

LGC&D Wealth Management, LLC

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The Boston Red Sox, John Henry and Another Bad Luck Streak

Overview: Boston Red Sox owner John W. Henry is also the founder of an investment firm that acts as a Commodity Trading Advisor (CTA). What are CTAs, and should they have a role in an investor's globally diversified portfolio? Academic evidence has indicated that for prudent investors it is better to avoid CTAs and continue to follow a disciplined strategy based on their individual long-term financial objectives with a portfolio of passively managed asset class funds.

The Boston Red Sox in a Nutshell

The Boston Red Sox won the World Series in 1912, 1915, 1916 and 1918. Then, in January 1920, they completed what may have been the worst trade in the history of baseball when they sent Babe Ruth to the New York Yankees. The Red Sox did not win another World Series until October 2004 when the "curse of the Bambino" was finally broken. John W. Henry, who purchased the team in 2002, was one of many individuals at the center of attention in the sporting world. But Henry was already well-known in the financial world as the founder of the investment firm, John W. Henry & Co.

Who is John Henry?

Forming John W. Henry & Co. in 1982, Henry made his fortune managing hedge funds in the commodities and futures markets and delivering great returns. The firm is registered with the Commodity Futures Trading Commission (CFTC) as a Commodity Trading Advisor (CTA). According to a March 2006 *Business Week* article, the president of the Futures Industry Association John Damgard was quoted as saying: "[Henry] is one of the all-time geniuses, and his track record has been extraordinary."¹

But recently the media has been reporting on a slump in Henry's funds. For example, Henry's Strategic Allocation Program, which lost almost 20 percent in 2005, lost an additional 10 percent in the first two months of 2006. That left investors with three-year annualized losses of close to 11 percent. Even the fund's five-year returns were below 3 percent (virtually identical to the return on one-year Treasury notes). And after a highly successful beginning, the fund's return since inception (July 1996) of 8.63 percent was now slightly below the 8.64 percent return of the S&P 500 Index for that period.

The fund's early successes did not help the majority of the fund's investors who jumped on the bandwagon during the last several years, after the stellar returns had been reported. In May 2005, the firm's assets under management stood at about \$3 billion. By March 2006, assets under management had shrunk to \$2.3 billion, perhaps a result of investors fleeing following poor performance.

Getting to Know CTAs

CTAs are defined as individuals or trading organizations registered with the CFTC through membership in the National Futures Association. They are granted the authority to make trading decisions on behalf of a customer in futures, options and securities accounts established exclusively for the customer, via a managed account. Actually, CTAs share several similarities with hedge funds, another investment vehicle we suggest is best avoided by the prudent, long-term investor.

- s Both are unregulated pools of assets.
- s Both typically charge a high fixed fee as well as a percentage of profits (usually 20 percent).
- s Both typically have a high water mark that supposedly protects investors. (An incentive fee is paid only on the portion of the gains that exceed the historical peak of the fund's net asset value.)
- s Both lack regulation, resulting in limited transparency. Investors may receive only very limited information on the performance as well as the riskiness of such funds. For example, a fund could provide high returns by using very high leverage (increasing risk in a highly volatile asset class).

Several academic papers have provided more insight into whether CTAs are worthy of consideration in an investor's well-diversified portfolio. In a paper published in the Fall 1997 *Journal of Portfolio Management*, the authors shared these findings:²

- s From 1986 through October 1996, 597 CTA funds had been dissolved with 304 CTA funds still operating.
- s Of the 323 CTA funds in operation at the end of 1989, only 95 were left by the end of 1995 — a mortality rate of 71 percent in just six years.
- s They also found that CTA funds dropped out of the database at almost four times the drop-out rate as for mutual funds.

A paper published in the September 2000 *Journal of Financial and Quantitative Analysis* found the following:³

- s Once reported returns of existing funds were corrected for survivorship bias for the period 1989–1997, realized returns were reduced by 3.6 percent per annum.
- s Covering the period 1989–1997, the paper found that such bias was at least two to three times higher than survivorship bias typically found in mutual funds.

A paper in the October 2001 *Journal of Finance* discussed the following:⁴

- s Funds that perform poorly tend to increase risks due to the incentive fee and the high water mark. This creates an unequal field in terms of incentives (agency risk), leading to the fund's propensity to double-down on bets, taking extreme risks when the CTAs incentive compensation is “out of the money.” Thus, characteristics that appear on the surface to be “investor-friendly” can instead lead to increased risk.
- s In addition, the high water mark increases the likelihood of a fund terminating its existence when it is “out of the money” in terms of incentive compensation.

In summary, a significant body of evidence has demonstrated that the ones most likely to experience wealth from CTAs are the fund sponsors and commission driven salespeople/advisors who market them. Like hedge funds, the cachet of privately managed accounts often attracts investors with high net worth attracted to the exclusivity. However, we feel that such products are highly risky investments with poor risk/return characteristics.

Henry & Co.'s Funds

Here is a summary of the track records of 10 John W. Henry & Co. funds, reported as of February 28, 2006. (Note: The performance data shown represents a one-year, three-year and five-year comparison of returns. These time periods were selected to provide a comparison based entirely on live data.)

- s One-year annualized returns ranged from –25.2 percent to 3.5 percent with nine of the 10 funds showing losses.
- s The three-year annualized returns ranged from –16.1 percent to –0.8 percent.
- s The five-year annualized returns ranged from –1.8 percent to 6.5 percent, with two of the 10 funds showing losses.

Benchmark	One-Year	Three-Year	Five-Year
Goldman Sachs Commodity Index	3.8%	10.9%	9.9%
Lehman Long-Term Gov't Bond Index	5.2%	4.7%	7.2%
MSCI EAFE Index	17.4%	28.9%	7.4%
S&P 500 Index	8.4%	17.1%	2.4%

Table I includes the one-, three- and five-year annualized returns of the four major indices/asset classes that the firm used as benchmarks. The poor performance of all the funds for the last several years left more than half the funds with performances below that of the S&P 500 Index (since their inception dates). Only in the case of the five-year returns, did even the best of the 10 Henry & Co. funds discussed above outperform one benchmark. (Six of the 10 funds outperformed the S&P 500 Index for the five-year period.)

Conclusion

What should an investor do with this information? Is Henry another Warren Buffett who just had a five-year run of bad luck? Did Henry inherit the curse of the Bambino when he bought the Red Sox? Or could it be that he was lucky in the early periods and now his luck has run out? While the evidence from academic studies suggests that it is likely that the latter explanation is the correct one, there is simply no way to know, at least before the fact. The real question facing investors is, why take that chance of it being luck when you don't have to?

¹ William C. Symonds, **Curse of the Bambino on the Trading Floor?** *Business Week*, March 20, 2006.

² William Fung and David A. Hsieh, **Survivorship Bias and Investment Style in the Returns of CTAs.** *Journal of Portfolio Management*, Fall 1997.

³ William Fung and David A. Hsieh, **Performance Characteristics of Hedge Funds and Commodity Funds: Natural vs. Spurious Biases.** *Journal of Financial and Quantitative Analysis*, September 2000.

⁴ Stephen J. Brown, William N. Goetzmann and James Park, **Careers and Survival: Competition and Risk in the Hedge Fund and CTA Industry.** *Journal of Finance*, October 2001.

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