

The End of Arbitrage, Part I

As a capitalist, I loathe capitalism. Capitalism is a wonderful system for free-loading or at least free-riding workers, consumers, and governments. Capitalists, meanwhile, suffer under the yoke of capitalism's immutable law: excess returns are transitory. No matter how high above the competition an innovative enterprise soars, the capitalist's rewards are fleeting. They will be destroyed by . . . capitalism. The same free-flow of money and information, of financial capital and intellectual capital that made the capitalist's signal success possible, will eventually drown opportunity in imitation.

I have more than once been a victim of capitalism's creative destruction. When I started in this business in 1978 more than half of what I did was conversions and reversals, arbitrage between puts, calls, and stock. There were then just 24 stocks with listed puts, 4 to 5 on each exchange. In our firm those 24 stocks were split among three people. But as a twenty-year old, brand new in the business, I made seven figures for the firm and six figures for myself, about as much as a solid major league baseball player in those days.

By 1982 puts were listed on about 300 stocks. But conversions and reversals was dead as a business. The rules had changed. Market makers could get financed on stock. A facility in pure option arbitrage was still fairly unusual in 1978; by 1982 you could probably read about it in Reader's Digest. Today there is nothing left to arbitrage in option arb.

Merger arbitrage suffered the same fate: a good business destroyed by the inflow of capital and the dissemination of knowledge. Capital flowed in when a bumper crop of underlying deals made the strategy hot. Soon an already bulging roster of full-time players was being crowded by bystanders eager to get in on the action. Brokerage houses started risk-arb research. Most arbitrage is enabled by a set of players constrained by rules, mission statements, or laziness, rendering them price indifferent at the margin. Fifteen years ago the default position of most institutional managers was to sell on an announced deal, so as to stay within portfolio policy, letting the arbitrageurs have the last nickel. When the arbs started turning nickels into fortunes, that position became untenable; everybody had to play. Today, every-

body does, but it's no way to make a living.

Pair-based, short-term mean reversion may be going the same way. When surging volatilities made stat arb look easy, money flowed in. Then came decimalization and ever better low-impact trade execution, and it's never going to be easy again. Bear markets do make it tougher; when everybody's making money only the arbitrageurs count the pennies. But even when bull markets and volatility come back, the algorithms aren't going away.

INCEPTION SHARES * Net Returns		
	MTD	YTD
STATISTICAL		
ONSHORE	0.66%	0.14%
OFFSHORE	0.66%	0.13%
CONVERTIBLE		
ONSHORE	0.97%	6.31%
OFFSHORE	0.97%	6.33%
HEDGED HIGH YIELD		
ONSHORE	0.73%	8.49%
OFFSHORE	0.73%	8.48%
DIVERSIFIED CONVERTIBLE		
ONSHORE	1.28%	1.20%
OFFSHORE	1.27%	1.16%
INTERMARKET		
ONSHORE	0.12%	4.33%
OFFSHORE	0.15%	4.28%
COMBINED FUND		
ONSHORE	0.76%	4.56%
OFFSHORE	0.76%	4.57%

* Limited Partner returns may vary depending on the timing of investment. Please refer to your individual monthly statement.

All these strategies still work sometimes. But it's hard for any one of them to support a diversified portfolio making sufficiently interesting returns to compensate for one's time and capital.

The same process that destroyed each of these strategies is now overtaking our entire industry. Just when "hedge funds" is becoming an obligatory asset class for institutional investors, the class as we have known it is about to disappear. The flood of institutional money into hedge funds essentially guarantees the end of arbitrage as a way to make a living. Arbitrageurs shift capital across markets to correct marginal disequilibria.

By definition they play at the margins. Mutual fund capitalization today may be seven or eight trillion, un-levered.

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Hedge fund capitalization now approaches one trillion, levered into total long plus short positions at least double that. That's already beyond any reasonable definition of marginal.

Even the total market value of hedge fund positions understates the increasing influence of alternative standards of practice and performance. To the extent that hedge funds have made a living exploiting mutual fund sub-optimality and are now being rewarded for that success, expect traditional managers to ape hedge fund strategies and traditional clients to pressure them to do so, within regulatory boundaries. Already the fashionable advice from once-staid consultants is "broaden manager mandates; don't obsess on the policy portfolio; let the managers earn their money." In other words let your traditional asset-class-representing managers act more like hedge fund managers. Dominant players don't resolve disequilibria; they create them. Being market neutral is impossible when you are the market.

When arbitrageurs can't arbitrage and hedge funds can't hedge, all that's left is a compensation scheme that implies excess returns. Where will they come from?

What business are we really in?

Reprinted in this summer's Harvard Business Review is Theodore Levitt's classic 1960 essay "Marketing Myopia," which famously urged managers to ask themselves: "What business are we really in?" If, in 1980, I had thought of my business as conversions and reversals, I would be working on my third decade of unemployment. If we had defined Whitebox's business as pair-based, short-term mean reversion—our first strategy—our landlord would be looking for a new tenant.

Narrow, product-centered definitions of one's business may blind one to the imperatives of change. But platitudinous "customer-centered" definitions illuminate nothing. Defining our business as "producing above-average returns while limiting risk" says nothing except that we'd like to make money for our investors, a goal we presumably share with most of our peers.

The most productive way to define one's business, as Levitt argued, is by skill. Not "what do you make?" nor even "what do your customers want?" but "what are you good at?" If you understand what you are good at, and understand it at the proper level of abstraction, the problem of change becomes the manageable one of applying your old skills to new opportunities.

Looking across the strategies that have worked for us, at Whitebox and before, most of our success has come from thinking creatively about market structure: market segments; the borders between them; interfaces at those borders; the price and value relationships that emerge. The key to producing interesting returns, at least for us, has been to find the currently interesting interfaces.

The Whitebox Hedged High Yield Fund makes for an especially clear example. HHY is positioned to play at the interface of debt and equity claims. Consider the spectrum of such claims. In an investment-grade company, equity holders own 100 percent of the net assets and will capture all the upside if the company grows profitably; the bondholders have all but perfect security, but none of the upside. At the other end of the spectrum in a classic distressed situation, debt holders own 100 percent of the assets and stand to gain 100 percent of the upside in their ultimate disposition. Not interesting interfaces.

The interesting space is somewhere in between, where creditors and equity holders become harder to distinguish. The high yield bondholder is getting equity-like yields, and like the equity holder is dependent on the success of the business for his security. This gray area, and the interacting ambiguities of price and the nature and surety of asset claims, has made for an interesting interface, and I expect it to continue to do so.

Another place we play is at the border of qualitative and quantitative disciplines. I am quite sure that working the shifting interface rather than the well-mapped interiors of either approach has been and will continue to be productive.

One consequence of the hedge-fundization of the world is that markets become unsegmented and boundaries blur. Arbitrage operates at market borders, but dissipates their effects. Many borders are artifacts of strict manager mandates and soften as mandates spread. Once intriguing topographies are flattened by the suddenly unbounded flow of capital. But this same softening and erosion of boundaries creates new interfaces, new ambiguities. Lately I have been intrigued by two.

The hedge fund manager as derivative

The first is the interface between the traditional and hedge fund manager, where a once-firm border

is becoming semi-permeable and thereby interesting. Put your typical hedge fund manager on an operating table and slice him up like a derivative. One not unuseful way to conceptualize the resulting parts is the

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alpha generator, who produces excess returns relative to the class, and the beta “isolator,” whose job it is to get your money into a non-obvious, often synthetic asset class (like converts stripped of their equity component) you want to reach usually because the risk-adjusted return is more attractive than you can get from more obvious asset classes. Of course in practice the two are hard to separate for a number of reasons, including that the definition of alpha depends on the level of abstraction at which you define the asset class.

Nevertheless these are two different functions, one more like an art and the other more like a craft. When the hedge fund world was a mere village, and clients were primarily smart nonconformists minding their own money, which tended to be denominated in millions not billions, there was not much demand to unbundle these functions or the corresponding fees. And alternative managers never like to admit that the alpha they are reporting consists largely of the beta of an unconventionally defined class. After all, the technical skills needed to operate in hard-to-reach or synthetic classes are considerable and the people who can do it deserve to get paid.

The flood of new money from institutional clients changes the landscape. Though the institutions may talk a good game they are not, by nature, alpha seekers. Most of them want asset-class representation, which they got from their traditional managers, but without traditional asset-class risk. They come to us because we offer a step-up in classes. This blurring of traditional and alternative manager functions is creating a fee arbitrage that, for instance, drives our diversified convert fund.

My guess is that converts as a class are priced to deliver maybe 8 percent a year over the next several years, which by the way is somewhat better than my expectation for equities over the same period. An 8 percent gross return from a manager who skillfully hedges out equity risk, but broadly represents the class with no pretensions to adding alpha, is a not unattractive alternative for institutions that might otherwise have that money in a conventionally managed fixed income portfolio. But at a net of 5, which is where you end up with a “1.5 and 20” fee structure, there’s not much reason to cross the street. A lifetime score of 200 basis points over asset class average

gets you in the investors’ hall of fame. Our beta-isolating convert manager can get most of the way there just by dropping the performance fee. After all, the performance fee implies excess returns and our hypothetical manager has no alpha pretensions. Like a traditional

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manager, he would then be paid for efficiently representing the class, but a bit more than a traditional manager because it’s a trickier job.

We expect the Whitebox Diversified Convert Fund to produce alpha; we think we have succeeded in configuring the universe to both represent the class and produce excess returns. But even if our gross returns only match our peers’, our investors will still be netting excess returns—thanks to our amazing skills as fee arbitrageurs!

Playing the finance/operations interface

The other newly interesting interface, and the one I think represents the real future of hedge funds, is between finance and operations. This is an interface that is always with us, but for that very reason often overlooked. A company hires a new VP of sales to re-energize a flagging sales force. Operations, right? Sure, he gets rid of some dead wood and brings in new blood, classic operations stuff. But he also reorganizes a commission and incentive system that the company has outgrown and performs the nontrivial calculus of splitting territories to motivate sales growth without making good produc-

ers feel like they are getting the shaft. Getting people to work harder for their current money in return for a chance at more upside is an exercise in behavioral finance and options pricing theory as much as it is anything else.

I don't propose to start making a market in sales commission options, but senior executive compensation and capital allocation/structure are big consequential issues that lie on the operations/finance border and can be crucial dynamic factors in returns to shareholders.

One reason for the slough of despond into which equities fell in the 1970s was increasing shareholder despair about defending their interests against an imperial managing class. The solution that emerged, the LBO, is best understood as a play at the finance/operations interface. By replacing equity

with high yield debt, the buyout guys enhanced operational discipline, fully valued the company's cash, imposed an automatic rather than policy governor on capital investment, and gave asset owners, though now technically

Overpaying people makes them greedy.

bondholders, the equity-like yields they had been unable to extract as shareholders. Management got equity incentives, but bondholders had prior, quasi-equity claims, ensuring management would get paid only for meeting benchmarks that translated directly into owners getting paid. The LBO solution was an elegant one because it addressed capital allocation, owner claims on assets and earnings, and senior management incentives in a single device, as they should be given the fuzzy borders that separate them.

No solution so elegant and conducive to virtue could be expected to endure. In the '80s the LBO solution was largely replaced with the stock-options gambit, which sought to align the interests of shareholders and management by making managers into owners, often on a grand scale. Two decades later it is clear this has been a spectacular failure. Abundant data now shows that giving massive equity grants to managers does not increase net returns to shareholders. This should not have been a surprise.

Spanking the spoiled heirs of capitalism

It is true that if you make managers into owners, they will start acting like they own the place. But there are many types of owners. There is, for instance, the founder, whose sweat equity and business ethic earns every dollar he's ever had and who carries on his back legions of beneficiaries from his employees to suddenly dear friends and impecunious relatives. And then there is the third-generation heir of the "family" company, who along with his crack-head cousins, runs the company as if its defining mission is to make the minority public shareholders rue the day they invested.

Overpaying people makes them greedy. Giving managers ownership stakes they do not earn does not make them heroic entrepreneurs. It is much more likely to make them spoiled, abusive, and intent on denying the contributions of others, labor and capital alike. If a manager works hard enough at convincing himself he's actually earned his good fortune, he's at risk of becoming a thief.

Helped by the post-bubble scandals, the option gambit is now widely discredited. And yet compensation schemes that boosted typical CEO salaries from 50 times the average workers' pay to 500 times (and that's counting only lawful compensation) have barely been trimmed back.

Of what interest is this to hedge fund managers or investors? Imagine a world in which all financial investments are mediated by hedge funds. In that world, toward which we are trending, all financial market arbitrage opportunities have dissipated so that every security trades at an efficient price relative to current value. There are thus only two ways to increase returns to investors: increase the underlying value of the assets or increase the share of asset value investors capture. Successful hedge fund managers, or any asset manager who aspires to charge premium fees for premium performance, will have to do one or the other or both.

One fairly straightforward way to do this is for hedge funds to function as collective bargaining vehicles for their investors, to win for them as a group some of the rewards of control that elude them as individual outside investors.

Insofar as one of the first orders of business is giving management a haircut, some of what needs to be done is just brute force collective bargaining. But there is more to it than that. When Warren Buffett buys into a company he gets better deals than the investing public for at least two reasons: he is good at structuring deals that serve both management and his Berkshire Hathaway investors better than mass-marketed public offerings would. And companies want him as an investor because he has a reputation for being actually helpful, especially in matters of capital allocation and structure. This is the preeminent interface of operations and finance, of which, as the LBO example shows, senior executive compensation is best understood as a subset.

Bad capital allocation is the prevailing sin of good companies. (Bad companies are soon relieved of the burden.) Capital allocation should correspond to one metric: prospective risk-adjusted return.

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In my experience, especially with small and mid-cap companies, it almost never does. What capital spending usually correlates to is cash flow. Companies with excess cash are invariably confronted with an extraordinary array of worthy cap-ex projects, usually at premium prices because their sector is booming. When cash is

short, by some miracle attractive projects disappear, though this ought to be the best time for sector bargain hunting.

One reason bad capital allocation happens to good companies is that good companies are run by good operations people who love what they do. Quite naturally their definition of success is doing more of it, without slavish regard to return on assets. Then there are the credit markets, which are structurally hostile to rational capital allocation at the company level. Every manager of a midsized business learns early the iron law of business banking: never lend money to a company that needs it. So you grab the cash not when it makes sense, but whenever your idiot banker opens the vault.

With these disadvantages it is almost impossible for capital allocation not to work better on the portfolio level. Much of GE's success over the years, like Buffett's in the last several decades, comes down to this perfectly legal form of insider trading: managing liquidity and leverage across a portfolio of companies to significantly enhance capital efficiency.

General Electric: the hedge fund

In the post-arbitrage world Berkshire Hathaway and GE, which have always been hedge funds, albeit atypical, are now more useful models than many traditional large hedge funds. The operations/finance interface is the best place I can think for mathematically sophisticated money managers who think in terms of the optionality of financial structures to make a contribution. Risk-adjusted return may be the right metric for capital allocation, but the right metric for risk-adjusted return, especially for investments in operations, must include embedded optionality.

Suppose there are two potential million-dollar investments in factory improvements: one that will save \$80,000 a year and one \$100,000 a year, for an 8 and 10 percent return respectively. It might seem obvious to go for the bigger return. But if the 8 percent return project can be replicated over 100 plants, and one successful demonstration project means you can raise \$100 million at 5 percent to do the other hundred, then your \$1 million investment in the first plant actually returns \$3 million.

That's a simple example of embedded optionality. The point is that guys who have spent their lives thinking about options and financial structures and guys who have spent their lives thinking about business operations have vastly different skills and ways of thinking about the world. Introducing into capital allocation discussions almost any objective party not caught up in the passionate beliefs and habitual definitions of success that drive decisions at the company level is likely to improve investment discipline. If that party has a direct interest in returns on the capital being allocated, so much the better. If that party actually brings to the table some sophisticated non-obvious ways of thinking about financial structures and relationships, everybody's probably going to eat better. Certainly active portfolio managers are a more credible force for handling issues of management compensation or of who gets a company's excess cash than that unicorn of the boardroom, the "independent director."

The calamities of 2000-2002 are driving institutional investors away from traditional asset allocation strategies that left them passive victims of markets turned savage. But exposure to market volatility is not the only risk of traditional passive money management. Passive investors need active managers to ensure their capital is put to its most productive use and that the owners of capital get paid for the use of it. The option gambit was a miserably and probably inevitably failed attempt to create such managers at the company level. What is needed are active business managers functioning at the portfolio level. As arbitrage profits dry up, hedge fund managers might consider applying for the job.

What else do hedge funds do in a post-arbitrage world? You'll have to wait till next month to find out. Don't worry, there's time. The future tends to run a little late.

You're invited!

On October 21, we are hosting the second annual Whitebox Investors Conference in Lake Tahoe, California. This year's big topics are "When Change Masks Value: The Intermarket Model

for Identifying Undervalued Companies in Transition” and “Radical Conservative Asset Allocation,” or “Asset Allocation without Asset Classes.” Featured speakers will include C-levels from some of the most promising companies in the Whitebox Intermarket portfolio, my colleagues Gary Kohler and Jason Cross, co-managers of the Whitebox Intermarket Fund, and other special guests to be announced.

The delegate fee is a modest \$495 including a one-year subscription to Andy’s monthly strategy report, the Whitebox Market Observer, focusing on special situations and non-traditional asset allocation (list price for 12 issues is \$450). The conference venue is the stunningly beautiful Resort at Squaw Creek in Tahoe, with special room rates for our conference delegates.

If you would like to come, just fill out the form below and fax it to (612) 253-6031. If that seems too hard, just call Amy at (612) 253-6030 and she will take care of you. Group rates are available for delegations of four or more. Amy handles that too.



Andrew Redleaf

WHITEBOX INVESTORS CONFERENCE REGISTRATION

Yes, please register me for the Whitebox Investors Conference on October 21 in Lake Tahoe, California. I understand the \$495 registration fee includes a one-year subscription to Andy’s monthly Whitebox Market Observer strategy report.

Name (as on credit card) _____

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Address (same as billing) _____

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