Memo to: Oaktree Clients

From: Howard Marks

Re: Hedge Funds: A Case for Caution

Once upon a time there was an asset class. It was all over the headlines. Its performance was terrific. Some said "too good to be true," but that didn't stanch the flow of money. After all, what other asset class had ever produced returns like these?

The performance brought vast amounts of capital to the sector. Demand exceeded supply, even as funds grew larger. The funds with the best records and discipline saw a deluge of money vastly exceeding their ability to accept it. Investors whose capital they turned away invested with managers who were less disciplined with regard to limits or with new funds. This gave rise to large numbers of start-ups and spin-offs from established firms. Lack of experience didn't prevent anyone from hanging out a shingle – or raising money. Some of the leading managers increased fees in order to appropriate more of their returns for themselves, and this enabled second-tier and new managers to charge fees that used to go only for proven performance.

Everyone agreed there was "too much money chasing too few ideas," but they invested anyway, often based on their managers' supposed skill and the fact that "Everyone's doing it; I can't just stand by and watch while they make money." You could see the end of this tale coming down the track like a locomotive. The perpetual motion machine eventually ground to a halt. **The combination of too much money chasing too few ideas dashed the hopes of those who in 1999-2000 looked for the "silver bullet" in venture capital. "Never again," they grumbled.**

<u>Hope Springs Eternal</u>

Of course, what they meant was, "Never again until next time." The fact is, investors never cease to dream of the silver bullet: the asset class or investment technique that can be counted on for high returns with low risk. Whenever one would-be silver bullet is discredited, investors give up on that irrational dream . . . and go looking for the next.

I say over and over that there's no such thing as a "good" asset class. No asset class or investment technique has the birthright of a particular rate of return, and certainly not of a high return with low risk. No asset can be depended on for good performance irrespective of the price at which it's bought. And no area can be successfully invested in without regard for the balance between the supply of investment ideas in the area and the amount of money investors want to deploy in it.

In fact, if you could ask just one question about a possible investment and be assured of one honest answer, I think it should be "what's the relationship between supply and demand?" If there are lots of assets for sale and few takers, those assets can often be bought cheap. If there are few assets offered and many would-be buyers, bargains are usually few and far between.

While no guarantee of a silver bullet, the former can be the source of some good ammunition. With the latter you're more likely to shoot yourself in the foot.

<ins>The New Solution</ins>

This memo's about hedge funds. They're the hot topic in the investment world today – the latest would-be silver bullet – largely, I think, because most have yet to disappoint performance-wise and because the big asset classes look unappealing.

Common stocks were the big-picture silver bullet in the 1990s. Professor Jeremy's Siegel's "Stocks For the Long Run" assured us there had never been a long period in which stocks didn't beat bonds, cash and inflation. The authors of another book, "Dow 36,000," were given space on The Wall Street Journal's op-ed page. Thus when stocks' popularity – and their representation in portfolios – hit a peak in early 2000, they were ready for a fall. A swoon that included the first three consecutive losing years since the Depression took the S&P 500 down 49% and the NASDAQ down 78%. As a result, stocks receive much less attention today than they did five years ago; less is expected from them in terms of return (even given today's lower prices); and they certainly aren't viewed as the place to put additional capital.

Neither are money market assets (yielding 1%+), Treasury notes and bonds (3-5%) or high-grade corporate bonds (4-6%). Institutional investors find these promised yields unexciting (and far below their portfolio goals of 8%+/-), and the widespread expectation of rising rates makes it seem likely that holding period total returns will be even lower.

With the two biggest markets holding so little appeal – and given the fact that it has to go someplace – money has been flowing to non-mainstream markets such as high yield bonds, buyouts, real estate, oil, timber . . . and hedge funds.

<ins>The Hedge Fund Movement</ins>

Hedge funds did great in the 1990s, produced moderate gains during the collapse of stocks in 2000-02, and were in double digits in 2003. I think they also exhibit many of the traits associated with the venture capital boom described on page one of this memo, including widespread investor participation. **I don't think hedge funds will bring losses at all comparable to what happened in venture capital at the peak, but I think their popularity is overdone and likely to lead to disappointment**. Given the magnitude of the hedge fund movement, a memo on the subject has become inevitable.

First, what are hedge funds? Briefly put, they're unregulated private partnerships that commingle the assets of institutions and wealthy individuals in pursuit of superior investment results. They're evergreen vehicles that offer periodic withdrawal opportunities to their investors, as opposed to closed-end entities such as private equity funds that promise no option to withdraw but begin to liquidate after a certain date and return money as they do.

Except for one other factor, they can have very little else in common. Hedge funds operate in a great many ways. There are arbitrage funds in fixed income, mergers, convertibles and "stat arb"; long/short funds in stocks in general, tech stocks and emerging markets; macro funds which place bets on currencies and world markets; and funds which make mostly-long bets in specialized market niches such as distressed debt. There are small hedge funds and enormous hedge funds. **Some hedge funds hedge – go short or otherwise take offsetting positions designed to reduce risk – and others don't. Thus some aim for steady returns with little volatility and market exposure, and some make massive, unhedged bets in pursuit of massive returns. Some hedge funds can fairly be described as pursuing "absolute return," and in the rest the returns are anything but absolute**.

What's that one remaining thing that hedge funds have in common? It's called **"hedge fund pricing,"** meaning the manager gets an annual management fee of at least 1-2% plus a share – usually 20% – of all profits earned in the portfolio. **In a world where the fees paid to long-only managers in traditional asset classes are a fraction of one percent, hedge fund pricing allows managers to make 3-4% or more and represents the *raison d'etre* for the hedge fund industry.** One of the cleverest observations I've read is from Paul Isaac of Cadogan Management: **"hedge funds are a compensation system often mistaken for an industry."**

From little or nothing a few years ago, many institutional investors now have 5-10% or more invested in hedge funds today. This has given rise to a massive expansion of the hedge fund community. There are estimated to be 7,000 hedge funds today, up from 1,640 a decade ago. Their current capital is estimated at between $850 billion and $1 trillion, up about ten times in ten years and well over 100% since the end of 2000. We read often of pension plans deciding to commit billions of dollars of additional capital to hedge funds. How will it play out?

<ins>Scalability</ins>

In my opinion, scalability is the most important issue surrounding hedge funds: can a good little idea become a good big idea? Everyone wonders about the scalability of hedge funds, but I think they're yet another area where most people agree on the existence of the potential problems but invest anyway.

It was in the mid-Seventies that I first began to hear of hedge funds such as Cumberland Partners and Steinhardt, Fine and Berkowitz. **At that time the hedge fund industry consisted of a handful of funds trying to earn superior returns with total capital of a billion dollars or so.** The funds limited their capital; researched smaller companies in greater depth than the mainstream investors; concentrated their portfolios in a handful of good ideas; and used shorting and hedging (but not leverage) to shape the pattern of their returns. For better or worse, their success over the ensuing 30 years led to fame and widespread emulation. **As a result, we now have thousands of funds trying to earn superior returns with roughly a trillion dollars, and with much more on the way.** (On September 13 The Bank of New York predicted that U.S. institutional investors alone would plow an additional $250 billion into hedge funds by 2008.) Can it still work?

I hope you'll permit me one of my tortured analogies. Have you seen the nature film on TV showing big fish eating? One of the big fellows rips a piece from his prey and moves through the water enjoying his dinner. But due to his poor table manners, he spews small crumbs as he goes. It's for this reason that each big fish is trailed by a hundred little fish. They snack on the scraps he drops, enjoying his leavings. He does the hard work, and they get a free lunch.

Well that's the way I've always thought of the investment world. Mainstream institutional investors emphasize the big asset classes and follow the big companies, creating a relatively efficient market and a context for relative valuation. But their attention wanes as the targets shrink, and their hands are tied by constraints on their behavior.

Little guys such as hedge funds operate in the interstices. They take advantage of small inefficiencies and misvaluations that the big guys create, permit or ignore. They pursue things that are unseemly, esoteric or highly labor intensive. And they can employ tactics like leverage and shorting – and live with levels of portfolio concentration and illiquidity – that aren't tolerated in the mainstream investment world. In other words they, too, benefit from the big guys' leavings.

The critical question is obvious: **How many little fish can thrive in the shadow of each big fish?** A hundred little fish trailing each big one all can do well. But those crumbs won't feed five hundred. Not only will the crumbs be insufficient in number, but the crowd will fight over them in a way that's unhealthy for everyone.

Tortured enough? Maybe so, but I think the analogy holds. **In my time in this business, the institutions have been the big fish of the investment world, and the hedge funds and alternative investment specialists have profited from their biases and limitations. But quintuple the number of "little guys" and maybe they'll no longer exhibit the same brilliance and adroitness.**

- How many under-researched stocks are there, and how much can be invested in them?

- How much of a bargain-priced security can be bought without the price being driven up?
- How big an arbitrage position can be put on without the profit spread shrinking?
- How many shares of an overvalued stock are available for short-sellers to borrow?
- How much of something can the hedge funds collectively own without illiquidity closing their exit window?

When there's an increase in the amount of capital that investors want to put into an area, there's no reason to expect a commensurate increase in the opportunities for good investment. So when the ratio of money to ideas increases, the implications for future performance can't be good.

Now it should be made clear that the venture capital boom, for one example, was based in a very narrow investment segment and dependent on the creation of new companies for the deployment of capital. Hedge funds, on the other hand, collectively are able to invest in any form of asset or security, in all of the world's markets and employing a wide variety of investment techniques, and through shorting they have to ability to profit from "inefficiencies" in overvalued as well as undervalued assets.

Thus the potential universe for hedge fund investments is enormous in the absolute. The real question is whether there are enough inefficiencies in this universe for all of the would-be hedge funds to invest in, and whether the presence of a large and growing number of funds has a deleterious effect on the adequacy of the supply.

Of course, it goes without saying: just as no asset class has the birthright of a given return, giving something the overly broad label of "hedge fund" – and paying its manager "two-plus-twenty" – won't make it a stellar, or even a steady, performer.

<u>The Hedge Fund Manager's Superior Arsenal</u>

A great deal is made of the powerful tools at the hedge fund manager's disposal. The ability to employ leverage – often in unlimited amounts – and the absence of constraints on investment tactics are lauded for their potential to add to results. But no one should forget their potential to do the opposite as well.

Almost every weapon in the investment arsenal is a two-edged sword. The only exception is genuine, sustainable personal skill. Everything else will make you money when it works but lose you money when it doesn't. Leverage and free rein are no exceptions.

Being able to leverage a portfolio means being able to invest a multiple of your equity capital. Why should an investor with $1,000 be content making $100 on a price rise of 10%? Why not borrow another $3,000, invest all $4,000 in the same assets, and make $400 on a 10% rise? All you need is access to 3-to-1 leverage . . . oh yes, and the ability to identify assets that appreciate.

In Vegas they say, “the more you bet, the more you win when you win.” Although the logic of this statement is impeccable, it omits the obvious addendum “. . . and the more you lose when you lose.” **Leverage is not a source of alpha; it’s a way of increasing your exposure to a given amount of alpha . . . or lack of alpha**. The 3-to-1 leverager described above will lose 40% of his equity if prices go down 10% instead of up. The ability to use leverage – which is high and rising today given the low cost of money and the lure of the “carry trade” – certainly doesn’t add asymmetrically to investment results.

Neither does freedom from constraints. Institutional investors usually spend lots of time negotiating what tactics a mainstream investor will be permitted to apply and crafting contracts to keep him from straying afield. Then they turn over a bunch of money to a hedge fund manager and say, “do as you please.” (I exaggerate for effect.) Does that make sense? Only in one case: where the manager possesses great skill and discipline.

Investment constraints (1) enable clients to know what style of management they’ll be getting and (2) hopefully limit managers to what they’re good at. Their absence sets the stage for surprises and permits managers to wander into areas where they may have less skill. Thus the results from unrestrained hedge funds are often unforeseeable, and these vehicles should be handled with care.

I think investors should pay above average fees only for asymmetric value added – that is, for a potential increment to returns that isn’t accompanied by a corresponding potential decrement. And I think only genuine skill adds asymmetrically to investment results, not leverage and not the mere ability to use a wide range of investment tactics. The key in hedge fund investing is finding managers who have that skill. It isn’t ubiquitous.

A Few Words on Performance

Frankly, I wonder whether the decision to invest in hedge funds today is fully supported by their performance in 2000-04, their period of great popularity.

I’ve watched institutions decide to join hedge funds. I think most of them invested for “absolute returns” – which I believe were supposed to be in the high single digits after fees – accompanied by low volatility and limited correlation with the mainstream markets. Now most institutions seem to be satisfied with their hedge fund performance and are signing up for more. **But I wonder whether they should be.** For the purposes of the analysis below I’ll use the CSFB/Tremont Hedge Fund Index.

- With the S&P 500 down 9%, 12% and 22% in the 2000-02 bear market, investors in the CSFB/Tremont Index’s average fund were delighted to make money, with the Index returning 4.9%, 4.4% and 3.0% in those years, respectively.

- And fund investors who might have expected much less were thrilled to see 15.4% from the Index in 2003.

On the surface, all seems well: small gains when the stock market cratered, and a pleasant surprise in the big year of 2003. But is everything really all right?

- Were the results in 2000-02 all they should have been? Because everyone was understandably thrilled to make money while stocks collapsed, I don't hear anyone grumbling about modest returns. But should they be? Institutional Investor magazine made the point in February 2003:

  > Hedge funds had a good year in 2002 – relatively speaking, of course. . . The trouble is, hedge funds are not merely supposed to do better than other investments. They're meant to outperform in absolute terms [I think this should be "perform in absolute terms"]. And most did not do that in 2002.

- Many students of the hedge fund area believe returns should be a function of interest rates, for example "LIBOR plus 500." In the early years of this decade, far less was achieved. Do the negative returns in the stock market fully explain the difference?

With 2003 one of the best years in history in most markets, was 15.4% enough? In 1996, '97 and '99, the Hedge Fund Index captured a very substantial majority of the S&P's return. Why in 2003 did it garner just over half the gain? Obviously the ability of the average hedge fund to beat the booming S&P in 1999 was an outlier, with active flipping of IPOs and other ways to "pick off" feverish retail investors presenting unusual profit opportunities. 1998's negative return was equally aberrant, with the Index return pulled down by a 38% loss on the average emerging market hedge fund. But with these caveats in mind, why was the capture rate in 2003 so tepid?

Year	CSFB/Tremont Long/Short Index Return	S&P 500 Return	Hedge Fund Return as Percentage of S&P Return
1996	22.2%	22.7%	98%
1997	25.9	33.1	78
1998	-0.4	28.3	n/m
1999	23.4	20.9	112
2003	15.4	28.4	54

- Most recently, the CSFB/Tremont Hedge Fund Index is up just 2.8% in the first eight months of lackluster 2004. **Again we must ask whether modest single digit returns are all that can be expected absent a tailwind from a strong stock market. What happened to the absolute return that would be earned with little reference to what went on in the markets? If the low returns are attributable to**

weak underlying markets, doesn't that suggest more correlation to market movements than was implied by the "absolute return" premise?

In other words, has hedge fund performance since 2000 been good enough? "Single digits in down years and double digits in up years" sounds like a good deal. **"Modest returns in bad years and modest participation in good years" is a little less appealing.**

I can think of four possible explanations for any shortfall from expectations: two benign and two unpleasant:

- If recent returns have been below expectations, this may be attributable to the low level of interest rates. Interest rates influence what funds will earn on their idle balances, proceeds from short sales, and arbitrage positions. So maybe hedge fund returns are due to pick up as short-term rates rise.

- And maybe hedge funds' good returns will be earned on average, rather than every year, and this has just been a below average period.

- But maybe more hungry "fish" with more money crowding into a given market are having the predictable depressant effect on returns. **Maybe there's a fixed amount of excess return available to be earned in a given year, and when it's spread over a lot more capital, the results become less positive. Or, even worse, maybe the combined efforts of all these people make the markets more efficient, reducing the total excess return available for them to share.**

- Perhaps the increase in the number of hedge fund managers has brought a decrease in their average alpha. **Why should we believe the last 20,000 managers to join the sector are as smart as the first 1,000?** One of the rationales for hedge fund investing, as The Wall Street Journal put it on July 7, is that, "Hedge funds still attract the smartest managers, lured by the rich fees." I may be missing something, but why should the appeal of rich fees be limited to smart managers? Can't they attract the not-so-smart as well?

It's my personal guess that there's truth in each of these four possible explanations. But if that's the case, the latter two will have a deleterious effect despite the validity of the former.

<u>Drawbacks and Pitfalls</u>

There are enough people out there trumpeting the benefits of hedge funds; you don't need me to repeat them. I'll just play my normal worrier's role by listing some caveats:

- The performance data on which investors are making the decision to commit to hedge funds is highly imperfect. It is unsystematic, unscientific and covers a short and notnecessarily-representative period. In addition, it's weakened by post-selection bias (low-return funds are unlikely to volunteer their performance) and survivorship bias (the estimated 25% of funds that go out of business each year are even less apt to do so). Importantly, holdings of illiquid or infrequently marked securities can cause betas and risk to be understated and thus Sharpe ratios to be overstated (Pensions & Investments, August 19, 2002).

- It is obvious that some of the tactics employed by hedge funds entail considerable volatility and illiquidity. And yet, hedge funds give their investors the periodic right to withdraw. **Thus, it's possible for a hedge fund to offer more liquidity than does its underlying investment portfolio**. This can be a formula for disaster. Given that a lot of the capital now in hedge funds is "hot money" prone to exit given a period of underperformance, it's not hard to envision (and in fact the community has seen) rapid-fire withdrawals that lead to downward spirals and penalize the last investors out the door, who can find themselves owning disproportionate amounts of hard-to-value and hard-to-sell securities.

- In most hedge funds, it's hoped that the managers' actions will neutralize the effect of market fluctuations. In other words, you're betting on the managers' skill, not the market direction. **As in any inefficient, alpha-based market niche, the performance gap between superior and inferior managers can be substantial. Thus you'd better find superior managers, and that's not easy. Also, since many of the best and most disciplined managers have closed their funds, you'd better hope the available funds will be able to replicate the returns that attracted you to the area in the first place.**

- With thousands of hedge funds all using computers to screen investment opportunities, there's a tendency for lots of them to move in the same direction at the same time. **This can shrink purchase opportunities, eat into prospective returns and reduce liquidity**. The Wall Street Journal described the situation on June 30: "Increasingly, the growing group of hedge funds pile into the same trades. With so much money chasing similar strategies, good investment returns become more elusive. Moreover, when an attractive idea turns sour, the rush to the exits gets crowded, exacerbating an already tense investment environment."

- We read often about the migration to the hedge fund world of people from elsewhere in the investment industry. This is the same phenomenon as we saw in the dot-coms in 1998-99. When people flood an area because of the easy money to be made there, the results are usually predictable.

- I'm particularly skeptical of the movement of people from traditional portfolio management to hedge funds. **Stock picking ability isn't sufficient for success in managing a hedged and/or leveraged portfolio -- risk management is at least as important. The two are not the same, and the traditional buyside professional doesn't have much experience in the latter.**

- As has happened in other alternative investment fields, changes in an industry can expose weaknesses in the compensation arrangements. Originally, management fees were intended primarily to cover operating expenses while incentive fees motivated managers to strive for profits. But as funds grow larger, some are at the point where managers can get rich on management fees alone. Recently we've seen investment celebrities start hedge funds with perhaps $3 billion of capital and management fees of 2% or so. $60 million a year is a pretty good start if you can get it. Fees like these can motivate managers to put a higher priority on perpetuating the management fee machine than on pursuing portfolio gains. Although hedge funds and private equity funds carry similar fee arrangements, the latter have hurdle rates that motivate their managers to try for double-digit returns. Hedge fund managers probably figure they can hold onto their capital and earn 2-4% a year for themselves with returns in moderate single digits. **I'm not sure that warrants the fees.**

- At the other end of the spectrum from managers able to attract billions in capital and massive management fees, the impatient newcomer with access to incentive fee money faces potential temptation that also might trouble investors: It makes perfect sense for him to start a fund and swing for the fences with highly risky securities, leverage and concentration. Hit a homer and he's rich; strike out and he goes back to his old job.

- We know incentive fees can serve to align interests between investors and their managers when profits are in the offing. But what happens when there are losses? When a fund has run up some serious losses and needs to recover to the "high-water mark" before it can generate incentive fees again, its personnel don't stand to share in gains for a while. So what is there to make them stay around to engineer the recovery, rather than move to a new fund where they can profit from dollar one? On July 15 The Wall Street Journal described one such situation: "Rather than try to dig out of the deep hole, while at the same time not getting paid as much as they could earn elsewhere, Mr. James and his team began to contemplate starting out on their own."

- Finally, I'll list a few other topics that may make hedge funds the subject of negative headlines in the future:

  - the risk implicit in the combination of leveraged hedge funds, leveraged funds of funds, and leveraged fund investors;
  - the absence of registration and regulation;
  - the lack of transparency;
  - the potential conflicts that arise when hedge funds are run within an organization that also manages non-hedge fund money in the same markets;
  - hedge funds' involvement in buyouts (do they have the needed skills? will it reduce their liquidity and ability to value the portfolio for subscriptions/redemptions?);
  - buyout firms' growing involvement in hedge funds (still more competitors?);
  - possible improprieties in hedge fund marketing;

- concern over the impact of hedge fund short selling;
- and, of course, the outright fraud that occasionally arises and always is a threat.

The Outlook for Hedge Fund Investing

As I said earlier, despite the troubling factors enumerated above, I do not envision a boom-bust scenario for hedge fund investors. After all, hedge funds spread their investment over almost all asset classes, and most funds are fairly disciplined in sticking to low-priced investments. So there isn't a single asset or group of assets where we have to worry about hedge funds creating bubble-like appreciation and the usual subsequent collapse.

No, the excesses aren't in the prices of the assets in which hedge funds invest. The excesses are in the trends affecting the industry: too much money coming too fast; too many funds managed by people of uneven skill; and too-high fees relative to the limited excess return the average fund is likely to generate.

I do not expect a debacle, just a disappointing experience. The sad fact is that, on average, hedge funds may go down as just another former silver bullet.

The high single digit return for which I think people invested wasn't a figment of anyone's imagination. It was probably reasonable looking back at the period preceding the current hedge fund boom. After all, in a period when stocks consistently returned double digits, Treasury notes paid 6% and high yield bonds yielded 12%, it's eminently logical that a few highly skilled hedge fund managers could earn 8-9% or more after fees on a low-risk basis.

But that scenario doesn't describe today or tomorrow. There's no reason to expect a near-term repeat of stock and bond returns like those, and certainly the hedge fund arena is far more crowded than it's ever been. So I think the average hedge fund might make 5-6% net of fees in the years just ahead. (That could change after lower prices and higher interest rates re-elevate the prospective returns on stocks and bonds – and after some disappointed capital departs the hedge fund field – but I'm just dealing here with the current environment. And please note that I'm not making a prediction, just a wild guess within a wide range.)

I'll go with 5-6% for the average hedge fund – considerably more from the best managers, less from the worst and, yes, total loss from the occasional risk-management disaster. Is that terrible? No. But the question is whether it will be entirely satisfactory.

- First, I think it may be less than the hedge fund managers and consultants have predicted.
- Second, it will put most institutions further behind their overall investment goals.
- And third, I think it'll look pretty anemic if Treasury note yields return to that range,

as they may, or if stocks can get anywhere close to their long-term 10% historic average.

A net return of 5-6% earned with low risk in a low-return world may sound pretty good to lots of people, especially in light of the pain that long-only common stock investors experienced in 2000-02. **I believe a great deal of current hedge fund investment is motivated by a desire for mid-single digit returns with safety, and also that a lot of funds have been designed to deliver them**. Managers are constraining risk; locking in profits at modest levels; dedicating their efforts to avoiding down months and quarters; and refraining from reaching for the stars. Some of this is good.

But I think paying fees of 2-4% to earn net returns of 5-6% may start to get old, especially if and when returns on mainstream stock and bonds get back to more attractive levels. That's why I worry about the potential for disappointment. **Right now, in a world of 1% money market rates and lackluster returns everywhere, that may be sufficient. But sentiment is inherently unstable, and I'm not sure investors will remain content if they begin to miss out on more elsewhere . . . while paying the highest fees in the investment world to do so.**

To start bringing this memo to a close, I'll cite John Moon and Tim Jensen's apt enumeration of the possible outcomes in our Emerging Markets Fund's second quarter letter:

> We have no idea if the hedge fund boom will peter out after several years of mediocre performance, end in another [Long-Term Capital Management] crescendo, or continue until all money is either indexed or run by hedge funds.

In testimony to Congress, Alan Greenspan focused on what I think is the most likely result:

> Hedge funds seek out the abnormal rates of profit often found where markets are otherwise inefficient. But these above-normal profits have attracted a large number of new entrants seeking to exploit a possibly narrowing field of inefficiencies. Not surprisingly the rate of return in this activity is reportedly declining. I would not be surprised if, with time, many of the new entrants exited, some presumably following large losses. (The Wall Street Journal, July 23)

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In my treasury of investment sayings, there's a special section reserved for what I call "the classics." None is more dependable than this: **What the wise man does in the beginning, the fool does in the end.** Intrepid pioneering investors get the underpriced gems. Once something has been discovered and the price bid up, the latecomers who come aboard in ever-increasing numbers – lured by past performance – can look forward to less return and more risk.

I can't imagine an investment area whose attractiveness can survive the onslaught of an investor herd thinking it constitutes the silver bullet. It wouldn't make sense for one to exist, given that it's the job of a smoothly functioning market to eliminate opportunities for unusual profits. **"Too much money chasing too few ideas" has been the death knell for investment fad after fad. This will never cease to be so.**

Hedge funds are just like any other investment tool. They are neither a good idea nor a bad idea. They have both plusses and minuses. They're subject to market forces capable of altering their attractiveness. And like any other investment that's in vogue, they should be handled with great care, with eyes wide open.

The right hedge funds may be just what the doctor ordered for investors who place a high priority on stable returns and are willing to trade away a lot of their upside potential for that stability. The key will be finding managers who possess skill, discipline and integrity. Doing so won't prove easy; there's no reason why finding superior managers should be any easier than finding superior investments. But as in other quarters of the investing universe, the rewards for success can be substantial.

There's no question that some of the smartest investment managers are gravitating to the hedge fund arena with its out-sized financial rewards. But they're not the only ones being drawn to the money, and some of the rest will turn out to be incompetent or downright unscrupulous. The tools are there for hedge fund managers to use, but all the tools in the world won't produce superior risk-adjusted returns without superior skill. **Just as all managers can't be in the top quartile, all hedge fund managers are unlikely to be smart enough to identify the markets' mistakes; undoubtedly some of them will be the ones making those mistakes**.

Finally, my personal bottom line: the most important element in the decision to invest in a hedge fund shouldn't be the sheer profit potential, but your comfort in entrusting its managers with the combination of potent investment tactics, high-octane fees and the absence of a hurdle rate.

October 6, 2004