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Craving the Excitement of Hedge Funds Part II

Hedge funds tout their ability to deliver what is known as alpha, or above benchmark returns. Unfortunately for investors, the academic research has shown that, in aggregate, the hedge fund industry has failed miserably at delivering alpha. In fact, historical evidence demonstrates that after accounting for biases in the data, the average hedge fund has a hard time keeping up with the returns of Treasury bills on a risk-adjusted basis.

Given the evidence, why do investors continue to pour money into hedge funds? The most likely explanation is that they are unaware of the evidence. Certainly the purveyors are not going to show you the true historical evidence. They are far more likely to show you raw returns data, unadjusted for either risks or other biases in the data (such as survivorship bias, self-selection bias, instant history bias and liquidation bias). And the surest way to achieve above average returns is to take more risk (at least until the risks show up) and then claim the excess returns are “alpha” and not related to incremental risk.

It is easy to fool people if they don't know what the appropriate benchmark should be. Consider the following example. Small-cap value stocks outperformed the S&P 500 Index by about 4 percent per year from 1927 through 2005. A hedge fund could have simply invested in small-cap value stocks and claimed that the 4 percent outperformance versus the S&P 500 Index was alpha instead of simply taking more risk (small-cap value stocks are riskier than the large-cap stocks that dominate the S&P 500 Index). Sophisticated investors would not be fooled by such marketing claims. They would compare the returns of the hedge fund not to the S&P 500 Index, but to a small-cap value benchmark (that is, Russell 2000 Value Index). Having compared the hedge fund's return

to the proper benchmark, the alpha would not only have disappeared, but after accounting for the typical 2 percent annual fee and 20 percent of profits fee, the alpha would have become negative. And net returns are all that matter.

Investors should expect to get market returns for taking market risks. One problem is that the risks of most hedge fund strategies do not mix well with the risks of equities. For example, their risks tend to show up at the same time the risks to equities in general show up. So just when you need low correlation, you get high correlation. The following are more reasons investors should avoid such investments.

Lack of liquidity. Investors in mutual funds have access to their funds on a daily basis. Hedge fund investors typically must accept long lock-up periods. In addition, redemption rights (the ability to withdraw assets from the fund) can be suspended.

Lack of transparency. Mutual fund investors have transparency of investment strategy and thus, know the risks taken by the fund's managers. This is not the case for hedge fund investors.

Loss of control of asset allocation and thus portfolio risk. Asset allocation determines the majority of the risk and return of a portfolio. Investors in passively managed funds take full control of their risk. The freedom of action that hedge funds have causes investors to lose control over their asset allocation.

The bottom line on hedge funds is this: They are traps for investors. In 2006 alone, nine hedge funds with assets in excess of \$1 billion closed their doors. More followed suit in 2007. If you cannot resist the world of hedge funds, perhaps you would be best served by employing a financial advisor that can keep you from taking detours from your well-planned investment journey.

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