FEATURE

PORTFOLIO STRATEGIES

What Are You Really Getting When You Invest in a Hedge Fund?

By William Reichenstein

Hedge funds are all the rage in the investment industry. Their historical returns look great. And best yet, their returns often are weakly correlated with the stock market—a feature that has helped their appeal in the 2000–2002 bear market. They are touted as a great asset class for adding diversification to a portfolio.

What a deal!

But, CAVEAT EMPTOR—buyer beware! If it looks too good to be true, it probably is.

This article takes a critical look at hedge funds and whether they can play a useful role in an individual investor's portfolio.

Traditional advice encourages individuals to take control of their finances, concentrating on factors not the least of which includes their asset allocation decision and the costs of their investments. Hedge funds mess up these controllable factors—they have high costs, and many are not clearly categorized as stocks or bonds or cash.

In addition, a review of the historical returns of hedge funds and other alleged advantages finds them suspect.

What Are Hedge Funds?

Hedge funds are limited liability partnerships that are open to the relatively wealthy. In the U.S., investors must have a net worth of $1 million or higher or an annual income in excess of $200,000 for the past two years to be eligible to invest in a hedge fund or a fund of hedge funds.

Hedge funds are unregulated and hold non-diversified investment portfolios. Although the Securities and Exchange Commission has made some noise recently about regulating hedge funds, they are currently unregulated (see the SEC's Note of Caution on page 12).

One justification for the lack of regulation is that the wealthy investors who invest in hedge funds should be able to fend for themselves, and even if the hedge fund falters it is only a small fraction of their wealth.

To say they are not regulated and not diversified says something about what they are not. But what *are* hedge funds?

No simple definition of a hedge fund exists. In the world of investments, hedge funds use many strategies that are not used by traditional mutual funds (see Table 1). This leads to a wide variety of investment strategies.

For example, some hedge funds use a long-short stock portfolio. [When you are "long" a stock, it simply means you own it. When you "short" a stock, you sell a stock that you do not presently own but that you have borrowed indefinitely from a broker; a short sale is made in anticipation of a

Table 1. Hedging Alternatives: What They Use

Hedge fund managers may use sophisticated investment strategies that are not used by traditional mutual funds. These include:

Arbitrage: Simultaneous buying and selling of a security in different markets to profit from the difference between the prices

Concentration: Positions in securities of a single issuer or market

Short selling: Sale of a security you do not own

Hedging: Buying a security to offset a potential loss on an investment

Leverage: Borrowing money for investment purposes

Risky and/or illiquid investments: Investing in distressed or bankrupt companies; volatile international markets; derivatives, such as options and futures contracts; privately issued securities

price drop.] A fund may be long Ford and short GM, or long Sears and short Kohl's; these are just two examples of many long-short pairs.

Some hedge funds use a long-short bond portfolio with leverage: For every dollar of capital, they may be long $5 of bond A and short $5 of bond B.

The range of strategies is so wide that the hedge fund industry itself is struggling to find a system to categorize the strategies. Some use long-only positions, while others use short-only or long-short positions. Some use leverage, while others do not. Some use stocks, while others use bonds or commodities or currencies. Some are directional—that is, designed to increase in value with the market—while others are market-neutral, depending on individual stock picks for increasing portfolio value.

In contrast, the traditional assets recommended for individual investors' portfolios are long-only positions in individual stocks or stock mutual funds and long-only positions in bonds and bond funds. These portfolios avoid leverage.

Let us return to the question, "What are hedge funds?" Although no single definition applies, one thing should be clear: Hedge funds as a group are not one single asset class.

The Individual Investor's Perspective

For individual investors, there are distinct merits in keeping the investment management process simple [which I described in my February 2003 column "10 Lessons You Should Learn From Recent Market History"]:

1) Select a strategic asset allocation—that is, your long-run normal asset allocations across stocks, bonds, and cash;
2) Periodically rebalance back to that asset allocation; and
3) Keep expenses to a minimum.

This management process is essentially the process advocated by mutual fund families in their life-cycle funds [discussed in my February 2004 column "Retiree Stock Allocation Recommendations: Do You Fit the 'Mold'?"], except that their strategic asset allocations slowly become more conservative as the individual approaches and enters retirement. In addition, this approach is consistent with the processes advocated by many other leading financial planning scholars and professionals. Since it is the standard advice given by many who have studied financial markets and investment history, it should not be discarded lightly.

This investment management process puts an emphasis on the factors that investors can control:

- You can control the amount you save each year;
- You can control the portfolio's asset allocation; and
- With diligence, you can keep expenses to a minimum.

Unfortunately, hedge funds are high-cost investments and they frequently mess up the asset-allocation decision. On these grounds alone, I discourage investments in hedge funds.

Asset Allocation Miscalculations

Hedge funds can cause individuals to miscalculate their true asset allocation for two reasons.

First, they are not one asset class and therefore cannot be easily classified, as the box on page 11 illustrates.

Second, some hedge fund managers refuse to discuss their strategy, allegedly because they do not want to reveal the market inefficiency that the strategy is trying to exploit. Individuals investing in these funds have no idea whether the hedge funds should be considered cash, bonds, or stocks and whether leverage is involved. Obviously, these individuals forego control of their asset allocation.

Whether due to misclassifying a hedge fund's asset class or the lack of knowledge about the fund's strategy, in practice hedge funds tend to interfere with individuals' ability to control their asset allocation.

High Investment Costs

A fund's total investment costs include the fund's expenses plus trading costs. The typical hedge fund charges 1% a year plus 20% of profits.

If you invest in a fund of hedge funds, then the total cost structure sometimes rises to 2% plus 30% of profits.

In contrast, numerous stock and bond mutual funds have expense ratios of 0.5% or less.

Hedge Funds & Asset Allocation: What the Heck Are They?

What asset class do hedge funds fit into?

That's hard to say, because it depends on the approach used by the hedge fund manager, as the following examples illustrate. Let's compare three hedge funds. The first two use long-short stock strategies, while the third uses leverage.

1) Long-Short Market-Neutral Strategy

The first of these is a long-short market-neutral hedge fund. For simplicity, assume this fund is long Ford stock and short GM stock, and this is its only long-short pair—in other words, the fund owns Ford stock, and has sold short GM (it has borrowed shares it does not own and then sold them). *Market-neutral* means this hedge fund is designed so that any increase or decrease in the overall stock market is expected to produce offsetting gains and losses in Ford and GM. So, whether the market goes up or goes down, the fund remains the same; it only makes a profit if Ford does well relative to GM.

If you own this hedge fund, what is it—that is, in an asset allocation framework, is it stocks, bonds, or cash?

The answer is that it should be viewed as cash. Since its returns are not sensitive to the market, it should not be classified as a stock. Instead, if markets are efficient, its expected return should equal the return on Treasury bills (the cash proceeds from the short sale are invested in Treasury bills, which provide the expected return). The hedge fund is betting that Ford's returns will exceed GM's returns by enough to more than offset the management fees and transaction costs. If that bet is successful, the hedge fund's actual return will exceed the return on Treasury bills. If that bet is not successful, the hedge fund's returns will fall short of the Treasury bill return.

The upshot is that for asset allocation this hedge fund should be viewed as volatile cash. Volatile cash! Now that is an interesting concept.

2) Long-Short Market-Neutral With Index Futures Strategy

Now, consider a second hedge fund that uses a long-short stock strategy. It is identical to the first hedge fund except it also has a stock index futures overlay. Because of the futures overlay, this hedge fund's returns should rise and fall with the stock market.

For asset allocation purposes, it should be treated as stocks.

3) Cash-and-Carry Strategy

Finally, consider a hedge fund that is following a cash-and-carry strategy: For every dollar of capital, it borrows $3 more at short-term rates and invests the $4 in longer-term bonds. If you have a $100,000 investment in this hedge fund, what is it in an asset allocation framework? Is it a $100,000 bond, a $400,000 bond, or something else?

The answer is not clear. If the probability of bankruptcy is small for the limited partnership, then it should be viewed as a $400,000 long position in bonds and a $300,000 short position in cash. Thus, a relatively small position in this hedge fund could cause a substantial change in someone's overall asset allocation.

Diversification Benefits

These three examples illustrate that hedge funds are not one asset class: One hedge fund should be viewed as cash, one as stocks, and the third as long bonds and short cash. Does that make them a good diversification tool for a traditional stocks-bonds portfolio, as the industry claims?

In fact, the diversification benefits are similar to those provided by various *traditional* asset classes. The first long-short hedge fund should provide diversification benefits similar to those of cash, the second should perform like stocks, while the third should perform like a leveraged bond position.

Since hedge funds are not one asset class, the diversification benefit provided varies among hedge funds.

The bottom line: For individual investors, there are easier, less expensive ways to attain various cash, stock, and bond exposures.

And the SEC's Note of Caution:

"Hedge fund investors do not receive the full set of protections commonly applied by the federal and states' securities laws to most registered investments. This means that you won't get the same level of disclosures from a hedge fund that you'll get from other registered investments.

Without the disclosures that the securities laws require for most registered investments, it can be quite difficult to verify representations you may receive from a hedge fund.

You should also be aware that the SEC and other securities regulators have limited ability to check routinely on hedge fund activities."

Trading costs are also high on hedge funds. For example, a stock mutual fund will buy Ford stock. But a long-short market-neutral hedge fund must buy Ford, sell GM, and also may buy stock index futures. Thus, long-short hedge funds have at least twice the level of transaction costs as a long-only strategy. Hedge funds are truly high-cost investments.

Lastly, the cost structure encourages the managers to take risky bets, since the manager is assured the high expense fee plus 20% of the profits—and none of any losses.

Hedge Fund Hype

Hedge fund salesmen like to point out strong industry returns and claim that these strong returns are due to hedge funds' ability to exploit market inefficiencies. This section examines these claims.

Returns

Strong historical returns on hedge funds are often touted as an attractive feature. But there are several biases present in these reported returns. Consequently, the reported numbers greatly exaggerate the returns that typical investors have earned. Moreover, there are good reasons to believe future hedge fund returns will be lower than historical returns.

The hedge fund industry asks current hedge funds to report their historical returns, and individual hedge funds choose whether they want to provide those returns. This procedure ensures that the reported returns exaggerate the returns earned by the typical investor. The biases include survivorship bias, non-reporting bias, questionable-numbers bias, and instant-history bias.

Suppose there were 1,000 hedge funds in existence five years ago, but only 550 of these remain today. Survivorship bias refers to the fact that the returns on the 450 non-surviving funds are not reported. Naturally, on average, these non-survivors' returns were poor. Yet, their returns and the returns earned by their investors are unrecorded. Thus, the reported returns exaggerate the returns earned by the average investor.

Survivorship bias also exists in the mutual fund industry. For 1971–1991, one study estimated that average reported returns in the mutual fund industry were 1.5% higher than the returns actually earned by the average investor. However, the survivorship bias in the hedge fund industry is probably larger than this.

The second and third biases exist because the current hedge funds can decide whether or not to report their current numbers, and their numbers are not audited. To continue with the example above, of the 550 survivors, 400 may provide their returns. Excluding the returns from the 150 non-reporting hedge funds is the non-reporting bias. In addition, the returns provided by the 400 hedge funds lack external verification. This is the questionable-numbers bias.

The last bias is the instant-history bias. A manager may begin several hedge funds, each one based on a different strategy with a small amount of the seed money in each. After a couple of years, the successful strategies will go public and their historical records are made public. The records of the unsuccessful strategies are not made public. Moreover, the historical returns earned by the successful strategies are not returns earned by typical investors.

It should be obvious that the industry-reported returns should be viewed skeptically. One study ["A Critical Look at the Case for Hedge Funds," by Richard M. Ennis and Michael D. Sebastian, Summer 2003 Journal of Portfolio Management] examined the overall bias in numbers for the 1992–2002 period by comparing the reported 7.1% average return on the Hedge Fund Research Fund of Funds Index, which is the return earned by actual investors in funds of hedge funds, to the Hedge Fund Research Composite Index's reported average return of 11.3%. The 4.2% difference suggests a large bias in the industry's numbers. Moreover, the 7.1% return earned by actual investors was less than the 8.5% return on the S&P 500 and the 7.3% return on the Lehman Aggregate Bond Index over the same period.

Alleged Exploitation of Market Inefficiencies

It is often claimed that hedge funds provide market-beating returns because they are able to exploit market inefficiencies. Hedge fund strategies do provide opportunities for skilled managers to outperform the market through their stock-picking skills.

For example, the manager of a traditional large-cap stock mutual fund can try to beat the S&P 500 using his stock-picking abilities by underweighting investments in stocks that will underperform the index and overweighting investments in stocks that will outperform the index. However, because this is a traditional fund that simply owns stocks, this manager can only *underweight* a stock with a 0.2% weight in the S&P 500 by 0.2%. That is, by *not* investing in this stock, he underweights it by 0.2%.

In contrast, by shorting this stock, the manager of a long-short hedge fund (with an S&P 500 futures overlay) could underweight it by more than the traditional mutual fund. For example, if he took a 3% short position in this stock and a corresponding long position in another stock in the same industry, he would have a 3.2% underweight on this particular stock. (The long position in the other stock of the same industry means that the manager is only shorting the *stock*, not the *industry*.)

Still Interested? Information You Should Seek

Here are some solid recommendations from the SEC on the information you should seek if you are considering investing in a hedge fund or a fund of hedge funds.

- ***Read a fund's prospectus or offering memorandum and related materials.*** Make sure you understand the level of risk involved in the fund's investment strategies and ensure that they are suitable to your personal investing goals, time horizons, and risk tolerance. As with any investment, the higher the potential returns, the higher the risk you must assume.
- ***Understand how a fund's assets are valued.*** Hedge funds may invest in highly illiquid securities that may be very hard to value. Moreover, many hedge funds give themselves significant discretion in valuing securities. You should understand a fund's valuation process and know the extent to which a fund's securities are valued by independent sources.
- ***Ask questions about fees.*** Hedge funds typically charge an asset management fee of 1%–2% of assets, plus a "performance fee" of 20% of a hedge fund's profits. A performance fee could motivate a hedge fund manager to take greater risks in the hope of generating a larger return. Funds of hedge funds typically charge a fee for managing your assets, and some may also include a performance fee based on profits. *These fees are charged in addition to any fees paid to the underlying hedge funds.* Therefore, if you invest in hedge funds through a fund of hedge funds, you will pay two layers of fees: the fees of the fund of hedge funds and the fees charged by the underlying hedge funds.
- ***Understand any limitations on your right to redeem your shares.*** Hedge funds typically limit opportunities to redeem, or cash in, your shares (e.g., to four times a year), and often impose a "lock-up" period of one year or more, during which you cannot cash in your shares.
- ***Research the backgrounds of hedge fund managers.*** Know with whom you are investing. Make sure hedge fund managers are qualified to manage your money and find out whether they have a disciplinary history within the securities industry. You can search the NASD's computerized database, or call your state securities regulator to find out this information.

On the surface this sounds like an important advantage.

But how important is it?

The key statement is that this is an advantage for a *skilled manager*. However, based on the evidence from the mutual fund industry and institutional fund management, those management skills are scarce. And for hedge funds, it becomes even harder to find a manager that has sufficient skills to more than offset the high management expenses and transaction costs of an active hedge fund.

There is another problem with the claim that hedge funds' alleged strong returns are due to their ability to exploit market inefficiencies. If enough money is thrown at a market inefficiency, it should disappear. For example, one hedge fund strategy is to take a short position in the most recently issued 10-year Treasury security and a long position in the next shorter-term security. The strategy claims that the price of the "on-the-run" (most recently issued) bond is higher than the price of surrounding bonds, because these bonds have a larger trading volume and investors are willing to pay for this greater liquidity. The strategy tries to sell this highly priced bond and buy a similar bond whose price does not contain this liquidity "premium." Then, when the next 10-year bond is issued, the hedge fund will unwind the first bet and capture the liquidity premium. If relatively few dollars try to capture this liquidity premium, this strategy might work. But as more and more dollars try to profit from this strategy, the liquidity premium should disappear.

In recent years, there has been a tremendous increase in the size of the hedge fund industry. Recent estimates suggest that there is now $600 billion chasing alleged market inefficiencies. It follows that the profit potential from exploiting these alleged market inefficiencies should diminish.

Furthermore, it is now apparent that some of the industry's historical returns were not earned by exploiting market inefficiencies. Rather, they were earned because some mutual funds allowed select hedge funds to use market timing to the detriment of the mutual fund's long-term investors. Hedge funds were not exploiting alleged market inefficiencies. Rather, they were allowed to exploit long-term mutual fund investors due to inefficient safeguards at select fund companies. Presumably, this loophole has been closed.

Current Popularity

There is no denying the current popularity of hedge funds. However, much of this popularity is due to the market neutrality of many hedge funds at a time when it was advantageous to be market-neutral.

During the bear market of 2000 to 2002, market-neutral hedge funds usually produced higher returns than traditional stock mutual funds. Hedge funds that produced positive returns compared favorably to stock funds that were in deeply negative territory.

However, during bull markets, stock funds usually beat market-neutral funds. And over the long run, stock markets trend up.

Moreover, if market neutrality is the desired characteristic, you do not need to be in a hedge fund. You can simply invest in cash.

In short, the industry's historical returns look impressive at first glance, but the picture clouds under closer scrutiny. And the claim that the alleged high returns are due to the managers' abilities to exploit market inefficiencies is problematic on several grounds:

- Few managers have demonstrated persistent security selection skills,
- Market inefficiencies should occur infrequently, and if one occurs it should quickly be eliminated, and
- Some of hedge funds' historical returns were due to market timing and other inappropriate practices.

The elimination of these sources of returns suggests that future hedge fund returns will be lower.

Summary

If it seems too good to be true, it probably is. The hedge fund industry touts strong historical returns as well as returns that are weakly correlated with the stock market, and it attributes success to managers' abilities to exploit market inefficiencies. Hedge fund proponents push the allure of high returns with limited risk.

If only it were true!

For most individual investors, hedge funds do not offer an attractive addition to their investment portfolio. For these investors, the primary reasons to avoid hedge funds are:

- They often cause the investor to lose control of his portfolio's asset allocation, and
- They have high costs.

Other reasons to avoid hedge funds include:

- Questions about their historical returns,
- The lack of evidence that managers can consistently add value though security selection, and
- The surge of money chasing the alleged market inefficiencies.

It is easy to understand why hedge funds are highly touted by the industry. Not only are they guaranteed their high expenses, but they get 20% of the winnings and bear none of the losses. This cost structure encourages risky investments and risky strategies.

But hedge funds are not necessarily an attractive investment alternative for individual investors, and they are unlikely to make any positive contribution to a traditional investment portfolio consisting of stocks, bonds and cash. ▲

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