A Homemade Hedge Fund?

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Hedge funds are sometimes represented as the Holy Grail for investors. They offer the enticing prospect of positive returns, whether markets are rising or falling. Their main technique for delivering positive returns in falling markets is by shorting, i.e. selling stocks they don’t own and buying them back later, hopefully at a lower price. This wonderful feat of levitation doesn’t come cheap: the typical remuneration package for a hedge fund manager is known colloquially as “2 and 20”: an annual charge of 2% of assets under management plus 20% of profits (of course there’s no 20% refund if the fund loses money!).

Over the last difficult few months, shorts have been among the few winning investments in my portfolio. I have two short positions – three if we count a sterling hedge– and all of them increased in value during December.

I closed most of my short position in Tesla in October[1] at a nice profit but kept a small residual exposure. Tesla’s share price fell 5% in December, presenting me with a gain of $17.50 a share. It fell another 7% on January 2, after it was revealed that car sales for the fourth quarter had fallen short of analysts’ expectations. This netted me a further $22.80 per share. The price has now recovered from that fall, but I’m holding on to my remaining short position. I believe that Tesla will run out of cash within the next few months and will have to come to the market in search of additional funds, from either shareholders or bondholders – or both. If that happens, I reckon that the market won’t take kindly to the news.

My short position in sterling also delivered a profit in December, but the purpose of the sterling short is to hedge currency risk on my domestically focused UK shareholdings, so I tend to ignore any gains (or losses) on the hedge.

My most spectacular gain in December was from a short position in the Japanese company, SoftBank.

SoftBank started life as a mobile phone company. It acquired the Japanese arm of Vodafone in 2006 and owns the US mobile operator Sprint. It also sees itself – with some justification - as a visionary investor in technology start-ups. Its most profitable investment is Alibaba, China’s answer to Amazon. It also has major stakes, either directly or indirectly, in the ride-hailing company Uber and in Yahoo and WeWork, the office-sharing company.

It recently got into trouble through the company it keeps. It has close ties with Chinese technology company Huawei, which is in trouble with the US authorities. It also has a close relationship with crown prince Mohammed bin Salman of Saudi Arabia, whose associates are currently on trial for the brutal murder of Jamal Khashoggi in Turkey. The Saudi connection, and SoftBank’s stake in WeWork, which I think is grossly overvalued, were the main reasons why I decided to short the stock some months ago.

For a host of reasons, SoftBank’s share price started dropping like a stone in December. It fell more than 25% between the start of the month and when I finally closed my position on 28 December.

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[1] See post #414 in https://www.askaboutmoney.com/threads/new-sunday-times-feature-diary-of-a-private-investor.195710/page-21

I was lucky in my timing: I got out almost exactly at the bottom of the market. On its own, my short position in SoftBank contributed almost 0.7% to the portfolio's performance in December.

Unfortunately, the short positions in Tesla and SoftBank were among my few winners in December. My top four long holdings all fell in value. Apple, which is still one of my top exposures despite recent share sales, fell by a whopping 11.6%; Ryanair was down 7.7% and Phoenix Group Holdings fell 6.2%. By comparison, Renishaw held up relatively well, falling "only" 1.3%.

The contrast between the gains in my short positions and the losses in my long positions caused me to toy briefly with the idea of making a fundamental change to my investment strategy. I considered adding more shorts to the portfolio in order to get some protection from market downturns, like the one we're experiencing now, while recognising that it would mean surrendering some upside in the good times. I reckoned that a strategy on these lines could reduce the volatility of my portfolio.

I was encouraged in this thinking by news that a hedge fund run by Crispin Odey delivered a 53% positive return for 2018. Ironically, in the light of Mr Odey's political leanings – he's an ardent Brexiteer - one of the top contributors to his positive result in 2018 was a short position he took on sterling.

I then discovered that Mr Odey's fund returned minus 22% in 2017. By coincidence or otherwise, his returns in 2017 and 2018 were an almost exact mirror image of my portfolio's performance of plus 50% in 2017 followed by minus 28% in 2018, or an average of plus 5.3% a year. (For the numerically minded, the average is money-weighted and allows for the fact that I splurged big-time when returns were good in 2017). Mr Odey had an even worse 2016. That year, his fund fell in value by almost 50%; in contrast, my portfolio delivered a positive return of more than 5% in 2016.

I decided therefore to stick with my current strategy of being primarily long in my investments, while adding a small number of short positions in companies I think are grossly overvalued.

There are very few in that category at present. On the contrary, I think most of my holdings are seriously undervalued. Although I'm now at the stage in life where I'm withdrawing more than I'm investing, I've managed to limit the number of shares sold at current depressed prices. I've even succeeded in increasing my exposure to Phoenix Group Holdings, which I think is particularly undervalued at its current £5.71 a share. As regular readers know only too well, though, my views on value don't always coincide with those of Mr Market.