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Radical Idea: Long-Only Hedge Fund

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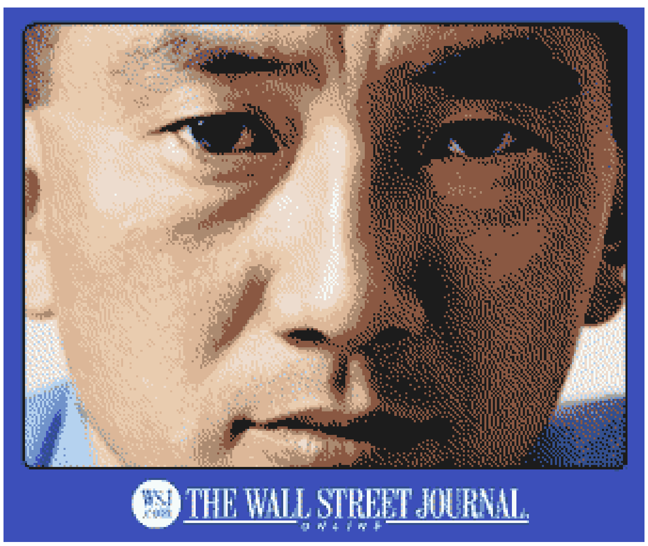
By Jon D. Markman, RealMoney.com Contributor

So far, 2004 hasn't been a great year for the hedge-fund community. According to a report published by Standard & Poor's on Thursday, an index tracking the major funds was up just 0.43% through the end of September. A sub-index tracking funds specializing in event-driven trading has fared best, up 1.9%, while an index tracking managed futures funds has fared worst, down 5%.



Meanwhile, there are persistent rumors that several of the largest trend-following funds in the country are down as much as 30% this year, as they have been chopped to death with whipsaws in the currency, grain and equity index markets.

The longer-term record of all of S&P hedge fund indices is terrific: up around 18% over three years and 48% over five years. So the recent underperformance of the indices, plus the serious downdrafts among the trend-followers, has made many high-net-worth investors wonder what is going on.

The popular answer among many in the hedge-fund community -- which may well be the right answer -- is that there are just too many funds now pursuing the same strategies. If a handful of multibillion-dollar funds are, for instance, long soybeans and short the U.S. dollar, then the idea can make a lot of money for them as it plays out. But if a dozen multibillion- and 20 multimillion-dollar funds try to pursue the same trade, there just aren't enough suckers around for everyone to take money from. The market becomes so efficient that even the best ideas are arbitraged away.

On the equity side, most trend-following funds have developed sophisticated quantitative models to determine which stocks should be shorted. As I described in my Value Investor newsletter this week, every manager likes to think his factors and weights are unique, but at the end of the day, the dirty little secret is that they are all very similar. The models look for overvalued stocks in downtrends; pretty simple.

The problem is that the models tend to find a lot fewer stocks that deserve to be shorted vs. ones that deserve to be held long, so those trades get very crowded. In addition, since everyone knows what everyone else is shorting there are many funds that have

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discretionary, or non-quantitative, arms that use this data to trade against the short-selling quants -- producing massive, excruciating short-squeezes that force the stocks up in big bursts of covering.

Now comes Steve Mandel with a quaint idea. The widely respected hedge fund manager -- a graduate of Tiger Management -- is reportedly getting set to introduce a long-only stock fund called Lone Cascade because he has come to believe that there are so many hedge funds shorting stocks these days that it has become almost a no-win game.

According to an account of his presentation to investors, published at the Web site Seeking Alpha, Mandel said: "The constraint on the growth of our existing funds comes from the short side of our balance sheet. The number of compelling short ideas is limited and the recent flood of money into hedge funds has increased the competition for these stocks. We therefore believe that the ability to add value through shorting in the years ahead will be more limited than it has been. Thus, it is our view that a long-only fund can provide competitive net returns with a comparable long-short fund over the intermediate term."

A spokesperson at Lone Capital said the 6-year-old firm has a policy of not speaking to the media, and it would not confirm SeekingAlpha.com's account. The spokesperson did confirm that the organization is starting a long-only fund and had discussed it with potential investors.

As the author of SeekingAlpha.com points out, it is remarkable to hear a major fund manager suggest that shorting stocks has become a tough game because of the difficulty in scaling the methodology. In other words, he is saying there just aren't enough shares of the kind of stocks everyone wants to short to allow anyone to make money. If true, it would account in part for the surprising shortfall in hedge-fund performance in the past year. And it would be ironic, not to mention potentially amusing, since so many mutual funds are now lobbying the **Securities and Exchange Commission** to gain the right to short; the same could be said of the higher fees being charged by many ordinary hedge funds, as reported in *The Wall Street Journal*.

Mandel is not necessarily implying that he foresees a bullish market environment. He's saying that his methodology of finding longs for this fund can succeed even in a challenging environment. This is a fair outlook. In 2000-02, as the broad market indices suffered, there was a roaring bull market in small-cap value stocks -- particularly regional banks, REITs and small industrial firms.

Shorting individual stocks is indeed a lot harder than it looks, particularly if you are trying to do it in size. Just look at the returns of stocks this year, which on the surface look so troubled. According to data in the screener database at MSN's Moneycentral Web site, among stocks with prices over $2 that trade at least 50,000 shares a day, gainers have far outpaced losers this year, 1900 to 1500. And if you narrow the search down to just stocks on the **New York Stock Exchange**, gainers outpace losers by nearly 2 to 1: 1,100 to 675.

If a trend away from short-selling becomes ingrained at some point, you can be sure it will ultimately go too far and set up some outstanding opportunities for bears down the road. I'll try to persuade Mandel to talk, and see if we can explore his point of view further.

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