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A COMMUNITY OF MASTER TRADERS

The Best Hedges are Size and Cash

The original concept of a "hedge fund" was based on a mediocre idea that was in large part a marketing gimmick.

A guy named Alfred Winslow Jones was credited with inventing the hedge fund structure in the 1950s (although hedge-fund-like setups had existed well before then).

The term "hedge fund" came from the idea of hedging your risk by shorting one stock against another, for example:

- If you are bullish on the auto maker Ford…
- But not so bullish on General Motors…
- You can "hedge" by going long Ford…
- And short General Motors…
- And thus have reduced overall risk in the market.

This kind of hedging never made sense in my opinion. It was always a weak proposition, due to risks and transaction costs. Think of it like this:

- Trader buys $1.00 worth of risk, paying commish and slippage
- Trader buys 80 cents of insurance w commish and slippage
- Trader now has 20 cents of risk…
- With commish and slippage costs to unwind two more times
- And questionable insurance in the first place

It's like running up a hill to sniff a bucket of urine. Why go to all that work just to dilute your exposure with insurance?

The legendary hedge funds, achieving legendary performance, certainly knew how to manage their risk.

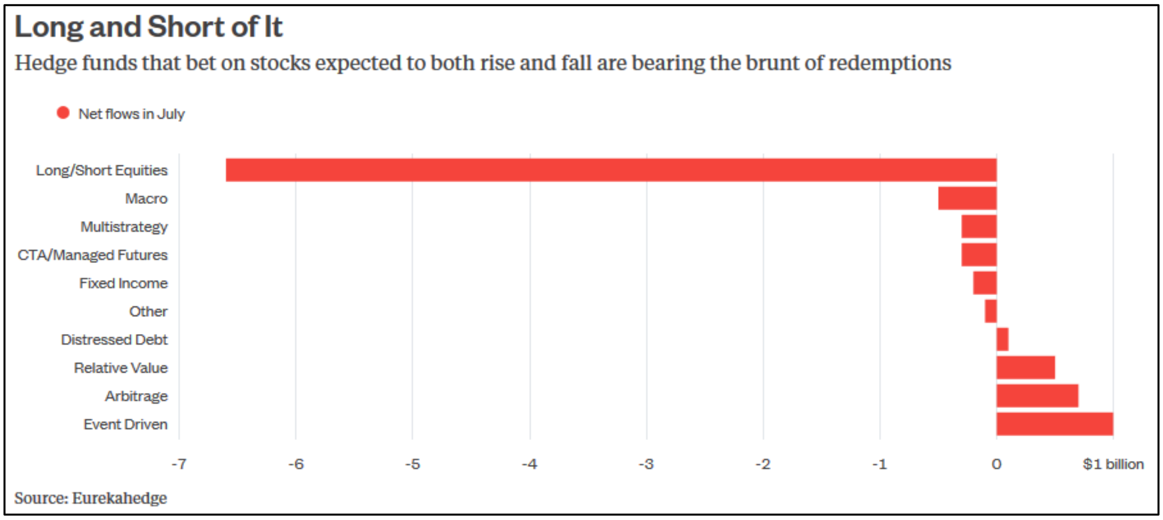
But their success was derived from being incredibly directional – i.e. NOT hedged – at the right time and place, while keeping their risk minimized at other times.

This is a very different philosophy than always trying to be a smart guy by buying insurance.

I have come to believe that an excessive focus on hedging, or buying insurance or reducing net exposure, is a sucker play that caters to built in human weakness. It's a kind of belief that one can have one's cake and eat it too, i.e. generate solid market returns while sidestepping volatility and the need for directional commitment. As a general rule that is fantasy catering to magical thinking.

Much of the hedge fund industry is built on this impossible proposition, that it is possible to generate excellent long-term returns without having to endure volatility.

In fact, many of investors' most serious problems come from this desire to avoid volatility while yet being greedy for returns, along with packaged solutions that supposedly deliver this but actually tend to deliver disappointment or blow-up.



The above chart shows hedge fund outflows for July 2016. The hedge fund strategy seeing the vast majority of bleeding these days is "long/short equities." Investors are dropping long/short like a hot rock.

Why is long/short so unpopular? Because the promise of this strategy, as it is sold, has to do with low market exposure.

The typical long/short fund has a stance that is "market neutral" or closer to market neutral than other funds, meaning longs are balanced with shorts. The result of this is that gains are always weighed down by losses. When the market goes up, the basket of longs gets diluted by the basket of shorts or vice versa.

Long/short hedge funds are guaranteed to underperform "long only" funds when the markets are strong trending. With markets on a one-way ramp from central bank stimulus in recent years, investors have grown tired of the underperformance.

In bear markets long/short funds do better – but even then, their promise to be "neutral" or lean toward that zone means they don't get the full benefit of being short either. They are always carrying that backpack full of rocks in terms of the insurance they carry around.

Now in our view, being long/short from an ABSOLUTE RETURN perspective, where you are willing to let market exposure tilt HEAVILY in one direction or another, based on general conditions, is great.

That is not what typical long/short hedge funds do. The typical long/short hedge fund always wants to lean towards X% of balance long/short at all times.

A fund that goes long or short stocks on an absolute return basis – with no worry about hedging – can tilt aggressively in one direction or the other. It can be very, very long… or very, very short… or flat and so on.

The idea here is:

- Take positions because they are good positions
- Don't try to tilt the portfolio for the sake of "hedging"
- Portfolio balance is a factor of consideration
- But the balance should not be artificially tilted…
- Or weak positions let into the portfolio only for the sake of balance

It took a while for me to see the clarity of why this is important. For a long time it was tempting to pay too much due to "balance" or to embrace the idea of increasing the size on a mediocre position because it provided balance to something else. But empirical evidence now clearly shows that is not the way to go.

The best "hedges" are probably size and cash, meaning:

- A position that is extended can see the risk reduced by changing the size, i.e. making it smaller.

- In an environment where things feel risky, there is nothing wrong with being mostly cash.

- The ability to put on LARGE size, i.e. "load the boat' on good positions, is also a long-term performance "hedge" in that doing such gives you the big outperformance that distributes over the other quiet periods where you had a lot of cash!

So here is an interesting point. The typical long/short hedge funds, which have a problem with trying to avoid volatility by carrying around insurance all the time, also have another problem. They don't have the ability to take extremely large size on their best positions… which in turn limits their ability to hold cash.

If you say to the typical money manager, "things are risky, why don't you hold more cash," if being honest they might reply: "Because if the market runs away my performance won't be able to catch up."

But if you have the ability to take large size on your best positions you don't have to worry about "catching up" with the market ever, because you know you can make gigantic returns in short spaces of time when your best positions start to work. The typical fund, which can never take more than rinky-dink size on any position, literally *cannot do that*. They are always tethered much tighter to general market performance. And that precludes them from holding too much cash!

So “size” is a hedge in that a problematic position can always be made smaller. But it is also a hedge in that the ability to take very LARGE size on one’s best positions, gives further license to hold cash more often… because there aren’t any worries about playing catch-up.

The net result is a willingness to endure volatility without being squeamish… in pursuit of absolute returns (only putting positions on because they are good)… while getting full benefit from being on the correct side of the market, and at the same time avoiding the baggage of paying for “insurance” and spreads that don’t really work.

Of course, sometimes you wind up close to neutral anyway, or have a roster of great long or short positions that balance each other – but if this happens ORGANICALLY that is fine.

There is a kind of purity here: 1) Find kick-ass positions. 2) Focus on sizing up in the best of those positions. 3) Don’t be overly concerned with volatility, just handle it. 4) See going to cash as totally fine. 5) Never worry about “catching up.” 6) Save a ton of headache. 7) Know the vast majority of opponents can’t do this, because they can’t utilize 2) and 3)!