"THE ROUGE ET NOIR HEDGE FUND"

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I am fortunate to have come from a family that introduced me to investing at a young age. My brother shared that background, and we continue to spend considerable time discussing various investment and economic topics. He works for a large financial institution helping to manage their fixed income portfolio; however his interests are broad, and I often bounce investment issues off him as they relate to the equity markets. Several years ago, we were discussing some issues related to hedge fund investing. He sent me a hypothetical "hedge fund proposal", which has broad implications in the world of professional investing. The following is his "proposal":

> *I propose to manage a $1,024,000 hedge fund, promising to return about 0.89% per month with "no risk". I will invest the proceeds in cash to earn about 0.5% per month. In addition, each month I will do the following: I will bet $4,000 on black at a single-zero roulette wheel. If I win, I sit on the beach the rest of the month. If I lose, I double up. If I win that bet, my hard work for the month is over. If I lose that one, I double up again, and so forth. I will end up ahead by $4,000 each month unless I lose 8 bets in a row. The probability of winning at least one bet each month before going bankrupt is 1-(19/37)^8, or .9952. My probability, therefore, after 5 years of showing a history of returning 0.89% each and every month is .9952^60, or about 74.8%. At that time, I go to investors to market my track record and receive a few hundred million dollars to manage and take fees. Any interested investors?*
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> *Obviously, this is silly (and does not consider the effect of management fees), but it seems there may be some parallels to the real world of hedge fund investing. If I'm managing a hedge fund and I've promised stable monthly returns, what happens when my strategy blows up, even if that means a 2% down month rather than a 1% up month that I've promised? Do I "go to the casino" on the last day of the month and take bets to get me up to 1% for the month, with maybe a 96% chance of success (making 3%) but a 4% chance of losing everything? How do we know if a hedge fund has not done this?*
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> *This is not intended to be any slam on hedge fund investing. Obviously, there have been some hugely successful hedge funds. I'm just trying to raise an issue (in hopefully an amusing way).*

The discussion is directed toward hedge fund investing, but I think its implications are much broader. His proposal uses a casino analogy to highlight some of the agency risks in hedge fund investing. It is the nature of the hedge fund fee structure to encourage the taking of unusual risks which can confuse the client. Risks which are low probability but high severity are difficult for anyone, particularly outsiders, to measure. It can be a profitable strategy for a hedge fund to take large risks, which are unlikely to be realized, in an attempt to earn small incremental returns in order to earn large performance fees. The roulette example highlights this risk, but in many ways, it was this type of risk that doomed the Long Term Capital Management hedge fund in the late 1990's. They took large, but unlikely, risks through massive leverage to earn relatively small incremental returns. When the strategy backfired (the large but "unlikely" risks worked against them), the fund shareholders were left with huge losses.

Of course, the agency risk is not limited to hedge funds; it is an important concern for mutual fund investors as well. The roulette example is, in my mind, also analogous to the momentum market so prevalent in the late 1990's. Investors made large investments when price became separated from value, in an attempt to keep pace with the momentum market. They did not realize they were taking ever larger risks for ever smaller incremental returns because, for a while, the strategy worked. However, eventually value prevailed and prices plummeted. In many ways, this is the risk we see with momentum investing, and why our investment decisions are always grounded in our valuation-based approach. Momentum investing can work for a long period of time and may fool investors into believing the strategy is generating excess returns. The problem is, when momentum investing stops working, the losses can be substantial. To us, it makes no sense to make any investment without first comparing price to value.

As always, our valuation driven approach requires a long-term perspective, and that is a point we are constantly emphasizing to our clients. In the short term, our approach may be to avoid what appear to be exciting areas of investment, because we see the risks as too great compared to the return opportunities. Those time periods are never fun, but they have happened in the past and will happen again in the future. But that is the nature of long-term valuation-based investing. We are constantly evaluating not just the potential return but the risk as well. Some risks are obvious. Hopefully this discussion helps investors to understand that other risks are difficult to discern but are still very real.

At Diamond Hill Investments, we are very focused on the risk/reward tradeoff in our investment decisions, and, while we will make mistakes, it will not be due to perverse incentives to take unwarranted risks. We manage our portfolios with the shareholders perspective, so we will not put business decisions ahead of fiduciary decisions.

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