GRANT'S

INTERESTRATE OBSERVER

Vol. 22, No. 7a — Two Wall Street, New York, New York 10005 • www.grantspub.com — APRIL 9, 2004

Fees and fees and fees on funds of funds of funds

On March 25, Man Group plc, the London-listed and London-based hedge-fund purveyor and distributor, parted the curtains on its fabulous fiscal year. Not only will net management fee income be "at the top end of market expectations," said management, but also—and more wonderful—"net performance fee income will be materially ahead of last year and significantly above market expectations." Assets under management totaled some $38 billion, the bulletin said, up 46% from a year earlier. Upon which, the share price spurted (on Bloomberg, the ticker symbol is EMG LN).

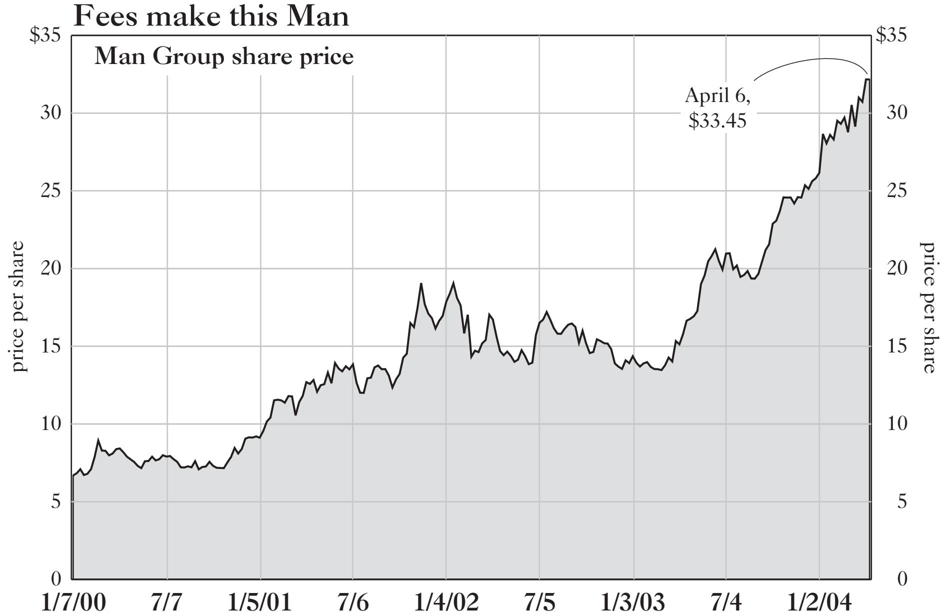
If $38 billion rings a bell, it happens to correspond approximately to the $36 billion of cash and cash equivalents recently lying fallow at Berkshire Hathaway. Skeptical minds will compare the size of Man's invested assets to Berkshire's cash and wonder what opportunities Man sees that Warren Buffett doesn't. Man has seen one, at least: the opportunity to levy an investment management fee of as much as 4% on top of an investment-performance fee of 20% on a growing, mainly non-American, clientele. Seizing that opportunity and not letting go, Man has generated returns on equity on the order of 25%.

Now unfolding is Man: Part II, a follow-up to the bearish analysis published here on January 30. We're still bearish, but the story will engage even readers without a rooting interest in the share price. The analysis comes in three parts, each reducible to a leading question. Thus: What are the barriers to entry in the hedge-fund business, in which a 26-year-old can raise $50 million? Can investors in hedge funds expect to succeed over a complete investment cycle, given high fees and the fast-growing population of magna cum laudes picking over the same opportunities? And: When has an investment fad not ended badly?

First came the hedge fund and then the fund of funds. And now comes the fund of funds of funds. The logic of "F3" is that, with all the good hedge funds locked up, an investor must settle for a fund of funds. But, to be prudently diversified, he or she must not rely on one or two. A basket is required—a fund of funds of funds. Against one such investment, an unnamed European bank is said to be willing to advance 80%, even though the investor is paying fees times three. The F3 promoters are, to us, unknown (and we don't mean to imply that Man is one of them).

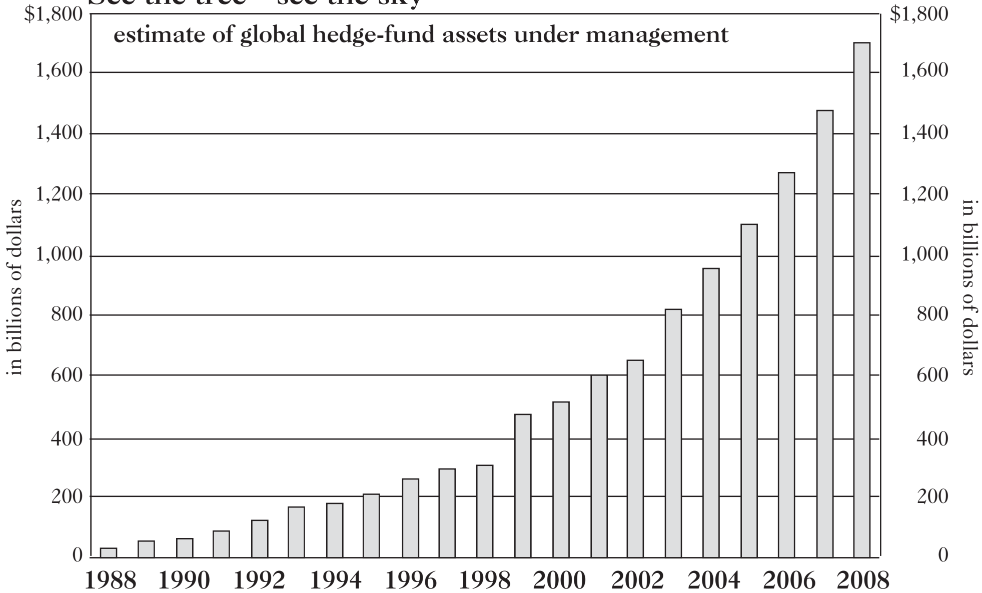
For newcomers, Man Group is the self-avowed global leader in "alternative" investments, especially hedge funds. It's a company in a hurry and it expands by acquisition. In 2002, Man made a notable acquisition of RMF, a Swiss creator of hedge funds with a special strength in convertible arbitrage and structured products. Though its heritage is English, Man speaks fluent brokerage-house American. Thus, it explains that RMF "focuses on robust solutions in hedge funds, leveraged finance and convertible bonds. In each of these asset classes, RMF has placed a premium on skill-based strategies with predictable outcomes and clearly defin-

Fees make this Man



source: The Bloomberg

See the tree—see the sky



source: Van Hedge Fund Advisors

able value added. RMF succeeded in developing a structured investment model in which investment selection, portfolio construction, risk management and investment service functions are modularized. The model can be systematically scaled to manage increasing investment volumes."

The world is a big place, but whether it is big enough to accommodate both the Vanguard idea (low fees) and the Man idea (high fees) may be doubted. Whether it is big enough to accommodate both the RMF investment idea (the model can be "scaled") and the Buffett investment idea (the model cannot be "scaled") is also unlikely.

"We've found it hard to find significantly undervalued stocks," writes Buffett in the new Berkshire Hathaway annual, "a difficulty greatly accentuated by the mushrooming of the funds we must deploy. Today, the number of stocks that can be purchased in large enough quantities to move the performance dial at Berkshire is a small fraction of the number that existed a decade ago. (Investment managers often profit far more from piling up assets than from handling those assets well. So when one tells you that increased funds won't hurt his investment performance, step back. His nose is about to grow.)"

Man Group does not invest as Buffett does. "Trading takes place around-the-clock," the company explains about AHL, one of its oldest money-management subsidiaries, "and real time price information is used to respond to price moves across a diverse range of global markets encompassing stock indices, bonds, currencies, short-term interest rates and . . . instruments traded are primarily futures and OTC foreign exchange forwards and metal contracts. Founded in 1983, AHL has always been underpinned by a strong research ethic."

When AHL was founded, hedge-fund assets were a drop in the fiduciary bucket. Today, worldwide, they are estimated to top $800 billion. They will double by 2008, to $1.6 trillion, Van Hedge Fund Advisors projects. UBS, in a December bulletin, forecast that Man's assets would double by 2006 (using a base of March 2003), to $56 billion. How can so many young, smart, aggressive, fee-driven and highly leveraged investors find wealth and happiness together on the same planet? With difficulty.

They might find it harder in the next bear market. In the 2000-02 downturn, hedge funds at least protected their clients' capital. "Now the longs are relatively expensive," notes a friend in the equity long-short fund-of-funds business, "and people in general are more net long than they were three years ago. So unless people somehow change their exposures on a dime, I just think there's going to be lower returns, higher volatility." Returns would be lower, our friend winds up, if only because there is so much more money deployed than there was when the new economy was still new.

To the hedge-fund business, a specter just as frightful as a deep bear market is a confidence-inducing, long-trending bull market. There is no end of investment products suitable for the do-it-yourself, buy-and-hold bull, and few of them levy fees that Eliot Spitzer would characterize as shocking. Thus, a visitor to ETFConnect.com will find 145 exchange-traded funds from which to choose. They can be bought or sold short. On some ETFs, an investor may buy or write options. ETF fees range from about eight basis points to just under 1% per annum. In theory, you, a sophisticated investor, could design

Now they get hedge funds

source: The Bloomberg

your own fund of funds of funds, saving the fees. In approved modular fashion, you could mix and match the Russell 2000 Value Fund with the HOLDRS Biotech fund; you could be long or short Germany, Singapore, South Korea or the U.K. (or, at least, the companies domiciled in those countries).

Of course, management is worth something—or, at least, some managements are worth something. Through long custom, hedge-fund general partners have taken 1% of the assets and 20% of the profits, although those numbers have been creeping higher. Man, by taking as much as 4% and 20%, is by no means off the 2004 hedge-fund reservation. However, no matter what the traffic will bear, fees make a powerful difference in long-term investment results. A 4% and 20% take, as the table shows, would reduce a 12% gross profit to a 5.6% net profit; the same take would shrink an 8% gross profit to a 2.4% net profit, a yield recently associated with short-dated T-bill returns more than with returns, say, on a highly leveraged convertible-bond portfolio.

Out of 12 analysts who follow Man, according to Bloomberg, 11 hold a view the Street might be expected to hold of the foremost public play in the hottest investment field. The 12th, a Bear Stearns team consisting of Tony Cummings and Haley Tam, is bearish. The two reason that, though performance fees are a critical source of Man's profits, they are unpredictable and of mysterious provenance. At 21 times estimated March 2004 "underlying" earnings, Man is no bargain; at 14.7 times estimated earnings including the 2003-4 performance bonanza, Man is still no bargain. "Although we afford little in the way of a multiple to performance fees, due to their lack of visibility," add Cummings and Tam, "we note that £130 million of performance fees would fund about a six million share buy-back." There are 310 million shares outstanding.

A 4-and-20 hedge-fund take
the effect on four profit scenarios*

Fund gross profits	$20.00	$16.00	$12.00	$8.00
Management fee of 4% of assets	4.00	4.00	4.00	4.00
Incentive fee of 20% of profits	4.00	3.20	2.40	1.60
Net profits	12.00	8.80	5.60	2.40
Doubling time (years)	6.1	8.2	12.7	29.2

*each fund starts with $100

Goldman Sachs is not a hedge fund, persistent rumors to the contrary notwithstanding. However, in its proprietary trading businesses, it implements strategies that resemble those employed by Man. So it bears on the hedge-fund discussion that Goldman is taking more risk in deploying its own capital. By the numbers, Goldman's average daily "value-at-risk" hit $71 million in the quarter ended February 27, up from $53 million in the year-earlier period. VaR measures the potential loss in trading positions owing to adverse market movement over a specified period of time. It has nothing to do with panics, crashes or hundred-year floods; VaR, rather, pertains to disappointments met on a bad day in a not-terrible market.

"What Goldman's first-quarter VaR told you," notes colleague Peter Walmsley, "is that the firm's risk managers thought they should put on more risk to make more money. For another thing, the 'diversification effect,' whereby different categories of risk offset each other because they were negatively correlated, was lower than in the fourth quarter or the year-earlier quarter. This tells you that seemingly different trades are relatively more correlated than before."

An omen bearish both for Man and for the hedge-fund boom appeared in the March 30 *Financial Times*: Germany is about to get its first homegrown hedge funds. "Lupus Alpha, a German investment boutique, will today launch a single hedge fund with an absolute return strategy," the *FT* reported, "while tomorrow will see the debut of a fund of hedge funds by DWS, the Deutsche Bank subsidiary and Germany's leading retail fund group." When, in 1998, stodgy German bank depositors stepped out of character and into the shiny bright Neuer Markt, the Teutonic Nasdaq, it seemed as if it really were a new economy. The history of that German equity experience was short and unhappy. Now hedge funds have come to Germany. Run for your lives, leveraged investors!

•

Subscribe to Grant's®

and get TWO FREE ISSUES added on to your subscription...

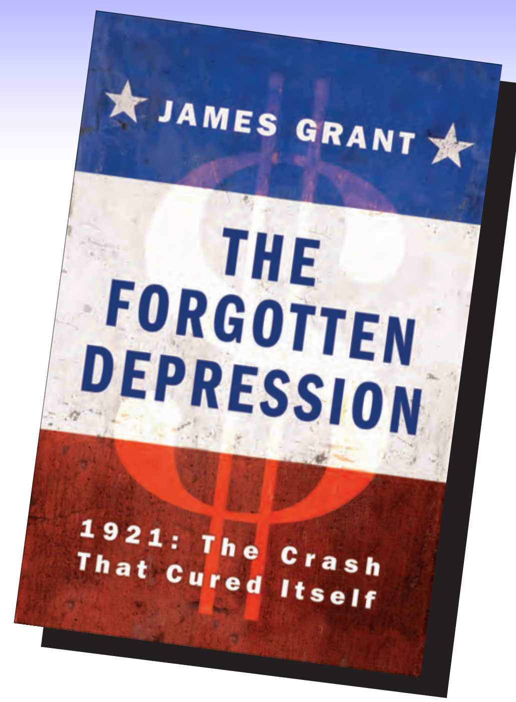
AND a signed copy of Jim Grant's latest book:*


GRANT'S

INTEREST RATE OBSERVER®

Vol. 32, No. 22 — Two Wall Street, New York, New York 10005 • www.grantspub.com — NOVEMBER 14, 2014

Read the footnotes



*New subscribers only, as supplies last

Don't wait. Subscribe *NOW*.

Take us up on this offer and you'll recieve 26 hard-copy issues instead of 24 (a $230 value), complimentary online access to the current issue, the issue archive, AND Jim Grant's latest book, The Forgotten Depression: 1921 The Crash That Cured Itself."

Go to www.grantspub.com/subscribe. Use Offer Code: GDMS

❑ **Yes, I want to subscribe.** Enclosed is my payment (either check or credit card).

Subscribe now and we'll add two free issues onto your subscription. That's 26 issues instead of 24—a $230 value. We'll also send you a signed copy of Jim Grant's latest book, "The Forgotten Depression, 1921: The Crash That Cured Itself."

Understand that as a paid-up subscriber, you may cancel at any time for a prorated refund on the remainder of your subscription.
*New subscribers only, as supplies last

❑ 1 year (~~24 issues~~) **26 ISSUES for $1,175**

❑ 2 years (~~48 issues~~) **50 ISSUES for $2,125**

Group rates available upon request.

❑ Check enclosed (Payment to be made in U.S. funds drawn upon a U.S. bank made out to Grant's.)

______________________________ Exp. _______
Credit card number

Signature ______________________________

CV number _________ (3-digit code on back of VISA/MC/Discover; 4-digit code on front of AMEX)

Name ______________________________

Company ______________________________

Address ______________________________

____

____

____

Daytime Phone (required) ______________________________

E-mail ______________________________

GDMS0701

TWO WALL STREET • NEW YORK, NEW YORK 10005-2201 • P:212-809-7994 • F:212-809-8492 • WWW.GRANTSPUB.COM