

## FT.com site : Tinseltown holds peril for hedge funds

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People: De Vany, Arthur

Companies: Paramount Pictures Corp (Duns:00-698-8802 )

Author(s): John Gapper

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### Full Text (953 words)

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In Jackass 2, a film that is doing well in cinemas at the moment, the practical joker Johnny Knoxville takes on a wild bull while wearing a red shirt and a blindfold.

The fate of Mr Knoxville and the film is being watched closely by some hedge funds, for Jackass 2 is one of a slate of 30 films at Paramount Pictures part-financed by outside investors. The partnership is the latest in a series of Hollywood deals in which the risks and rewards of films are being shared between studios, hedge funds and private equity investors.

The question is whether hedge funds are likely to gain any better treatment from Hollywood than other outsiders who have tried to break into its insular culture. Studio heads are usually happy to take the money of foreigners and strangers in return for sharing a little of the glamour of Tinseltown. But Hollywood accounting is designed to retain as much of the resulting profits as possible.

This time, the investors are supposed to be more sensible and sophisticated than the average Hollywood tourists. The Paramount deal, for example, was structured by the investment bank Dresdner Kleinwort and involved sophisticated modelling of the likely equity returns. With leverage, the hedge funds hope to gain returns in the double digits and perhaps above 20 per cent.

You have to wonder whether Hollywood fits the Wall Street model. In theory, a film is akin to any other investment the risk of investing in one film is high, but it is reduced by spreading the bet across a portfolio. Funds such as Melrose Investors 2, the Paramount vehicle, insist on investing in slates of at least 15 films, without studios being able to keep the best prospects to themselves.

"My risk is spread across the slate with no cherry-picking," says Laura Fazio, a managing director of Dresdner Kleinwort. That is better than investing in single films, says Larry Ulman, a partner of Gibson, Dunn & Crutcher, a law firm that has represented studios in several deals. "Sometimes you get Dodgeball (a hit) and sometimes Poseidon (a dud). It is Las Vegas," Mr Ulman says.

Actually, it is worse than Las Vegas. If you put enough bets on a roulette wheel, the portfolio effect will eventually work you know how much you will lose. But profits and losses from films are unpredictable and variable. Indeed, Arthur De Vany and David Walls, two economists, argue that they do not follow the normal distribution of results observable elsewhere.

If film profits tracked a normal bell curve, most films would achieve close to the median return and only a few would make or lose a lot of money. At the extremes, there would be a tiny number of blockbusters and big loss-makers. In practice, there are more big winners and losers than a statistician

would expect: the bell curve has "fat tails" because extreme events occur unusually often.

One reason for this is word of mouth. Although studios market and promote films in proportion to their production budgets, they have no control over how film-goers will react. Some films, such as Poseidon, open in a blaze of publicity but quickly fade while others, such as March of the Penguins, start modestly and gain momentum as word spreads among friends about their merits.

Mr De Vany, a professor emeritus of economics at the University of California, Irvine, says this creates an unusual hazard for investors. Instead of gaining from a portfolio effect, they are likely to experience more variability in returns the more films they invest in. "They have not been in the business and they do not know what probability distribution they are up against," he says.

Nor does it help much to rely on the judgment of a studio management team by investing in a slate it has chosen, according to Mr De Vany. His argument is dubbed the "nobody knows anything" hypothesis, after the phrase of William Goldman, the Hollywood screenwriter. Since returns are so unpredictable, even old hands have no idea which films will succeed and which ones will fail.

That is a counsel of despair for hedge fund investors so it is just as well that there is some evidence against it. Abraham Ravid and Suman Basuroy, two economists, found that films featuring sex and violence had more predictable returns than family-rated fare. This could explain why studio heads keep on making them despite the fact that family-rated films such as cartoons are more likely to become blockbusters.

Furthermore, a recent analysis by Merrill Lynch found that, although returns on single films followed the "fat-tailed" distribution identified by Mr De Vany, returns on film slates followed a fairly normal bell curve distribution. A single film is likely to make a loss more than 50 per cent of the time, while an investment in a slate should be profitable more than 80 per cent of the time.

Still, a 20 per cent chance of loss is enough to give anyone pause. And it is unlikely that Hollywood will ever be as predictable as other markets. Investors in Virtual Studios, one film fund, discovered that when it made an estimated \$50m loss on its investment in Poseidon. Warner Brothers tried its best to make Poseidon a blockbuster hit, but it was to no avail.

"Life is not an illogicality; yet it is a trap for logicians," G.K. Chesterton wrote. "It looks just a little more mathematical and regular than it is; its exactitude is obvious, but its inexactitude is hidden; its wildness lies in wait." Mr Knoxville found that out when he took on a wild bull while blind-folded. Hedge funds that invest money in Hollywood films probably ought to bear it in mind too.

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