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The Performance of Funds of Hedge Funds

[#2 of a 3-part series]

Overview: One of the risks of investing in hedge funds involves tying up large amounts of assets in a single investment vehicle. The advent of funds of hedge funds supposedly provided advisors with a means of diversifying the risks of investing in hedge funds. Have investors been rewarded? The following article summarizes a study showing that investors have not been rewarded for investing in such vehicles.

Funds of hedge funds have achieved rapid growth in the past several years. In 1990, their assets under management totaled $1.9 billion and represented 5 percent of hedge fund assets. By 2006, there were 6,100 funds of funds and assets under management had grown to $700 billion (about half of the $1.41 trillion directly invested in hedge funds). One of the reasons behind the dramatic growth is the increased interest from a wide array of investors. Is the interest justified? Or it just another example of the triumph of hype and hope over wisdom and experience?

Manuel Ammann and Patrick Moerth sought the answer to those questions. Their 2008 study, "Performance of Funds of Hedge Funds," was published in the Summer 2008 *Journal of Wealth Management* and covered the period from January 1994 through April 2005. The following is a summary of their findings.

- The equal-weighted return of funds of hedge funds was 6.5 percent per year, or 1.9 percent less than the 8.4 percent per year equal-weighted return of hedge funds. The asset-weighted returns were somewhat higher at 7.6 percent.
- The authors noted that a fee structure consisting of a 1 percent management fee and 10 percent performance fee (which is a common structure for such vehicles) would reduce returns by 1.84 percent per year. This could almost single-handedly account for the performance difference between hedge funds and funds of funds. Thus, while funds of hedge funds provide a diversification benefit, they do not add value, they subtract it.
- Based on equal-weighted returns, survivorship bias was 1.7 percent. (It was 0.3 percent for asset-weighted returns.) This compares to a survivorship bias of more than twice that amount (3.5 percent) for hedge funds themselves. Thus, while funds of hedge funds appear to reduce survivorship bias, they do not appear to add value. At best, they appear to cover their costs.
- There was no evidence of statistically significant performance persistence.

Other Asset Classes

It is also worth comparing the performance of other asset classes to the equal-weighted performance of funds of hedge funds. The following table provides the returns of several asset classes. Note that the funds of hedge funds outperformed only two asset classes.

Asset Class	Annualized Return (%)
Fama-French U.S. Small Value	15.0
Dow Jones Wilshire REIT Index	13.4
Fama-French U.S. Small Cap	11.1
S&P 500 Index	10.3
S&P GSCI	9.5
Fama-French U.S. Large Value	8.9
MSCI EAFE Value Index	8.2
Lehman Brothers Intermediate Credit Index	6.7
Equal-weighted fund of hedge funds	6.5
MSCI EAFE Index	5.7
MSCI Emerging Markets Index	2.2

Source: Dimensional Fund Advisors. January 1994–April 2005.

In hindsight, investors would have been better served through a conservative portfolio consisting primarily of fixed income investments. Consider the following table. The fixed income portion is represented by the Lehman Brothers Intermediate Credit Index, and the equity portion is divided equally among the nine additional asset classes from the previous table.

Asset Allocation: Equity/Fixed Income	Annualized Return (%)	Standard Deviation (%)
70% Equity/30% Fixed Income	9.3	9.6
60% Equity/40% Fixed Income	9.0	8.3
50% Equity/50% Fixed Income	8.7	7.1
40% Equity/60% Fixed Income	8.3	6.0
30% Equity/70% Fixed Income	7.9	5.0
Equal-weighted fund of hedge funds	6.5	5.1

Source: Dimensional Fund Advisors. January 1994–April 2005.

Investors who held a portfolio with 70 percent fixed income would have enjoyed higher returns than the average fund of hedge funds (7.9 percent to 6.5 percent) with less volatility (5.0 percent to 5.1 percent). Those with higher equity allocations would have had higher returns with more volatility.

Summary

The bottom line is that investing in funds of hedge funds has proven to be the triumph of hype and hope. These vehicles have produced returns below the returns of the hedge funds in which they invested and the difference appears to be explained by their additional layer of fees. Thus, we can conclude that they have subtracted value, not added it. That is pretty damning in light of the overall evidence that once all the biases in the data are accounted for, hedge funds themselves have had a hard time keeping up with the risk-adjusted returns of Treasury bills.

Before considering an investment in any type of hedge fund, investors should pay close attention to the following quote from David Swensen, chief investment officer of the Yale Endowment: "In the hedge fund world, as in the whole of the money management industry, consistent**,** superior active management constitutes a rare commodity. Assuming that active managers of hedge funds achieve success levels similar to active managers of traditional marketable securities, investors in hedge funds face dramatically higher levels of prospective failure due to the materially higher levels of fees."[1]

[1] David Swensen, *Unconventional Success*, (Free Press, 2005).