September 2007 *MoneyMinute* – No Free Lunch

Note from Rich Chambers, CFP®: With all the volatility recently, I thought it was time for a historical perspective. John Buckingham – portfolio manager of VALUX, a fund we use for some clients – writes the *Buckingham Report,* and his view of the market is similar to mine. I hope you learn something helpful from his recent writing. I marked **bold areas** to emphasize important sections I want to be sure you see.

No Free Lunch
By John Buckingham

Most long-term-oriented investors understand that equity prices are volatile and that occasional downturns are the price one has had to pay to achieve long-term returns that have averaged 10% for large-capitalization stocks and 12% for small-capitalization stocks over the past eight decades.

Though the recent downturn in the equity markets has spooked many folks, it should be pointed out that according to Bespoke Investment Group, **10% losses have occurred on average every 16 months based on data going back to 1940**. The recent stretch of 1,591 days since the last 10% tumble is the second-longest hiatus during that time period.

Judging by the number of trading systems we see at investment conferences and the amount of attention paid to short-term market predictions, we know that many investors are not content to simply invest for the long term as they still try to time their moves into and out of equities. After all, wouldn't it be great to get out of stocks before a correction sets in and get back in just in time for the next rally? Alas, this is easier said than done as very few have achieved consistent success with efforts at timing.

In fact, as financial-services research firm Dalbar Inc. has determined, the **average equity fund investor has earned only a 4.3% annualized return over the past two decades, compared to an annualized return of 11.8% for the S&P 500 over those same 20 years**. Why is this? Dalbar states, "As markets rise, investors pour cash into mutual funds, and a selling frenzy begins after a decline. Tracking the dollars going into and out of mutual funds over a given month compared to market performance proves the correlation: as markets rise, cash flows swell; as markets decline, cash flows deflate."

With impressive credentials and the best computing power at their disposal, the brightest minds on Wall Street don't want to ride through the stock market's inevitable ups and downs either, so they have created alternative investment vehicles, commonly referred to as hedge funds. These are usually aggressively managed portfolios that use leverage, in addition to long, short and derivative positions in both domestic and international markets, with the goal of generating high returns, either in an absolute sense or as compared to a specified market benchmark.

Despite expenses that often total 2% in annual management fees in addition to an incentive fee of 20% of profits, investors, including supposedly conservative pension plan managers, have rushed to throw their monies at long/short, market-neutral and other types of hedge funds, lured by the

potential for market-beating returns with limited market risk. This despite the lessons learned from the 1998 implosion of the massive hedge fund Long Term Capital Management and from the collapse of energy hedge fund Amaranth last year.

We also might add that exiting from a hedge fund can be far more complex than selling a stock or mutual fund. Many hedge funds give money back only at the end of a calendar month, or the end of a quarter, and then only if the request has been made 30 to 60 days in advance. Of course, for long-term-oriented investment strategies, a lengthy 'lock-up' period is not necessarily a bad thing!

Recent unprecedented (in the eyes of many hedge fund managers) volatility has led to more carnage in the hedge fund world. While the Bear Stearns High-Grade Structured Credit Strategies Enhanced Leverage Fund was completely wiped out–that is, investors lost 100% of their money–we trust that those who placed their assets in this fund understood the risks involved.

We are not so sure that we can say the same for those who put their faith in market-neutral hedge funds as there is an implied expectation, though it is certainly not guaranteed, that money should be made no matter the short-term direction of the market. Obviously, with published reports out in recent weeks suggesting that Highbridge Statistical Opportunities Fund lost 18% over the first nine days of August or that Black Mesa, which was said to own a portfolio with about $1.9 billion in long positions and $1.9 billion in short positions, was down roughly 7.5% over the first seven days of this month, it is not easy to be market-neutral. And we can't overlook the fact that the $10 billion Goldman Sachs Global Equity Opportunities Fund supposedly lost more than 25% early this month, before receiving a $3 billion cash infusion from Goldman and other new investors.

As Bob Olstein said in this weekend's *Barron's*, "Investors have no idea how market-neutral or high-return fixed-income funds are deriving profits and holding down volatility. If you want to invest in derivatives or go long and short and you want to leverage up 10, 20 and 30 times to get higher returns, basic investment theory says you are going to take a risk somewhere…if it is cataclysmic and the derivatives go against you with that kind of leverage, the lights turn out. I don't like that bet."

Rich's Summary:

As John says, markets go up and go down. It has always been that way and always will be. Avoiding downturns by exiting the market generally results in significantly lower returns. Accepting interim losses is the price of obtaining better than money-market returns.

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