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Return Free Risk

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Robert Heinlein, one of the most prolific sci-fi authors of all time, was a sceptic of specialisation. To quote:

"A human being should be able to change a diaper, plan an invasion, butcher a hog, conn a ship, design a building, write a sonnet, balance accounts, build a wall, set a bone, comfort the dying, take orders, give orders, cooperate, act alone, solve equations, analyse a new problem, pitch manure, program a computer, cook a tasty meal, fight efficiently, die gallantly. Specialisation *is for insects."*

Absolute return funds (hedge funds) take this advice to heart. Most are generalists that trade in different asset classes, go long one currency while shorting another, trade frequently, use leverage and other non-traditional methods to generate returns. The thinking being, by investing in several uncorrelated or inversely correlated assets, they can generate more stable and lower risk returns above the risk-free rate (i.e. government bonds). But often, all investors see is return free risk after all the trading and investment fees are paid to the managers.

Absolute return funds, in aggregate and over a 10-year cycle, barely beat inflation. Even this, while an unimpressive feat, is flattering because there is survival bias massaged into the aggregate numbers. Funds that shutdown or choose not to report after years of poor performance are not included in the statistics.

Some do spectacularly well in one year only to disappoint in the next. At Tacit, while we often meet with and sift through the investment proposals of some of these funds, we do not invest with them. This is not because we believe what they attempt to do is impossible. It is possible, just very difficult. And if you are being pitched by the salesperson of an absolute return fund, it is probably too late.

What do we mean by that? Examining the most successful hedge fund of all time, based on long term returns, is an ideal case study.

Renaissance Technologies Medallion fund has reported annualised returns of about 70% over a 20-year period from 1994 – 2014. Over the same period, the FTSE 100 returned about 4% annualised while the S&P 500 returned around 7% annualised. A return of 70% annualised over 20 years will turn a £100,000 investment into a £4 billion nest egg. However, no investor actually saw such compounded returns. The fund was closed to outsiders since 1993 so in the period between 1994-2014, it was only managing internal employee money.

Why would the most successful hedge fund of all time refuse to accept outside money? Even during the tumultuous year that was 2020, the medallion fund returned 76%. The answer is: scale.

The medallion fund, and most other successful hedge funds often have a capacity constrained strategy. In plain English, this simply means that the inefficiencies that they attempt to capture in the market can only work when working with relatively smaller sums of money – £1.5 billion approximately in this case. In order to maintain such high returns, the fund has to continuously return capital to its investors in order to minimize the assets it invests. It can only operate on a small scale. The two other publicly available funds offered by Renaissance have nowhere near as impressive a record as the closed medallion fund. They also both experienced relatively high double-digit losses in 2020.

Herein lies the problem with investing in hedge funds for the majority of people. Apart from the difficulty of predicting which will perform well in advance and the overly generous fees they take for the privilege of investing your money, there lies a

paradox. The fund with a truly unique strategy that is likely to succeed as a hedge during crisis after crisis will not have any salespeople. They probably run a capacity constrained strategy and are not open to new money. The hedge fund that manages billions of sterling worth of assets is likely to have lots of salespeople and beautiful brochures but unlikely to have the will nor the way of exploiting market inefficiencies partly because its large size precludes it from the smaller inefficient parts of the market.

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