PERSONAL INVESTING

Those fantastic, "hedge funds"
Capital gains in coins

The Jones Nobody Keeps Up With

Alfred Winslow Jones

There are reasons to believe that the best professional manager of investors' money these days is a quiet-spoken, seldom photographed man named Alfred Winslow Jones. (The picture above was taken while he was on vacation in Mexico City recently.) Few businessmen have heard of him, although some with long memories may remember his articles in FORTUNE; he was a staff writer in the early 1940's. In any case, his performance in the stock market in recent years has made him one of the wonders of Wall Street—and made millionaires of several of his investors. On investments left with him during the five years ended last May 31 (when he closed his 1965 fiscal year), Jones made 325 percent. Fidelity Trend Fund, which had the best record of any mutual fund during those years, made "only" 225 percent. For the *ten*-year period ended in May, Jones made 670 percent; Dreyfus Fund, the leader among mutual funds that were in business all during that decade, had a 358 percent gain.

The vehicle through which Jones operates is not a mutual fund but a limited partnership. Jones runs two such partnerships, and they have slightly different investment objectives. In each case, however, the underlying investment strategy is the same: the fund's capital is both leveraged and "hedged." The leverage arises from the fact that the fund margins itself to the hilt; the hedge is provided by short positions—there are always some in the fund's portfolio. There are about sixty investors in each of the two funds, and their average investment now works out to about $460,000.

Jones's accomplishments have spawned a number of other "hedge funds." In the last two years, two of Jones's principal associates have left his organization and set up limited partnerships of their own. One is known as City Associates (it has capital of about $17,500,000), the other as Fairfield Partners ($14 million); both have had outstanding performance records. This month a new partnership, Fleschner Becker Associates, will go into business as a hedge fund; its principals are Wall Street brokers who have done business with Jones over the last few years. Besides these partnerships, a number of other hedge funds are operating on a small scale.

In addition, a small brokerage firm named L. Hubshman & Co., which has also done business with Jones, has bypassed the partnership pattern and is setting up an open-end investment company (i.e., a mutual fund), the Hubshman Fund, which will invest on hedge-fund principles. It remains to be seen whether a regulated investment company can use Jones's techniques as effectively as a private partnership does. Meanwhile Hubshman's move opens the way for a large number of investors to buy themselves a stake in the hedge-fund idea.

A sociologist on Wall Street

For most of his life Jones, who is now sixty-five, was more interested in sociology and in writing than he was in the stock market. In 1938 he set out to get his Ph.D. in sociology at Columbia University. While working toward the degree, he served as director of Columbia's Institute for Applied Social Analysis and undertook for it a major project on class distinctions in the U.S. The project became the basis for his doctoral thesis, which was published under the title *Life, Liberty, and Property* (two years ago it was reprinted by Octagon Books, Inc.). FORTUNE asked Jones to condense the book into an article (February, 1941) and hired him as a writer. Over the next five years (part of it spent with *Time*) he wrote articles on such non-financial subjects as Atlantic convoys, farm cooperatives, and boys' prep schools. He left Time Inc. in 1946, but in March, 1949,

he was back in the pages of FORTUNE with a free-lance article, "Fashions in Forecasting," which reported on various "technical" approaches to the stock market.

His research for this story convinced him that he could make a living in the stock market, and early in 1949 he and four friends formed A. W. Jones & Co. as a general partnership. Their initial capital was $100,000, of which Jones himself put up $40,000. In its first year the partnership's gain on its capital came to a satisfactory 17.3 percent, but this was only a suggestion of things to come. Not quite all the original capital has been left in the partnership, but if it had been it would today be worth $4,920,789 (before any allowance for the partners' taxes).

In the early years Jones was experimenting with a number of investment approaches, including the "hedge" idea, which was essentially his own. Increasingly, he began to concentrate on refining and employing this new technique.

How the hedge works

In effect, the hedge concept puts Jones in a position to make money on both rising and falling stocks, and also partially shelters him if he misjudges the general trend of the market. He assumes that a prudent investor wants to protect part of his capital from such misjudgments. Most investors would build their defenses around cash reserves or bonds, but Jones protects himself by selling short.

To those investors who regard short selling with suspicion, Jones would simply say that he is using "speculative techniques for conservative ends." As illustration, he is given to contrasting his methods with those of an investor who has, say, $100,000, and elects to invest $80,000 of it in stocks and the rest in "safe" bonds. Jones would use the $100,000 to borrow perhaps another $50,000. (Under the current margin requirements of 70 percent, he could not borrow that much to buy listed stocks; however, he could borrow even more than $50,000 for purchases of convertible bonds and unlisted stocks.) Of the $150,000 total, he might put $110,000 into stocks he likes and sell short $40,000 worth of stocks he thinks are overvalued. Thus he ends up with $40,000 of his long position hedged—i.e., offset by a short position—and the remaining $70,000 fully exposed.

This figure represents 70 percent of his original capital, and Jones therefore describes his "risk" as 70. (In practice, there is an added complication: Jones adjusts the dollar figures in a calculation that assumes some individual stocks to be more volatile, and therefore more risky, than others. Every stock in Jones's portfolio is assigned a "velocity" rating—e.g., Syntex's is 6.61, Kerr-McGee's 1.72—and the dollars invested are multiplied by these factors. The "adjusted" dollars are then used to figure the risk.) By Jones's method of measuring, the more conventional investor who put $20,000 into bonds, neither borrowing nor selling short, had a risk of 80. If the stock market goes down by 10 percent and all stocks in these two portfolios do likewise, Jones will break even on the hedged part of his portfolio and will lose less on his unhedged position—$7,000 instead of $8,000—than the other investor. If the stocks all *rise* by 10 percent, Jones will make less than the other investor.

His problem, therefore, is to buy stocks that will rise more than the general market, and sell stocks short that will rise less than the averages (or will actually fall). If he succeeds in this effort, his rewards are multiplied because he is employing, not just a portion of his capital, but 150 percent of it. The main advantage of the hedge concept, then, is that the investor's short position enables him to operate on the long side with maximum aggressiveness.

Jones's record in forecasting the direction of the market seems to have been only fair. In the early part of 1962 he had his investors in a high risk position of 140. As the market declined, he gradually increased his short position, but not as quickly as he should have. His losses that spring were heavy, and his investors ended up with a small loss for the fiscal year (this is the only losing year in Jones's history). After the break, furthermore, he turned bearish and so did not at first benefit from the market's recovery. Last year, as it happened, Jones remained quite bullish through the May-June decline, and then got bearish just about the time the big rally began. As prices rose in August, Jones actually moved to a minus 18 risk—i.e., his short positions exceeded his longs, with the unhedged short position amounting to 18 percent of the partnership capital.

In the "right" stocks

Despite these miscalculations about the direction of the market, Jones's selections of individual stocks have generally been brilliant. When he finally did turn bullish in the fall, he was long on a lot of the "right" stocks—e.g., Syntex, National Video, Fairchild Camera, the airlines. By the end of February he had racked up gains for the fiscal year of 38 percent in one fund, 31 percent in the other, compared to an increase (including dividends) of 6 percent for the Dow-Jones industrials.

Any hedge-fund operator will explain that although the hedge concept is essential—"I need it to sleep nights," says one of them—the real secret of his success is his ability to get good information about stocks and to be able to act on it quickly. The partnership form of organization is helpful in both respects, and it is worth examining Jones's arrangements closely.

Jones changed his firm from a general to a limited partnership in 1952 in order to accommodate several friends who were by then eager to have him handle their money. The new partners were let in on the understanding that they could withdraw their money from the partnership, or put

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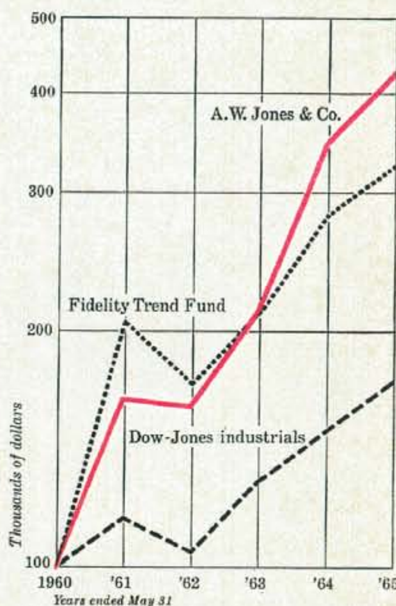
Jones's Big Jumps



The remarkable record of A. W. Jones & Co. is compared here with the performance of, first, the Dow-Jones industrial average and, second, the Fidelity Trend Fund—which had the best record of any mutual fund in existence during the five years covered by the chart. The comparison assumes initial investments of $100,000 (net of sales charges and commissions) in the Jones and Fidelity funds and also in an imaginary fund constructed along the lines of the Dow-Jones average. It also assumes reinvestment of all capital gains and dividends, including those that would have been received by a holder of the thirty Dow-Jones stocks. The figures charted for Jones reflect a limited partner's gains *after* the deduction annually of 20 percent of his profits—i. e., the amount that goes as payment to Jones and the other general partners.

This particular comparison puts Jones's record squarely up against that of Gerald Tsai, who until very recently ran Fidelity Trend Fund's portfolio and who, on the strength of his superior performance with it, this year sold an amazing $270 million worth of shares when he began his own Manhattan Fund. Tsai's big year during the period covered by the chart was 1961, when Fidelity Trend's shares gained by 105 percent; he ran into trouble, however, in the next year. Jones, meanwhile, had only a small dip in 1962. (All the comparisons refer to years ending May 31—which is when Jones's fiscal year ends.) Although he misjudged the market and rode with a short position that was much smaller than it could have been, the hedge concept helped him to cut his losses somewhat during the 1962 market slide. Jones's best years were 1961 and 1964, in each of which his investors made 65 percent.

new money into it, only at the end of each fiscal year. This agreement still exists. Moreover, Jones and the other general partners are to receive as compensation 20 percent of any realized profits (after deduction of realized losses) made on the limited partners' money. This arrangement is common to all the hedge funds, and the idea was not original with Jones. Benjamin Graham, for one, had once run a limited partnership along the same lines. There are also some mutual funds today—e.g., Oppenheimer Fund, Equity Fund, Leon B. Allen Fund—whose managers are paid on the basis of profits, although less liberally than Jones; the Hubshman Fund will have a similar arrangement.

The limited partners would seem to have no cause for complaint about the huge profits realized by Jones. Those sensational comparative performance figures reflect the limited partners' results *after* deduction of the general partners' share of their profits. In other words, the figures understate Jones's actual superiority over Fidelity Trend and Dreyfus in portfolio performance.

The push to get aboard

It is small wonder, then, that as the years have gone by a lot of investors have sought to get into Jones's partnerships. But since they are organized as private, unregistered funds, Jones took in only a few additional partners each year, primarily investors who were relatives or close friends of existing partners.

By now, however, the partners have got to be a diverse group. The largest limited-partnership interest belongs to Louis E. Stephens, a Mexico City businessman (he is the retired general manager of General Products S.A., a chemical company), who had $2,200,000 in one Jones partnership at the start of this fiscal year. Another large stake is held by A. Arlie Sinaiko, a physician turned professional sculptor, who, together with his family, has about $2 million invested with Jones; most of this amount represents portfolio appreciation. Several of the Richardsons associated with Richardson-Merrell, including the company's chairman, Smith Richardson Jr., have money in the partnerships. So does Louis Fischer, author of *The Life of Lenin* and other books, and Samuel Stayman, the bridge expert. Stayman, whose wealth comes primarily from a woolen business, also has money in the two other big hedge funds, City Associates and Fairfield Partners, and in Buffet Partnership, Ltd., a $45-million Omaha operation that uses hedge principles to some extent but that has mainly, and very successfully, concentrated on long-term investment. Other prominent businessmen in the hedge funds are Laurence Tisch, president of Loew's Theatres, and Maurice Perlstein, ex-president of Kellwood Co.

All told, Jones's limited partners had an investment with him of $44,898,000 as of June 1. Of this amount, about $5 million represented investments by the immediate

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Money in Coins

Collecting American coins is strictly a hobby for most of the collectors, but for others it is a lucrative investment program; even some of the hobbyists have lately found their "portfolios" appreciating at an annual compounded rate of 20 or 30 percent. Coins have long had good growth rates, and in recent years the rates have been accelerating, thanks to a steady increase in the number of collectors. There are now an estimated eight million collectors in the U.S.; and while most are not terribly zealous, simply putting aside certain coins they find in their pockets, there are perhaps 2,500,000 who are willing to spend more than the face value for coins.

Both kinds of collectors are normally interested in assembling complete sets of the coin series on which they concentrate—e.g., of Washington quarters for all the years they have been struck. As the number of collectors grows, so does the competition for rarities, especially the scarcer coins in each series. For example, the six most wanted Lincoln pennies, each of them minted in quantities of less than two million, would currently cost a collector a total of $980 if he wanted them in slightly worn condition. As recently as 1961 he could have got the same six pennies from a dealer for $280.

Collectors buying with profit in mind have reason to demand extraordinary gains from their investments. Coins, of course, produce no dividends. The investor often must pay the coin dealer twice what the dealer would offer him for the same coin, which means that it might take the investor three or four years just to get even. Finally, coin collections are not always easy to liquidate even at dealer bid prices. If a dealer is not in the market for coins, he might offer to auction them—for a 25 percent commission.

A logical first step for prospective numismatists is to read the collector's bible: *A Guide Book of United States Coins*, by R. S. Yeoman (Whitman Publishing Co.), also known as the Red Book because of its color. It lists every coin minted by the U.S. Government, the quantity minted, and the average retail prices in any of several conditions. A companion volume, the *Handbook of United States Coins* (the Blue Book), gives the prevailing wholesale values, i.e., the dealer bid prices. Each of the two books is revised annually.

Coin analysis, like stock analysis, is heavily concerned with past price performance. The investor can get a feel for the market by tracing the prices of various coins through back issues of the Red Book (now in its nineteenth edition) and the Blue Book (twenty-third). One spectacular gainer was the 1950-D (for Denver) Jefferson nickel, whose Red Book price advanced from 90 cents in 1958 to $26 this year, i.e., for coins never circulated. Some dealers attribute this performance to a combination of hoarding and speculative excess. (The price of the coin has recently dipped several dollars below the Red Book figure.) But the 1950-D does have the classic numismatic virtues: it is the most sparsely minted coin (only 2,630,030 pieces) in a series sought by many collectors.

Several different price trends have been discernible in recent numismatic markets. Coins in uncirculated condition have, as a rule, been appreciating more rapidly than circulated ones, and this trend has prompted many speculators to salt away rolls of twenty, forty, or fifty new coins, and even bags of 500 or more, in the hope that on some tomorrow they can sell them at a premium. Demand for freak coins—those with errors in engraving or stamping—has been growing fast too. There has been a steady rise in the price of the 1804 silver dollar (pictured), one of which sold for $36,000 at an auction three years ago. Only fifteen of these are known to exist.

But prices of some coins have fallen sharply as new supplies came on the market. When the Treasury Department dipped into its supply of old silver dollars a few years ago to meet the demand from collectors, Nevada casino operators, and silver hoarders, numismatists found that certain rare specimens in their collections had suddenly become commonplace. Wild speculation in uncirculated rolls that had been struck during the 1950's was followed by a price collapse in the early 1960's, and in some cases prices are still 30 to 40 percent below their highs.

Profits made in the sale of coins are treated, for tax purposes, as capital gains. If someone finds a rare coin in his pocket, and proceeds to sell it, the capital-gains regulations—including the six-month waiting period—apply.

families of the ten general partners. In addition, the general partners themselves, who have agreed to keep all of their investment funds in the partnership, had another $5 million invested. Of this about $2 million is Jones's own. (His two children, both of them limited partners, have another $2,500,000 together.) In total, including the gains he has made so far this fiscal year, Jones is managing close to $70 million of capital. Even with the borrowed money added in, this makes his operation no bigger than a medium-sized mutual fund.

But the weight Jones swings on Wall Street is many times magnified by the fact that, like all hedge-fund operators, he is a prodigious producer of commissions. Since short sales can never result in anything but short-term gains or losses, the hedge operator moves in and out of them freely. Similarly when he has losses on the short sales, he also finds it easier to take offsetting short-term gains on long positions. In general, the hedge funds have a high portfolio turnover.

Where the commissions go

One big reason the hedge funds find it natural to move in and out of stocks a lot is that, far more than most other funds, they have a special ability to get a flow of good, fresh ideas about stocks from brokers—and get them early. Most mutual funds are virtually compelled to channel a large proportion (perhaps as much as 90 percent) of the commissions they generate to brokers who sell the shares of their fund to the public. They have very little commission business left over for any firms that are unimportant in mutual-fund sales but that are strong on research. The partnership funds, on the other hand, have no shares to sell and thus can afford to "pay" a generous portion of their commissions for research. In Jones's case, the payments take a round-about form. The brokerage firm of Neuberger & Berman executes practically all Jones's orders, but keeps only about 50 percent of the commissions generated; it sends the remaining 50 percent, in the form of "give-up" checks, to brokers designated by Jones. A brokerage firm that Jones relies on heavily for research may get possibly $50,000 in give-ups a year, of which a third or more might go to the salesman who was covering the account and supplying those good ideas. That salesman is therefore likely to be very cooperative about keeping Jones informed.

A shortage of shorts

The Jones organization is set up so that decisions about purchases and sales can be made immediately, without committee consultation. There are five portfolio managers, all general partners, each of whom has discretion over a percentage of the partnership capital; in addition, several outside "advisers," one of them an investment counselor, the rest brokerage-house analysts or salesmen, have been given blocks of capital to manage. Either Jones or his No. 2 man, Donald Woodward, sees each order before it is executed, but they interfere only when it seems to them that the partnership is getting overloaded with a given stock—e.g., if several of the portfolio managers are being sold on the stock at the same time—or is maneuvering itself into an undesirable "risk" position.

The portfolio managers will tell you that, given the long-term trend of the market upward, their most difficult job is picking good short sales. Wall Street's analysts typically concentrate on discovering bullish corporate situations, and only rarely have promising shorts to bring to Jones. As a result, he and the other hedge-fund managers normally consider themselves lucky to break even on their short portfolios. Early last month Jones was short about sixty different stocks, including Korvette, Bristol-Myers, Admiral, and Du Pont. *All* of the big hedge funds were short Control Data (see the article on page 165).

Recently Jones has devoted more and more time to traveling and to philanthropic projects, many of them financed by his own Foundation for Voluntary Service. He has made some field trips for the Peace Corps, and his foundation is currently supporting the activities in this country of five young social workers from India, as a sort of "Reverse Peace Corps." He is also thinking of writing another book—on what to do about poverty in the U.S.

—CAROL J. LOOMIS

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problem. Some would not mind keeping the certificates for customers if they could charge for the service. (Right now any broker has the right to charge, but none dare exercise it unless competitors do too.) Some brokers feel that cash customers should be strenuously encouraged to keep their own certificates. And some brokers believe that the storage is worth the costs it entails—because it increases the chance that any future sale will be handled through their firms.

Just about all branch managers and many top executives in the brokerage business came up through sales, and they are often not effective administrators. Many of them seem disinclined to relate their operations to the firm's profits in any systematic way. A trader in one of the Street's institutional houses recently described the senior partner of his firm: "He'd rather trade 100,000 shares at an eighth spread than 10,000 at $2. It's not that he's deliberately choosing $12,500 profit over $20,000. He just can't resist a big deal."

The industry's move to electronic data processing will doubtless force many firms to think more rigorously about their costs—and help to reduce them. The Midwest Stock Exchange in Chicago operates a computerized "back-office" accounting service for fifty-seven of its members, most of them also N.Y.S.E. firms. By pooling a large volume of paper, the Midwest claims, it can handle a transaction profitably for 65 cents, versus a $1.75 average for a member firm doing its own work manually. Each participating firm has a tape punch and an input unit in its office—and needs nothing more in the way of record-producing equipment. James E. Day, president of the Midwest, says that the system won't pay for firms with less than a hundred buy-and-sell transactions a day; it's still cheaper for them to do their work manually. On the other hand, a firm with more than 8,000 transactions can just about afford its own computer. Day guesses that there are only about eight to ten firms in the U.S. with any such volume. But many more than that—perhaps more than fifty—have their own computer systems, which means that many are probably losing money on their machines.

The profitable institutions

The institutions in the stock market are among the most profitable accounts for brokers, even though virtually none are on a margin basis. The reason they are profitable is simple enough: the commission on 10,000 shares is exactly 100 times that on 100 shares, yet the large block is sometimes almost as easy for the broker to handle as the small one. Institutional business has come a long way since the days when it consisted mostly of college-endowment funds and bank trustees handling funds for widows, orphans, and black-sheep remittance men. The institutions now hold New York Stock Exchange stock worth about $110 billion, roughly 20 percent of all the stock outstanding on the Exchange. The pension funds own the biggest chunk of that, perhaps 29 percent of the total. But the most active traders in the group are the mutual funds. All told, the mutual funds probably generated around $50 million in commissions last year on listed business on the Big Board. The bulk of these naturally went to brokers that sold the funds' own shares to the customers.

Reciprocal arrangements with mutual funds are important to many brokers. Merrill Lynch, virtually alone among the big commission houses, does not sell mutual-fund shares, and Chairman McCarthy says that the firm is getting less than a normal share of mutual-fund commission business. Bache, which is perhaps the largest seller of mutual-fund shares, probably gets the largest volume of mutual-

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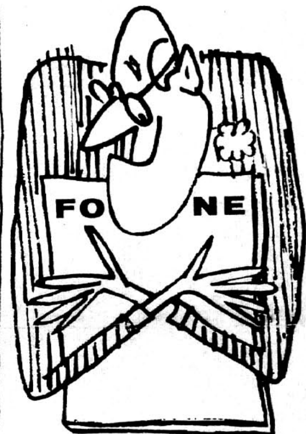

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