Monetizing hedge fund transparency

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*Hedge fund transparency was in the **news** again last week as EU Commissioner Charlie McCreevy told a conference audience that hedge funds need "to provide effective due diligence of the funds' liquidity and risk management, valuation process as well as on the basic investment proposition."*

Note that McCreevy stops short of calling for position-level transparency. Indeed, there can often be little value in knowing the positions in a fund whose purpose is to produce alpha through a dynamic trading strategy. But some hedge funds do pursue a buy-and-hold strategy. And for those funds, position level transparency can potentially provide useful insights.

*In the latest installment of our monthly contribution from a member of the Chartered Alternative Investment Analyst (CAIA) Association, Mebane Faber, CAIA, proposes a way to exploit position level transparency that currently exists for US equity hedge funds. Many of you may know Mebane through his popular blog **World Beta**, where he writes about many of the ideas below. He is also the co-founder of **AlphaClone** and co-author of "**The Ivy Portfolio: How to Invest Like the Top Endowments and Avoid Bear Markets.**"*

Alternative Viewpoints - powered by CAIA: Let the Top Hedge Funds Manage Your Portfolio

Special to AllAboutAlpha.com by:** Mebane Faber, CAIA, CMT, Portfolio Manager, **Cambria Investment Management

Picking stocks is hard. Academic research has shown that most individuals and professionals under perform their benchmark indexes. That is not surprising given **new research** from Blackstar Funds that shows that roughly two thirds of all stocks under perform their index over their lifetime, 40% are unprofitable investments, and nearly a fifth lose at least 75% of their value.

That being said, would anyone deny that there are some managers who are very good at stock picking? Warren Buffett is certainly good at it; so are David Einhorn, Seth Klarman David Tepper, and David Dreman - all elite money managers that have proven they can pick winning stocks consistently.

By reviewing the publicly-available SEC form "13F", you can see the holdings of these and any other professional money manager with assets under management of over $100 million.

This information is interesting. But since it is backward looking, can it be of any value to investors? It turns out the answer is "yes", as long as you use a structured and quantified process. I recently co-founded a software tool called "*AlphaClone*" to harvest these ideas from 13F filings and test them. In fact, you can use 13Fs from top managers as both an "idea farm" for new stock ideas as well as an alpha generator in the long only equity space.

13Fs and Two Case Studies

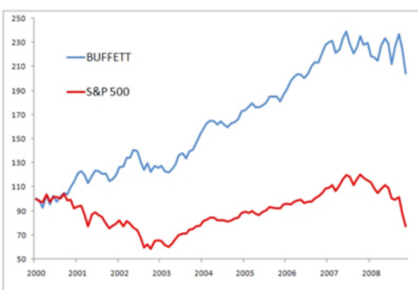
Typically, tracking 13Fs of leading funds works best on managers who employ long-term holding periods (Buffett, for example, has stated that his favorite holding period is "forever"). Since the portfolio data in 13Fs is 45 days "stale", this will minimize the effects high turnover (indeed, the manager may very well *not even own* the stock by the time the 13F is posted).

The major value added by these managers is their stock picking and not necessarily their investment timing. While most hedge funds short-sell, invest internationally, and/or use derivatives to hedge or leverage their ideas, these positions do not show up on the 13F filing.

It is very important to back test the managers' strategy in order to determine if it is appropriate for tracking. Many funds, such as the hugely successful Renaissance Technologies are not appropriate for tracking due to their heavy involvement in derivatives. Likewise, SAC is probably not the best fund to track due to exceptionally high turnover in the portfolio.

Let's take a look at Berkshire Hathaway's portfolio as an example. About 85% of the portfolio is concentrated in Buffett's top ten holdings.

It turns out that a simple portfolio that invests in Buffett's top 10 stock holdings, equal-weighted and rebalanced quarterly, beats the market by 10% a year from 2000-2008. A recent academic paper, "**Imitation is the Sincerest Form of Flattery**" (2008) examined a similar the strategy for Buffett from 1976-2008 and found an *11%* out performance…



BUFFETT

- Annualized Return: 6.5%
- Volatility: 13.2%
- MaxDD: -23.4%

S&P 500

- Annualized Return: -3.6%
- Volatility: 15.8%
- MaxDD: -44.1%

(Source: AlphaClone)

Investors can also create a "fund-of-funds" of their favorite managers. A simple example is 20 "Tiger Cubs" that are progeny of Julian Robertson's Tiger Management. Taking the 10 most popular stocks held by these managers, equal-weighted and rebalanced quarterly, would have outperformed

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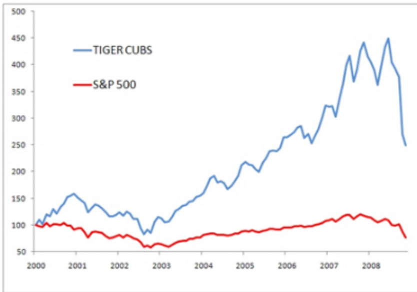
the market by *over 13%* a year from 2000-2008 and is outperforming the market by 15% already in 2009.



TIGER CUBS

- Annualized Return: 11.1%
- Volatility: 25.5%
- MaxDD: -50.0%

S&P 500

- Annualized Return: -3.6%
- Volatility: 15.8%
- MaxDD: -44.1%

(Source: AlphaClone)

So what stocks are being produced on the "idea farm" of the best managers today? Using AlphaClone I put together 30 funds I considered to be outstanding value managers with names including Appaloosa, Baupost, Blue Ridge, Dreman, Greenlight, Jana, and Private. Historically their most popular holdings have outperformed the market by about 14% a year. Here is a list of their most popular holdings right now:

- Conoco Philips (COP)
- Wyeth (WYE)
- Pfizer (PFE)
- Wal-Mart (WMT)
- MasterCard (MA)
- Qualcomm (QCOM)
- Burlington Northern (BNI)
- Priceline (PCLN)
- UnitedHealth Group (UNH)
- SPDR Gold (GLD)

While many investors can create a fund of funds of their favorite managers to uncover new stock ideas, 13F tracking could also make sense as a replacement for an equity allocation to the underlying funds.

Benefits and drawbacks to using 13F filings instead of direct investing

Some potential benefits of the 13F strategy versus allocating to fund managers include:

- **Fees** - most hedge funds charge 2% and 20% (and a FOF layers on another 1% and 10%). The FOF investor would have to return 7% of alpha just to deliver a 10% to the end investor.
- **Access** - many of the best hedge funds are not open to new investment capital.
- **Fraud & Transparency** - risk is eliminated.
- **Tax Management** - hedge funds are typically run without regard to tax implications, while the 13F investor can manage the positions in accordance with his tax status.

Potential drawbacks of the 13F strategy versus allocating to a hedge fund manager include:

- **Expertise in portfolio management** - The investor does not have access to the timing and portfolio trading capabilities of the manager (could also be a benefit).
- **Exact holdings** - Crafty hedge fund managers have some tricks to avoid revealing their holdings on 13Fs - shorting against the box and moving positions off their books at the end of the quarter are two of them. The lack of short sales, international holdings, and futures reporting means that the results will differ from the hedge fund results.
- **Forty-five-day delay in reporting** - The delay in reporting will affect the portfolio in various amounts for different funds due to turnover. At worst, an investor could own a position the hedge fund manager sold out of 45 days ago.
- **High turnover strategies** - Managers who employ pairs trading or strategies that trade futures are poor candidates for 13F replication.
- **Arbitrage strategies** - 13F filings may show that a manager is long a stock, when in reality he is using it in an arbitrage strategy. The short hedge will not show up on the 13F.

There are numerous other ways an investor can utilize SEC 13F filings from top managers to generate ideas and alpha. Portfolios can be created with static or dynamic hedging, as well as focusing on specific sectors and market capitalization tranches.

- Mebane Faber, March 2009

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