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PROFILE.....

Hands-Off Investor

Talking with Charles Wright, Co-Principal, Fall River Capital

By ERIC UHLFELDER

Fall River sticks to its systems—and lets profits take care of themselves.**CHARLIE WRIGHT DOESN'T BELIEVE IN EFFICIENT MARKETS.**

The unorthodox is typical for the 58-year-old money manager who has run his own manufacturing outfit, oversees a venture-capital group, wrote a book on trading, helped implement Milwaukee's welfare reform in the mid-1990s, holds a second-degree black belt in tae kwon do, and flies single-engine planes from his home in St. Croix.

Co-principal of Wisconsin-based Fall River Capital, an eight-year old commodity-trading adviser, or CTA, with \$302 million of assets under management, Wright believes that "Markets reflect human nature, and human nature is often wrong."



Quiana Duncan

On Sept. 15, when the Dow fell 500-plus points, Wright's Fall River Fund was up by 3%.

The hedge fund's transactions are focused exclusively on identifying commodity or currency prices that are breaking out of a trading range. If everything works properly, he'll be long if it's going up, short if it's heading lower. And when the trend breaks down, he gets out.

"We have found that if we focus on controlling losses and volatility, the profits will take care of themselves," says Wright, a Harvard MBA grad whose book was titled *Trading as a Business*. Strict discipline has eliminated fundamental and visceral analyses from the investment process. Price is the thing, and volatility determines the size of the bet.

That's why he and partner Rob Friedl have created a wholly systematic trading strategy. "Buys" and "Sells" of futures contracts, the only vehicle in which the firm invests, are determined by pricing models based on 30 years of trading histories. Wright's system doesn't care if OPEC is cutting oil production or whether Obama or McCain becomes president.

His overall results have been stellar.

Since August 2000 when Wright and Friedl started their flagship Fall River Fund, which holds less than 10% of the firm's assets, they have produced an annualized rate of return of 19.01% through August of 2008. That swamps the return of the S&P 500, which has managed just 0.38% in yearly gains over that period.

Over the past one- and three-year periods, the fund was up 45.99% and 31.61% annualized, outpacing the broad market by more than 57 percentage points and nearly 28 percentage points, respectively. And since inception through July, the latest full reporting period for hedge funds, Fall River was the fifth-best performing global macro fund, according to BarclayHedge.

The strength of Fall River's strategy was evident on Monday, Sept. 15—the day Lehman Brothers went belly up, Merrill Lynch had to sell itself, American International Group teetered on the brink, and the Dow lost more than 500 points. Wright's flagship fund rose 3%.

It's not that Wright and Friedl run a leveraged bear-market fund, but the government's decision to stay, albeit momentarily, out of the mix allowed the market's primary trends, fraught with fear, to reassert themselves.

This is what the firm calls an "event," which establishes, terminates, or restarts trends from which the fund can profit. And Fall River did so because it was short stock indexes and long interest rates (betting fixed-income rates would fall and prices rise).

A KEY CHALLENGE TO THIS STRATEGY, however, was brought to the fore by the speed at which these trends broke. Fall River soon gave back some of its gains when the government jumped back into the picture, salvaging AIG and distressed bank-held mortgages, and backstopping the country's money-markets funds. By week's end, stocks were soaring, bond prices were falling and Wright's positions were stopped and reversed.

"It's very difficult to invest when governments intervene," Wright says, "because they are looking to alter market trends on which our system is based." He's against the ban on shorting certain stocks, but believes regulators should try to come up with ways to prevent speculators from ganging up on individual shares. In Wright's view, the government should play the role of umpire, keeping the game fair rather than interfering in the outcome.

Commodity-trading advisers (a.k.a. managed futures) are the oldest types of hedge funds, dating back more than a half century. Many investors aren't aware that they are the most transparent of all hedge funds. Holdings are marked to market every day; futures markets are global and liquid.

The Commodity Futures Trading Commission, a federal agency that monitors futures trading, was created by Congress in 1974, and the industry's watchdog, the National Futures Association, checks the backgrounds of all individual participants, tests for proficiency, regulates compliance, audits books every three years, and levies fines for violations—up to

\$250,000 per transgression.

"There is no oversight equivalent to this in the hedge-fund industry," says Wright, a Wisconsin native who's lived in St. Croix for the last four years. (He headed a private industry group in Milwaukee that helped put Wisconsin Gov. Tommy Thompson's welfare-reform programs in place in the mid-1990s.)

Fall River trades across seven markets: agricultural, metals, energy, stock indexes, short rates and bonds and currencies. By extension, this gives Wright access to more than 80 submarkets, ranging from unleaded fuel, wheat and zinc, to British gilts, Euribor rates, and the Hang Seng index. And because the fund can bet them either long or short, it has the potential to perform well in any market—so long as there are apparent trends.

Obviously, the duration of price-moves can vary greatly. So Wright's and Friedl's strategy uses three time periods for its programs, each based on a specific range of stop-loss orders—the set price that will trigger sale of a contract. The fund's Global Strategies program is designed to hold a position for more than a month. Its VOLEX (Volatility Expansion) strategy aims to last between a week and a month. And the Global Opportunities program, which looks to profit from abrupt shifts in markets, is designed to terminate contracts in less than a week. In practice, the fund's bets can last from several hours to more than a year. Most of the firm's money comes from individually managed accounts that use some of these strategies, but are customized to meet client preferences.

"Research and practice [have] shown that this time-diversification is key in generating consistent long-term performance," Wright explains. No one strategy ever represents less than 20% of the fund or more than half its assets.

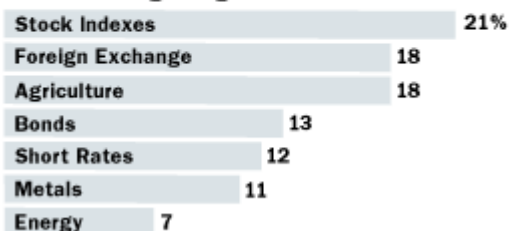
Before Fall River adopted this approach, the fund suffered its worst drawdown period—the time between its last high and the reclamation of that level—from early 2004 through the first five months of 2005. It was down 49% at its nadir.

"There's a time in every manager's life when he goes through a trial by fire," Wright says, "and this was ours."

Hedging Against Future Shock

Fall River uses three time periods for its programs, each based on a specific range of stop-loss orders.

Market Weightings



Source: Fall River Capital

Borrowing from his experience running a manufacturing company, Wright evaluated all the firm's basic premises. He found that the CTAs' fundamental belief—that markets move in their own direction and at their own pace—was no longer valid. Increasing correlation among many markets made hedging less effective and losses more likely.

So he and Friedl, who works at the Milwaukee headquarters, re-engineered the

fund to be more duration-sensitive. Unwilling to divulge their entire solution, Wright says the new programming significantly altered the size of initial investments and the amount of subsequent purchases and sales. The idea is to reduce the volatility as like-minded investors increasingly move in herds from one market to another.

It seems to be working.

Starting from June 2005 and running through August 2008, the fund has realized annualized gains of 34.01%. During this time, its worst decline was 11.69%.

Unlike stock or bond funds, Fall River measures the size of its investments by the degree of risk to its assets. In other words, it's looking at the maximum amount of money the fund could lose on each contract based on where its stop-losses are set, rather than the number of dollars invested initially. The degree of volatility determines the amount of risk taken on individual investments, which range from 0.25% to 1% of assets.

Examples of the automated nature of the fund's trades executed this year include its long exposure to heating oil. It lasted more than two months through July 18, when the program triggered the sale as commodities were peaking. The net gain was 52 basis points. Just prior to that sale, the fund also went short the same commodity, producing another 42 basis points over the next five weeks as commodities prices plunged.

As global equity markets stumbled into summer, the fund, starting in June, went short the broad Italian MIB 30 equity index. As of the end of August, the fund was up 95 basis points on this trade.

Toward the end of July, as the U.S. dollar rallied, Fall River went short the Australian dollar. After five weeks, the fund sold out and netted a gain of 55 basis points.

In December, as overnight bank rates fell, Wright and Friedl, who met at a trading seminar Wright ran in Chicago in the late 1980s, went long the fed-funds rate, betting short-term rates would continue dropping. By mid-April, after the Fed had cut rates by two percentage points, the fund locked in a 42-basis-point gain.

"While our trading strategy sounds bereft of creativity," explains Wright, "market interpretation and nuance are essential elements of our programs' design."

But the firm's top-tier performance depends on the managers' keeping their hands off once the programs are running. So theoretically, no market—even the current one—should be more challenging to Wright and Friedl than any other.

ERIC UHLFELDER, who wrote *Investing in the New Europe*, covers global capital markets from New York.

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