

Hedge Funds For Dummies

(Published April 2008)

— *By Allen Giese*

You should be in Hedge Funds! Everyone does it! It's the hottest investment out there!

Feel like you are missing the boat? With all the press hedge funds are getting and the hype we hear on the financial news channels it's no wonder we all don't transfer everything in our portfolio over to the hottest hedge fund manager. Enough of you have asked us about our views on using hedge funds in our portfolios that I feel somewhat compelled to share our thoughts.

So have you caught yourself wondering what a hedge fund really is and whether or not it might be something you should consider as being part of your portfolio? You're not alone.

At an advisor seminar I was attending recently, Ken French, the noted economist from Dartmouth and collaborator on some of the most compelling arguments on Modern Portfolio Theory was asked about his views on hedge funds. "Do you know what a hedge fund really is?" he asked, "It's a mutual fund for stupid people." Ken isn't known for mincing words. I love it when I don't have to try and figure out what someone is really saying.

Do you like high fees? You'll love hedge funds!

One of the things that make a hedge fund unique is its ability to escape many of the normal regulations that apply to mutual funds. As long as the hedge fund restricts access to only "sophisticated" investors (a very loosely defined term), hedge funds can avoid making their performance public or having their numbers audited.

When it comes to fee structures you find a level of complexity that would never survive in the mutual fund universe. The most common compensation structure in the hedge fund business is the so-called "two and twenty," where the manager charges a 2% annual fee and receives 20% of profits. This fee structure, which has produced astronomical manager compensation, is one of the stark dividing lines between mutual funds and hedge funds.

Here's an example of how fees add up.

Let's say you invest \$500,000 in a "two and twenty" hedge fund that earns 10% on average over a two year period. The fees are 4% per year (i.e., 2% + 20% x 10%), right? Wrong! You have to consider the variation in returns from year to year.

The math looks quite different if the hedge fund earned its 10% average return by gaining 60% in year one and losing 25% in year two.

In the first year you would pay 14% in fees (2% + 20% x 60%) and in the second year you would simply pay 2% (the fund manager only shares your profits, not your losses), for an average fee over the two years of 8%... on a 10% average return!

In dollar terms, your \$500,000 investment would be worth \$532,140 at the end of the two-year period, for a gain of \$32,140, but you would have paid fees over this time frame of \$86,860!

If this hypothetical illustration isn't compelling enough, the actual compensation in dollars might be. For example, in 2004 hedge funds fees totaled \$70 billion on assets estimated to be \$1 trillion, which works out to an average of 7%. In that same year, Alpha magazine reported that the average take-home pay of the top 25 hedge fund managers was a whopping \$251 million! Maybe I should open a hedge fund... then my wife can get anything she wants (I'm going to pay for that one later!).

Do you like investments with no reliable historical data? You'll love hedge funds!

Hedge funds are currently under no obligation to disclose their results. Consequently, hedge fund databases are of very low quality and are filled with "backfill" bias (managers only report after they have good performance) and "survivorship" bias (data vendors only supply data on funds that are still in operation so when you look at the group the average performance numbers do not incorporate all the funds that have ceased to exist... which would obviously bring the numbers down quite a bit).

Eugene Fama, Finance chair at the University of Chicago notes that it takes roughly 40 years of stock market data before conclusions about volatility and returns become statistically significant. The hedge fund data we do have has only been recorded since 1994 (14 years)... and that data is filled with the biases mentioned above. Needless to say, it will be a long time before we can draw any meaningful conclusions about hedge fund returns... assuming we no longer have survivorship and backfill bias in the database.

Do you like investments with difficult to understand performance data? You'll love hedge funds!

The underlying securities in a hedge fund portfolio are often subject to what is referred to as "stale pricing." Since hedge funds frequently own securities that are very illiquid, considerable time may have passed since the last reported trade. It's kind of like trying to

figure out the value of your house when no houses in your neighborhood have sold in the last year.

Sometimes the hedge fund manager, after some time has passed since the last trade in a particular security, may set a value by estimating what he or she thinks it might be worth... leading to managed prices. You can imagine how this flexibility in valuation could possibly work toward the managers favor... if he/she were so inclined.

These are just the three biggest reasons we really don't like hedge funds. Believe me... the list goes on but I'm often reminded to keep the financial jargon short and not put you to sleep. If you, however, are the rare breed that really wants to learn more and talk about it at great length, we're here for you and would welcome the discussion.