Back to the Future

Stardate 41357.2. The U.S.S. Enterprise was in the, rather difficult to pronounce, Xkduglmndpf nebular system in the Alpha Quadrant. Data and Deanna Troi were playing poker on the Holodeck. They had programmed a 21st century bar atmosphere and "activated" Sigmund Freud, the psycho-analyst, and George Soros, the absolute-return manager, for their game of poker. They wanted to have a chat about markets in the early stages of the 21st century. They appreciated philosophical excursions and drawing parallels between past and current events.

During the game, Data hypothesised that long-only managers of the past were similar to the "Borg" (a massive organization of cybernetic organisms assimilated from other species). The Borg were a species that have given up the individualism for the benefits of the cosiness of collectivism. George actually subscribed to the same point of view. In a Senate testimony in 1994 he argued that the long-only industry is trend-following, i.e. homogeneous by definition. It is "long" the market irrespective of valuation. This, George argued, leads long-only managers to define risk in relative terms and find comfort in hugging an artificial benchmark and seek mediocrity.

The ship's counselor, Deanna Troi from Betazed (best known for her inter-species telepathy and her emotional empathy with most other species), sensed some hostility in George's remarks. She argued that according to her knowledge of human history, the 21st humans were quite civilised – apart from minor self-destructive activity such as smoking or intra-species wars. She could not agree with George that a large majority could be so wrong by being "long-only" and George and some of his followers could be so right by pursuing absolute return strategies. She asked Data to shed some light on the subject. Data, the android with encyclopaedic memory, explained:

Economic thinking in the 20th and 21st Century was flawed. There was a huge bias toward monetarism (which later has been proven as a false ideology) and to something contemporaries called "the concept of general equilibrium" (which today we know does not exist). Equilibrium is the product of an axiomatic system. However, when a hypothetical equilibrium is presented as a model of reality a significant distortion is introduced. The crowning achievement of the axiomatic approach was the "theory of perfect competition." Contemporary economists argued that under certain specified circumstances the unrestrained pursuit of self-interest leads to the optimum allocation of resources.[1] It is this line of thinking that has served as the theoretical underpinning for the laissez-faire policies of the 19th and 20th century and was also the basis of the belief in the "magic of the market place" in the early 21st century.

Investors who refuted classical orthodox-economic thinking of the time, many of them so-called "hedge fund managers", were able to exploit many market inefficiencies derived from a large crowd hugging incomplete economic theories which, themselves, were based on unrealistic econometrical model assumptions. Only a minority of investors thought that changes in credit, risk perception and

[1] By 2001, Hippies, Environmentalists, Fluffies and Spikes (i.e. anti-globalisation zealots and other juvenile moralists), religious fanatics, and post-soviet Marxists (i.e. social-democrats) were all heading were Rousseau (the political theorist, not the landscape painter) was heading 250 years earlier.

flows were veritable input parameters for the investment decision process. It was this minority who focused on variables were the predictable power was high. Most investors played a guessing game, trying to anticipate the direction of the market, i.e. focused on variables were predictability was low.[2] In addition, contemporaries were often fooled by randomness as they failed to understand that financial decision making was based on an imperfect understanding of the situation. On top of this failure, there was overconfidence. As one contemporary of the time put it: “Market-participants thought they were experts in the techniques of the Kama Sutra, but in reality were sufferers of rheumatism and osteoporosis at the same time.”

Out-of-the-box thinking was not a feature of the time. Finding comfort with a benchmark and therefore pursuing mediocrity was. That is one of the reasons why absolute return strategies had a slow start and only really picked up by institutional investors in the 2000-2003 bear market. Only much later did social scientists realise that methods applied to natural phenomena do not apply equally to social phenomena. In the early stages of the 21st century, followers of behavioural finance, praxeology, and reflexivity were considered either as disciples of a right-wing sect or geeks. The ultimate hoax of the time was done by Alan Sokal. He submitted a parody of the type of work that has proliferated in the 1990s to an academic journal (“Transgressing the Boundaries: Toward a Transformative Hermeneutics of Quantum Gravity”), to see whether they would publish it.[3] The article was accepted and published. The hoax was that the content was completely nonsense. The conclusion from the (uncontrolled) experiment was that one easily could contribute to contemporary (academic) thinking as long as it was in the right format.[4]

Data ended his monologue by stating that the worst offenders of geek-talk were derivatives analysts, who’s tactic was to use scientific terminology without bothering much about what the words actually meant and displaying a superficial erudition by shamelessly throwing around technical terms in a context where they were completely irrelevant. Derivatives analysts of the time were intellectually so disturbed, that they regarded anyone not using derivatives to manage risk as Amish.

Deanna and Data both felt that they had to investigate further. Captain Picard agreed and sent an Awayteam down to 21st century earth. The objective was to get a historical perspective. Here is their report.

Excessive Demand for Hedge Funds?

Demand in hedge funds had increased during the 2000-2003 bear market. During most of the 1990s, hedge funds had as much appeal to institutional investors as a Ferengi in a see-through night gown from Victoria’s Secret. 10-15% return per year with little volatility from balanced hedge fund portfolios was an extremely unattractive proposition during the bull market. But this changed after the bull market of 1982-2000 had ended (and everyone agreed it had ended). By the end of

[2] Pre 2013, the consensus was that markets were deterministic (as in Isaak Newton’s calculus of the orbits of planets). Post 2013, the consensus view was that capital markets were a chaotic system (as is the weather), i.e. medium and long-term predictability is zero by definition.

[3] From the conclusion: “the π of Euclid and the G of Newton, formerly thought to be constant and universal, are now perceived in their ineluctable historicity; and the putative observer becomes fatally de-centered, disconnected from any epistemic link to a space-time point that can no longer be defined by geometry alone”.

[4] See Sokal, Alan (2001) “Fashionable Nonsense – Postmodern Intellectuals’ Abuse of Science,” Picador, New York.

2001, the appeal of hedge funds to institutional investors was more like “Seven of Nine” in a see-through night gown from Victoria’s Secret.[5]

By mid 2003 the interest accelerated to unprecedented levels. Even Hollywood took notice of this development in capital markets and promptly devoted their 5th Harry Potter movie to the hedge fund industry. This film (Harry Potter and the Index Rebalancing Tool – directed and produced by entertainment mogul Thris Curner) levelled all previous records. At the same time, most pension plans had seen their surpluses wiped out in the devastating bear market of 2000-2003 (some already had their surplus wiped out as early as 2001). The cause was primarily due to their misunderstanding of risk. The perception of risk in the early 21st century was about as developed and sophisticated as the table manners of a Klingon in the late 24th century.

In the late 20th and early 21st century, risk to a large extent was defined as annual standard deviation of returns (volatility). Only a minority of investors distinguished between upside and downside volatility. In a relative-return context there was no incentive to distinguish. During the last five years of the 1982-2000 bull market volatilities tripled and co-variance among index constituents approached unity without investors taking action. As equity valuation increased and portfolio diversification benefits decreased, portfolio risk increased as a result.

Financial libraries of the time were full of literature arguing that equities were ok in the long-term (without emphasising the fact that one might not live long enough to experience the “long-term). Only very few investors and contemporary market observers warned that this might not hold indefinitely. Contemporary thought was based primarily on the observation of the performance of the U.S. stock market. The U.S. stock market started the 20th century as an emerging market and ended the century as world leader of the global economy. Little emphasis was put on the fact, that their evaluation of markets was biased towards the most successful survivor of a large sample of capital markets. Little emphasis was given to the fact that an investor in 1900 would have had his risk spread into other large economies such as Japan, Argentina and Imperial Russia of which the former had severe disruptions in the first two world wars and the latter two disintegrated. Spock, given his affinity to statistics, calls this “survivorship bias”.[6]

An increase in volatility and correlation were not the only factors leading to the 2003 disaster. There were additional factors. A further factor was a misalignment of interests between investors and their managers. Institutional investors perceived risk as a mismatch between asset and liabilities whereas managers where defining risk relative to a benchmark index. Contemporaries used terms such as ‘index hugging’ and ‘relative-return manager’. The mismatch led to a death spiral. Assets were falling and liabilities were increasing (due to human longevity and falling interest rates). Pension funds had to lower the risk of their portfolios at the time when markets were falling. They had to catch the proverbial

[5] "Seven of Nine" had been disconnected from the Borg collective mind through the neutralization of the upper-spinal column neurotransceiver – so now you know.

[6] At age seven, Spock was telepathically bonded with a young Vulcan girl named T'Pring. The telepathic touch would draw the two together when the time was right after both came of age: once every 7 years all Vulcan males experiences pon farr, a powerful Vulcan mating drive which demands that they mate or die. In 2267, however, T'Pring chose Stonn, a Vulcan, over Spock, and the Vulcan returned to the U.S.S. Enterprise unwed.

falling knife and got hurt by doing so. Only a minority of contemporaries regarded this constellation as suboptimal (at the end of 2001, only 1% of assets were managed on an absolute return basis).

Not all countries anticipated in hedge fund enthusiasm equally. In addition, different countries were affected differently from the turbulence of the early 21st century. One country (at the time known under the acronym "UK") had large equity allocations and probably the most extreme aversion to spread risk and, therefore, absolute return managers. (Investors in that country associated hedge funds with LTCM and excessive leverage as they did associate risk management instruments (back in the 2000s called derivatives) with Nick Leeson, hidden accounts and fraudulent behaviour.) The undiversified and unhedged outright exposure led to huge losses that resulted in the social riots of February 2003. Their leaders took a larger interest in fighting foreign wars and the native citizens took more interest in the probable fatherhood of Liz Hurley's unborn than in the probability distribution of returns. This myopia weakened the country's social structure to the extent that it fell prey to the aggressive expansion plans of Iceland and lost its independence in the two-day war of 2007.

Ahead of its time were – believe it or not – institutional investors in Switzerland – at the time a country famous for its charming and humble financial professionals, subtle corporate governance and leading aviation entrepreneurism. (There were many me-too countries following in the footsteps of the Alpine aviation pioneers post 2001.) Many Swiss institutions made their strategic decision to diversify into spread risk and focus on absolute returns during the 1990s. This diversification allowed them to steer through the turbulence of 2000-03 more or less unharmed with the pension surpluses intact. Data ended his report with the notion that this is probably one of the reasons why – 400 years later – most inhabitants of the Alpha Quadrant ritually stir pieces of old bread in a pot of melted cheese on a regular basis.

Captain Picard was satisfied. However, he was still curious whether these "absolute return mangers" were adding value or whether they simply had a superior investment process for a given episode in financial history. At this very moment, "Q" from the Q Continuum materialised. "Q" didn't speak straightforward. He had the habit of telling a story and allowing the listener to answer the question himself.

Do Hedge Fund Managers Add Value?

"Q" told an anecdote from the mid 21st century. Apparently, Warren Buffet, Peter Lynch and George Soros all went to Heaven. When they stood in front of God – one of Qs colleagues – they were asked to explain to God why he should allow their soles to rest in piece for eternity. The question was put to Warren first. Warren said that he brought value investing to humanity and therefore should be allowed in. God agreed and said that Warren may sit to his left. Peter was next. Peter argued that he brought the PEG ratio to investors, allowing investors to balance valuation with growth expectations. God agreed and allowed Peter to take place to his right. "And what have you brought to humanity" God asked George. George responded: "You are sitting on my chair."

Alexander Ineichen