

Investors are struggling with the question of how to identify hedge funds that will not disappoint in down or volatile markets. We can find a lot of practical answers by going back to the industry's earliest origins.

An Oldie, but a Goodie

The hedge fund strategy which Matarin Capital manages today shares its approach with the first-ever hedge fund, which was created in 1949 by a man named Alfred Winslow Jones. By contrast, many modern hedge funds have veered away from these original roots. In markets such as those which we've seen in 2014-15, and many others in the past, the hedging philosophies of the industry's founder have offered a lot of benefit...and we can also benefit by making some improvements on his pioneering early work.

A.W. Jones' was a long/short equity hedge fund which was geared to be "market neutral," although this nomenclature wouldn't come until much later. Jones was originally an academic, skilled in statistics, and when he started his fund with his life savings of \$40,000 he was personally quite concerned with avoiding losses, even in the event of a market downturn. He developed the methodology of buying and shorting different stocks in equal proportions so that if the market went down, the stocks that he was short would generate more of a profit, just as if the market went up, the stocks that he was long would contribute to more of a gain. He even invented an approach to make the longs and the shorts in his fund proportionate in terms of riskiness.

At Matarin, we have similar portfolio objectives to Jones: to generate positive returns regardless of the market environment, which means avoiding losses even in the event of a market downturn. We believe that when it comes to delivering strong and stable returns, the component of the investment process which is focused on asset selection should be multifaceted and adaptive. For example, at Matarin we select stocks using four broad Concepts (Business, Price, People, Catalysts), each of which has specific advantages at different moments in a market cycle. Investors turn to hedge funds to make them money regardless of what the market is doing, and achieving that can mean very different things at different times.

Matarin's investment process is also similar to A.W. Jones' in terms of buying and shorting in equal proportions in terms of riskiness. But we are able to leverage over half a century of advancement in computing power to be much more precise about the matter. For example, A.W. Jones built his portfolio as a collection of long-short pairs of two stocks at a time, which is just what some "market neutral" or "relative value" hedge fund investors still do today. But at Matarin, instead of balancing out the risks of stocks pair by pair, we take into account the riskiness of whole diversified portfolios on the buy side and on the short side. In this way, we can be much more precise. There is less room for error in trying to estimate the riskiness of a whole group of stocks than in trying to estimate or adjust the riskiness of just one or two stocks. When looking at just two stocks, there are a lot of stock-specific risks within each individual business that are just too hard to predict, but when looking at a whole diversified portfolio, those individual-firm risks get spread out and effectively diminished. This "whole portfolio" approach also enables us to balance a much broader range of risks than A.W. Jones ever could because with many more stocks in play, we can move many more levers. Thus, at Matarin we balance out risk along additional dimensions. Our diversified long portfolio is similar to our diversified short portfolio in terms of the sectors and industries represented, the average size of the stocks, the exposure to changes in oil prices, exchange rates, and interest rates, and more. The result is that if any one of these elements becomes risky in moving stock prices up and down (as they most definitely have been in 2014-15) the balance between our long and short portfolios should hedge out all of those risks so that we can still add value simply as stock pickers.

The Long and Short of It

A.W. Jones always called his fund a "hedged" fund, because of the way in which he hedged his buys with shorts. When his fund became very successful, others bore witness to it and mimicked his attractive 20% performance fee structure. But some of these followers either did not use shorts or did not short very much, and Jones was outraged. He bemoaned that these new "hedged"

The Jones Nobody Keeps Up With



Alfred Winslow Jones

Alfred Winslow Jones, taken from Loomis, Carol J. "The Jones Nobody Keeps Up With." *Fortune* April 1966: 237

(continued from prior page)

funds would not be able to fulfill the essential hedging purpose which was their namesake. Without the proper shorting discipline, if the market went down, they would not be a hedge. Eventually, the industry would even stop calling these “hedged” funds. Even in today’s markets, with the S&P 500 up only 1.6% year-to-date in the context of heavy volatility, investors are looking for their hedge fund investments to offer real diversification from the risky stock market returns. Many are finding disappointment. For example, a recent report by the American Federation of Teachers union gathered data from several public pension plans’ portfolios and found that 10 of the 11 plans in their study have experienced “significant correlation” between the returns of the hedge funds they are invested with and the returns of their pension funds in total. Unfortunately, this was true even during the financial crisis of 2008. It is hard to avoid the temptation of abandoning the hedging discipline, especially when markets are rallying. But the failure to maintain meaningful short positions has limited many hedge funds’ ability to play the crucial hedging role. Even A.W. Jones once let long exposures get too aggressive and eventually paid the price, leading to the fund’s largest drawdown in 1969. This was a down year for the stock market which came after nearly a decade of solid market returns with losses only in 1962 and 1966. Jones would later confess that maintaining short positions during the earlier 1960s was so emotionally difficult that he’d been tempted to abandon the practice of shorting all together! Over half a century later, the failure to maintain meaningful short positions continues to limit many hedge funds’ ability to play their crucial hedging role.

The Price is Right?

On the subject of fees, too, the hedge fund industry has moved away from Jones’ original vision. Jones’ fund charged *only* a performance fee of 20%, so that his company would always earn exactly 20% of whatever returns it could generate for investors and the investors would keep 80%. By contrast, in today’s common “2 and 20” fee structure, it would be mathematically impossible for a client to hold onto 80% of the profits from their hedge fund investments because of the 2% flat fee that is taken away up front, before the 20% performance fee is added on. By way of further illustration, for a client to be able to hold on to only 75% of the profits from their investments in a “2 and 20” fee structure, a hedge fund would have to earn 32% in returns every year *on average*. If the fund’s average returns are lower, the clients’ share will be less. Most funds have just not consistently earned returns sufficient to be able to maintain a client/manager split at that level. At Matarin, however, all of our products are priced to be able to deliver a fair client/manager split, based upon a formal fee philosophy which we published immediately when we founded the firm.

No Such Thing As A Free Lunch

There were three pillars to the discipline of hedged fund investing as A.W. Jones defined it: 1) shorting, 2) performance fees, and finally, 3) leverage. Many relative value or market neutral managers will also use leverage in their funds to increase overall returns, which is to say that instead of buying and shorting stocks with simply the degree of exposure that would be allowed by cash on hand, a fund may borrow capital from its prime broker to buy and short with two, five or even ten (!) times the degree of exposure that cash on hand would allow. In this way, the fund investors may gain or lose two, three or ten times the returns that their investment would otherwise allow, after paying some interest to the broker on the borrowed capital. Financial leverage is something which Matarin resolutely avoids in our hedge funds because we understand that leverage risk often becomes most problematic when the markets are in decline, and that these will also be the times at which we most need to be *avoiding* systematic risks for our clients. We maintain a highly liquid portfolio, with positions that we can easily exit, for similar reasons – liquidity risk can tend to correlate with leverage risk and market risk in weak market environments. Clients themselves must also appreciate that funds which are being disciplined about shorting and conservative about the use of leverage and liquidity may tend to lag more aggressive hedge funds and the stock market itself when risk appetite is extremely high. The hopeful payoff for this conservative positioning is that such funds should remain more likely to offer downside protection when it’s most needed.

“Hedging is a speculative tool used to conservative ends,” A.W. Jones is often quoted as saying. As today’s investors begin to look for more steady, conservative returns in a volatile market environment, it may become necessary to look beyond the mere “hedge” funds to the truly well “hedged.”