

Drobny, Steven – The Invisible Hands

John Wiley & Sons, 2010, [Finance] Grade ★★★★★

The hedge fund advisor Steven Drobny had a huge international success with the book *Inside the House of Money* where he in a very easy going way interviews a number of high profile macro hedge fund managers on topics such as how they got into the business, their processes and beliefs. Perhaps because I am not as into macro trading I was not as thrilled as many others. This new book takes on a very serious topic: what will come after the 60/40- and the Yale-models? That is, how should the investment models of the likes of pension funds develop?

The concept is the same as in the last book. Drobny interviews a new round of managers of smart money, but this time on how managers of real money should run their business. Not surprisingly given that some of these people have egos larger than the empire state building the short answer is that they should be like macro hedge fund managers or at least give their money to them. Most agree on the problem description and I also think that it's spot on: low understanding of illiquidity risk and overlooking the opportunity cost of not holding cash to be able to reinvest in bad times, underestimation of tail end risks, not understanding the time varying nature of expected returns, being too complacent around the variations in asset correlations and around the fact that diversification into overvalued and overcrowded assets gives no diversification. Furthermore the obsession with relative return gives a short term focus which prevents paying small fees for insurance in good times to be able to soften the drawdowns later.

As the interviewees are a diverse bunch the remedies proposed are quite diverse. Some would hardly work on a larger scale and most would at least not work if they actually became the new model and the whole long only crowd would move in the same direction even if they could be good

investment cases for the individual fund. The broad conclusions that Drobny draws from are three pieces of advice; 1) replace return targets with risk adjusted return targets, 2) look forward, not backwards and 3) rethink liquidity. I would say that another general advice in the book is to broaden the search for risk premium to invest into. The Bridgewater "all weather model" gets its fair share of votes also. The second piece of advice above points to the need to replace allocations based on return expectations build from averages over 50 years and instead adjusts these averages to what is reasonable for the next five to ten years when taking the starting valuation, overcrowding and the economic picture into account.

This is not light reading for the layman but the idea behind the book is till great. Input to an important topic from a knowledgeable but unrelated source. My main objection is that this is only about 1/3 of the text. The rest is basically "House of money II" where the hedge fund managers' discuss their best trades etc. I'm also not really sure if the hedge fund managers' focus on avoiding drawdowns is always suitable for someone who truly has a very long time horizon. With a true long horizon it only becomes relevant to avoid drawdowns to the extent that they impair the returns compounding more than the potentially higher return from the volatile asset will give? The usefulness of a model focused on avoiding drawdowns as opposite to "seeing over the dips" depends very much on the type of environment one is in. When we eventually enter the next structural bull market the 60/40-model might not be so bad.

Drobny makes you feel like you're sitting in on a number of conversations between friends so even if the topic of pension fund revamping is perhaps not the sexiest in town it's a fairly pleasurable read. I'm not sure the book goes all the way with the proposed topic though.

Mats Larsson, October 13, 2011