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Investment Perspectives
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Hedge Funds

The news that a large hedge fund lost over 65% of its value in a short period of time in September has re-focused attention on the entire hedge fund industry. Yet it is far from a monolithic industry; hedge funds range the gamut from low to high risk, from substantial to modest volatility, and from opaque to highly transparent operating procedures.

Hedge funds are not an asset class. An asset class defines a particular medium of investment, such as equities or bonds, but hedge funds invest in virtually all investment areas. A hedge fund is just a different investment methodology (being able to go "short," thereby profiting from a decline in the price of a security, as opposed to the traditional fund which only owns and trades securities "long"), backed by a different compensation system. Additionally, many hedge funds can borrow to leverage their investment portfolio.

Hedge funds focus on many different investment themes. Some of the more common include:

1. ***Common Stocks***: funds will be long those stocks that the manager thinks will rise while short those that are projected as overvalued; subcategories include those funds restricted to a single industry, a specific market capitalization group, or a geographical area, while many other funds prefer to operate with a broad mandate such as "value" or "growth" investing;
2. ***Arbitrage***: funds try to determine, in an announced merger, which stock will be the better value; or, in a company with different classes of securities (such as convertible bonds, common stock, preferred stock, or warrants), which class represents the better value;
3. ***Market Neutral***: a fund will always hold as much stock "short" as "long," so that theoretically the investor gets no exposure overall to changes in the level of the market as a whole, only to the manager's supposed ability to choose those stocks which will either rise or decline in value;
4. ***Global Macro***: a fund that places little if any limitations on how it will invest its shareholders' money, but which claims it will invest wherever it sees reasonable opportunity, sometimes with considerable leverage.

The hedge fund, which lost much of its assets in September, was of the latter category. The fund stated that it would invest in four different trading strategies but it placed no limits on how much of the fund's assets might be invested at any one time in each strategy. In the late spring and summer months, this fund placed a very large bet on just one of its strategies, energy (specifically natural gas), on the expectation that prices would rise.

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According to press reports, the fund also borrowed to leverage its natural gas position three or four times (meaning that the market exposure of its invested portfolio was three or four times larger than its stated capital). However, because of a relatively calm hurricane season and mild summer, natural gas was perceived to be in over-supply by summer's end, causing the price to collapse and the fund to lose about $6 billion of shareholder money in less than two weeks.

At Aureus Asset Management, we have taken a firm stance of not investing any of our clients' funds in global macro hedge funds. Past performance of a global macro hedge fund can never be a guarantee or even a good indication of what the future performance of that fund might be. Any fund that can arbitrarily change tactics and strategies, at any time with no warning to shareholders, is a speculation, not an investment. In addition, any fund that can borrow up to three or four times its capital base is engaged, in our opinion, in speculative activities.

However, we do believe that carefully selected hedge funds, with narrow and easily understood mandates, serve a useful investment purpose. Funds with managers who know a single industry extremely well, and concentrate their holdings in that industry, can be judged and monitored with some assurance of a consistent investment profile. The same logic persuades us that funds in a single geographical area, or in one market capitalization group, can be assessed with a relatively high degree of confidence. Finally, we select only funds with very careful and relatively low limits on borrowing capacity.

Our limited partnership, Aureus Fund I, provides global diversification for our clients. The Fund is restricted to managers with a very clear and relatively narrow investment mandate, some of which are "long" only while others are hedge funds. Each manager is monitored monthly for depth of knowledge, for risk control procedures, and for performance relative to stated goals. The Fund currently invests in thirteen managers, each of which is a specialist. Yet by combining thirteen specialists, the Fund provides excellent geographical, industry and market capitalization breadth.

These thirteen specialists are selected also to mirror our asset allocation recommendations. By so doing, we believe we have created an overall investment strategy that measures well against our clients' objectives of both capital preservation and growth, in a truly contemporary wealth management model.