

STOCKBOY

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Hedge Fund – Well Paid for Being the Anti-Buffer

‘I’m Bearish Over the Next 3 Weeks’

Huh? Three weeks? This quote from a hedge fund manager was featured in the October 4, 2010 issue of *Investment News*. This perspective was, in fact, the subject of the article. Unbelievable. Not only did the hedge fund manager end up being way wrong in his bearish prediction, but his perspective borders on the absurd. In an investment world where the big winner the past 50 years—Warren Buffett—looks out a decade or more when he considers investing, this hedge fund guy is guessing - -and it basically comes down to guessing--the market's direction over three weeks.

Hedge funds tend to make bold and unusual predictions. This hits upon one of the big myths of the investment industry – that hedge fund managers have some kind of magical ability to predict market movements or have access to information unavailable to average investors. They do not. A few hedge funds in fact do have access to insider information and they go to jail for it, if caught (for example, the current case with Galileo). However, for the most part, hedge funds do not know more or perform better than a regular mutual fund over time. Yet hedge funds have much higher fees – typically 2% plus 20% of profits. Nice for the hedge fund.

Whenever a system is focused primarily on the compensation of its managers, the product and result likely suffer. Hedge fund investors should keep this in mind. Yes, there are strong performing hedge funds out there, but those that do so on a consistent basis are few and far between and often closed even if you find them.

Hedge funds can indeed be of value for investments in a style different from the standard market, thus giving an investor greater diversification. Beyond that, their value is suspect. Providing consistent outsized returns is much more myth than reality, while the very high fees are a definite reality. Next time you hear that a manager is leaving a mutual fund to join or start a hedge fund, rest assured the primary reason is he can get rich quicker as a hedge fund manager.

Is it the ‘Big Switcheroo’ Already?

In the last issue, *Stockboy* discussed how stocks have been relatively unpopular versus bonds for well over a year. I suggested this imbalance may change soon. Turns out it may have already happened. In December, the stock market trended upward as ‘retail investors’ apparently returned to the market, while bonds were ‘sold off’ as interest rates drifted upward. It’s not surprising this dynamic has shifted when AT&T is paying an almost 6% dividend to stock holders while AT&T 5 year bondholders get less than 3%.

Blue Chips—Top Dogs

It seems all investments have some problems at the moment. Cash pays basically nothing, muni bonds are showing signs of weakness due to concerns over municipal and state debt levels (addressed as a potential big problem in *Stockboy* since 2006), corporate bonds are at premium prices and real estate is still working through its bubble from 3-plus years ago. Stocks, as always, can become volatile without warning as we found during the recent flash crash and the Great Recession of 2008.

That said, blue chip stocks are now perhaps the most compelling sector of the investment spectrum. They have stronger financial positions than most other entities, including many national governments (with the caveat that most national governments can print money). Blue chip companies are sitting on piles of cash and are making more money every quarter to add to the pile. They usually pay a nice, tax-advantaged, often-growing dividend, on top of their long term growth potential. Thus, blue chips provide a lot of worthwhile benefits in this uncertain world. Microsoft is a case in point. It has \$31 billion in cash. It pays a 2.3% dividend that was just increased 23% in September (this still only represents about 25% of their increasing profits). Microsoft is growing nicely of late yet sports a p/e ratio of eleven.

Turnarounds Can Surprise

It is human nature to make long term, knee-jerk predictions when big news events occur. Often, these prognostications—even those made by experts—are wildly wrong. This year in the NFL, Michael Vick had an MVP-like season for the Philadelphia Eagles. It’s easy to forget that he was recently in prison for two years and many experts wrote off his future prospects at that time.

Everyone remembers BP’s troubles in 2010. As oil leaked into the Gulf for months, BP’s reputation took a huge beating and many thought BP would end up declaring bankruptcy. Now, less than a year later, BP is out of the daily headlines. Though not out of the woods from the economic distress of affected Gulf businesses, nor of environmental issues due to the spill, BP is quietly improving as a company and as a stock.

Conversely, Apple had an incredible 2010. They kept blowing the doors off earnings estimates as iPhones and iPads were in hot demand around the world.

It may seem totally counterintuitive, but I would not be surprised in the least if BP has a better 2011 in the stock market than Apple. Perspectives often change much more quickly than we expect and fortunes have a way of changing without much notice. Investors ultimately look at what’s coming down the road rather than what is in the rearview mirror. Apple will have a hard time continuing to wow us each and every quarter since expectations are already sky high. Conversely BP, with few proponents, would have to do relatively little to begin to impress.

Remember, just two years ago, many people—including more than a few in Congress—were discussing whether GM and Chrysler should be saved or just left to close their doors (and Ford apparently wasn’t far behind). Now all three are enjoying what could be a big comeback while the long-time industry kingpin—Toyota—is looking vulnerable. Fortunes can change before we are aware of it. As an investor, it pays to keep this in mind.

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