Short's Story: Money Manager Stan Druckenmiller Is Still Be
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Barron's National Business and Financial Weekly; Mar 28, 1988; 68, 13; ProQuest
pg. 13

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Shorts' Story

Money Manager Stan Druckenmiller Is Still Bearish

STANLEY F. Druckenmiller isn't a stereotypical bear. The late great bull market, he says, now that *was fun. Indeed, despite a puckish sense of humor, Stan takes no obvious pleasure in watching stocks go down in flames. What he does like to watch, however, is the value of the portfolios he manages for Dreyfus Corp. grow. And, if it takes shorting stocks—or implementing exotic bearish strategies in futures—well, so be it (at least in the funds whose charters give him that freedom).*

Stan, a self-described dull fellow who spent two semesters at the University of Michigan pursuing a Ph.D. in economics before it dawned on him that he didn't want to teach, got his start as a securities analyst in Pittsburgh. Only 18 months later, in mid-'78, Pittsburgh National made him director of its equity and fixed-income research. In 1981, Stan started his own money-management firm, Duquesne Capital Management. Dreyfus hired him as a consultant in 1985, and a year later, Stan made it to the Big Apple. He joined the money management giant full-time, to run its Dreyfus fund and its Leverage fund, and to start up three new funds, all with "Strategic" in their names. The latter funds, in particular, give Stan a lot more investing latitude than most other mutual-fund managers enjoy.

These days, as intimated, Stan is shorting more than he's buying. We got him talking last week—on one of the days when the market wasn't tanking. The following Q&A details why he's currently bearish and what he's doing about it.

—Kathryn M. Welling

BARRON'S: Stan, word is that you are a little different from other mutual fund managers. . .

Druckenmiller: We all gamble with other people's money and charge them a fee. But three of the funds I run are creatures called the Strategic funds—all of which have the ability to go net short. The idea, and it was really Howard Stein's, in setting them up last year was that we had been in a bull market for 12 years at that point, but that some day, it was going to end. And we were starting to see a heavy inflow of dollars into equity funds, just as the mutual fund industry did in '68. We thought it'd be nice to have vehicles in place where possibly we could make money in a down market. Or at least, protect people's capital. Certainly, a year isn't enough of a history to say they work. But we are not upset about the start. We designed the Strategic funds so that they can employ very aggressive asset allocation, and it's not just in the prospectus. We actually do it. Two of them, Strategic World and Strategic Aggressive, are particularly interesting because they're limited partnerships.

Q: Why's that interesting?

A: They look and act just like mutual funds, but because of their limited partnership status, they aren't restricted by the 90-day rule.

Q: Which says?

A: Only 30% of a mutual fund's gains can be generated in trades under 90 days. Because they don't operate under that restriction, the two limited partnerships have all the derivative markets, as well as the more conventional markets, at their disposal. And the derivatives can be very useful in trading the swings in this volatile market.

Q: Some folks blame index futures and the other derivatives for a large part of that volatility. And say that they almost caused the world to end in October.

A: We don't like to think that the kinds of things we do with derivatives caused the end of the world. We don't do this thing called portfolio insurance. In fact, I've never quite understood why it was supposed to work. Apparently, with portfolio insurance, as the market goes down, you sell more. As the market goes up, you buy more.

Q: That's the theory.

A: Growing up in mid-America, I was always taught—I'm not saying I always do it—to buy low and sell high. Our participation in the derivative markets—and we're not claiming to be world savers, but we tend to trade against whatever the daily trend of the market might be, rather than with it. So often, we find ourselves on the other side of portfolio insurance. When prices are plunging, rather than sell, we prefer to buy, and vice versa.

Q: Is trading index futures a large part of what you do?

A: No, not really. The use of derivatives by the funds has been overstressed. The funds are unlike conventional funds because, if we don't like the market, we don't just go to 20% cash; we might actually go net short. And the derivatives just happen to, at certain times, be a convenient way of doing that quickly. But where you really are going to make, or lose, money for shareholders is with the decision to be in or out of the market. That's the big decision, not daily trading in derivatives or some fancy insurance spread.

Q: You almost sound old-fashioned.

A: What we do is old-fashioned, actually. All the derivatives do is greatly increase the speed at which we can move, should we have to.

Q: So are you in, or out of, the market today?

A: Let's put it this way. The Aggressive fund is net short. Investing is about 10% net long. And World is 30% net long. But it's short Japan and the U.S. It's long mainly Continental Europe. So all three funds are, at least in conventional terms, very defensive here. Our mandate, as we look at it, is to make money on an absolute basis; to protect our shareholders in declines and try and make money in any environment. You can't really compare us with people whose charters are to be fully invested, no matter what.

Q: How much more defensive could you get?

A: I could go to net short in all three funds, and the net short position in Aggressive, which is currently marginal, could become quite a bit shorter. Right now, it's under 20% and it could go as high as 60%-70%.

Q: Would you call that aggressively bearish?

A: That's not really that

Continued on Page 22

Short's Story

Continued from Page 13

aggressive, if you're trying to make money in any and all kinds of markets. If a normal mutual fund is 60% long, you wouldn't say that's really long. And my mandate is not to care about market direction. Sixty percent net short is no wild bet. Now, 200% net short would be. But we'd never do that.

Q: Okay, Stan. But why are you defensive now?

A: Well, we look at the market in three different ways—and each of them is flashing warning signals. First of all, we look at valuations. We use them to determine, really, the market's risk level, as opposed to its direction.

Q: Because overvalued stocks can get more overvalued—and vice versa?

A: Exactly. That's an important consideration, if for no other reason than because the market became very overvalued at the end of 1927, but if you had shorted it then, you were broke by mid-29. And, if you had shorted the market in January of '87, when it became very overvalued by traditional measures, you would have had a big problem by August. On the other hand, valuation is something you have to keep in mind in terms of the market's risk level.

Q: Why's that?

A: When catalysts come in to change the market's direction—which I'll get into in a minute—you have to realize that the decline could be very major if you're coming from the kinds of overvaluation levels witnessed in '29 and in the fourth quarter of last year. Conversely, if valuations are very low, as they were in 1932 or August of '82, the move could be explosive on the upside, once market direction changes. So valuation is something we keep in the back of our minds.

Q: What do you keep in the front of your mind?

A: I guess the major thing we look at is liquidity, meaning as a combination of an economic overview and how the Fed is responding to that economic situation.

Q: Can you be more specific?

A: I'll try. Contrary to what a lot of the financial press has stated, looking at the great bull markets of this century, the best environment for stocks is a very dull, slow economy that the Federal Reserve is trying to get going. Not a recession, but an economy slow enough that the Fed is actively trying to get it moving. Your best bull market this century was from 1922 to '29, when, it's a little-known fact, you had no corporate earnings growth. Then there was the 'Fifties bull market, while earnings grew at, I think, 2% a year, which was a dramatic slowing from 10% a year in the 1940s. Then, of course, there was the 'Eighties bull market. And, at least until the earnings really started to grow in '87, the market was fine.

Q: You're saying that a booming economy isn't good for the stock market.

A: The reason is really quite simple. Once an economy reaches a certain level of acceleration, not only is the Fed no longer with you, but the way we look at it, three very bad things start to happen.

Q: Which are?

A: The Fed, instead of trying to get the economy moving, reverts to acting like the central bankers they are and starts worrying about inflation and things getting too hot. So it tries to cool things off. This takes money out of financial assets, shrinking liquidity. That's one. Then, corporations start having to build inventory, which again takes money out of financial assets and shifts it into the real sector. And finally, if things get really heated, companies start engaging in capital spending.

Q: Go on.

A: All three of those things, which usually take place against a background of great earnings in a roaring economy and great enthusiasm for the stock market, tend to shrink the overall money available for investing in stocks—and stock prices go down. In other words, they set up a very perverse situation. When things look bad and they're not so hot, usually events take place that move money from real assets into financial assets. Then, when things start to look better, eventually you get to the point where the opposite happens.

Q: The trick is figuring out just where we are in that cycle. How do you go about doing that?

A: We have some stuff we use internally to measure the momentum of the economy and of the Fed's response to it.

Q: Such as?

A: Well, the Fed's response, we gauge basically by looking at the year-over-year rate of change in real money supply, which is the money supply divided by the inflation rate. In addition, we watch non-borrowed reserves, a Fed statistic that comes out every other Thursday, and tends to lead the rate of change in real money.

Q: What's it telling you?

A: Looking at what the Fed is doing with non-borrowed reserves now, not only is real money going the wrong way, it is not going to turn favorable anytime in the next month or two.

Continued on Page 24