



The Strachman Report

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Profile: *Richard Bookbinder, Bookbinder Capital*

Quick – it's 1999 and the Nasdaq is booming. Pick an Internet company to invest in – or three, or four. Did you find an Ebay? Or are you stuck with 50,000 shares of Pets.com? It seems like an eternity ago, but the situation in hedge funds is analogous, says Richard Bookbinder of Bookbinder Capital of New York. "Being invested in five tech stocks in 1998 did not make you diversified," Bookbinder says. "You need to understand the methodology of what you're investing in." Similarly, "investing in hedge funds directly is a full-time job," he says. "You can't just sit down with a database, hear about a hot fund from a friend or read about one in the newspaper."

Like Answers and Company, Bookbinder believes that it takes certain qualities to make a successful fund manager, a rigor that justifies decisions as well as the backbone to keep from following the crowd. While many in the industry moan about the layered costs of fund of funds, they can't argue with Bookbinder's numbers. The firm, which celebrated its six-year anniversary in October, has seen an average return of 10% per year, without a single down year.

Variety is the spice

The secret to Bookbinder's success has been his careful allocation to managers with a variety of styles. Typically, the fund will invest in sixteen to twenty different managers at once, though limiting the selection to strategies with which Bookbinder feels comfortable. Bookbinder currently has investments standing with sixteen different funds, with a target return of about 10% per year. "More than twenty can make you over-diversified," he says. And too few can mean too much risk. The fund has investments in several long/short equity funds, event-driven funds and relative value funds, for a total investment value of about \$30 million, a number that has remained stable over the last few years. By eliminating many of the dodgier strategies – as well as some that Bookbinder simply doesn't feel qualified to evaluate – he finds that the universe gets much narrower, helping him winnow his choices. For instance, he avoids most currency and emerging market funds, black box strategies and anything too highly leveraged.

This leaves him with about half the hedge fund world – some 5,000 funds – to choose from. That's too many for the casual investor to evaluate on his own, says Bookbinder. "I speak with every manager personally," Bookbinder says, "to make sure that their interests are aligned with ours." He then checks their balance

sheets, to make sure that the past returns they've produced are sustainable. "We don't want an 8% return one year, followed by a loss of 4% the next." He also examines the methodology of their research process, to separate the gamblers from the investors

"It's a question of experience," Bookbinder says. "I happen to have six-plus years in hedge fund land.

Before that, I spent twenty-five years on the institutional fixed-income side of the business." That experience allows Bookbinder to make his investment decisions based not on the herd mentality, but on hard facts. It's the same experience that made him a success at Sandler O'Neill, the firm he started in 1988 to help

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institutions make their investments in fixed income. "A lot of it is pure liability management," he says, pointing out that an undiversified portfolio can lead to big losses. "That knowledge transferred seamlessly into risk management when I entered the hedge fund side of the business," he says.

The wealth of experience that Bookbinder brings to the table has brought in customers from a variety of backgrounds. The average customer is an individual with high net worth, a family office functioning as an investment organization for a family's assets or a smaller corporation or pension plan. He also has about thirty-five limited liability partnerships on his books, all of whom are striving to make the best of what can at times be a confusing universe. The fund charges 1.25% of net assets, plus 5% of any returns above 10%. Since, though, the fund attempts to return a steady 10%, this second charge remains "highly theoretical," which is just the way Bookbinder says he likes it.

How to avoid implosions

For the average hedge fund investor, the danger is always getting into something that you can't get out of. "With tie-ups of a year being common, we have to be

careful," he says. Once in a fund, while Bookbinder prefers not to bail out, "we will redeem if we have to." To keep funds honest, Bookbinder stays in touch with the managers, in many instances on a monthly basis. "Before we make an investment, we take a look at the numbers and make sure the returns are repeatable," he says. "Then, once we're invested, if we have to make a change, we will."

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Bookbinder's philosophy points out another danger for the typical investor: style drift. Many newer funds are quick to bolt into the newest and riskiest strategies in hopes of building stellar returns. The funds often implode or, if they survive, find their returns leveling off and falling. Because Bookbinder has such a stringent set of requirements and because he stays in constant touch with his chosen managers, the firm is able to avoid being taken for a ride. If a manager starts to drift, is bought out or simply begins to stagnate, Bookbinder's size and experience makes necessary changes possible. Where a single investor might find the lack of liquidity in a hedge fund makes a swap prohibitive, Bookbinder can do what needs to be done.

"The biggest mistake a first-time investor in hedge funds makes is going in without realizing that it should

be a full-time job," he says. "We make our decisions over a long period of time, and it takes pros to be able to do that." By sticking with smart managers, keeping them honest and making changes where he has to, Bookbinder has been able to avoid the lackluster returns of many of his peers.

"Right now, the big concern in the hedge fund world is the number of blowups of the past few years," says Bookbinder. With the imbalance of supply and demand, many second- and third-tier managers have made the leap into hedge funds, and many of them lack the talent and resources to produce good returns. "Research and due diligence are the keys," he says. And Bookbinder puts his own efforts into the equations. Rather than farm out the work, the firm does its own research. In fact, before making any investment decisions, Bookbinder himself carefully analyzes the prospectus of every fund. With his long track record of success, he can ask the hard questions of managers and get answers.

Take a real estate equity fund Bookbinder discovered several years ago when it had \$50 million under management and just a two-and-a-half year track record. Since Bookbinder made the investment, the fund has compounded in the mid teens and today has more than \$500 million under management.

The bottom line

While Wall Street, and Answers and Company, have raised questions about the layered fees of many fund-of-funds in the past, we feel that Bookbinder has a good thing going. We agree wholeheartedly that leaping into hedge funds blind is a bad move. We spend our time poring over statistics and getting to know managers before we make recommendations; Bookbinder does the same. While layered charges can subtract from returns, it's hard to argue with the bottom line at Bookbinder. Before trying to build a diversified hedge fund portfolio yourself, consider whether it isn't best to turn to a professional for help. For turning in positive numbers year after year, Bookbinder is among the best.

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