THE LONG VIEW

WILLIAM EHRMAN

A wake-up call to the hedge fund industry

"THIS MOVE IS EXACTLY THE PROBLEM WITH MOST HEDGE FUND MANAGERS WHO ARE TRYING TO BE TOO SMART BY BEING A MARKET TIMER RATHER THAN AN INVESTOR"

CalPERS, one of the largest and most forward-thinking of all pension funds, could dramatically cut back its exposure to hedge funds later this year following an asset allocation review.

It should not be forgotten that CalPERS was the first major US public pension fund to make a significant foray into hedge fund investments, so where it leads, other pension funds will surely follow.

If CalPERS does reduce hedge fund exposure, it will boil down to a combination of exceptionally poor performance (both absolute and relative) to the market averages over the last five years, combined with high fees.

The original objective of hedge funds was to lose less or even make some money in down years, perform near the averages in up years and outperform over market cycles.

Managers must know when to hold them, when to cut back their net exposure and when to go net short.

But as an asset class hedge funds have underperformed the market averages by more than 50%, or 10% per year over the last five years.

The collapse in the financial markets and the relative outperformance by hedge funds in 2008, led to an explosion in AuM for the hedge fund industry right at the bottom of the market.

Managers need to control risk by maintaining ample liquidity at all times, proper asset allocation and by superior stock selection both on the long and short side of the market.

That is the role of a hedge fund manager and there are some good ones out there.

Goldman Sachs' equity strategist group put a stop sign out for equity investing last week, expecting a three-month market correction.

At the same time, this group firmly stated that equities are the asset class of choice and will significantly outperform over the next year.

This move is exactly the problem with most hedge fund managers who are trying to be too smart by being a market timer rather than an investor.

Yes, a market correction could occur at any time caused by a number of factors and events we don't see now, such as foreign conflicts, poor weather or something else unpredictable. Wealth is created by investing, not trading, and by always controlling risk.

The preconditions for a market top are still not present. Monetary policy remains easy, interest rates are low, the dollar is strong, economies are improving and, finally, corporate profits are rising.

This is a market of stocks rather than just a stock market. Selection, both on the long and short-side, will set managers apart, as it always does over time.

Basic in-depth research and identifying/understanding both positive and negative change in corporations remains the key for successful investing both on the long and short side of the market.

Corporations are implementing plans as if under attack by an activist and also need to succeed/thrive/prosper in a competitive global economy. Change is in the air and so are opportunities to make money. That is the role of a successful hedge fund manager.

Finally, don't react to every piece of news immediately, take time to reflect and think about the real economic impact, and, as always … invest accordingly! ■

WILLIAM EHRMAN, founder and CIO, Paix et Prospérité Fund

THE WEEK IN QUOTES

"WE NEED TO BE WHERE OUR CLIENTS ARE"

Martin Hughes, CEO at Toscafund, explains the London firm's decision to open its first US office

"WE REGARD MR MICALIZZI'S MISCONDUCT TO BE AT THE MOST SERIOUS END OF THE SCALE"

London tribunal upholds the FCA's decision to ban Alberto Micalizzi, who shielded losses from investors in 2008

"WE REMAIN CAUTIOUS AS WE LOOK TO THE SECOND HALF OF THE YEAR"

Man Group CEO Manny Roman has a muted outlook following mixed first-half performance