Agincourt Capital Management, LLC

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INVESTMENT UPDATE

It's a frustrating time for investors, as nothing seems cheap anymore. US stocks' price-earnings multiples are back to 1996's "irrational exuberance" levels. Ten-year bond yields are hovering around 4% (and well below 2% when adjusted for inflation). And if you want a big laugh at your next cocktail party, just use the phrase "real estate bargain."

Plan sponsors, especially those that have been getting insufficient contributions over the past few years, are looking at a difficult road ahead, marked by modest returns and growing liabilities. Administrators, trustees and committee members are hearing the warnings from their actuaries and consultants: *you've got to boost the performance of your investment portfolio*. With the so-called traditional areas of the investment landscape offering no easy answers, investors are increasingly placing funds with "alternative" investments, especially hedge funds.

The natural result is that hedge funds have been growing at an alarming rate. According to Hedge Fund Research in Chicago, hedge fund assets hit the $1 trillion mark in the first quarter, a 56% gain in just two years. During this same time, the number of hedge funds increased from 5,300 to almost 8,000. The growth in assets is an indication of increased investor demand for riskier investment strategies (if not riskier assets), but the growth in the number of hedge funds points to something else entirely: a massive expansion in the hedge fund *business*. Is this a good thing, or a bad thing?

First, some background. The term "hedge fund" describes any of the various loosely-regulated "private" investment funds traditionally offered to institutional and ultra-wealthy individuals. In the past, hedge funds tended to focus on taking both "long" and "short" positions in a variety of securities; these hedged bets gave the funds their name. These days, hedge funds may be invested in stocks, bonds, converts, currencies, commodities, or financial contracts/derivatives. Their strategies include global macro, various types of arbitrage, market neutral, distressed, and multi-strategy. Most seek to exploit short-term movements in securities' prices, and have little regard for long-term investment themes.

Hedge fund management is highly lucrative. In a time when fees for traditional money management have been on the decline, hedge fund fees show no signs of coming down from their lofty levels; in fact, a recent survey by the Hennessee Group showed that hedge fund fees were actually *increasing*. The typical hedge fund charges "two and twenty"—a two percent base fee, plus 20% of the gains in the fund (though some funds charge less). That compares to roughly 50 basis points for the typical equity fund and 30 basis points for fixed income management. Simple economics tells us that any industry with excess profits will see a rapid influx of new competitors. Ergo, more than 100 new hedge funds have been forming each month.

With this growth must come some growing pains. Early on, hedge funds were pulling many of the so-called "best and brightest" from Wall Street and more traditional money managers, lured by big fees and the promise of a whopping payoff. Given the growth of the hedge fund industry, it's reasonable to expect the talent pool to become somewhat diluted. Recent reports indicate that many of the larger funds are now recruiting heavily on college campuses.

As with other forms of money management, the barriers to entry are low—all you need is an office with a phone and a computer, a strategy, some seed capital and a clearing broker. And there are plenty of resources out there to help anyone to start up their own hedge fund. A website search on Google for "Start Hedge Fund" returned 1,180 results. Many of these "hits" were news items detailing one or more members of an investment team leaving their current employer to start a hedge fund. But some of these results linked to websites that will help you set up your very own hedge fund.

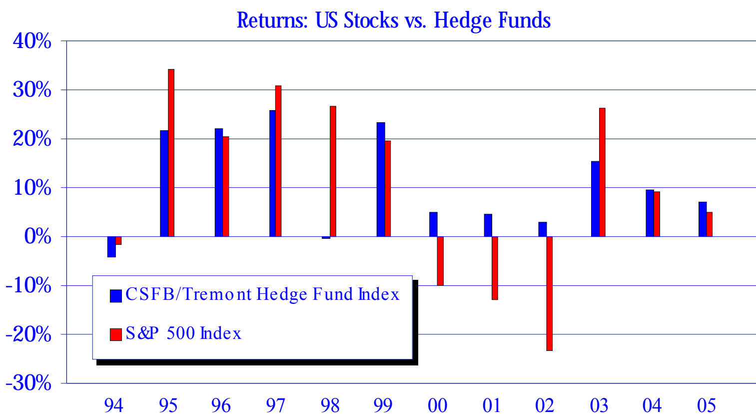
One website, "Hedge Fund Dynamics," has a very professional look to it. Send them your email address (as we did—for research purposes only!) and you will receive the *Journal of Hedge Fund Regulation and Compliance 2004*, a 16 page booklet which not only has tips on how to best structure and attract seed capital for your new hedge fund, but also has guidelines to help "understand what's necessary to avoid registration under state securities laws and SEC regulations."

Which brings us around to the point of this discussion: Hedge funds make a lot of sense from the hedge fund managers' standpoint—the fee arrangement is a "You win, I win big—you lose, I still win" equation. From the clients' standpoint, historical returns for the average hedge fund have been good, with a low correlation to other asset classes. But hedge funds *are* riskier than traditional asset

classes—they are largely unregulated, produce more volatile returns, often tie up investors' capital with "lock out" periods and, as we saw in the spectacular 1998 meltdown of Long Term Capital Management, use leverage that makes the very structure of the fund company itself an issue for investors to worry about.

Given the unparalleled growth of hedge funds, the thinning of talent and the massive quantity of money chasing a finite number of financial anomalies, the question must be asked: Is this an asset class that can continue to justify its fees?

The chart on this page shows the annual performance (2005's numbers are for the first quarter, non-annualized) of the S&P 500 stock index and the CSFB/Tremont hedge fund index, a popular broad index of hedge funds. While it's true that the average hedge fund outperformed the stock market (as measured by their respective indices), essentially all of that advantage was earned in the 2000-2002 period, when stocks were declining. More recently, hedge fund returns are looking increasingly ordinary.



We can only assume that hedge fund strategies, like so many other successful investment strategies, are suffering from their own success. The anomalies that hedge funds, in all their varieties, have been trying to exploit are fast disappearing. In the zero-sum game that is the capital markets, the crowded hedge fund field is looking like just another overvalued asset class.

One development that should bring some comfort to those who place money with hedge funds is the Securities and Exchange Commission's proposal that hedge funds lose their "private advisor" exemption and register, just like any other money manager, under the Investment Advisors Act of 1940. In their proposal (File No. S7-30-04), the SEC points out that hedge funds "Do not file registration forms with us identifying who they are, do not have to maintain business records in accordance with our rules, do not have to adopt or implement compliance programs or codes of ethics, and are not subject to Commission oversight. We lack authority to conduct regular examinations of advisers exempt from the Act's registration requirements." This proposal is scheduled to become effective in February of next year.

The "private advisor" exemption was intended to give smaller firms, and advisors who serve only a handful of so-called sophisticated investors, a break from the expense of SEC compliance. That exemption, according to the SEC, has been improperly applied to hedge funds, many of which are very large and serve both institutional and individual clients. In particular, the SEC seems interested in protecting individual investors, who are increasingly investing in hedge funds, directly or indirectly through retirement funds or funds of funds.

We believe individuals deserve the same safeguards as investors who place their money with mutual funds, stock brokers or money managers. Even institutional investors stand to benefit from these changes—after all, "sophisticated" investors have a responsibility to know what their hedge fund manager is doing with their funds. How can trustees of retirement plans, for instance, make informed decisions on the quality of the management of their funds if they are left in the dark? Current regulations don't even require the hedge fund manager to report who's on their staff.

The argument from hedge fund managers is that these changes will be expensive to implement. There were dissenting votes from the SEC to the proposal as well, pointing out that the regulatory agency's scarce resources could be spread too thin, and that the SEC hadn't yet defined exactly what they were going to be looking for in their audits. But expenses for disclosure and reporting are a normal part of life for traditional money managers and there's no reason (especially given their fee structure) why hedge funds can't afford to comply. As for the SEC focusing on hedge funds to the exclusion of more pressing needs, that seems to be a problem that planning and scheduling can handle; with their ability to charge fees and levy fines, the SEC has the monetary resources.

The most important aspect of the proposal is that the SEC will be able to visit hedge fund managers' offices. The threat of SEC examiners camping out at a hedge fund's offices for a week or more, and thoroughly inspecting all the managers' files and records as well as all other aspects of the managers' business sends a clear message to hedge fund managers that they will need to put their clients' interests first.