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Craving the Excitement of Hedge Funds? Part 1

The exclusive nature of the hedge fund “club” creates an aura about them that attracts investors the way swim-up bars attract guests at all-inclusive resorts. While the hedge fund industry touts its performance record, academic studies have discovered that there are many biases in the reported data. Once the biases are accounted for, returns investors have earned have been well below the returns of equities — even before accounting for the incremental risks of hedge fund investments.

Burton Malkiel and Atanu Saha, in their 2005 paper “Hedge Funds: Risk and Return,” used the TASS database of hedge funds and concluded that previous research, using the same information, had *underestimated* biases in the data:

- There is a substantial attrition rate — less than 25 percent of the funds in existence in 1996 were still alive in 2004. The difference in returns between the live and defunct funds exceeded 8 percent per annum (13.7 percent vs. 5.4 percent).
- Survivorship bias overstated returns by 4.4 percent per annum (13.7 percent vs. 9.3 percent) — for the period survivorship bias in mutual funds was about 1.2 percent per annum. The S&P 500 Index returned 9.4 percent per annum during this period (1996–2003).
- Backfill bias overstated returns by over 5 percent per annum.

Investors should note that academic research has also found that past performance of hedge funds is not a good predictor of future performance. Consider the following.

John W. Henry had been a hugely successful hedge fund manager since the early 1980s. On May 29, 2007, TheStreet.com reported that since December 2004, Henry's main investment fund had lost 36 percent.

Despite superior results prior to 2004, an investor in the fund from inception in 1996 would have underperformed an S&P 500 Index fund and even 30-year Treasuries. Yet the average investor likely did even worse, because investors tend to pile in *after* funds produce great returns and only exit *after* they experience poor returns. The result is that investors tend to under perform the very investment vehicles in which they invest. This appears to be the case with Henry's fund. The latest annual report revealed that half of the investors in the fund had actually *lost* money over the long term.

No Refund Policy

Investors need to understand the following about hedge funds. While hedge funds charge large annual fees (typically 2 percent), and they typically earn 20 percent of the profits in good years, they don't return the performance-based fees when investors experience losses. Another reason why hedge funds should be thought of as compensation schemes rather than investment vehicles.

Summary

Investing was never meant to be exciting, as Wall Street would like you to believe. Instead, investing should be about developing and following a strategy that provides the greatest likelihood of achieving your financial goals.

But just as there are always actively managed mutual funds that manage to outperform their benchmark for a period of time, there will likely be a few hedge funds that also do so. And the financial media will continue to hype them.

Unfortunately, as Gary Weiss, author of *Wall Street Versus America*, noted: "Usually the financial press, functioning in the role of the *griot* imparting oral tradition, forgets to mention that the superstar investors tended to make their biggest bucks when they were managing small sums of money. Some of the biggest names in the business liquidated or wound down their funds when their

assets swelled beyond reasonable size, the odds caught up with them, and their performance turned lousy." Also, unfortunately, no one has yet found a way to identify the few winners *ahead* of time.

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