge and understanding. One example of the divide between science and street-smartness is the unfolding of the Boxing Day Tsunami of 2004 off the west coast of northern Sumatra. All the science of Western civilization did not help to foresee the earthquake or prevent devastation and death. One interesting aspect of this tsunami was that hardly any members, if at all, from the aboriginal tribes were killed. They were able to conclude from the behavior of the animals that something bad was about to strike

and they moved inland prior to the disaster. They knew their market and *read* the signs correctly. They were what I believe is best described as *savvy*.

Ben Put This is an extreme example.

George Jones Yes, it is. However, it demonstrates that some aspects of risk are not measurable with conventional scientific means such as value at risk, stress tests, scenario analysis, extreme value theory, and all that. Survival strategies might or might not involve science.

Winnie-the-Bear I know. *In theory, theory and practice are much the same. In practice, they are not.*

George Jones Absolutely. Mathematics allows you to frame the problem but might or might not be helpful with the solution. In the recent financial tsunami it has become apparent that it is the *decision maker* who is the risk manager, not the department in the other building that *measures* risk scientifically down to four decimals. Risk management is not a science, neither is it art, as it is sometimes claimed. It's a *craft*: you learn it on-the-job. It's all *learning by doing*.

Winnie-the-Bear I know that. *Success is going from failure to failure without a loss of enthusiasm.* Someone once told me *don't let schooling interfere with your education.*

George Jones Your witticisms apply very well to the profession of risk management Winnie. Economics and financial economics at the academic and especially theoretical level have become purely mathematical and hardly assessable for practitioners. This is often referred to as *physics envy* that describes applying mathematical rigor to a science to make it look more like physics—the mother of all sciences—irrespective of whether it makes sense or not.

Winnie-the-Bear *Nonsense is good only because common sense is so limited.*

George Jones Absolutely. The observation that the mathematical rigor that makes sense when examining the motion of planets or molecules might not apply to some of the social sciences was somehow overlooked by the mainstream. In his acceptance speech when picking up the Nobel Prize in 1974, Friedrich Hayek argued against the use of the tools of hard science in the

social sciences. Potentially a case could be made that financial economics is not only in need of an overhaul with respect to finding new ways of explaining the Darwinian fight for survival under competition but also a simplification of the theories for them to be of value to practitioners making decisions under uncertainty. We ought to simplify.

Winnie-the-Bear

I like that. *Any intelligent fool can invent further complications, but it takes a genius to retain, or recapture, simplicity.*

George Jones

Absolutely. *Confusion is often the last redoubt of the high minded, the intelligentsia and academia. I prefer the simplicity of Audrey Hepburn's simple black dress to the egregious tastelessness of designs by modern day designing madmen.*

Ben Put

Rubbish. Risk management needs to be *independent*. Everyone knows that.

George Jones

Everyone *thinks* that Ben. Yes, it is the consensus that risk managers need to be independent from the risk taking, have no skin in the game, and have no clue what is going on in the market place. However, it's wrong. Warren Buffett explained the craftsmanship that is risk management very well in his most recent annual report. When he took over a company that had a very large and complicated derivatives book a couple of years ago, he downsized the whole thing to the point where he could *understand* it because true *risk is not knowing what you're doing*.

Winnie-the-Bear

This seems obvious, does it not? *Either you understand your risk or you don't play the game.*

George Jones

It *does* sound obvious, doesn't it? The reason for downsizing and reaching an *understanding* of risk is that it is *he* who has the responsibility, no one else. If money is lost, it's *his* fault. You cannot outsource responsibility. But that is exactly what the consensus and some honorable gentlemen in Basel suggest and how banks are handling the situation: trying to hand responsibility to a group of twenty-somethings with math degrees.

Winnie-the-Bear

I'm sure they're all very nice people. And by the way, outsourcing responsibility gives you more time to play *Bridge*.

- George Jones Yes, they are nice people. But that's beside the point. The point is that banks have become too large for the chieftain to understand the whole risk to the organization. Decisions are made by committees. But a group of yes-men do not make good investment decisions nor are they very keen to waive red flags.
- Ben Put To be fair, George, there were cases where the twenty-somethings actually knew *and understood* the risk but were perceived by the management committees and board of directors as eggheads and their warnings ignored.
- George Jones That's part of the problem Ben.
- Winnie-the-Bear I think I understand. You're saying that with hedge funds there is no disconnect between the people with the *responsibility* and the people who *understand* what is going on.
- George Jones Essentially, yes.
- Winnie-the-Bear Will need to think about this a bit. Makes sense though. Anything else?
- George Jones Another area where the risk management profession went wrong is that it seeks answers. This is wrong. After 10,000 years of civilization and philosophical thought we actually do now know the answer *to life, the universe and everything*.
- Ben Put Which is what?
- George Jones 42
- Ben Put 42?
- George Jones 42, yes. The point is, Ben, that the answer has little or no meaning. The questions are the key, not the answers.
- Winnie-the-Bear Gotcha. *Wisdom is not a product of schooling but of the lifelong attempt to acquire it...The important thing is not to stop questioning.*
- George Jones Of course. Risk management is a *thought process* in which constant questioning *is* the task. Risk management is a philosophical endeavor not a mathematical riddle. Markets are made of people, who are influenced by events, by their feelings and beliefs about events and by their expectations of other people's feelings and beliefs. As Bernard Baruch

put it: *Anyone taken as an individual is tolerably sensible and reasonable – as a member of a crowd, he at once becomes a blockhead.*

Winnie-the-Bear Yes, I understand. *Successful investing is anticipating the anticipations of others.* That's were Keynes' wet T-shirt contest comes in, right? What was that all about anyway?

Ben Put Keynes described the action of rational agents in a market using an analogy based on a fictional newspaper contest, in which entrants are asked to choose a set of six faces from photographs of women that are the most beautiful. Those who picked the most popular face are then eligible for a prize. A sophisticated contest entrant, wishing to maximize his chances of winning a prize, would think about what the majority perception of beauty is, and then make a selection based on some inference from his knowledge of public perceptions. This can be carried one step further to take into account the fact that other entrants would each have their own opinion of what public perceptions are, and so on.

Winnie-the-Bear George?

George Jones What Ben is trying to say is that *a mob has heads enough but no brains.* There are no fundamental laws in finance. However, look at all the financial textbooks. You wouldn't intuitively think that they deal with people. All our business textbooks on finance are built on stilts of mathematical axioms that are untrue when dealing with people. I don't think the word "trust" appears once in all the orthodox financial textbooks I flipped through and binned. However, if there is an axiom in business in general and investment management in particular, it's trust.

Winnie-the-Bear I know that. *Human beings, who are almost unique in having the ability to learn from the experience of others, are also remarkable for their apparent disinclination to do so.*

George Jones Did you know that under Uciits III one can create a portfolio with a VaR of 20% at the 99% confidence interval for a one month period, that is, a portfolio that is more risky than the one LTCM had before it blew up?

Winnie-the-Bear Shocking, isn't it? I have absolutely no clue what you just said; but, nevertheless, it's shocking.

Ben Put Some people are in for a big surprise then.

- George Jones Yes. The first principles of finance are wrong. Warren Buffett once joked that he would like to fund university chairs in financial orthodoxy, so that the professors would train even more misguided financiers whose money he could win.
- Winnie-the-Bear ... as in zero-sum game. That's funny. Is that the reason why successful hedge fund managers donate money to formal education and their alma mater?
- George Jones Of course.
- Winnie-the-Bear So you're essentially saying that if all the *assumptions* of a model are wrong then the *conclusions* must be wrong too.
- George Jones Of course. GIGO [garbage in, ...] applies. Different endeavors, as Aristotle wrote, require different degrees of precision. Abstract theorizing in finance is like learning the Kama Sutra by heart but not being able to find a spouse.
- Ben Put I think that's generally referred to as *suboptimal*.
- George Jones Finance is not one of the natural sciences; neither is economics. Textbook economics is like physics in the 6th century. Back then, people thought that the sun circles the earth because a seriously looking chap with a beard said—probably in a Monty Python-esque manner—it was a jolly good idea. The then-models became ever more complex as observation over observation over observation failed to meet predictions. So the sophisticates of the time added layer upon layer upon layer of complexity for the models *to fit* the real world.
- Winnie-the-Bear Why does this sound familiar?
- George Jones It's the same in economics and finance. There is evidence upon evidence upon evidence that the world does not function according to how the theory suggests it should. Neoclassical economics assumes human behavior as universal laws and creates increasingly complex econometric models to defend the priesthood, that is, rationality and market efficiency.
- Ben Put So George, you're saying the financial crisis is to *efficient market theory* what Copernicus' insight was to the Ptolemaic world view?

- George Jones Well, I'd actually say that efficient market theory is to investment management what the stork-theory is to family planning, but yes, you got the gist of it. Geocentric models were eventually binned and replaced by heliocentric models. In finance and risk management we are in a state where a large majority of practitioners *and* academics actually agree that what is taught is wrong.
- Winnie-the-Bear *It is a miracle that curiosity survives formal education.*
- George Jones Here's a true story for you Winnie: A well-respected financial professional stands in front of an audience of 150 teachers of finance. He asks them by the show of hands who actually *believes* in the efficient market theory.
- Winnie-the-Bear *I have noticed that everyone who has ever tried to tell me that markets are efficient is poor. How many?*
- George Jones About three or four people raised their hands. Then he asked who actually *teaches* the efficient market theory. Guess what happened?
- Winnie-the-Bear Dunno.
- George Jones All hands went up.
- Winnie-the-Bear You're joking.
- George Jones Nope, true story. In academia, *form* beats *content*. The way the research is conducted and presented is more important than getting it right. In addition, academics are not held responsible for getting it wrong which is in stark contrast to absolute return investors. Most often the academic study is based on a methodology that applies to the model world but has no meaning in the real world. In academia, ideas need to be presented in an orthodox way to be published in a scientific magazine. Have I told you about the hoax yet?
- Winnie-the-Bear What hoax?
- George Jones A couple of years ago a French physicist wanted to know whether he could write an article that was scientific in *form* but was complete nonsense in terms of *content* and then get it published by a reputable scientific magazine. The title of the paper was *Transgressing the*

Boundaries: Toward a Transformative Hermeneutics of Quantum Gravity.

Winnie-the-Bear

Sounds like nonsense to me.

George Jones

It was complete nonsense. Guess what happened?

Winnie-the-Bear

Dunno.

George Jones

It got published.

Winnie-the-Bear

You're joking.

George Jones

Nope, true story. The paper was a hoax. The article was accepted and published. The author immediately revealed the hoax, provoking a firestorm of reaction in both the popular and academic press. The idea behind the "test" was to show how science is apparently abused. He argued that the most common tactic is to use scientific or pseudoscientific terminology without bothering much about what the words actually mean.

Winnie-the-Bear

I guess *common sense counts for way more than pure intellect*. This is the case despite the seeming oversupply, after all, *common sense is the best distributed commodity in the world, for every man is convinced he is well supplied with it*.

George Jones

Absolutely. Another observation the physicist wanted to illustrate is the current importing of concepts from the natural sciences into the social sciences without giving the slightest conceptual or empirical justification.

Winnie-the-Bear

What you say actually makes a lot of sense. *Investment is by nature not an exact science*. I always thought there was something wrong with me when I tried to digest an academic paper on hedge funds. Guess there're many academics out there trying to play a hoax on me.

Ben Put

Hedge funds provide *beta* that is cleverly marketed as *alpha*. Hedge fund *replication* makes hedge funds obsolete. If there is an area in which hedge funds really excel it is marketing.

Winnie-the-Bear

George?

George Jones

In the investment management profession we became accustomed using terms such as *alpha* and *beta*. These terms stem from models that are now

nearly a half a century old. These models from the 1960s often imply linearity, that security prices are normally distributed, that markets are frictionless, that we can all execute our orders at the market price, and that we do not need bother with such vagaries as paying transaction costs or taxes. Whoever suggested that the notion *alpha* is an intelligent way to describe what investors are searching for in relation to investing in hedge funds, I have no clue.

Ben Put

What's your point?

George Jones

Hedge fund replication is to the intelligent investor what Beavis and Butthead is to educational science. I believe that one of the most important words in investment management, that—interestingly but perhaps not surprisingly—is not given much airtime in financial textbooks, is *conviction*.

Ben Put

Given the number of hedge fund managers on the way to prison, that makes perfect sense.

George Jones

I'm referring to 'conviction' as in *confidence*, rather than its legal use. Yes, you do see the occasional financial professional taken from his home on a Saturday morning at 6am in handcuffs. After a crisis the authorities need a very public *photo op* and a scapegoat—often indicted on flimsy evidence taken out of context—to brush over their supervisory failure. Sometimes the scapegoat is a hedge fund manager. More often than not these scapegoats are acquitted some time later when the world's attention has moved on. Ask Ed Thorpe what he thinks of Rudy Giuliani in this regard.

The reason for the word *conviction*—as in confidence—not given much airtime in financial textbooks is because it is not quantifiable and it is rather difficult to describe.

Winnie-the-Bear

Try.

George Jones

Take hedge fund replication for example. The intelligent investor knows from the start of the hype that the ideas behind hedge fund replication are nonsense and we—the intelligent investors who believe that the ideas behind hedge fund replication are nonsense—have quite strong *conviction* in our views. However, it is difficult to elaborate other than through common sense, which is—of course—ambiguous...

- Winnie-the-Bear ... and not equally distributed. *Only two things are infinite, the universe and human stupidity, and I'm not sure about the former.*
- Ben Put So George, you're saying the buyers of these cloning products are scientifically-minded lemmings, who believe markets are efficient and frictionless, and think that risk premiums can be picked up cheaply and in general they lack common sense?
- George Jones Essentially, yes. However, there are hardly any buyers. The imaginary friends of the cloners have not yet put on their buying boots and bought. The product hasn't taken off. Becoming rather cynical as I grow older, I'm tempted to argue that the more professors in the field of finance rubber stamp a product, the higher is my conviction in avoiding it.
- Ben Put That's preposterous.
- George Jones I know. I apologize. Am sure it's just me.
- Winnie-the-Bear It seems you are going down a slippery slope here George. After all, *convictions are more dangerous foes of truth than lies*. Why are you so negative on this cloning idea? Wouldn't it be nice if we could turn *lead* into gold? Wasn't there a lady once who could spin *straw* into gold? Where is your sense of history?
- George Jones What hedge funds do is best described as *active risk management*, as mentioned earlier, and Rumpelstiltskin's daughter might or might not travel all the way to Oslo to pick up a prize. Active risk management is a task where you must look ahead, not back. The past might or might not be prologue to the future. You need to *understand* the past, not extrapolate it. Thinking about the future is a creative task. You need imagination. You cannot buy Steve Job's biography, type some of the parameters into an Excel spreadsheet and then go on and expect your laptop to run *Apple*. The world just doesn't work like that. Producing profits while actively managing the risk of loss of principal is more difficult.
- Winnie-the-Bear Wasn't there an academic paper out recently that suggested that at least some of the clones haven't done so badly?
- George Jones Yes. The report based it's analysis on a thirteen month period.
- Winnie-the-Bear Isn't that a little bit on the short side?
-

- George Jones Yes, it is a little bit on the short side, isn't it? And it is based on a period where there was hardly any money in the products which reduces the practical applicability further. Another academic report, by the way Winnie, labeled these products as *systematically inferior* to real hedge funds. That makes academic research in the field of investment management so tremendously helpful: for every claim, a counter claim can be found quite easily.
- Winnie-the-Bear Thought that might be the case. I recently came across an academic paper that suggested—in essence—systematic funds were better than discretionary managed funds based on some metric that made no sense to me. So you're saying it's quite easy to find a paper suggesting that discretionary funds are superior to systematic funds based on some other arbitrary metric, right?
- George Jones Yes. The choice of metric determines the conclusion of your examination.
- Winnie-the-Bear So you're saying it's not only *caveat emptor* but also *caveat lector* [reader beware]?
- George Jones Yes, of course.
- Winnie-the-Bear I get it. You need to think for yourself. We talked about this the last time. Where does your conviction come from, in general or in the case of hedge fund replication?
- George Jones As I said, it's difficult to explain. I guess it's a mix of intuition and experience. Obviously, the two are interrelated. Perhaps it's a sound and healthy world view, I'm not sure. Take magic, for example. I have seen hundreds of magicians perform in my years and I'm still flabbergasted every time I see the old trick with the rope. However, every time I see a magician cut an attractive female assistance in half, I have great conviction that he didn't *really* cut her in half. It's a trick. Even if I do not know exactly how the trick works. Apart from having no inclination to cut an attractive female assistance in half myself, my intuition, experience and world view tell me, it's a trick. And—which of course is terribly unfortunate and a complete failure on my part—I cannot prove it mathematically. I just know with a very high degree of conviction that the

attractive female assistance is well off and can go on doing whatever it is that attractive female assistances do when they have not been cut in half.

Ben Put

So academics in the field of finance are magicians now?

George Jones

To some extent, yes. Just without the entertainment bit. What the hedge fund replicators do is essentially put some historic time series into a hat, shake it, and pull out an algorithm and then go on and claim they have a meaningful product. They of course would never invest their own money in the product, but for their clients they claim it's the new black.

Winnie-the-Bear

Sounds like hedge fund replication is the financial equivalent to *Marmite*; you either love it or hate it. You mentioned that conviction is so important in investment management. How do I get *conviction*? What marks a good investor anyway?

George Jones

Conviction you get through research.

Ben Put

And this is not a self-serving comment at all, is it?

George Jones

Not at all. Thoughtful research should give you insight and understanding which then goes on to increase your conviction in a certain idea. It boils down to knowing what you're doing. It means sophisticated investors—or shall we say more determined investors—who have done the research are more likely to be able to pick up the various liquidity and complexity premiums. They will be making better investment decisions. The investors who do not do the research do not have the required conviction and stamina; and it seems to me, there is a tendency that they arrive late to the party, that is, buy high and sell low. In my experience, every theme, trade, or strategy has a beginning and an end. It's not enough to get the entry right; you need to get the exit right too.

Winnie-the-Bear

Am not sure I got that.

George Jones

The bottom line is, Winnie, you need to know what you're doing. You need to apply *reason* to acquire *understanding*. This takes an effort. If you want to gain insight in the supply and demand of the market for cotton for example, it is not enough to just study a Victoria's Secret catalogue; you need to dig deeper. When examining stocks you need to look for a catalyst that causes revenues of the stock to rise ...

- Winnie-the-Bear Like what? Buying pharmaceutical stocks ahead of the *Tour de France*?
- George Jones For example, yes. Again, you need to have some insight, special knowledge, or edge. Otherwise you're doomed to do the classic mistakes of which buying high and selling low is just one example. Have you ever heard of the *Knowledge-Pyramid*?
- Winnie-the-Bear Do I look like Robert Langdon to you?
- George Jones The Knowledge-Pyramid symbolizes a five-layered pyramid where the base is *data*, the next layer is *information*, then comes *knowledge*, then *understanding* and the capstone at the top is *wisdom*. Let me draw it in the sand for you.
- Winnie-the-Bear Looks nice. A question of time until someone uses a symbolized knowledge pyramid as a corporate logo, I'm sure. Isn't the more data the merrier?
- George Jones Not at all. Take economics data in the US and elsewhere as an example. The authorities have been bombarding investors with ever more data on how to slice and dice the economy. However, the volatility of the revisions has increased and the *trust* in the numbers by the market place has decreased. It's not just that the authorities came up with funny ways for measuring inflation or unemployment statistics that excluded—well—the unemployed; the numbers often do not pass the smell test. More and more investors prefer anecdotal evidence or shadow stats over misleading, over-hyped, prone-to-revision, and late official data.
- Winnie-the-Bear What's the bottom line George?
- George Jones Less can be more. Apply common sense, question orthodoxy, think for yourself, and understand the axes of other market participants. It is understanding, insight and—ideally—*applied wisdom* that investors should aim for. As one Über-hedge fund manager—or shall I say philosopher—keeps saying: *As an investor, as long as you understand something better than others, you have an edge.*
- Winnie-the-Bear This makes sense. Information and knowledge I get at school or from reading clever books. *The schools are not nurseries of progress and improvement, but conservatories of tradition and unvarying modes of*

thought. It is understanding and wisdom—quite often in form of unorthodox ideas and perspectives—that improves my investment decisions.

George Jones Exactly. And that's why the price and value of the base of this pyramid is low and the price and value increases as you rise to the top of the pyramid. Data, information and knowledge from formal education is but a stepping stone to acquire understanding, insight, and wisdom. A book in finance costs peanuts whereas one lunch with Warren Buffett costs millions. That's the market pricing the difference between knowledge and wisdom.

Winnie-the-Bear Tell me, George, if an investor thought very hard about investing in hedge funds throughout the *naughties*, watched the sector compound capital at a double digit rate, invested in 2007 and then panicked in 2008 and redeemed; how would you call that?

George Jones Suboptimal.

Winnie-the-Bear Weren't investors misled? After all, hedge funds are not transparent, are they?

Ben Put Right. That's a big negative.

George Jones It is true that *government sponsored systemically important enterprises* are more transparent than are hedge funds. Did it help? It isn't the lack of data, information and knowledge that is the problem. The problem is a disconnect between *knowledge* and *understanding*. All the information in the world is of no use if you do not *understand* what it means.

Winnie-the-Bear And this gap can be closed through thoughtful research?

George Jones Yes. If not through thoughtful research, *what else?*

Winnie-the-Bear We haven't touched on business ethics yet. I get the impression that financial professionals are quite a greedy bunch whereas everyone else seems humble, honorable and nice.

George Jones No one is indifferent as to how much they get. We know that all living creatures on the planet actually prefer more over less. The reason for this is that if you have too much of something you can dispose the part you

don't need. However, if you don't have enough—say food, air, money, etc—your survival is at stake.

Winnie-the-Bear *The animal gorges himself because he does not know when he may find food again; this uncertainty is the origin of greed.*

That's a lame argument though.

George Jones I know. Was worth a shot.

Winnie-the-Bear So, George, what's your outlook; not for life, the universe and everything, but for the hedge fund industry and it's investors?

Ben Put Am sure he's bullish.

George Jones I am. Surprised you noticed. Ten years ago, LTCM—a large hedge fund that resembled a highly leveraged risk wholesaler—collapsed. In the aftermath, the hedge fund industry was pronounced dead. Fast forward ten years. Another financial crisis involving excess leverage and government rescue. Again hedge funds are at a popularity trough. *The past may not repeat itself, but it sure does rhyme.* In the aftermath of 1998, a year or two after the dust had settled, institutional investors started to examine hedge funds and slowly but steadily and decisively started to invest. I can imagine that the 2009-2014 period could resemble the 1999-2004 period with respect to institutional involvement in hedge funds. The financial news headlines and institutional interest and flows in the second half of 2009 already resemble 1999 in that regard.

Winnie-the-Bear What caused interest in hedge funds to rise from 1999 onwards?

George Jones Mainly the dim outlook for equities at the beginning of the decade and the search for yield and uncorrelated returns. Note that the dim outlook at the beginning of the decade was justified. The decade ends this month and many equity markets are down for the whole decade, both in real and in nominal terms.

Winnie-the-Bear So this was a *lost decade* then?

George Jones Yes, or a *loss decade* for the long-only equity investor. The US stock market, for example, started the decade at 100 and will end it at around

80. The average hedge fund investor on the other hand started the decade at 100 and will end at around 180.

Winnie-the-Bear

That's a big difference. It seems to me that all the fuss about hedge funds might actually be worth it.

George Jones

Yes. The funny thing is that hedge funds seek *absolute returns* but it is their *relative returns* that put them on the agenda of the institutional investor. Given that most investors are expecting that both equities and bonds will continue to experience extreme volatility in the next decade, the value proposition of hedge funds—upside optionality while actively controlling potential loss of principal resulting in continuous positive compounding of capital—looks rather attractive *relative* to everything else.

Winnie-the-Bear

But you're also saying that if history repeats itself, the last ones to invest—the late longs—will get smoked again, right?

George Jones

Yes, of course.

