Hedgehog Investing

By Michael Mitchell

INTRODUCTION

In my twenty-plus years of interviewing asset managers, I've heard rationalizations for just about every investment discipline imaginable. Since I limit my interviews to managers who have demonstrated the ability to outperform recognized market indices, there is generally some justification for their fervor. These are knowledgeable, articulate people — missionaries for their investment strategies. But after a while, their strategies, no matter how passionately supported, all start to sound like the same song simply played in different keys. After dissecting hundreds (thousands?) of investment disciplines, it takes more than above-average performance or a zealous presentation to get me excited.

This month, I interviewed an investment manager who revived my enthusiasm. Dan Cashman is founding partner of Cashman and Associates in Valley Forge, PA. Cashman and Associates was established in January, 1996, after Mr. Cashman resigned from a $2 billion firm he had co-founded. Interestingly, it was the growth of his previous company — staff, facilities and product offerings more so than assets under management — that led to his gutsy decision to leave an enterprise he had spent 16 years building and start anew.

Over the years Cashman has been featured in numerous financial and investment media and was the subject of a flattering article in Forbes after the 1987 crash. Cashman has authored several insightful papers, including one written in August, 1987, entitled *The Wheel Turns*, which warned of a major collapse in the equity market. In that dissertation he stated that there had never been a period in this century, including 1929, where there was such little value. Within weeks the great collapse of October, 1987, occurred. Another, entitled *His Majesty Rests*, authored August 16, 1982, the very day the market bottomed at 785, counseled a fully vested position based on Cashman's assessment that the markets possessed the greatest value in this century, save for August of 1932.

This article was reprinted with permission of the author.

Cashman espouses what is a rare and refreshingly uncomplicated approach to investing, a *concentration of ideas* as opposed to the much more common diversified portfolio theory. In fact, even the company's logo, the hedgehog, exemplifies Cashman's investment approach. It seems an obscure Greek poet, Archilochus, remarked, "The fox knows many things, but the hedgehog knows one big thing." Cashman's hedgehog represents not one big thing literally, but rather the hedgehog makes the case for simplicity and concentration.

Q Financial planners typically recommend a diversified portfolio on the theory that it lowers risk. Why are you more comfortable with a concentrated portfolio?

A Over the thirty-two years I've been managing money, I have constantly had our analysts present me with dozens of ideas each year. You see, the system that pays them equates productivity with volume. But at the end of each year, I noticed that the few ideas that truly impassioned them were the ones that tended to be the best money makers. These were the ideas that were gin clear to me and possessed a high probability — rather than a possibility — of happening. Year after year I would incorporate this handful of wonderful ideas into a portfolio and then be compelled to surround them with a cluster of lesser lights simply to achieve the "diversification" that the marketplace demanded. But now, working with my best — and only my best — ideas, I am free to concentrate our portfolio and this is our edge.

Dan Cashman
Remembering the future

respected journal that claimed anything past eight holdings for the sake of diversification is redundant. Yet you'll see virtually every equity mutual fund with hundreds, even thousands, of names.

Warren Buffett argued that diversification increases risk.

The total costs of the average fund range between 1 and 1 1/2%. To me that's risk, the acceptance of sub-par performance at a greatly elevated price. It's sad that most people lack a clear alternative.

You see, the way I've described the architecture that goes into an idea that becomes a holding greatly reduces risk. Risk must always be defined in conjunction with reward. I believe our product achieves a beautiful balance. I think you can achieve stellar returns, not every year, but over time, employing the system I've described. Remember earlier I quoted Warren Buffett from his 1993 Annual Report. He argued that diversification increases risk. He further stated that you should own just a few holdings, the one's you know best, because that approach presents the least risk and offers the greatest potential profit. I couldn't agree more. That is why I started Hedgehog Partners, and that is why our standard portfolios look so totally unlike virtually every other manager. Obviously if I invest in clunkers, there's a risk to both capital and opportunity. But I believe our ideas will turn out pretty much as I envision, as long as we steadfastly hold to the disciplines demanded of GEMS.

Q What direction would you like to see your firm take?

A I hope we're never all that well known to the general public. If I had the choice, we'll never be a candidate for a fund supermarket because if asked I know we'd say no. I hope that doesn't sound arrogant; it's simply a way of saying we don't equate getting big with anything important. Staying small and avoiding complexity are two good ways of taking investing to its highest levels. That's best for our clients and, interestingly, best for us too. That's our primary goal. If we achieve it, we'll all be assured of our secondary goal — having fun.

Q But how can you expect the public to find you if you're barely known?

A I won't attempt to offer any solution to the problem other than great luck. However, nature favors the prepared. In our Partnership, which has only four Limited Partners at present, we have a gentleman who made an investment with us based on our 1996 results which were published in a hedge fund journal and also because he bought into the concept of concentrated holdings. He did some homework and found his way to us. But he's rare. I'm going to do everything I can to make him look smart. The majority of future investors will undoubtedly emerge after several solid years. That's the way it always works. How can you expect otherwise?

Q Thanks, Dan. Any final words?

A Yes, tell your readers our firm's greatest asset is 104 years of collective mistakes.

Michael Mitchell is an independent financial writer specializing in investment management.

Cashman and Associates

1235 Westlakes Drive
Suite 240
Berwyn, Pa 19312

Phone: 610-725-8200
Fax: 610-725-9585
E-Mail: cashmanlp@aol.com