INTRINSIC VALUE/BY ROGER LOWENSTEIN

Where's the Reward in Hedging Against Risk?

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Suggest that a money manager abandon hedging, and the conversation is apt to be short. What seat belts are to the freeway driver, hedging has become to the investing pro. It is a Prozac for the risk-averse, practiced widely, questioned almost never. This is why the annual report of **Labrador Partners** L.P. reads with a certain newness.

Labrador, a New York investment partnership, is run by Stephen Farley, who counts himself a long-term, fundamental investor. In his five short years managing money, Mr. Farley has done a lot of things right, but hedging, in his opinion, isn't one of them. This puts him at odds with most academics, including Nobel Prize winners, and with scores of working fund managers, some managing billions.

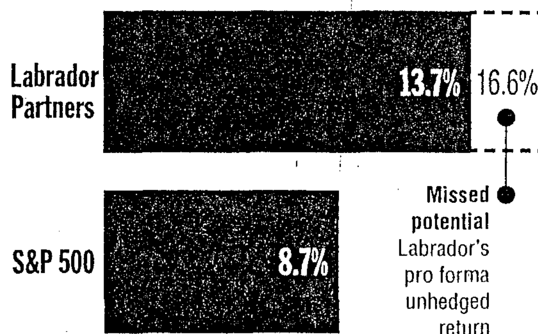
Mr. Farley, it should be said, manages only $30 million and has never won a Nobel Prize. What he *has* done is beaten the Standard & Poor's 500 index by five percentage points a year. Since 1990 he has reaped a compound average gain of 13.7% (which he splits with his investors one-to-four). The S&P returned only 8.7% a year.

The news is that Mr. Farley could have done better. Like many of his peers, Mr. Farley pursued "various hedging activities," such as buying "put" (or bearish) options on the stock market. This is akin to insurance. When the market was weak, Labrador profited on its puts, allowing it to avoid a down year. When the market was strong, the general partner of Labrador slept less fitfully.

But after calculating what the puts cost him, Mr. Farley's sleep turned out to be fitful after all. Had he not hedged, the ride would have been bumpier, but his average return would have been a glorious 16.6% – nearly twice the S&P's.

Pricey Protection

Annualized total returns, including dividends, 1990-94



This should raise a question: If Labrador Partners can do better without hedging, what about everyone else?

It will be noted that no one who buys fire insurance feels cheated just because his house didn't burn. Investing, though, is different. The average Joe cannot afford to lose his house, and therefore is wise to carry a policy. But a long-term investor can afford to ride out a market drop.

Mr. Farley, for example, invested in his biggest holding–**International Speedway** Corp.–in 1990. That stock, like the general market, was later jolted by events in Baghdad, Sarajevo, Mexico City and elsewhere. Mr. Farley was hedged against such events, but to what end? None affected the value of Speedway for more than an eye-blink. The only risk Mr. Farley truly had to appraise was the risk of declining race-ticket sales, etc.

That risk–the risk to Speedway's business–he calculated well. Four years later, Mr. Farley, who is 35, still owns the stock, and it has tripled. In his words, "Volatility does not equal risk. Had we not hedged, we would have reported more-volatile investment results"–but better ones.

This premise was relayed to Jeffrey Geller, a managing director of BEA Associates who runs $2.2 billion in equities with various hedges. "Long term, you're definitely better off without the hedge," Mr. Geller agreed. Long term, after all, stocks go up. Why then, do his clients clamor to hedge?

Mr. Geller's clients–pension funds such as the one at General Motors Corp.–invest for the longest of terms, that is, the retirements of pensioners. It may seem nonsensical for a fund charged with delivering value in the year 2020 to hedge against a market downturn in 1995, or 1996. Yet they do so en masse. Indeed, the amount of stock controlled by options trading on the S&P 500 is now far greater than volume in actual stocks.

One Fortune 500 fund manager responds that at times (such as now) when the market "looks" toppy, it is only natural to hedge one's bets. Yet in the same breath, this manager concedes the obvious: he cannot know better than anyone else what the market will do.

Burton Malkiel, a Princeton economist, suggests another answer. While the funds have a guarantee of longevity, the *managers* of the funds don't. As long as pension administrators insist on grading stock-pickers quarter to quarter, they will get hedge-happy managers with twitchy trigger-fingers. And they–and their pensioners–will pay a price for it.