

## Lemonade for Sale

Horatio Alger stories which allude to finding the proverbial toy at the bottom of the manure pile or turning lemons into lemonade are a reflection of the American dream – rags to riches, something from nothing, a pot of gold at the end of your own personal rainbow. Still while dreams and wishes upon a star do come true for some of us in this Jiminy Cricket world, there can be a cost to fantasies ungrounded in reality and everyday common sense. In the world of money we have our oft-cited historical examples: tulips, portfolio insurance, NASDAQ 5000. Pop went these bubbles and the savings for that matter of investors lured in at or near the top. It's a story of the ages, an endless ticking of the human metronome setting a cadence swinging from fear to greed then back again. What isn't always obvious, however, and what makes the game go on and on is that the lure morphs into a different shape, sometimes during the same generation of investors. A good fisherman knows that if the fish aren't biting you change the bait and a good salesman knows that if you can't sell lemons, push the lemonade.

So it is with today's craze for hedge funds. Longer term returns for both stocks and bonds are sinking through the double-digit return line and moving perilously close to

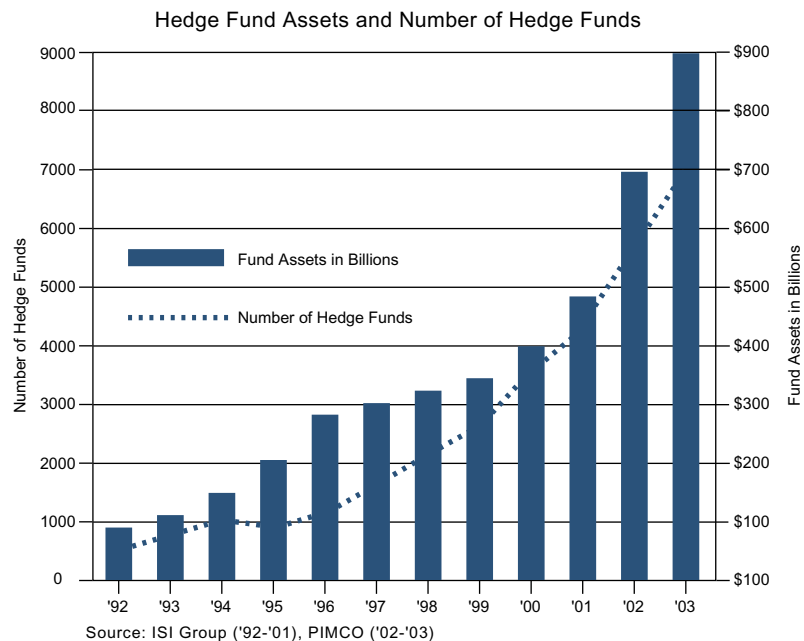
0% for a growing number of longer term time periods. Since Wall Street has left the real estate commissions to the Century 21s of the world, there seems few attractive investments left to generate the fees upon which to support that summer home in Amagansett. Enter stage left – the hedge fund. Now let's be honest here. Wall Street does benefit enormously from the growing boom in HFs. Such funds are estimated to provide \$10 billion annually or more than 7% of the Street's total revenue via trading commissions. In addition, fees for loans, back-office clearance, and even matchmaking or client introduction services run into the billions as well. But the Street is not the only seller of mining equipment in this hedge fund gold rush. There are now over 7,000 hedge funds managing nearly a trillion dollars of assets, all offering the hope of near double-digit returns in a much lower return investment world. And the price tag averages 2 and 20 – 2% annual fixed expenses and 20% of the profits.

While I haven't come to praise hedge funds, I won't be the first to bury them either. In any event, their undertaking won't need a Bill Gross, Jim Grant, or William Donaldson to do the dirty work. The previously cited financial metronome will serve as a convenient gravedigger no

doubt as greed leads to intense competition and excessive fees. Both of these should eventually reduce the product's average investment return to something approaching mediocrity, and mediocrity rarely sells on Wall Street or Newport Beach for that matter. But it's not just the competition and costs that should spell the eventual demise of the hedge fund craze. It's the realization – advanced here perhaps – that hedge funds can be manufactured in everyone's backyard like a gallon of Kentucky moonshine with revenue stamps attached, no less. You can start your own "hedge fund" and do almost all of the things the hedgies do without the "2 and 20." Steven Galbraith, principal at Maverick Capital, a leading hedge fund, recently was quoted as saying that, "The barriers to entry in this business are nonexistent. It's roughly equivalent to creating a lemonade stand." He may not have known how right he really was. The chart below confirms the sale of a lot

of lemonade in the last few years, but it neglects the potential for a do-it-yourself home brew.

What is a hedge fund? Supposedly the genre revolves around an ability to buy assets that will go up in price, sell ones that go down in price and if things don't move too much, to capture yield or carry during the wait. Somehow, with the exception of shorting, that sounds like the standard active management dictum that has been around for nearly half a century now. Of course proponents claim that HFs attract the industry's best talent and that the fees provide a significant incentive to identify and focus on winning strategies. Poor babies; thanks to capitalism, HF managers have had the ability to move out from under the oppression of investment management firms that are paying them a paltry few million dollars in bonuses a year at their own shops where they can wring 5, 10, 15



million or more if they make really good lemonade.

Actually their wizardry in my opinion has little to do with buying or selling the right stocks at the right time and everything to do with leverage. Hedge funds in reality are just unregulated banks, operating on a poorly disclosed amount of equity capital and taking the spread between their cost of funds and their riskier and longer dated assets. How much equity capital and therefore how much leverage is a fair question without reliable answers. *Grants Interest Rate Observer* in a recent issue, while asserting that nearly three quarters of HFs use leverage, surprisingly released their own survey showing \$3 of assets on average for every \$1 of capital, a figure that would stand in conservative contrast to banks at \$10 per \$1 of capital. I have my doubts, not because of *Grants*, which is a well-written and researched bi-weekly, but because the industry's "advertised" returns require a much healthier dose. Banks after all, provide historical returns of 1¼% on assets and via 10 to 1 leverage manage to up that return to 13-14% on equity. Granted there are very few equity equivalents in bank portfolios but with poor to negative returns for stocks over the past 4 years it's difficult to believe that the hedgies can come close to double-digit returns without a much healthier dose of leverage. Those returns may be coming through their use of derivatives which themselves are levered many times over. Whatever the amount, to my thinking it's leverage, not the investment acumen of 7,000 hedge fund managers that makes this mare go.

Which brings me back to my premise of the eventual demise of the hedge fund craze through the route of competition, excessive fees – and an ultimate realization by sophisticated investors that they can do whatever their hedge fund manager can do at 1/100 of the price. If the magic of a bank, or an unregulated bank – a hedge fund – comes from its ability to borrow more money at a cheaper price than the everyday Joe or Jane, then Houdini's "Metamorphosis" has now been exposed. Because ANYONE can now borrow more than enough money to make almost any investment they want at the same interest rate that banks and hedge funds do. Such financial wizardry these days comes rather commonly via the use of financial and commodity futures as well as super-charged options on any or all of them. Want to buy \$1 million dollars of stocks? If done via your broker the conventional way with a minimum margin requirement of 50% and a cost of money far in excess of the Fed's 1¼% current standard, you'd have little chance of making a brew of modern day lemonade. But with an S&P 500 futures contract, you can put up a minimum of 2-4% equity – not 50% – and borrow the rest at a 1¼% interest rate. You might be wiped out the next day but your destruction can be engineered in much the same way the big boys and girls play. Do you like Treasury bond prospects? Instead of 10% margin and confiscatory broker margin loan rates, buy a Treasury contract with the same terms as your S&P 500 futures. And don't forget those low 1¼% borrowing rates, which are implicit in the pricing of the contract itself. Similarly, commodities

– gold, oil, the Euro, Yen, pick your poison – can be levered and financed at the same yields as hedge funds do. You can even short them under the same terms, adding a weapon to your arsenal that the HFs claim is inherent to their structure – the ability to hedge an attractive asset with the simultaneous sale of an unattractive one. While you may not have the same “expertise,” the collective wisdom of 7,000 hedge fund managers must be perilously close to the median intelligence and street smarts of the investment community as a whole. An average investor might not do much worse, and after fees, probably much better simply via a diversified portfolio of financial futures.

I must be careful here. Recognizing the inherent fertility yet potential destructiveness of leverage, it is important to emphasize that I use these examples not to encourage you to make your own lemonade but to emphasize how overpriced the industry’s current products are relative to what they offer. Leverage induces not only additional volatility to a portfolio, but the potential judgment day of failing to meet a margin call and watching your equity disappear without the ability to recoup. For those reasons alone, hedge funds are proper investments for only the most risk-oriented investors. But, if an individual investor were to utilize leverage, it can be done more safely and effectively via a host of closed-end stock and bond funds bought at a discount to net asset value which utilize 50% leverage borrowed at near Fed Funds yields to bolster the returns of their funds over the long term.

While inducing additional volatility, the discipline of this near constant yet mild leverage can help an investor to increase returns, much like banks do, by borrowing short and investing longer and riskier.

So if you’re thinking about a hedge fund to bolster your portfolio returns, give it a long think. They’re risky and they’re generally overpriced. You can do better elsewhere or even on your own. On a broader perspective, the growing fascination with hedge funds and indeed the ability to lever almost any asset at minimal borrowing costs which was the heretofore province of strongly regulated banks, promises excessive speculation that inevitably will follow the financial metronome’s pendulum towards greed then back to fear, producing a number of near certain bubble poppings in the process. America’s and, therefore increasingly, the world’s economy is unstably founded on a base of cheap money used as leverage to support certain asset prices of dubious value. If and when the cost of those funds moves sharply higher for any reason – a dollar crisis, inflation, foreign central bank sales of Treasuries, increasing budget deficits, to name a few – then the flaws of a levered economy will be quickly exposed. It is then that many hedge fund managers will wish they had stuck to selling lemons, instead of lemonade and that they could return to their staid old jobs centered around active money management.

William H. Gross  
Managing Director

P I M C O

840 Newport Center Drive  
Newport Beach, CA 92660

949.720.6000

**Past performance is no guarantee of future results.** The chart portrayed in this article is not indicative of the past or future performance of any PIMCO product. This article contains the current opinions of the author and such opinions are subject to change without notice. This article has been distributed for educational purposes only and is not a recommendation or offer of any particular security, strategy or investment product. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed.

A Hedge Fund is an aggressively managed portfolio, which may take positions on speculative opportunities such as options and short selling which entail risk. Most hedge funds are limited to a maximum of 100 sophisticated investors. Closed-end funds, unlike open-end funds, are not continuously offered. After the initial public offering, shares are sold on the open market through a stock exchange.

In an environment where interest rates may trend upward, rising rates will negatively impact fixed income securities. Bonds with a longer duration (a measure of the expected life of a security) tend to be more sensitive to changes in interest rates, usually making them more volatile than securities with shorter durations.

Each sector of the bond market entails risk. Municipals may realize gains and may incur a tax liability from time to time. The guarantee on Treasuries and Government Bonds is to the timely repayment of principal and interest, shares of a portfolio are not guaranteed. Mortgage-backed securities and Corporate Bonds may be sensitive to interest rates. When interest rates rise, the value of fixed income securities generally declines and there is no assurance that private guarantors or insurers will meet their obligations. An investment in high-yield securities generally involves greater risk to principal than an investment in higher-rated bonds. Investing in non-U.S. securities may entail risk due to non-U.S. economic and political developments, which may be enhanced when investing in emerging markets.

No part of this article may be reproduced in any form, or referred to in any other publication, without express written permission of Pacific Investment Management Company LLC. ©2004, PIMCO.