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Eureka! I discovered how funds are named

By Terry Smith

Hedge funds' performance was lamentable during the financial crisis

Last month Calpers, the California Public Employees' Retirement Scheme, one of the world's largest pension funds, announced it was withdrawing its $4bn investment in hedge funds. This raises some serious issues, not the least of which is why it invested in hedge funds in the first place.

In its fiscal year ended June 30 2014, Calpers earned just 7.1 per cent on its hedge fund portfolio compared with 18.4 per cent on its fund overall. But 2013-14 was not a uniquely bad year for hedge funds and neither was Calpers' poor experience unusual. The average hedge fund returned an average of 7.4 per cent in 2013, underperforming the S&P 500 Index by 23 per cent and underperforming the market for the fifth straight year.

In a sense the underperformance of hedge funds against a benchmark is not the main problem for a fund such as Calpers which should probably ignore index benchmarks anyway, but the underperformance of hedge funds compared to what Calpers can and has achieved in other investments is more problematic – as is the fact that it paid $135m in fees in 2013-14 to those hedge funds.

In his 2012 book *The Hedge Fund Mirage*, Simon Lack presented evidence that over the period 1998-2010 hedge fund managers' fees accounted for between 86 per cent and 98 per cent of total returns earned. The term "hedge fund" has become a means of describing a fee structure which benefits the fund managers rather than a description on any particular methodology of investment.

Calpers' exit has sent hedge fund managers a public health warning

Unlike bankers, who have made efforts to appear contrite following the financial crisis, "hedgies" strenuously point out their industry has done nothing for which it should apologise

The defence which is sometimes raised for hedge funds is that this underperformance is not a good reason to abandon them, as their strategies are uncorrelated to the general trend in markets and that will prove worthwhile when markets go into reverse. This would be more credible if it weren't for their lamentable performance during the financial crisis of 2008-09 when so many of them proved to be leveraged long-only funds rather than hedged in any way which would justify the name.

However, there may have been another way of spotting the incipient problem in Calpers' hedge fund portfolio. Of the 24 hedge funds involved, no less than 11 had the word Eureka in their title. "Eureka!" is the translation of an ancient Greek word meaning "I have found it!" which Archimedes is alleged to have exclaimed upon discovering the way to measure the volume of an irregular object by measuring its displacement of water. More recently, it became a term associated with the discovery of gold, especially in the California gold rush of the 1840-50s.

Naming your fund after such a well-known scientific discovery or finding riches was setting yourself up for a fall or your investors for disappointment, but it was clearly of great benefit if you were trying to market your fund to Calpers.

This brings me to the subject of fund names. You may be familiar with the concept of the circle of competence, often quoted by the great investor Warren Buffett and his partner Charlie Munger. The idea is that you are only likely to succeed in investing if you stick to investing in things which you understand, which seems intuitively obvious but is often disregarded by many investors.

Names of funds are often a clue to the fact that you may not understand what they do (or perhaps aren't meant to). I am spoilt for choice with regard to examples, but I wonder what investors in the "SocGen UK Step Down Defensive Kick-out Plan" think they own, for example.

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Many fund names also send warning signals by breaching Smith's Law which states that you should never use a phrase if its opposite is so illogical that you would never say it. For example, you may find individuals who refer to "forward planning". Has anyone ever done any backward planning? At best, forward planning is tautology. How many companies say they will grow by means of "selective acquisitions"? Of course, none would say they have a policy of indiscriminate acquisitions (even though that is surely the reality in some cases).

What are we to make of the Sanlam Global Best Ideas Fund? Would anyone ever market a Worst Ideas fund? If I were an investor with the group I might be concerned about what I was getting in any of their other funds. How about Pimco's Fundamental Advantage Fund? Would the fees perhaps be lower to attract investors into a Fundamental Disadvantage fund?

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