Skill and Luck 2

One time I was with a colleague in Japan interviewing managers. My colleague Patrick knew his way around Tokyo, well, somewhat, so we only spent 25% of the time lost instead of the usual 50%. This was early 2006 when Japanese hedge funds were facing a particularly horrible time. The January and February losses on the broad market were about 7% each on each downleg. Taking into account some upside volatility the market actually only lost slightly over 5% from the beginning of the year till mid February.

Hedge funds trading Japan from Japan had mostly sustained double digit losses and were facing tough questions from their investors. In the latter half of 2005, the fund of funds community, that is the people who invested on behalf of investors into hedge funds, had been very bullish about prospects for Japanese hedge funds. They had piled into Japanese hedge funds rather exuberantly.

At the annual Goldman Sachs Asian hedge fund conference usually held in November in Tokyo, the mood was upbeat and investors outnumbered hedge funds by several multiples. Some 600 over people showed up, some uninvited, hedge funds and investors both. Times like this I get nervous. I have no reason to be. No good reason at least. But human beings are like lemmings sometimes. In November 2005 we were being told that the smart money was already invested but that the party would continue. I was and am of the view that this was the correct view to take and this story is not one about contrarian investing. This story is about a particular hedge fund.

(Throughout this Blog names of people and companies are changed, so are particular circumstances so don’t bother trying to figure out who I am talking about. Usually the characters are composite characters, sometimes reflecting the schizophrenic nature of some managers, but more often because it makes for more colorful description.

John was the manager of a Japan equity long short fund. In Asian markets, equities are the most liquid and visible of markets. The dominance of bank lending has stifled the growth of corporate debt although this has changed considerably since the 1990s. Still, the majority of hedge funds in Asia will be involved in trading equities. Local currency debt is a growing market. Emerging market managers trading in Asian markets but sitting in London or New York mostly participate in the hard currency soveriegn and sometimes corporate market for debt but these rely more on macro economic analysis than bottom up stock selection.

Anyway, John was an experienced trader who had cut his teeth trading at such intitutions as HSBC, Citigroup and Merrill Lynch. He had grown up in Asia despite his African American / Japanese ethnicity. He spoke fluent Japanese and he had an excellent network in Japan.

Following a pretty good career at Citi, John joined a hedge fund launched by a big name trader who had come off the proprietary trading desk of Deutsche Bank. The fund launched with some fanfare and raised 500 million USD in capital. It traded for a year and then came unstuck. Prop desk traders are in hot demand when it comes to hedge fund start ups, but there are risks. There are always risks. With prop traders the risk is that the guy was never a very good fund manager to begin with. Maybe he was just a psychotic risk taker and his success at some investment bank was down to the quality of risk management and not to his own skill. Any prop trader leaving to set up his own fund will tell you that this is not the case. They will tell you how risk management in an investment bank is stifling and does not understand the true nature of risk, does not understand the structure of the market, or the intricacies of trading. Success at Goldman Sachs, Morgan Stanley or JP Morgan on the prop desk does not automatically translate into success at one’s own hedge fund. In any case, John’s new venture collapesed in a cloud of redemptions as investors sought to cut their losses and exposure to further losses.

When I went to see John, he had just completed his separation from the ill fated hedge fund and started his own firm. In the course of the interview I began to suspect that John was actually a very good investor. Having traded Japan myself I was in a position to discuss at the position level, his current portfolio and understand his rationale for each position. Subsequent reference checks in the days following allowed me to confirm that the damage at his previous shop was due to poor risk management on the debt side of the portfolio. John was good and the implosion of his old shop was not his fault. It was bad luck that he had saddled up with the wrong posse and got burned.

Unfazed, John picked himself up, dusted himself down and re-launched himself with his own capital. The investment in the business totalled over a million USD and he had another 3 million USD to invest in his own fund. Unfortunately for John, he launched his new business at the end of 2005. His first 3 months were horrible and saw losses totalling 17% by March. Losses do strange things to people. His natural instinct told him to stick to his knitting and he would recover but as he was at the stage of raising capital, courting funds of funds as investors, he changed the way he managed money. By June the losses were nearly catastrophic.

I kept in touch with John throughout and followed his investment strategy through the months. They were sound and would eventually turn his way. Unfortunately, as the great Lord Keynes said, the markets can stay irrational longer than one can stay solvent. I have lost track of John now and he may have thrown in the towel. I hope he hasn’t because he was a skilful investor on a bad roll. At least that was my opinion.

The first question is, how do you distinguish between bad luck and poor skill? If one has traded the same markets or strategies one can empathize with the manager. What if the strategy is alien and one is learning about it for the first time. Technical competence and skill are very different things. Competence can be learnt. Skill takes experience to learn, sometimes painful experience. Here again, skill could be discerned if one knew enough of the strategy and had sufficient information (transparency) to understand the rationale behind the positions.

A more difficult question as an investor is how long do you tolerate bad luck?