



BALTIMORE CAPITAL MANAGEMENT

575 S. Charles Street, St. 506
Baltimore, MD 21201
Phone: 410-727-4480
Fax: 410-783-7917

Email: agraham@baltimorecapital.com
www.baltimorecapital.com

EVALUATING RISK

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In the past few weeks one of the investment world's largest hedge funds experienced a loss of 50% of its assets on an energy (natural gas) investment that went wrong. While this has happened before with hedge funds, the magnitude of this loss was immense.

I think this shows that investors should try to understand what they are investing in. In the case of hedge funds they are often a black hole where investors would have difficulty understanding what is going on. The fact that investors, at most, will see quarterly statements and in some cases, only yearly statements, it is difficult to know what the manager is doing. Additionally, most of the reports provided do not show what transactions occurred in between statements. With some hedge funds the transactions are so numerous that it would be difficult to provide that information.

As with investment managers, there are good and bad hedge fund managers. The difference is in disclosure and fees charged. With hedge funds the fees are generally much higher and disclosure, much less so.

When evaluating any investment manager, one should look at much more than average returns. A good place to start is by looking at the bad years to see how those years compared to the stock market returns. If the manager does worse than the market in bad years, they are probably invested in more risky assets. It may be that the up years are strong enough to make up for the bad ones; but the issue is, as an investor are you willing to live with the extra volatility?



Source: Bloomberg

It is always worth looking closely at a manager's holdings to see if the account is overly diversified, showing a lack of conviction on any investment, or too concentrated investment holdings, showing a willingness to take on too much risk on a particular investment.

At Baltimore Capital Management our emphasis is first not losing money for our clients. We tend to outperform down markets and under-perform up markets. I often say that if you loose 50% in the first year and make 50% in the second year, you are not even. You actually are left with 75% of your investments.

While we like diversification it makes little sense to own more than 30 names. Over the years we have seen many investment managers of mutual funds own upwards of 100 names. Not only does this show a lack of conviction, but it also makes the account act like an Index Fund or move like the market, never outperforming it.

In summary, investors should look closely at what they own and how often their holdings change.