

GRANT'S

INTEREST RATE OBSERVER

Vol. 16, No. 19

30 Wall Street, New York, New York 10005 • www.grantspub.com

OCTOBER 9, 1998

Missing 'd'

A half-century ago, Alfred Winslow Jones, a Harvard-educated sociologist who overcame an early career in financial journalism to achieve success on Wall Street, invented the modern hedge fund. Phoenician sailors earned a share of the profits of a successful voyage, Jones would later say (he was a fine raconteur). By the same token, a risk taker was entitled to share in the profits he made on dry land. The share that Jones selected was 20%.

We turn to the ghost of Jones in the wake of the Long-Term Capital disaster and the crisis of the "hedge" funds. It is of more than typographical interest, we think, that the name Jones gave to his partnership was "hedged" fund. The loss of the final consonant says something about the evolution of 20th century fiduciary methods.

Supposedly, a hedged fund is hedged. It is protected against market risk by the structure of its longs and shorts. It is protected also against emotion, to a degree, because a hedged investor must try to find shorts even in a rising market and longs even in a falling one. The underlying theory of such an arrangement is that, whereas the market can't be forecast, a particular company can be analyzed. Jones advocated these ideas. However, he was also a believer in the art and poetry of technical analysis. He was an investor in a market-timing service—the name was Market Action—that massages the advance-decline statistics for its chartist subscribers.

A formative intellectual experience in Jones's career was a piece he wrote about stock-market forecasting for *Fortune* magazine in 1949. It was his work on this essay, "Fashions in

Forecasting," that led him, according to *The New York Times*, to believe he could do as well as the professionals. He did better, in fact, and his method was to be long and short at the same time. He used what a present-day financial chef might regard as the merest pinch of leverage. And he tried to measure the volatility, or "velocity," of the stocks he was long and short. "Hedging," he was quoted as saying, "is a speculative tool used to conservative ends." Jones did not invent the 20% profit participation. However, as much as anyone else, he opened the eyes of Wall Street to the vistas of sharing in the upside. The risks of sharing in the downside presented themselves in due course.

Alex Porter, who used to work for Jones (and who continues to manage hedged portfolios for himself and his partners), describes the Jones method. Assume, says Porter, that you have \$100 in equity capital and that you're long \$80. Assume next that you buy another \$50. This margin-assisted increment brings your total long exposure to \$130. How to protect yourself against a downturn? By selling short \$50 against the \$50 of incremental longs. Thus, your net long exposure is reduced to \$80—assuming, of course, that your shorts don't go up instead of down, which can happen even in the best of families.

"That's the way it started," Porter relates. "It just started shorting against the increment. He figured if we can just pick stocks, let's leverage that, but not let the leverage kill us. Let's go short against the increment. Let's go short against the leverage." The contrast with Long-Term Capital is obvious. Even if nobody in Greenwich

actually said, "Let's let the leverage kill us," apparently nobody insisted on the opposite. Not content with leveraging the portfolio, a certain number of the general partners leveraged up their own households.

"Transparency and regulation" is the battle cry in the wake of the Meriwether disturbances, but Jones preferred discretion and self-control. In the late 1960s, Porter recalls, the firm handed out no business cards. There was no mention of A.W. Jones & Co. in the directory in the lobby of the Stone & Webster Building in lower Manhattan, where it kept its offices. It fell to Lester Kissel, name partner of the law firm of Seward & Kissel and himself a general partner of Jones, to ensure that the partnership remained outside the reach of the 1940 Investment Company Act. It was a constant struggle. The SEC satisfied itself that Jones and the Jones partnerships were on the level only after an investigation that a reporter described as "thorough."

When Jones did make a rare public appearance—in 1966, he gave an interview to Carol Loomis in *Fortune*—he was able to say that his fund had been up by 670% in the prior 10 years. The public mutual fund that came closest to Jones's results over the same period was Dreyfus Fund, which had been up by a mere 358%.

Not only were these results wonderful on their face, but they were obviously better than the ones recently produced by Long-Term Capital, which used vastly greater leverage. Certainly, it does no good to leverage the wrong trades. Any general partner working for a 20% interest in the

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upside is tempted to fly too close to the sun. Long-Term seems to have found the temptation irresistible.

Probably, the financial markets were not so efficient in Jones's time as they later became. Jones's fund, which had the hedge-fund field largely to itself until the mid-1960s, was nimbler and better informed than its institutional competition. The 20% performance fee—now a standard for hedge funds (Long-Term demanded 25%, perhaps on account of its Nobel Prize-winning strategy department)—was an inspiration. Jones farmed out "segments" of the portfolio to the bright and aggressive young men he hired, and he pitted them one against the other. Laggards in the creative struggle moved on to other work.

Although a great one for hedging, Jones never stopped looking for the technical Holy Grail. "In the late 1960s and early 1970s," Porter says, "he had friends who would come in who didn't have anything else to do and who had solved the formula. [They] had a system, and they would talk to us endlessly about their system and about why he should use it. Somebody would track it for a while, and, of course, it blows up."

According to the Loomis article, Jones was caught in the 1962 stock-market break, and he was actually net short (an unusual position for him) as the market rallied in the summer of 1965. According to an eyewitness, the Jones fund fared so poorly in the 1969-70 sell-off that the founder briefly considered quitting. Plainly, the genius of the Jones partnership lay not in a fool-proof system but in the talent and prudence of the people who managed it.

Just as plainly, the idea of a hedge fund was one of the great ideas that would, in a cyclical fashion, be taken to excess. When *Institutional Investor*, in a 1977 article, asked what had become of all the hedge funds, it discovered that the bear had eaten them. "Quite simply," wrote *II's* John Thackray, "what was larger than life on the upside was magnified on the downside, too—despite the apparent 'hedge' concept that was supposed to enable them to profit on their short positions. Performance fees, in an era of non-performance, dried up. And many of the names that once were mentioned in hushed, awed tones either vanished from the scene or changed their ways of doing business." Jones himself, when asked what lay ahead for the hedge funds, sounded defeated. "I don't believe it is ever going to become a big part of the investment scene, as it was in the late 1960s," he said. "The hedge fund doesn't have a terrific future."

Even in 1966, a farsighted observer could see trouble on the horizon. Already there was beginning to emerge a type of financial asset that could be classified (to quote the investor William Michaelcheck) as "the Class of Asset that is Owned by Hedge Funds." Thus, for example, *Fortune* reported that every hedge fund in America seemingly was short the common stock of Control Data. Only half a lifetime had to pass before every hedge fund in America, now collectively wielding enough billions of dollars to threaten the global financial system, would be short Treasuries and long mortgages, junk bonds or Italian governments. In this way, the hedge funds went unhedged.

We know another former Jones employee—he, too, is a stock-market investor—and we asked him where Long-Term Capital lost its way. The cardinal Meriwether error, he said, was that he didn't really invest. Putting up money on the expectation that one interest rate will move a certain way in relation to another interest rate may be many things, he said. But, he reiterated, it isn't investing.

"The only way I know how to create long-term wealth," said this alumnus, "is through investing. Now, Warren Buffett (who is better known than I and wealthier) figured out a long time ago that there are times when they give away great companies, and their management is out there every day creating value, generating a return on assets, generating a return on equity. . . generating wealth. If you just buy those companies fairly valued, they continue to do well. . . ."

"But," our man went on, "if you can do 'em as Buffett did in '74, and maybe today when guys are throwing them away in panic, you can make an awful lot of money. Now that's the only sort of investing I understand."

As for A.W. Jones & Co., the firm will soon mark its 50th anniversary. In 1983, Robert L. Burch 3d, son-in-law of the founder and newly installed at the head of the firm, made a strategic investment decision that anticipated the return of the performance-based, highly leveraged, risk-taking portion of the investment cycle. He turned over a sizable portion of the assets to an up-and-coming former stockbroker, Julian Robertson. Robertson still has them.

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