Bright Shiny Objects, All That Glitters Isn't Gold, and Lessons Learned from Richard Cory
By Alan Snyder

In 1897, Edwin Arlington Robinson penned the poem "Richard Cory," which elegantly describes the issue we seek to confront. If you're not familiar with the poem you may have caught the Simon and Garfunkel song.

Whenever Richard Cory went down town,
We people on the pavement looked at him:
He was a gentleman from sole to crown,
Clean favored, and imperially slim.

And he was always quietly arrayed,
And he was always human when he talked;
But still he fluttered pulses when he said,
"Good-morning," and he glittered when he walked.

And he was rich—yes, richer than a king—
And admirably schooled in every grace:
In fine, we thought that he was everything
To make us wish that we were in his place.

So on we worked, and waited for the light,
And went without the meat, and cursed the bread;
And Richard Cory, one calm summer night,
Went home and put a bullet through his head.

No doubt all of us at one time or another are swayed by appearances, if we are honest with ourselves. Only later do we discover that this suspension of disbelief has hurt our results. Let me state upfront that this happened to us in our relative youth, and share what we learned from it. No bona fide excuses, we fell into this trap in the early 2000's with a small investment in Bayou Fund. Notwithstanding the size, it was painful, dumb and avoidable.

Samuel Israel III founded the Bayou Hedge Fund Group. He and his family enjoyed a storied background. Samuel grew up in one of New York's richest families. The Israel family founded a commodities trading business of legendary Wall Street fame and success. Donaldson, Lufkin, and Jenrette ("DLJ") eventually bought this profitable global trading powerhouse. After a decade of Wall Street experience, Samuel set out to make his mark, starting with hundreds of millions. Pedigree, experience, contacts, and significant capital could have been a recipe for success. Instead, we were snookered.

Reported results were cheery. However, actual results were not. After an initial period of healthy gains, trading losses became substantial with ever larger bets being made in an attempt to recover. The original accounting firm was replaced and the new one, engaged between audits, turned out to be a fraud with the CFO in cahoots. The saga of what happened to Samuel and the CFO is an interesting read, although painful for us and too lengthy to recount herein. Over time, we recovered more than half of the investment.

Fraud is the most difficult and challenging risk to uncover. However, the controls Shinnecock has in place today would have raised sufficient issues to dissuade us from investing in a fund such as Bayou. In earlier notes and on our website, www.shinnecock.com, we have enumerated the questions to ask, the data to require and the activities to undertake during an onsite visit. We will, in a subsequent note, share our thoughts on a 165 variable quantitative toolkit for pre-investing and after-the-fact evaluation.

How can a reader evaluate whether he or she might have any "Bayous" in their portfolio now?

Aside from the toolkit touched upon earlier, we have found five ongoing monitoring steps implemented subsequent to our Bayou misadventure, which would have helped us:

1. Regular dialogue with the manager and their people to discuss the business and their lives. Creating this relationship is rewarding on many fronts, not solely for monitoring.

2. Periodic sweeps of data from audits, examinations, investor complaints., and all currently used marketing materials. Typically, these are not shared in monthly or quarterly investor reporting but provide valuable insights.

3. Assets under management ("AUM") analysis from parties independent of the manager, typically an administrator. For this, separating performance results from investor additions and withdrawals can be enlightening. Yes, over the last 28 years this has saved our bacon. While not meaning to dismay or shock our readers with the following intemperate comment, sometimes a manager does not share information equally with all investors. A large withdrawal should trigger further dialogue. Maybe that investor discovered or was told something we should uncover. On the other hand, uncommonly rapid growth in AUM may result in excessive cash drag, too much pressure to invest capital without the duty of care undertaken earlier or asset growth simply outstripping rational position sizing. Finally, monthly AUM verification by a third party can help eliminate the most common of frauds: reported manager assets that aren't actually there.

4. Normative behavior analysis. Apologies for the buzzword but it describes what we are examining. How do the performance results for a particular allocation compare to what has historically been achieved, up or down? Style drift can be deadly. If the result is more than one standard deviation, plus or minus (though statistically this should occur 32% of the time without style drift), we increase our monitoring as a preemptive prophylactic.

5. Peer group comparison is an obvious step. However, over the years the normative behavior analysis has proven to be the most enlightening.

In a subsequent note, we will describe exiting a manger or position using efficient frontier, time windowing in correlation, "pre-nup" arrangements and portfolio balance.

Bayou was not only painful but embarrassing, yet thankfully our losses were small given our penchant for diversification. Now, the shocker of our beliefs: fraud is not our greatest fear, awful performance is any portfolio's waterloo. Frauds are few and far between and with great care can generally be avoided. Awful performance can be fathered by so many causes as to be more pernicious.

Many of you have been sharing suggestions, improvements and general counsel stimulated by these scribblings. Thank you, thank you, thank you. Keep 'em coming.