Hedge Fund Investing In A Post 2008 World

Investing is not for the faint of heart. Neither is it for the psychotic risk taker. Investing requires balance, rationality and a good deal of detached and independent thinking. So don't listen to me. Figure it out for yourselves. Here are a few common declarations by investors and a few (loaded) questions they should ask.

We will only invest with managers who did well through 2008. Did 2008 represent normal conditions? What is the probability that the liquidity conditions of 2008 repeat themselves? How does one manage around this probability? What is the opportunity cost of assuming a high probability say > 20%?

We will never invest with any manager who suspended or (gated) restricted redemptions in 2008. Would it have been preferable to have a firesale, or an orderly liquidation? Would it have been fair to all investors both those who want out and those who want to remain invested? Was the manager protecting their own franchise or exercising due care in discharging their fiduciary duties?

We were surprised and disappointed at the behaviour of the manager in 2008. Did one understand what the manager was doing prior to crisis? Leading into the crisis? Did one understand what the manager was facing in the midst of the crisis? Coming out of the crisis? To the extent that one is comfortable investing in distress investing funds, does one see some parallels between gating and suspension and the Chapter 11 reorganization process?

We will only invest with liquid funds. Does one need the liquidity? If the only time one needs the liquidity is in a crisis then is seeking partially liquid investments which end up illiquid in a crisis the right strategy? An illiquid strategy or portfolio offering liquid fund terms is usually a failure of asset liability management, but how about a liquid strategy or portfolio with less liquid fund terms? Is it fair for a manager to demand some level of stability of assets for business stability reasons?

We will only invest with managers who have a long and consistent track record. How does one differentiate between skill and luck? Track records are the result of the combination of skill and luck. How many teaspoons of skill were added to how many thimblefuls of luck? See my coin tossing experiment.

We will only invest with managers with a record of making money on the short side. We will not invest with managers who use futures to short. Does it matter how the pasta is made if it is healthy, non toxic, hygienically prepared and tastes good? Or perhaps the diner would like to take a turn as cook?

We will never invest in managers who are short volatility. Is a short volatility portfolio always vulnerable to tail risk?

We always want the manager to have substantially all of his liquid net worth in the fund. Would you put substantially all of your net worth in your portfolio of hedge funds? Is such a manager diversifying their own personal portfolio sufficiently? What does this say about the risk aversion of the manager, their confidence in themselves and their propensity to take risk in the fund?

We will not invest in highly levered funds. In fixed income arbitrage, what level of leverage is acceptable and what is typical? In a futures based portfolio, how do you define leverage? What does margin to equity tell you about sensitivity of the NAV to fluctuations in the underlying markets?

We like to invest in market neutral funds. What market is the portfolio and the underlying positions neutral to? In credit for example, is the spread neutrality matched across the term structure?

We seek a fund with percentage of winning months over 90%, volatility below 3%, average returns of 11-12%, drawdown of no more than 1%, an 18 year track record, assets under management of several billion USD, monthly liquidity and fees of 1 and 20. Does one require an independent custodian and administrator? Does the fund sound familiar?

Investors are still adjusting from the shock of 2008 and the shock of 2009. It will take time. In the meantime, the measure of rationality in the world remains constrained. While it remains so, there are still obvious opportunities.