

# Financial Control Limited

## THE INVESTOR February 2003

### Thought of the Month - Would risk transparency save investors?

As most of you know, hopefully from the press and not from your hard-earned dollars, several hedge funds have "blown up" in the past twelve months. The question is, for those who advocate transparency of risk figures on a monthly basis, would such transparency have saved investors from getting wiped out? Unfortunately, I don't think so in today's hedge fund reporting environment. In other words, such funds were wiped out in a matter of days or weeks, but hedge fund reporting is typically monthly and redemption frequency might be even less frequent. So how would transparency of risk reporting have helped? Then of course, there are prominent critics of several other aspects of risk reporting: on one hand there is Mr. Lars Jaeger advocating full position transparency because anything less is insufficient to allow one to properly judge risk<sup>1</sup>, and then there are those such as Mr. Nassim Taleb who argue that risk aggregation using metrics such as Value-at-Risk is meaningless<sup>2</sup>. So what's the right answer? Regardless of your position on disclosure of risk information, it seems that the only thing that may have saved investors in these funds is daily reporting of positions and risk details combined with daily redemption liquidity and tighter internal controls. A nice wish list!

### Why is the Sky Blue? Why are the "guys" running the Yale Endowment so admirable?

So the Yale Endowment only earned about 1%<sup>3</sup> last year? In a vacuum, that sounds quite bad. Compared to a CTA or macro hedge fund, it's even worse. But considering that the endowment has over US\$10.5bn and endowments are typically run very conservatively, it is nothing short of amazing. In other words, forgetting about market impact associated with such a large investment portfolio, with boards of governors, trustees, professors, administrators, and everyone else associated with a typical university offering their opinions on how "the nest egg that is the key to the intellectual capital of future generations" should be managed, it is a small miracle that the endowment is not parked entirely in US Treasury bonds. In other words, not only does the investment management team of the Yale Endowment have to constantly educate all interested parties about various choices in the investment universe ranging from timber to private equity, they must have the courage to actually invest significant portions of the endowment capital in a range of non-traditional asset classes. These allocations to non-traditional asset classes would most likely make the average institutional investor run for cover, and possibly make the average hedge fund manager blush. I tip my hat to the Yale Endowment team for surmounting numerous obstacles in their quest for top quartile risk-adjusted returns!<sup>4 5</sup>

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<sup>1</sup> See [www.partnersgroup.net/pdf\\_downloads/Global\\_Pensions.pdf](http://www.partnersgroup.net/pdf_downloads/Global_Pensions.pdf)

<sup>2</sup> See [www.gsm.uci.edu/~jorion/oc/ntaleb.htm](http://www.gsm.uci.edu/~jorion/oc/ntaleb.htm)

<sup>3</sup> See [www.yale.edu/about/Endowment\\_Update.pdf](http://www.yale.edu/about/Endowment_Update.pdf)

<sup>4</sup> For those interested in learning more about the Yale Endowment's investment process, see the book review section of our website.

<sup>5</sup> Interestingly, not everything about Yale's investment team is admirable: the Yale Endowment is locked in a battle with its unions over non-disclosure of various aspects of its investment portfolio. See also [www.uh.edu/admin/media/topstories/2002/deal/200211/20021114yale.html](http://www.uh.edu/admin/media/topstories/2002/deal/200211/20021114yale.html)

## Nourishment - P/E ratios are as much art as science

After some serious soul searching, I finally came to the conclusion that the exalted P/E ratio must eventually be humbled by someone. These days P/E ratios are touted by the broker community as if they are the only thing that matters. Pick up just about any financial journal and there is some article pronouncing that stocks are "cheap", stocks are "expensive", or stocks are priced "just about right" and the only measure offered is their P/E ratio. Just to be on the safe side, I inquired with several persons "in the know" to get to the bottom of this P/E thing. Some of the feedback was quite discouraging:

- The "E" in the P/E ratio might be projected earnings for the next year, or historical earnings for the past year or three years, or even "normalised earnings"<sup>6</sup> for the past ten years.
- The "E" in the P/E ratio might be based on operating earnings, reported earnings, cash earnings, or some other definition of earnings.
- The P/E ratio is aggregated for an index like the S&P 500 and compared to historical levels even though the composition of the index might be completely different in terms of industries and style (e.g., value, growth)
- The P/E ratio is compared to historical levels even though economic environments might have been completely different across history, with various combinations of GDP growth, interest rates (real and nominal), inflation, etc.
- The P/E ratio is compared to historical levels even though monetary and fiscal policy (and resulting levels of taxation, government spending, money supply, budget and trade deficits, etc.) might have been completely different over time.

So where does this leave us? It's often more meaningful to build a diversified portfolio across asset classes than to make serious portfolio allocation decisions based on the elusive nature of the P/E ratio!

## Feedback

These newsletters are designed to provoke thought and stimulate debate based on real world challenges that we face in our daily lives as we manage investments for ourselves and for others. As always, we greatly appreciate your comments and feedback. E-mail us anytime at [help@financialcontrollimited.com](mailto:help@financialcontrollimited.com) if you would like a) for us to clarify anything, b) to recommend improvements to us, or c) to just debate with us – we like philosophy especially as it relates to financial services! Or visit our site at [www.financialcontrollimited.com](http://www.financialcontrollimited.com)

This issue of the newsletter was written by Robert Jones and edited by Ben Vella.

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<sup>6</sup> "Normalised earnings" is a fancy phrase used by some to mean that earnings should be calculated over a long-enough time period to include a full economic or business cycle, so as to not over or underestimate the P/E ratio based on a firm's most recent earnings.