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Ultimate hedge

Passive people may be nonassertive, but passive investors are another breed of cat. They are out to conquer the world, to judge by the inflows into Vanguard and its ilk over the past 12 months ($229 billion into passively managed funds, according to Morningstar, just shy of the $236 billion removed from actively managed funds). The tribulations of the active spirits, especially hedge funds, is the subject at hand—that and a revisit to a 21st-century monetary hedge.

We write with close attention to a new essay by the protean Murray Stahl, chairman, chief executive officer and chief investment officer of Horizon Kinetics and publisher of *The Devil's Advocate Report Compendium*. Stahl's essay in the new edition falls under the headline, "Interest rates, hedge funds and the rise of the artificial asset class." Cryptocurrency is that asset class.

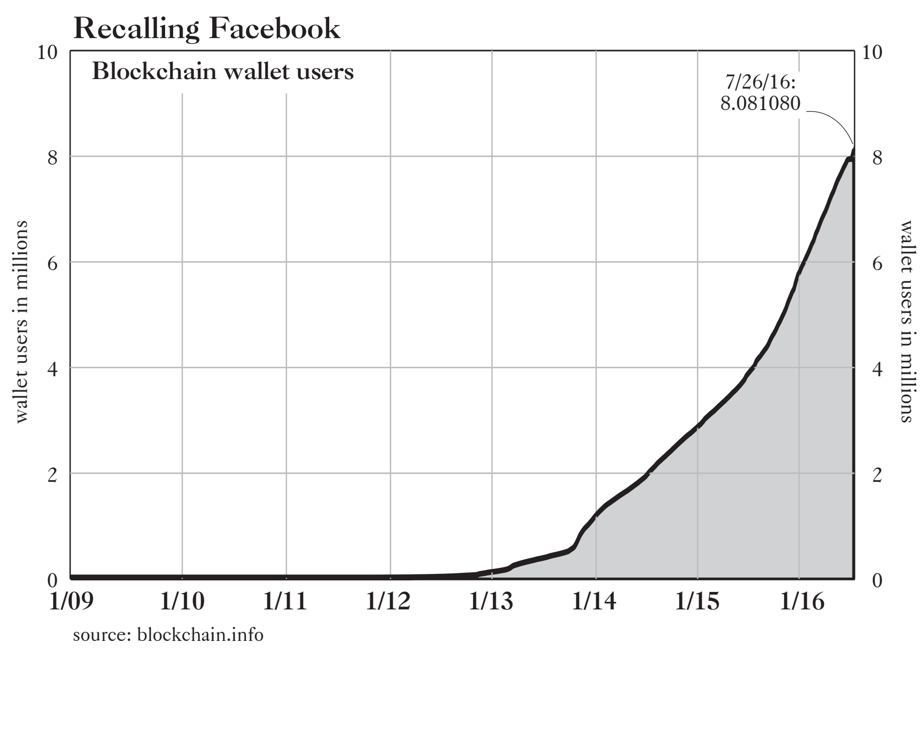
For reasons best known to themselves, the market gods have cast a plague on hedge funds. Or should we say "hedged" funds, as did the progenitor of the type, Alfred Winslow Jones, in the 1950s and 1960s? Jones would go long the stocks he liked and short the ones he didn't. The sum of these positions would represent more than 100% of his capital, with margin debt financing the increment. A management fee of 1% and a performance fee of 20% would compensate the intrepid manager.

It paid to be hedged in a world of free and upstanding interest rates. You would sell short a stock and invest the proceeds in, say, an 8%-yielding Treasury bill (an actual yield as recently as August 1989). You, the hedged investor, would keep six percentage points, your prime broker, two. Think of it: You were ahead of the game by 6% even before your painstaking security analysis began to bear fruit.

How different it is today, Stahl reflects. As money-market interest rates do not actually exist, neither do short-sale rebates. On the contrary, you pay to procure the borrowed shares with which to implement a hedge. And as for the work you have devoted to security selection, the algorithmic traders heartily thank you for it. Ever alert to successful trading patterns—like the one that you have independently conceived—they will beat you to the execution punch every time.

Tiny interest rates present a multifaceted dilemma for the hedged investor. E-Z credit prolongs the lives of failing companies that the forces of creative destruction would otherwise put out of business. And if, even in this time of record-low yields, a failing company can't raise a loan, a creditworthy acquirer might buy the weakling. And if no such buyer steps forward today, the bulls may hope (the bears dread) that one will materialize tomorrow. In short, hedged investing is hazardous business when central bankers rule the world.

And as with companies, so with currencies and sovereign debt: They stay afloat on the water-wings of cheap debt. "For instance," Stahl observes,



"the creation of the European Union, the European Central Bank and the euro were intended to prevent a repetition of the history of the Banca D'Italia funding the chronic deficits of the Republic of Italy with money creation and the endless depreciation of the Italian lire [sic]. Now the euro is in danger of resembling the Italian lire."

And yet, Stahl marvels (as do we and so may you), the owners of $12 trillion of sovereign debt are willing to pay the respective borrowing governments for the privilege of lending them money. Which singular facts lead Stahl to cryptocurrencies, especially Bitcoin, of which there will finally be no more than 21 million on the face of the earth.

Writing about the assymetric possibilities of wonk-money, Stahl sounds a lot like Wences Casares, the Argentina-born Bitcoin pioneer who addressed the fall 2015 *Grant's* conference. Yes, Casares acknowledged, Bitcoin could become worthless; the odds of a wipe-out he judged to be one in five. Then, again, there was a greater chance of Bitcoin coming into its own—30,000 people were buying their first coins every day. As Casares spoke, the price was $250 per crypto-coin. It is $656 today.

"A purchase of Bitcoin, however small," Stahl proposes, "is nothing other than a short sale of the currencies of the world. It should be obvious that if it were to gain the confidence of a meaningful number of investors, it would not trade at a market capitalization of $9 billion [$10.3 billion as we go to press].

When Stahl sat down to write, just $10 trillion of sovereign debt was quoted at negative yields. "If Bitcoin were simply to be equal—via market demand—to the value of all government bonds with negative yields, the increase in value would be 1,111.11 times," he continued.

Now, then, "if a portfolio having a 1% position experiences a 1,111.11 times appreciation in that position, the portfolio increases by .01 multiplied by 1,111.11, or 11.11 times. If this occurs over a five-year time period and if the price of every other position remains unchanged, this would be the equivalent of a 64.68% annualized rate of return. But that's hardly impressive enough: If all other investments were to become worthless during this hypothetical time period and no dividends or interest were collected on any position, this portfolio's rate of return would decline to 61.86%. Talk about a hedge!"

It's a heartening sign, said Stahl, that so many people are trying Bitcoin on for size—opening a digital wallet even if they put nothing inside it. "You can actually visualize this," he tells colleague Harrison Waddill. "If you look at the blockchain wallet's website, and look at the graph of blockchain wallets—if you just look at the graph without looking at the scale, it looks like the graph of Facebook accounts. It's a 45-degree angle. Literally a straight line."

Stahl, whose Polestar Fund manages $120.6 million, says that he owns a Bitcoin position of a little less than 1% of AUM. On a more conventional unconventional note, he adds that he owns a pair of precious-metals plays, too (Franco-Nevada and Silver Wheaton). "I haven't given up on gold and silver by any stretch of the imagination," he says. "I just felt like I wanted to diversify into something which is entirely different."

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