

## **When Risk Is Ignored**

### **Who's Zoomin' Who**

**By Glenn Kautt, CFP, EA**

Readers may remember the title, "Who's Zoomin' Who?" from the Grammy winning album by Aretha Franklin in 1985. "You will remember my name," Aretha wryly announces at the end of this album's title cut. "I'm the one who beat you at your game." The title refers to street slang popular in the 80's for someone trying to hustle another person. Aretha Franklin put it in the context of men trying to impress her with talk and other antics. Of course, she saw through their charades, at least in the song.

A few years ago, a headline caught my eye in the *Wall Street Journal*. "In 7 Days, a Hedge Fund Lost All Value," reported the headline Friday, January 24, 2003. This \$300 million hedge fund, bankrolled with as much as \$180 million from well-known investor George Soros, went down in a highly publicized ball of flames. The choice of the fund's name "Eifuku," meaning good fortune or prosperity in Japanese, could not have been farther from the truth. The spectacular collapse suggests what we know so well—the world's smartest and best known investors lose their shirts when they place highly leveraged, risky bets.

At the time, this fund had been in existence for three years and it was flying high. It returned a reported 18 percent in 2001, its first full year of trading. Then, it rocketed up 78 percent in 2002. That amazing return points out the even more amazing amount of risk the fund was taking in placing its investment bets. Another hedge fund manager quoted in the *Journal* said, "You need to be aware that if you can make that much money, you can also lose that much money." No kidding!

In all of this, where's the consideration for risk? Where's the idea of an efficient portfolio? Remember William Sharpe and his Nobel Prize winning work on the efficient investment frontier and the Sharpe Ratio? What do you think the Sharpe Ratio was on this hedge fund? In a way, doing a post mortem analysis is a bit like doing an investigation at a crime scene. Who did this terrible thing? The fund manager, a guy (criminal?) named John Koonmen was borrowing money from three large brokerage firms and placing bets by both buying and selling various securities. On one—that's *one*—trade he waged over *\$1 billion* in NTT DoCoMo, Inc., Japan's largest cellular telephone provider and its parent company Nippon Telegraph & Telephone Corp. using borrowed money.

Of course, Koonmen made millions from rapid-fire trading of stocks, bought a metallic-gray Aston Martin Vantage sports car, lived near the top of a luxury tower in a posh Tokyo district and owned a plush home in Hawaii. Frankly, this guy reminds me of some other extremely well educated and bright guys who blew it big-time with Long-Term Capital Management a few years ago. The principals of that firm vaporized over \$5 billion and nearly caused the failure of Wall Street. What were these guys thinking?

Well, the only positive news about the demise of Eifuku is that it won't create any major stress in the financial system, in contrast to the Long-Term Capital Management situation. The differences are the size of the bets, which were less than

one percent of Long-Term Capital's, the management of the loans in today's financial markets, and the fact that the risk was owned by private investors in the fund including the large stake held by Soros. By the way, the Sharpe Ratio for this sorry loser, which is annual return minus the risk-free return divided by the standard deviation of return, is in the minus 100s range.

So, who's really zoomin' who these days? In search of the financial equivalent of the Golden Fleece, the lost Ark of the Covenant, the Silver Chalice and King Arthur's Excalibur, really smart people are still doing really stupid things. Hedge funds are not heavily regulated. Other headlines in the *Wall Street Journal* and other financial publications point to the US Security and Exchange Commission's consideration of major changes to the way hedge funds are regulated—currently, only 40 percent of funds are managed by companies that register with the SEC! Yet people are still being suckered by talk of some "system", some new technology, etc., etc., etc.

No matter how they are registered, the real problem is that investors truly do not understand and cannot adequately measure or gauge the level of risk inherent in these types of highly focused and leveraged investments. This is true of other investments, too. The measurement and assessment of risk in relation to return, postulated by Harry Markowitz and William Sharpe over 40 years ago, has led to an entire industry devoted to understanding and managing risk first, then seeking superior returns. The empirical evidence is overwhelming for large or small scale investing: risk and return go hand in hand. The much too clever Koonmens of the world probably knew these rules at some point in their careers, but forgot to play by them, obviously.

So, somewhere out there somebody's probably zoomin' somebody else. When someone approaches you with a really good deal...be careful!