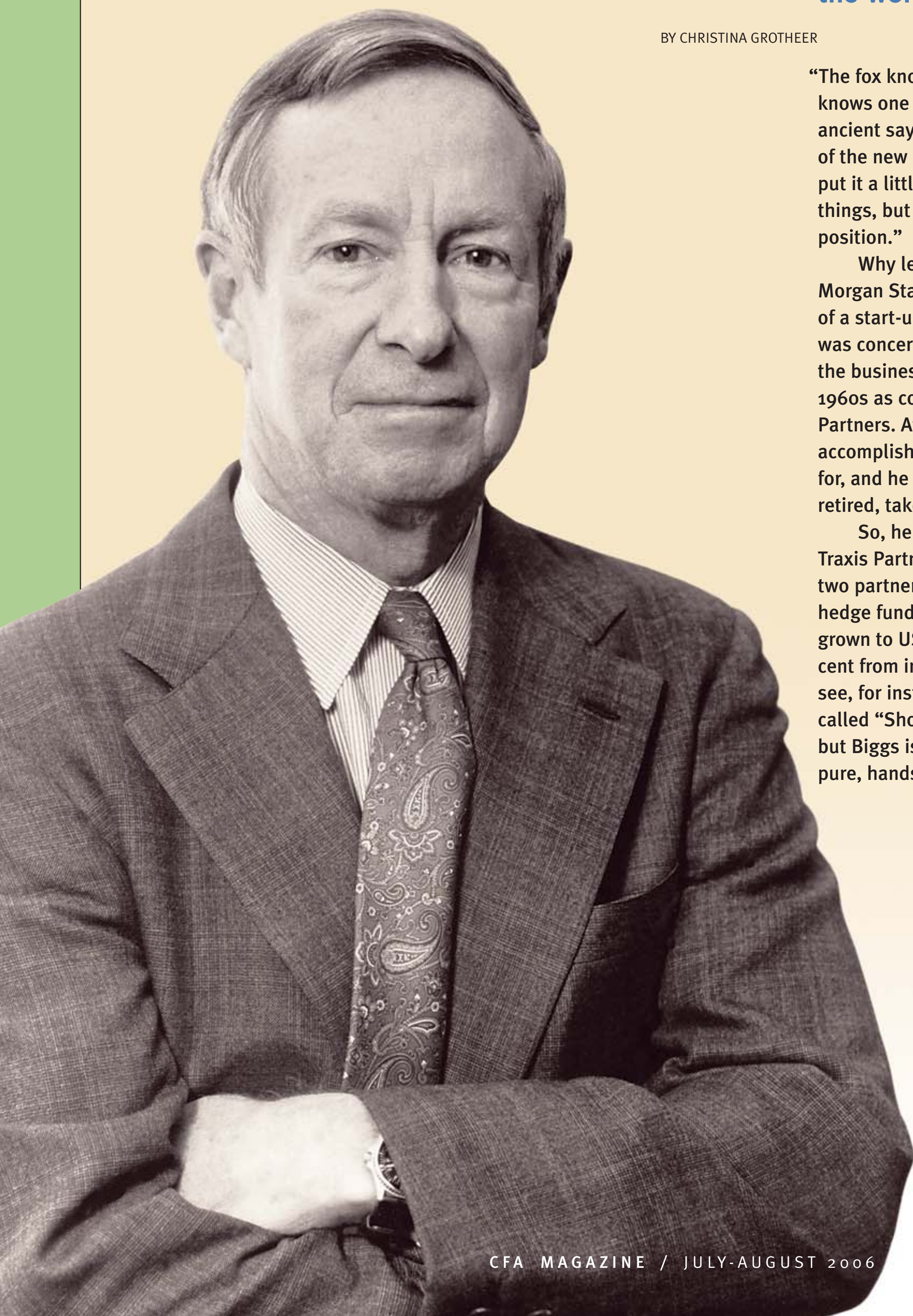
# THE HEDGEHOG

**Barton Biggs on hedgehogging, mug's games, and why investment management is the most overcompensated business in the world.**

BY CHRISTINA GROTHEER



"The fox knows many things, but the hedgehog knows one big thing." If the originator of that ancient saying had known Barton Biggs, author of the new book *HedgeHogging,* he might have put it a little differently: "The fox knows many things, but the hedgehog is shorting the fox's position."

Why leave the security of 30 years at Morgan Stanley for the extreme unpredictability of a start-up hedge fund? As far as Barton Biggs was concerned back in 2003, why not? He knew the business from his initial foray in the late 1960s as co-founder of the hedge fund Fairfield Partners. At Morgan Stanley, he had already accomplished everything he could have hoped for, and he wasn't particularly enamored of a retired, take-it-easy, lots-of-golf lifestyle.

So, he decided to make a fresh start. Since Traxis Partners was launched by Biggs and his two partners just under three years ago, the hedge fund's assets under management have grown to US$1.5 billion (an increase of 55 percent from inception). It hasn't been all roses—see, for instance, the chapter in *HedgeHogging* called "Short Selling Is Not for Sissies"—but Biggs is back to doing what he most loves: pure, hands-on money management.

**You've probably been asked this question a thousand times, but are we reaching a critical mass of hedge funds?**

I don't think so. About a thousand new hedge funds start up every year, and a thousand old ones disappear every year. And they go out of business not because they crash and burn in some dramatic way but because they simply don't have enough performance to attract money and to keep their managers alive. Twenty percent of nothing is nothing.

**Has the SEC's relaxing of restrictions on leverage and shorting by mutual funds led to increased crowding in certain styles of hedge funds?**

Sure, that's definitely happening. The short side, currencies, and commodities are overpopulated with momentum traders, some of whom are crazy. I think they are mug's games.

**Are hedge funds becoming less of an alternative investment?**

I don't think the right description of hedge funds is that they are alternative investments. They are absolute return investments. That's the category that somebody like [academic researchers at] Yale or Harvard classifies them under: absolute return, not alternative investments.

I suppose you could say that to the extent hedge funds perform the way they did in the last bear market, then they could be called an "alternative," but I think absolute return is more accurate. Hedge funds are—

**In search of alpha?**

Right. And alpha comes in varying forms at different times. Particular ways to run money come in and out of style. Back in the late 1960s and early 1970s, so-called go-go investing was very much in style, where everybody wanted to have an investment management firm that was filled with young, aggressive "kid" investors who had no memories, no scars, and no fear. The kids obsessed on buying small growth stocks, and then in the early 1970s, they collected some serious scars.

In the later 1970s, market timers came into style. Then, there was a long period where the big investment firms were thought to be the right place to have your investments. That was the rise of Capital Research and Alliance and places like that.

And now we're having a migration of talent away from those big investment management firms for a variety of reasons. I talked about this in the book—the bureaucracy, all the rules, the conflicts of interest—so, the talent is migrating to hedge funds.

The hedge fund is another way for people to run money. It happens to be a way in which there are high fees charged. Eventually, the sheer size of the money going into hedge funds and the number of hedge funds that exist are going to inevitably result in a decline in hedge fund fees. In fact, my guess is that compensation across the investment management business is beginning a secular decline. It's the most overcompensated business in the world. Never have so many been paid so much for adding so little. It's an evolutionary process.

**What most concerns you about hedge funds moving into private equity?**

In the first place, I think private equity is the next great bubble. There is no asset class too much money can't spoil. Second, it's a highly illiquid, long-term investment, which is totally inappropriate for hedge funds that have liquidity requirements. Third, most hedge fund managers don't know anything about it.

**What can hedge funds do to minimize tax consequences for their investors?**

That's up to the style of the manager. There are going to be trading hedge funds that are more inclined to take a lot of trading profits and losses; they are going to generate short-term gains. There are also other hedge funds, which we're more like, that are more long-term investors and so are conscious of creating long-term capital gains.

It is a case of what the hedge fund's investment style is, but I think that hedge fund managers should be aware of their investors' tax considerations and they should be motivated to strive for long-term rather than short-term gains.

**According to one article, a London-based fund of funds is creating a fund of funds of funds, which will invest in 11 underlying funds of funds, adding a third layer of fees. What do you think about this?**

It's ridiculous. It is so silly that I don't know what else to say about it.

**Back in the 1960s, you co-founded a hedge fund in which you almost got a lesson in Keynes' belief that "the market can remain irrational longer than you can remain solvent." What happened?**

We were short the Nifty Fifty. We went short a little early and they kept on going up. But when the market began to break, they went down and we began to develop big profits in them.

We covered our shorts too soon. It's similar to when stocks are going up; you can never imagine how high they are going to go at the peak of euphoria. The same thing applies to even superb growth companies when they are going down: You can never imagine how low they are going to go in the depths of despair. And God forbid that they momentarily have a business stumble.

**What are the most striking differences between today's hedge fund world and what you experienced the first time around?**

It's not really that different. It's obviously a much, much bigger space, and the fund of funds didn't even really exist in the 1970s, but it's still the same old game, what Adam Smith wrote about in his book *The Money Game*: It's the same old game. It's bigger and faster in terms of the money flows than it was then, but I don't think it's that much different.

**What made you decide to go back to hedge fund investing in 2003?**

I love Morgan Stanley! It made me rich, but I'd been at Morgan Stanley for 30 years and I felt it was time to move on. I'm an investor, not a corporate manager. Also, I really wanted to be able to focus on running one portfolio with my own money in it rather than focus on running 10 portfolios with all kinds of restrictions with what I could do with my own money.

**Have you ever come close to starting over your portfolio at Traxis Partners the way Baruch and Livermore used to?**

We definitely do that. When the portfolio feels stale, we do go through an agonizing reappraisal process. We don't sell everything, but we try to simulate the new money experience. We go away for a weekend and each of us separately constructs a fresh portfolio. In effect, we consciously construct the portfolio and bring it to the office. Then the three of us talk about it and discard the dead wood from the old portfolio.

**I love your quote of John Masters that "if you feel entirely comfortable, then you're not far enough ahead to do any good." How many positions do you have that fit into this category?**

Yeah, that warm feeling of everything going well is usually the body temperature at the center of the herd. We describe ourselves as being contrarians, so when we have positions that seem to be in the consensus—that everybody else likes as well—it makes us nervous and forces us to analyze the ruling reasons for those positions even more carefully.

**How are you feeling about the market in 2006?**

In the book, I said that a number of very smart people whom I respect believe that we have not made the lows of the 2000 secular bear market. I think we have. I think we made the lows in 2003. So how do I feel? I'm still very bullish about the market as of this date—April 22, 2006.

**What are your thoughts about Asia today?**

I think we are halfway through a secular bull market in the emerging markets. Emerging markets now sell at a discount on valuations to the developed markets. Emerging markets as a group sell at 12–13 times earnings. Developed markets sell at 17–18 times earnings.

I think before the bull market in the emerging markets is over with, emerging markets will sell at a premium to the developed markets. Since markets are prone to bubbles, particularly in a global investment world with excess liquidity, it's likely the emerging markets will end in a big bubble somewhat comparable to the tech bubble. I hope so.

**You hope so?**

All big, long bull markets end in a bubble because that's the nature of investor greed and fear. I hope it does in the sadistic sense that we will make a lot of money on the way up and, as usual, sell too soon.

**Got it. What other regions are you excited about right now?**

We have a high percentage of our fund in emerging markets, one way or another. In Europe, we own Turkey and Russia. In South America, we own Brazil and nothing else. In Asia, we own a broad cross-section from Thailand and Malaysia to Taiwan and Korea, and I really view Hong Kong as an emerging market. And we, like everyone else, like Japan.

**You make a number of references to behavioral biases in *HedgeHogging*. What do you think about behavioral finance?**

What do you mean by behavioral biases?

**I noticed a number of places where you talked about market sentiment being irrational or how investors too often buy high and sell low, which made me wonder if you were a proponent of behavioral finance.**

Behavioral finance? Is that a synonym for the madness of crowds?

**It's the idea, mainly from academia, though a few investment management firms are applying it, that you can make money exploiting inefficiencies in the market that are created by predictable, but irrational, investor behaviors.**

Yeah, OK, I view that as an article of truth; it's part of being a contrarian. It's all part of what's pretty obvious in markets: That markets are always reflecting what the conventional wisdom of the time is. And the job of the investor is to identify what the conventional wisdom is, whether it's wrong, where the investment opportunities are. So if that's behavioral finance, then I believe in behavioral finance [laughs].

*Christina Grotheer is a contributing editor and an editorial consultant to* CFA Magazine.

Though he was born with a "silver investment spoon" in his mouth, Barton Biggs didn't get interested in investing until he found himself at loose ends a few years out of college. His father told him to read Benjamin Graham's *Security Analysis* once and then again. He was hooked, finished at the top of his business school class, and went to work as an analyst at EF Hutton in 1961.

Just four years later, he launched a hedge fund, Fairfield Partners, which he left in 1973 to become a managing director and general partner at Morgan Stanley. Biggs spent the next 30 years at Morgan Stanley.

He was the firm's first research director. He also established Morgan Stanley Investment Management in 1975 and served as its chairman for 30 years. *Institutional Investor* magazine named him to its All-America Research Team 10 times, and from 1996 to 2003, he was voted the top-ranked global strategist.

By the mid-1990s, Morgan Stanley Asset Management was annually adding more new institutional accounts than any of its competitors. Biggs also was a member of the five-man executive committee that ran Morgan Stanley until its merger with Dean Witter in 1996.

In June 2003, Biggs left Morgan Stanley. He and two colleagues, Cyril Moulle-Berteaux and Madhav Dhar, formed Traxis Partners—the largest new hedge fund of 2003. Traxis now has more than US$1 billion in assets under management.