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## No Longer Just the Facts

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Hedge-fund managers are ditching the just-the-facts formulas from their quarterly or annual investment letters, in an effort to hold and keep investors' attention. Here are excerpts from a few.

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*An excerpt of the investment letter sent from Americus Capital Advisors managing principal Paul J. Reiferson and principal Jeffrey Lopatin to investors on Jan. 23, 2006*

Right outside our office here on 60th Street, people routinely race in front of speeding taxis, risking their remaining lifetimes to save seconds. Explained in those terms, many would presumably see its foolishness, but they do it not because they are dim-witted, but because they are human. Should we expect different behavior when people risk not their own lives but other people's money?

"Everyone in Manhattan does that," the man in the street might answer, "and I have never seen anyone hit." Your portfolio manager sometimes catches himself using similar logic. When his 5-year-old son tearfully asked him not to go to work, he answered comfortingly: "Has Daddy ever left for work and not come home?" These are not satisfactory answers. No matter how many times someone successfully darts before a taxi or Daddy leaves for work and comes home safely, it does not alter the calculus of catastrophe.

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Americus is obsessed with this line of thinking. One story in particular has been a continual inspiration for investments, and relics relating to it collected over many years serve as constant reminders. One is a 1908

baseball with a message inscribed on its surface in ink, dirt, grass stains and scuffs. Another is a photograph of Fred Merkle, whose life was ruined by that ball, which sits directly on your portfolio manager's desk. The story reads like fiction: the New York Giants and the Chicago Cubs are in one of the closest pennant races in baseball history. It is the top of the ninth inning at the Giants' own Polo Grounds with the score tied and two out. Merkle, a smart, cool-headed, rookie infielder, hits a timely single, advancing "Moose" McCormick to third. Al Bridwell singles to center field, scoring McCormick. Merkle, fearing the thousands of fans pouring onto the field, runs to the Giants' center field clubhouse before touching second. This is not at all unusual, since fans exit from center field, and Merkle is merely doing what he normally does. Cubs second baseman Johnny Evers sees the potential to force Merkle out and calls to the center

fielder for the ball, who throws it over Evers' head. Giants third base coach "Iron Man" Joe McGinnity also sees what is unfolding, grabs the ball and throws it into the stands. Two Cubs infielders race into the stands, seize the ball from a fan, and return it to Evers, who stands on second holding the ball aloft (the same ball in Americus' offices). Umpire Hank O'Day runs to second, where he is surrounded by Chicago players and a riotous mob, which begins to beat him until police escort him from the field.

There is on the National League's books Rule 59, which states that if a base runner reaches home during a play in which the third man is forced out, the run does not count. In the whole history of the National League, Rule 59 has never once been enforced. Every time Merkle has ever seen a similar play, the run has counted despite the force-out. Only two weeks before, in fact, Umpire O'Day allowed a run in a nearly identical situation, which the Cubs protested. But today, perhaps influenced by that protest, O'Day calls Merkle out, disallows the run and declares the game a tie.

National League President Harry Pulliam upholds O'Day's decision (the pressure will contribute in a few months to Pulliam's suicide) and declares that if Merkle's base-running error causes the Cubs and Giants to tie, there will be a special playoff game. At season's end, for the first time in baseball history, the teams are tied and the playoff is held. "Merkle's best chance to go down in baseball history is for the Giants to lose today," writes the St. Louis Post-Dispatch. "At least a dozen persons will then remember him for life." The Giants lose. Almost fifty years later, The New York Times reports his death: "Fred Merkle, former major league baseball player who was best remembered for a 'boner' that cost the New York Giants the pennant in 1908, died today. He was 67 years old." It is part of the logic of life that the punishment for such mistakes is excessive.

Merkle's story tugs at us because he enacts a classic problem in philosophy. For centuries, it was taken for granted that repeated observations can prove a hypothesis. Newton's theory of universal gravitation, for example, was understood to be a "law" because every observation seemed to confirm it. David Hume showed in 1740 that nothing justifies this logical leap. Hume's followers invoked the experience of Europeans who had, for thousands of years and through countless observations, seen nothing but white swans. The phrase "all swans are white" even appeared in a popular logic textbook. But when Australia was settled by Europeans, they discovered black swans. No number of observations of white swans could ever justify the conclusion that all swans are white. Hume's reasoning is unimpeachable. Even Newton's "law" of universal gravitation was supplanted by Einstein's general relativity. Yet Hume's argument was never fully accepted. It was reintroduced in 1934 by Karl Popper, who appeared to end the argument for all time, at least in philosophy departments.

But there will never be an end to it. Otherwise smart people will risk their lives to save seconds crossing 60th Street, parents will comfort their children with faulty logic, ignored rules will be enforced, "laws of nature" will be supplanted and investors will risk dollars to make pennies.

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*An excerpt from an investment letter sent by Stark Investments managing partner Michael Roth  
Sept. 14, 2004*

## **Risk Arbitrage - Slammed I Am...or...Unattractive, and the Most Likely Reason of All May Have Been That the Spreads Were Two Sizes Too Small**

What do we think about the opportunities in risk arbitrage? Well...

We do not like them

They're a sham

We do not like them

You'll get whammed

We would not like them here or there

We would not like them anywhere.

We do not like the tight spread jam.

We do not like them they're a scam.

We do not like them in a house.

We do not like them with a mouse.

We do not like them here or there.

We do not like them anywhere.

We do not like the risk and spam.

We do not like them you'll get crammed.

Not in a box.

Not with a fox.

Not in a house.

Not with a mouse.

We would not buy them here or there.

We would not buy them anywhere.

We would not buy them and get slammed.

We do not like them they're flimflam.

We would not, could not, in a car.

We would not, could not, in a tree.

Not on a train! Not in a tree!

Not in a car! Just let them be!

We would not, could not, in the rain.

Not in the dark. Not on a train.

Not in a car. Not in a tree.

We do not like them, so you see.

We could not, would not on a boat.

We will not, will not, with a goat.

We will not buy them in the rain.

We will not buy them on a train.

Not in the dark! Not in a tree!  
Not in a car! Just let them be!

We do not like them in a box.  
We do not like them with a fox.  
We will not buy them in a house.  
We will not buy them with a mouse.  
We do not like them here or there.  
We do not like them ANYWHERE!

Well, that may be a bit too much.  
They may not all be bad, as such.  
A few made money quarter past.  
But the few good deals don't long last.

By and large spreads are too tight.  
And any relief is not in sight.  
M&A is not the answer.  
Too much capital is like a cancer.

So that's why risk arb is a sham.  
That's why we don't give a, er, darn.

\* \* \*

*An excerpt from an investment letter sent by Stark Investments managing partner Michael Roth in October 2005*

### **October -- Stark Ravin' Bad**

Once upon a market dreary, which meandered, weak and weary,  
Given many a quaint and curious report of macroeconomic lore --  
While I nodded, nearly napping, suddenly there came a tapping,  
As of someone gently rapping, rapping on my trading floor.  
" 'Tis some investor," I muttered, "rapping on my trading floor--  
Only this and nothing more."

Ah, I do recall cold sober it was in the bleak October;  
And each separate widening spread wrought its ghost upon the floor.  
Eagerly I wished the morrow -- vainly I had sought to borrow  
From my trades surcease of sorrow -- sorrow for the lost bravado--  
For the appetite for risk that had been widespread heretofore--  
Gone this month for evermore.

And the sudden, sad, uncertain busting of each merger spread  
Thrilled me -- filled me with fantastic terrors never felt before;

So that now, to still the beating of my heart, I stood repeating,  
" 'Tis some investor entreating entrance to my trading floor--  
Some nice investor entreating entrance to my trading floor--  
That it is and nothing more."

Presently my soul grew stronger; hesitating then no longer,  
"Sir, " said I, "or Madam, truly your forgiveness I implore;  
But the fact is I was trading, and so gently you came rapping,  
And so faintly you came tapping, tapping on my trading floor,  
That I scarce was sure I heard you"-- here I opened wide the door--  
Darkness there and nothing more.

Deep into the darkness peering, long I stood there wondering, fearing,  
Doubting, dreaming dreams no mortal ever dared to dream before;  
But the silence was unbroken, and the stillness gave no token,  
And the only word there spoken was the whispered word, "Bernanke?"  
This I whispered, and an echo murmured back the word "Refco!"--  
Merely this and nothing more.

Back into the chamber turning, all my soul within me burning,  
Soon again I heard a tapping somewhat louder than before.  
"Surely," said I, "surely that is something from my apparatus;  
Let me see, then, what threat is, and this mystery explore--  
Let my heart be still a moment and this mystery explore--  
'Tis the software and nothing more!"

Open here I flung the door, when, with astounding speed there tore,  
In there stepped a market maven, looking every bit hardcore;  
Not the least obeisance made he; not a minute stopped or stayed he;  
But, with mien of lord or lady, perched inside my trading floor--  
Perched upon an Aeron chair just inside my trading floor--  
Perched, and sat, and nothing more.

Then this loony dude beguiling my sad fancy into smiling,  
By the grave and stern decorum of the countenance he wore,  
"Though thy head be shorn and well tanned, thou," I said, "art sure no  
Greenspan,  
Ghastly grim and ancient maven steeped in monetary lore--  
Tell me truly what returns the future market holds in store!"  
Quoth the maven, "Nevermore."

Much I marveled this ungainly dude to hear discourse so plainly,  
Though his answer little solace -- little comfort bore;  
For we cannot help agreeing that no living human being  
Ever yet was blessed with seeing such a seer on his trading floor--

A market maven with such foresight standing on his trading floor,  
With such a bearish view as "Nevermore."

But the maven sitting lonely on the placid chair, spoke only  
That one word, as if his soul in that one word he did outpour.  
Nothing further then he uttered, not a syllable was sputtered--  
Till I scarcely more then muttered, "Other trades have blown before --  
On the morrow my trades will soar, as my trades have shone before."  
Then the dude said, "Nevermore."

Startled at the stillness broken by reply so aptly spoken,  
"Doubtless," said I, "what he utters is his only stock and store  
He must be some hedge fund master whom unmerciful Disaster  
Followed fast and followed faster till his fund one burden bore --  
Till the dirges of his Hope the melancholy burden bore  
Of 'Never - nevermore.'"

But the maven still beguiling all my fancy into smiling,  
Straight I wheeled a cushioned seat in front of the dude so near the door;  
Then upon the cushion sinking, I betook myself to linking  
Fancy unto fancy, thinking what this ominous dude of yore--  
What this grim, ungainly, ghastly, gaunt, and ominous dude of yore  
Meant in croaking, "Nevermore."

This I sat engaged in guessing, but no syllable expressing  
To the dude, whose fiery eyes now burned into my bosom's core;  
This and more I sat divining, with my head at ease reclining  
On the trading desk that the Bloomberg gloated o'er  
But with monthly losses piling with the Bloomberg gloating o'er  
Shall I trade, no, nevermore?

Then methought, the air grew tenser, could this guy be any denser?  
Opportunities lay all about, all around the trading floor.  
"Wretch," I cried, "thy sense has left thee – good returns are never risk free  
Some trades have become repulsive and those trades we now ignore!  
Opportunities abound my friend, so forget the trades you so deplore!"  
Quoth the maven, "Nevermore."

"Profits!" said I, "think of deals! – they're all around, they have appeal!  
Whether bearish bent, or whatever losses made thee very sore,  
People here are all undaunted, on this frozen land enchanted --  
In this home by Cheesheads haunted -- tell me truly, I implore --  
Have you – Have you any sense left? -- tell me -- tell me, I implore!"  
Quoth the maven, "Nevermore."

"Profits!" said I, "think of new stuff! – profits always won't be so tough!  
By the heavens that bend above us -- by the markets we both adore--  
Lift thy soul with sorrow rich, for by trading within many a niche,  
You shall clasp a return for which, you shall shout 'bring me some more' --  
And avoid the fatal glitch that produces returns which you'll abhor."  
Quoth the maven, "Nevermore."

"Be that word our sign of parting, dude or fiend!" I shrieked, upstarting --  
"Get thee back into your limo and take the pessimism you bore!  
Leave no black cloud as a token of that lie thy soul hath spoken!  
Leave my optimism unbroken! – please get off my trading floor!  
Take thy bleak from out my heart, and take thy form from off my floor!"  
Quoth the maven, "Nevermore."

And the maven, never flitting, still is sitting, still is sitting  
On the pallid Aeron chair just inside my trading door;  
And his eyes have all the seeming of a demon that is dreaming,  
And the lamp-light o'er him streaming throws his shadow on the floor,  
And my soul from out that shadow that lies floating on the floor  
Shall be lifted -- evermore!

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