



Seven Easy Ways to Land Yourself in Trouble with Hedge Funds

A view from the devil's advocate's chair

By Tim Hale, Albion Strategic Consulting, June 2005

Why are we so desperate to believe in hedge funds?

Hedge funds are the panacea for investors, proving an escape from the low prospective returns from bonds and equities, and benchmark hugging managers, and delivering investment utopia – *'equity like returns, bond like risk, and low correlation to traditional asset classes'*; well that's what the sales people tell us and what investors seem desperate to believe. For some, the mere mention of *'convertible arbitrage'* or *'global macro'* fogs up an otherwise clear thinking mind. Perhaps it is the racy and enigmatic world of hedge fund managers that draws us in, eager to be part of the action; or maybe it's that we simply can't resist the free lunch seemingly on offer.

Of course it makes sense to explore any opportunity to improve the general characteristics of our investment portfolios, but perhaps we need to be a little more discerning in what we read, hear and ultimately believe. Hedge funds may well have an important role to play in many investors' portfolios, and yes, an increasing number of major investors are entering the fray; but that does not mean that investors can abrogate responsibility for common-sense and a little bit of thought before doing so. One thing is for certain – intellectual sloppiness is likely to make the stampede into hedge fund investing disappointing for many.

Believing, instead of thinking, will leave you sorely disappointed

When it comes to hedge fund investing, there is plenty of scope for weak thinking; yet, with a little insight it is possible to get a far clearer picture of how to avoid some of the pitfalls and disappointments that lie in wait for the undiscerning. Here are seven areas that any investor would do well to consider and avoid:

1. Thinking that hedge funds are a distinct type of investment, or asset class

The first mistake to make is thinking and talking about hedge funds as if they are a new asset class with distinct characteristics; in fact, they are not an asset class at all, but a bewildering array of strategies to exploit existing asset class and security valuations. Hedge fund managers can adopt almost any strategy that they think will work, using almost any asset class and instrument that they wish. As most of you will know already, some managers rely in part on the direction of markets for returns while others don't; some use leverage yet others don't; some short sell securities and others don't; in fact, there are probably as many different strategies as there are managers. There may even be no funds out there that reflect the 'characteristics' that supposedly describe the industry!

Sure you can lump hedge funds together into broad categories such as *'equity market neutral'* or *'distressed securities'*, but the way in which money is managed can differ markedly within each category. In fact the correlations between funds in any one category tend to be low suggesting that 'similar' funds are in fact very differently managed¹.

At one end of the spectrum lie the out-and-out return focused portfolios with their commensurate level of risk, at the other lie more moderate returns from portfolios aimed at consistently generating positive

¹ H.M. Kat and S. Lu, *An Excursion into the Statistical Properties of Individual Hedge Fund Returns*, July 19, 2002 (working paper).

returns that are not related (too much) to the direction of the markets. At each end of the spectrum and all the points in between, these objectives can be achieved in a wide number of different ways. So statements like *'hedge funds are high risk investments'* are overly simplistic and inaccurate.

2. Using sweeping generalisations without common-sense

As investors, we often simplify the complexity of the financial markets to make easy to understand but solid long-term assertions on which to base our investment strategy such as *'equities for the long run'*, or *'bonds tend to provide some protection from equity market falls'*. We feel comfortable with these generalisations, as they are based on long-term and relatively clean data series, and most of us know that there are exceptions, sometimes prolonged and painful, to these rules. However, we give the same credibility to the claims of the hedge fund industry at our peril. What actually is normal in this relatively new industry? Simply don't give too much credence to the industry claims of *'equity like returns, bond like risk, and low correlation to traditional asset classes'* and make any manager you employ convince you of the characteristics of the fund they run.

3. Thinking that you can capture industry 'characteristics' easily

Let's just suppose for a moment that the hedge fund industry sound bite above is true. If you could achieve that sort of investment profile then you would rightly make a significant allocation to hedge funds. Some very skilled and sophisticated institutional investors have done just that; a leading example being Yale University's investment program lead by David Swensen, which has been very successful at it. However, don't underestimate how difficult it is to achieve; even the largest institutions such as CalPERS use specialist consultants to help them.

Given that there are as many strategies for generating returns as there are managers, how will even the relatively astute investor be able to recreate these characteristics? The fund of hedge funds route, with its lower investment minimum, has almost become the default approach these days. Yet even so, research has shown that the average fund of funds returned almost 3% lower than an passively constructed portfolio of funds¹, suggesting that the selection of funds and the allocation of capital between funds, fails to cover the costs of their 'skills'. With over a thousand funds of funds to choose from, and over 80 with more than \$1 billion invested, it's not an easy task even finding a good one. Investable indices may be a better option for some and are explored a little further below.

4. Mentally suspending the zero sum game for hedge fund managers

The hedge fund manager's pitch goes something like this: *"I have the skills to generate returns that are not dependent on the direction of the markets but in my ability to make market timing calls, select and own undervalued securities or short overvalued securities, invest in illiquid sectors of the markets, hold concentrated portfolios, and borrow to magnify the skill-based returns that I make for you"* (any and all of the above may apply). Alternatively this could cynically be stated as *'I'm going to fleece all the dumb patsies playing in the markets and make a killing for my clients and myself'*. At least most hedge fund managers' motives are aligned with their clients through co-investment of their own capital.

Sure the wider parameters that hedge fund managers give themselves provide more scope to make returns and magnify them with leverage (unrelated to skill and applicable to any investment); however, generating skill-based returns through market timing and security selection is a less-than-zero sum game after cost, and in the case of hedge funds, considerably less-than-zero after management fees (1% to 2%), performance fees (20%), and turnover costs. Just because the playing field is wider does not mean that the basic rules of the game have changed. Even if the markets that some hedge fund managers operate in are less efficient, costs tend to be higher and the zero sum game still applies. Someone has to pay for a hedge fund manager's skill-based returns. So who is the patsy?

'Traditional' institutional investors, who represent the bulk of assets actively managed, have failed to generate skill-based returns as a group over time, indicating that patsies are hard to find. Even the most likely candidates i.e. individuals trading their own brokerage accounts, turn out to make market returns

as a group, before costs². So, it begs the question of just who is going to fund the promised skill-based returns of the \$1.2 trillion³ hedge fund industry (almost three times the size of the UK's mutual fund market). Either their returns are more market related than they are letting on (true in some cases) or someone is going to take a severe investment beating.

A sceptic might be inclined to believe that the incredible failure rate of hedge funds points to the patsies being some of the hedge fund managers themselves. They give themselves a longer leash on which to roam the markets for opportunities and leverage their positions but this also provides them with greater cord to hang themselves with. Today there are around 7,000 or so hedge funds in existence (it's a moving target). It is estimated that over 3,000 funds have disappeared off the radar screen since the start of 2000, with an attrition rate of around 10% of funds in 2004 alone, as many failed to make decent returns, fell prey to operational issues, or closed for other reasons. Accurate numbers are hard to obtain, as some funds don't even get recorded in any universe before failing. In fact, around 30% of funds don't even make their third birthday⁴.

5. Believing hedge fund managers are today's alchemists

Three years of good performance in a former life in a traditional investment firm or the proprietary trading desk of a bank (heads, heads, tails) is enough to hang out your shingle and raise a couple of hundred million on, be your own boss, and provide yourself with the opportunity to make yourself rich in the process. That's an attractive proposition for many and it's no wonder that there is such a rush of bodies to the door.

Yet only a handful of traditional investment managers appear to have any long-term, skill-based performance persistence i.e. more than two or three years of skill and/or luck. To believe that the proportion of such managers is any higher in the hedge fund world is optimistic to say the least. Estimates of around 5% to 10% of hedge fund managers being truly skilled and having the potential to generate strong skill-based returns do not seem unreasonable. Rightly you would want these people to manage your money, as would anyone currently invested with the other 90% of managers. Finding and accessing them is the tough part.

The resultant growth in indexing in the traditional investment world is juxtaposed to the very claims of the skill-based hedge fund world. Paradoxically, many investors who use indexing at the core of their traditional strategies because skill based returns are so hard to generate, are also eyeing up hedge funds, believing that they somehow have the powers to use skill, not markets, to generate long-term returns. Somewhat curious given that today's hedge fund manager was yesterday's traditional long-only manager.

The success, mystique, and wealth of the longer established hedge fund managers, along with the flow of many 'top' traditional managers into the industry, reinforces our hopes that the pool of talent can defy the zero-sum gravity that holds other mortal managers and investors in the land of index-hugging and index funds. We want to believe that they are out there, that we can find them and that we can gain access to their skills. However, believing that hedge fund managers are, as a group, today's alchemists will leave you sorely disappointed.

Hold in awe those who in twenty years time have delivered you with consistent equity-like returns, with a bond like risk, and low correlations to your existing portfolio, generated from skill rather than markets. Some managers may well be truly talented and deserve the accolades they will ultimately receive.

² B.M. Barber and T. Odean, *The Common Stock Investment Performance of Individuals*, May 1998

³ Tass Report Feb 2005

⁴ C. Brooks and H. Kat, *The Statistical Properties of Hedge Fund Index Returns and Their Implications for Investors*, 2002.

6. Confusing the leveraged carry trade with skill

It is hard for many investors to be able to identify skill from luck and leverage. The cheap cost of funds in the past few years has allowed some carry trades to work well i.e. borrowing cheap money and investing it in riskier assets. However, leveraged returns also provide scope for leveraged losses. The problem is that it has been a few years since a sudden and severe market shock and investors are being seduced by relatively encouraging returns in an industry where a three year track record makes you the exception rather than the rule.

Let's imagine that a new manager puts up a shingle based on three years of market-beating performance as long only bond investor and raises \$250 million from investors. He then leverages the portfolio borrowing four times his investors' equity, using derivatives and his prime broker margin financing, and he invests this in the high yield bond sector, yielding 3% above his cost of funds of say 4%. Yields remain unchanged throughout the first year. Gross return on investors' equity is healthy 19% or so, and everyone is happy. He's especially happy because he takes a management fee of 2% of equity i.e. around \$5 million to pay for the running his business, and 20% on all returns above his hurdle rate of LIBOR. His performance based fee runs to a handy \$7.5 million, which he invests in the fund to align his interests with those of his investors. He is now a 'successful' and increasingly wealthy hedge fund manager, who can probably raise significant assets on the back of this success.

That's a bit simplistic I accept, but you get my point - the skills required to generate short-term returns may be limited and 'success' in this (and many cases in the real world) is a function of leverage and luck. Given the fact that many funds are relatively young, it is hard to pick the truly talented managers from those whose carry trades have worked to date. Remember that those who get this leveraged play wrong you won't probably ever see again.

7. Believing the numbers – lies, damned lies and hedge fund data

Perhaps in an attempt to simplify the concept of investing, it is easy to overlook the quality of the data series that we have available to us from the mainstream universes available such as CSFB/Tremont, CISDM, or Hedge Fund Research. First, we have only got around a decade of spotty industry data to look at, and the majority of individual hedge funds are relatively new at less than three years old. That's a lot shorter than the century of reasonable data we have for traditional asset classes.

Let's look for a moment at the CSFB/Tremont Hedge Fund Index, which is often used as a proxy for the industry. It returned just under 11% per year from its inception in 1994 to the end of the first quarter of 2005, with a level of volatility equivalent to owning investment grade bonds, and it looks as if it should be a good diversifier for bond and equity investments. However, you have to look beyond the numbers to get a real picture for what is going on. Let's take a look at returns, risk and correlation to traditional asset classes in turn.

7.1 Industry return numbers are significantly overstated

The industry's numbers are plagued by a number of well-recorded biases. First, the universes that are created to generate industry and strategy numbers reflect only those funds that voluntarily submit performance data; some funds don't submit because their performance is poor; some won't because they don't need more assets or want to remain out of the spotlight. Second, only those who survive are reflected in the numbers; this survivorship bias is deemed to overstate returns by 2% or so. Third some funds fail before ever making the universes, let alone dropping out of them. Finally funds joining the universe 'backfill' their preceding performance data which adds further bias, given that funds joining are likely to have good performance. All in all data biases could overstate returns by 6% to 8% per year according to Professor Harry Kat, a leading voice of commonsense on the hedge fund scene⁵. You do the mathematics – the industry has generated cash-like returns for significantly more than a cash-like risk and certainly with a lot more hassle for investors.

⁵ Financial Times FM. *Academic raises doubts about hedge fund returns*, 18 October 2004

7.2 Industry 'risk' numbers are understated

Here too we have a problem. It's no good just working out the volatility of returns, as we would with a traditional equity portfolio to measure what the industry calls 'risk', as some hedge fund strategies generate returns that do not have a nice even bell-shaped distribution but more of a "that's good, that's nice, that great, what the hell happened there?" profile of returns. Maybe some funds haven't hit their 'what the hell happened there?' moment yet, but that does not mean that they won't. In investment parlance, they suffer significant skewness and excess kurtosis, words that are meaningless to most, but important concepts to all potential hedge fund investors. Adding hedge funds to your portfolio may bring some larger than anticipated surprises if you don't understand the return profile that the strategies you choose to invest in may deliver.

Nicholas Taleb, in his wonderfully written and absorbing book *Fooled by Randomness*⁶, elaborates on a mindset referred to as 'black swans', where traders (and people in all walks of life) disassociate profits they make from the potential catastrophic losses that may be lurking around the corner. Just because you have never seen a black swan does not mean that they don't exist; some hedge fund strategies may be paddling in black swan territory!

7.3 Correlations between hedge funds and traditional investments are understated

While some managers play in the more efficient markets, others buy exotic or illiquid securities and let's just say that the pricing strategies for these securities are varied, as they operate in a largely unregulated world. In fact, a recent global survey⁷ somewhat alarmingly revealed that two-thirds of hedge funds had no documented pricing policy despite the fact that 20% of hedge fund assets are in more exotic and hard to value instruments. Stale pricing, where asset are only re-priced periodically, can result in significant understatement of true price volatility, and overstate the beneficial risk reduction they appear to bring to an investors overall portfolio.

The effect of stale pricing is illustrated nicely in a simple but revealing piece of analysis⁸; two stocks from the S&P 500 were priced at one month and three-month intervals over a 50-year period. Their correlations to the S&P500 index were computed monthly using these two different price data, revealing that using monthly prices the correlations were 0.74 and 0.58, whereas using quarterly prices their correlation to the market dropped dramatically to 0.33 and 0.25 respectively - same stocks but different apparent correlation benefits.

Stale pricing of illiquid securities can hide the true pattern of their returns and this may well be the case for many hedge funds. It is also worth bearing in mind that in extreme market conditions, just when you need the low correlations, most strategies will be affected in one way or another: liquidity invariably dries up, credit spreads widen, and irrational investor withdrawals exacerbate the difficulties of managing the portfolio through these periods, particularly in esoteric and illiquid holdings.

In conclusion, return numbers, in aggregate, appear to be significantly overstated, the pattern of hedge fund returns may mean that more familiar measures of risk such as the volatility of returns may not be particularly useful, and the true ability of hedge funds to reduce overall portfolio risk may be overstated by stale pricing and the 'what the hell happened there?' pattern of returns of some strategies. If you were thinking about plugging them into your means variance optimiser to find your perfect asset allocation, think hard about the value of the exercise you are about to embark on.

6 Nassim Nicholas Taleb, *Fooled By Randomness*, TEXERE, 2004

7 AIMA, *Asset Pricing and Fund Valuation Practices in the Hedge Fund Industry*, May 2005

8 P. Gompers and J. Lerner, *Private Equity and Asset Allocation: Clues to a Puzzle*, Salomon Smith Barney Private Equity Research Initiative 2001

Clear thinking guidelines to avoid disappointment

Guideline 1: Ask yourself why you are thinking of investing in hedge funds in the first place. If it is to diversify the risk in your existing portfolio, have you pursued all of the other options using less esoteric and practically cumbersome investments such as real estate funds and commodity-based ETFs? If not, then maybe take a look there first. Look to see whether you can replicate the characteristics by using traditional asset classes first. What about holding a little more cash?

Guideline 2: Treat any industry generalisations with the scepticism they deserve and make allowances for the overstatement of returns and the understatement of volatility and correlations. Remember that black swans do exist.

Guideline 3: Decide what it is that you want your 'hedge fund' investment to do for you. The choice is simple; you are either looking to generate equity-plus returns or you want them to diversify the risk in your portfolio. Don't expect both in any great measure. Perhaps begin by trying to understand the profile of different categories first, but always remembering that individual funds may vary significantly within a category.

Guideline 4: Evidently, this game is about picking individual managers. Ask yourself just how many managers will actually deliver consistently positive returns over your investment timeframe and who will still be around when you need them in 15 years time. You have to find a way of selecting either individual managers, or fund of funds managers who will generate consistent skill-based returns, over time. If you don't have a process then ask yourself whether you can afford to get manager selection choices wrong and whether you should be playing this game at all.

Guideline 5: Perhaps consider using an investable index product where your money is invested in a pool of managers that constitute an investable index. At least take some time to read up about them. The benefits are that you do not have to select managers yourself or choose a fund of funds manager and pay a second layer of substantial fees.

Guideline 6: Finally, be prepared to be disappointed. Hedge fund investing is not alchemy and the bulk of managers have not yet seen a financial market crisis such as the Russian bond crisis that brought down Long Term Capital in 1998. GM's recent credit downgrade seems to have hit hedge fund returns markedly – anticipate that the black swan could potentially be near. At the very least accept that hedge fund returns of 10% going forward look on the high side (forgive me this sweeping generalisation about hedge funds!). They will almost certainly be lower than in the past as competition intensifies in some strategies.

An apology to good hedge fund managers

This article is meant to get investors thinking about some of the issues that they face as they consider investing in hedge funds. It does not seek to label all hedge fund as potential time bombs or their managers as lacking in skills, or just plain lucky. It is not meant to be an assault on skill-based managers. There are some very smart and hard-working people in the industry, but that just raises the bar for all in a game of winners and losers. Rarely is an industry so brutally cruel on its skilled and dedicated participants, and rarely too are the chances of success (from an investment perspective) so stacked against them throughout their careers. Unfortunately hard working and smart does not necessarily translate into skill-based returns sustained over long periods of time, the measurement of success in this industry, from an investor's perspective. There are undoubtedly a few managers who outperform over long periods of time as a consequence of their superb skills. They are to be congratulated.

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