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POINCIANA ADVISORS GROUP, LLC

Debunking Hedge Fund Myths

Overview: This article looks at six myths surrounding hedge funds and some of the reasons why many high net worth investors continue to invest in hedge funds despite growing academic evidence and reports by more than a few in the financial media that hedge funds are "mad, bad and dangerous."[1] The evolving body of information about hedge funds has led us to conclude that they are not prudent, appropriate investments for globally diversified portfolios, regardless of an investor's net worth.

Hedge funds represent a specialized niche within the investment fund arena. In 2007, the Financial Stability Forum estimated that hedge funds numbered 9,000 funds and held $1.6 trillion.[2] They differ from a typical mutual fund in several ways:

- They are generally available only to high net worth individuals.
- Unlike the typical broadly diversified mutual fund, they generally have large, highly concentrated positions in just a few securities.
- They have broad latitude to make large bets (either long or short) on almost any type of asset, be it a commodity, real estate, currency, country debt, stock and so on.
- Management generally has a significant stake in the fund.
- Management has strong financial incentives. Fees typically range from 1–2 percent per year, plus 20 percent of profits (above a specified benchmark).
- Management is subject to less regulatory oversight than mutual fund managers.

Myth #1: Historically, hedge fund investors have received superior returns.

Debunking the Myth: In a February 2004 article in the *Journal of Financial Planning*, William Jahnke stated, "The impressive performance numbers reported for various hedge fund strategies create a distorted impression because participation in performance databases is elective, and one can safely assume that hedge fund managers opt to participate only after a period of good past performance."[3] Since hedge funds are not required to report their performance, funds can choose to skip reporting after a period of underperformance, or report returns after a period of outperformance and then "back fill" data for previous years. When fund managers choose to report performance and subsequently fill in data for years past, this creates an instant history that can be misleading.

Hedge fund managers seek to outperform market indexes such as the S&P 500 Index by exploiting what they perceive to be market mispricings. Studying their performance would seem to be one way of testing the Efficient Market Hypothesis (EMH); if markets are largely efficient, then active managers should have little ability to outperform their respective benchmarks. (The EMH states that in a market that includes many well-informed and rational investors, all seeking to maximize profit, securities will be appropriately priced and reflect all available information. In an efficient market, no information or analysis can be expected to result in outperformance of an appropriate benchmark.)

A 2006 study, "The A, B, Cs of Hedge Funds: Alphas, Betas and Costs," covered the period January 1995 through March 2006. The authors found that the average hedge fund returned 9.0 percent per year, lagging the S&P 500 by 2.6 percent per year.[4] Equally important, this study includes the bear market of 2000 to 2002 (the type of market when hedge funds are supposed to perform the best).

One example of how quickly good funds can go bad is Peloton Partners. The hedge fund management company, founded in 2005 by two former Goldman Sachs partners, showed significant gains on bets against the U.S. housing market. Peloton reported an 87 percent return in 2007, and the company won two awards at a ceremony hosted by trade publication *EuroHedge*.[5]

However, the firm began betting that highly rated mortgage securities would ultimately pay off, despite the heavy turmoil rocking the housing markets. Those bets unraveled quickly, and the *Wall Street Journal* reported that Peloton lost about $17 billion in a matter of days around the end of February 2008.[6]

Another measure of an investment's risk is its likelihood for survival. **Survivorship bias** occurs when the returns of a poorly performing fund escape consideration as fund managers either eliminate the fund or merge it with a better-performing fund. Studies that fail to account for funds that have been dropped or merged during the study period introduce survivorship bias in the findings. A study by Burton Malkiel and Atanu Saha found that survivorship bias in the reported data on hedge funds creates an upward bias of 4.4 percent per year.[7] Yet, inflated, biased numbers can be the ones reported to unknowing investors.

Such data indicates that the likelihood of a hedge fund not surviving is a legitimate risk. How long are hedge funds likely to survive? In the study, "Hedge Fund Survival Lifetimes," the author summarized the findings of several earlier studies conducted on the topic. The results of those studies included the following data:[8]

- ▲ The attrition rate for hedge funds since 1994 was almost 15 percent per year.
- ▲ The probability of a hedge fund failing in its first year was 7.4 percent. Failure probability then increased to more than 20 percent in the second year.
- ▲ About 30 percent of hedge funds do not make it past three years.

The results of the "Hedge Fund Survival Lifetimes" study, which covered 1990–2001, concluded that *50 percent* of hedge funds do not make it to the sixth year following their first reporting.[9] Given that average investors are highly risk averse, these do not seem to be very attractive odds. Even by selecting only hedge funds that have survived at least five years, the risk of failure is not significantly minimized. How does survivorship bias relate to the superior returns myth? If, as suggested by the study, approximately 50 percent of the hedge funds did not celebrate their sixth anniversaries, we could assume that investors in those funds may have lost some or all of their original investment.

Cases in which fund managers have fabricated return figures to lure new investors to a fund have been reported, such as the Florida case where a hedge fund "sent out monthly e-mails boasting of 200% returns in three years."[10] Investors flocked to the fund, and the SEC charged the fund managers with fraud, halting the fund's activities with a series of emergency orders in February 2004. According to an SEC announcement, the fund managers allegedly "charged investors fraudulent fund performance fees based on the fictitious gains."[11] The fund accumulated $10 million but lost much of the value of the fund on speculative trading with an end value of approximately $2 million.

Yes, a few hedge managers succeed. However, we encourage investors to ask the following questions when deciding whether an investment's potential rewards are worth its risks:

- ▲ Does the approach succeed more frequently than can be expected from random luck?
- ▲ Is there persistence in performance?

The historical record suggests that the answer to both questions regarding hedge funds is, "No."

Myth #2: Hedge funds are special opportunities for high net worth investors.

Debunking the Myth: Hedge fund investing appeals to many high net worth investors because of its exclusive nature. It also offers a potential for great rewards, and these rewards are often dangled in front of investors as the media showers the latest superstar performers with attention. "The hedge fund offers an irresistible velvet rope, the allure of investing where most everyone else hasn't been invited to invest."[12] Unfortunately, evidence has shown that these fund managers demonstrate no greater ability to deliver above-market returns than do active mutual fund managers.

Exclusivity may be eroding anyway, as the hedge fund industry has been casting a wider net to find investors. Generally, only "accredited investors" — those individuals who have earned a minimum of $200,000 in annual income for at least two years or have a net worth of at least $1 million — have been able to invest in a hedge fund. However, the introduction of funds of hedge funds offers investment opportunities in hedge funds with lower minimums and no limits on eligibility. Some have suggested that hedge fund investors might consider a fund of funds to try to minimize survivorship risk and return dispersion via diversification. But, unfortunately, this results in an additional layer of expenses, added to fees that are often already steep.

It is possible that the popularity of funds of funds could damage the foundation of the hedge fund "club mentality." Funds that reduce minimums in an effort to boost membership could dent the image of exclusivity, or the increased availability of funds of funds could make hedge funds seem less exotic and more commonplace. While funds of funds might discourage a few high net worth investors from participating in hedge funds, lowered minimums could expose a new group of investors to extremely risky investment vehicles. We share the SEC's concerns that "less sophisticated investors … may not possess the understanding or market power to engage a hedge fund adviser [*sic*] to provide the necessary information to make an informed investment decision."[13] We might even go a step further and express similar concern for any investor considering hedge funds. While passive funds may be perceived as "boring" because of their low cost and common availability, we would suggest they make better investment vehicles.

Myth #3: A hedge fund manager's ownership interest in a fund aligns interest with the investor's regarding acceptable levels of risk.

Debunking the Myth: A manager's alignment of interests based on ownership is only as strong as the dollar value of that original investment. Depending on the amount of a manager's personal investment in a fund relative to the fees he or she may potentially earn, a manager may decide to take additional strategic risks.

Another important but typically overlooked risk related to hedge funds is the compensation structure for hedge funds, which creates what is known as **agency risk.** Most managers receive their compensation in the form of incentive pay (usually 20 percent of profits above a specified benchmark, in addition to the typical 1–2 percent operating fee). This means investors take 100 percent of the downside risk, but they do not participate fully in an upside gain. It also leads to potential agency risk when a manager is approaching the end of a year and has not yet achieved the benchmark level above which incentive compensation is paid. This can create disparate incentives between the manager and the investor. If the manager wins by taking on large risks in an attempt to beat the benchmark, he or she will receive incentive pay. But if the manager's risk-taking loses, the fund's operating expense fee will still be paid. This can create a misalignment of interests and an incentive for the fund manager to take on greater risk in an "I win big / I don't entirely lose" game.

Such practices have led to the eventual destruction of several hedge funds. For example, a manager takes a big position that loses and then decides to double up in an effort to recover from the loss. If the market keeps going against the manager, he or she might double again, until the game ends. The study "Hedge Fund Survival Lifetimes" found that managers did, in fact, assume greater risk in the last month of operations than they did six and 12 months prior to closing.[14] This finding confirms those of another study, which found that funds performing poorly in the first half-year exhibit increased volatility during the subsequent half-year.[15]

Myth #4: The hedge fund industry has operated for many years without SEC regulations, so any new regulations imposed by the SEC are excessive.

Debunking the Myth: "Hedge fund investors are big enough to look out for themselves."[16]

Investors who assume the SEC is monitoring hedge funds for wrongdoing might be surprised to learn that in its September 2003 report "Implications of the Growth of Hedge Funds," the SEC stated it was unsure of the overall size of the industry: "Despite the growth of the hedge fund industry in the last decade, we do not have accurate information about how many hedge funds operate in the United States, their assets, or who controls them."[17]

In October 2004, the SEC voted 3–2 in favor of requiring hedge funds to be regulated more like Registered Investment Advisor firms and mutual funds. However, opponents of the registration rule quickly expressed their displeasure, even within the SEC itself. SEC Commissioner Cynthia Glassman voted against the rule and said after the vote, "I am disappointed with the approach that was chosen … I believe it is the wrong solution to an undefined problem."[18] In June 2006, a U.S. Court of Appeals struck down the rule.

Subsequent attempts by the SEC to provide additional regulations on hedge funds have also been met with significant opposition. For example, the SEC has proposed raising the minimum amount of assets needed to invest in hedge funds to be $2.5 million excluding real estate, up from $1 million including home values. The proposal triggered a round of letters from individual investors commenting on the move, which is unusual as most such comments come from lobbyists or interest groups. One investor wrote, "Stay out of my wallet, stop trying to protect me from myself, stop presuming to know more than I do about my own life, risk-tolerance and financial sophistication."[19]

We are very concerned with these regulatory issues: 1) hedge fund misconduct could involve theft or misappropriation of investor funds, 2) current reporting requirements could allow the possibility that some hedge funds might create instant histories, and 3) investors will invest before they learn some of the reasons why hedge funds are higher-risk investments. We would suggest that issues of transparency and regular reporting rules continue to be addressed and ultimately regulated in a fair and consistent manner by an appropriate entity.

Myth #5: A hedge fund is a great way to diversify, because it provides low correlation with the equity markets.

Debunking the Myth: Correlation refers to the degree to which one security or asset class follows another security, asset class or inflation. The goal is to diversify a total portfolio across asset classes that have low (or negative) correlation, so they do not all rise and fall simultaneously. When discussing the theory at the heart of Myth #5, we might ask: How can investors be sure hedge funds have low correlation with the equity markets? If the SEC has stated that it cannot clearly define a hedge fund, and hedge funds are not required to disclose investment strategies, investors may find it difficult to verify.

Some question the very existence of a low correlation between equities and hedge funds. In his aforementioned article in the February 2004 *Journal of Financial Planning*, William Jahnke concluded: "Most hedge fund strategies are highly correlated with the stock market when the stock market is performing badly … because a significant decline in the stock market is often associated with a widening of credit spreads, an increase in market volatility, and a decline in market liquidity."[20] Often, a fund will use returns and reporting data to demonstrate a correlation but that data may not always be accurate because of the reporting methods hedge funds use (see Myth #1 for complete details). Moreover, a **flight to quality** (a phenomenon that most often occurs in bear markets during which investors rush to move their assets to safer investments) can cause additional problems for hedge funds trying to achieve low correlation.

One reason that hedge funds fail to provide proper diversification relates to "lock-out" periods. During these "lock-out" periods — specified in a fund's prospectus — hedge fund rules prohibit investors from removing their assets (whether the fund is outperforming or underperforming). Investors wishing to perform annual portfolio rebalancing or experiencing changes in financial or life circumstances may not be able to make changes to assets inside their portfolios because the assets are unavailable for withdrawal from a hedge fund. Finally, investors who believe hedge funds provide diversification might want to reconsider their decision to hold them for that reason because, as indicated above, they do not seem to provide low correlation with equities.

Myth #6: "This one's different." (Investors think they've found the hedge fund exception to the rule.)

Debunking the Myth: Some investors might effectively dismiss some of the evidence against hedge funds by arguing that the hedge funds they are considering today are different from the troubled hedge funds of yesterday. Sometimes, potential investors can be convinced that a fund is unique by the very composition of a fund — with either different investment products or strategies. However, any investment vehicle that takes tremendous risks to capitalize on market mispricings is taking on a type of risk that academic evidence has shown cannot be expected to generate premium returns. Studies have shown that asset allocation determines the vast majority of portfolio performance.

Some of the newest hedge fund styles and garden-variety hedge funds include:

- ▲ Long only
- ▲ Long/short
- ▲ Short only
- ▲ Global macro
- ▲ Event driven/merger arbitrage
- ▲ Convertible arbitrage
- ▲ Financial arbitrage
- ▲ Currency
- ▲ Commodities
- ▲ Emerging markets
- ▲ Private placement
- ▲ Distressed securities

These strategies all share similar structures under which the funds are operating: exposing investors to agency risk and investing large, highly concentrated positions in just a few securities. However, our preferred strategy is to build an appropriately diversified portfolio of various asset class funds.

The following tale recounts the spectacular collapse of Amaranth Advisors, one of the (if not, the single) largest hedge fund collapse in nearly a decade.

Amaranth was one of the brightest stars in the hedge fund galaxy. The fund, which held more than $9 billion at its peak, not only rewarded investors with excellent returns, but did so when other markets were lagging. During the bear market of 2002, the major indexes fell 17 percent or more that year, while Amaranth produced returns of 11.3 percent. It even outdid its peers. The average hedge fund lost 1.5 percent, according to Hedge Fund Research.[21]

According to the *New York Times*, Amaranth delivered solid returns over the next two years, then again trounced its benchmarks in 2005. The hedge fund returned more than 18 percent, while the S&P 500 Index returned 4.9 percent and the average hedge fund returned 6.2 percent.[22]

Much of Amaranth's success came from its energy desk. In 2005, trading-related profits from energy totaled nearly $1.3 billion and produced nearly $2.2 billion from January 2006 to August 2006.[23]

The sweet success quickly turned sour for Amaranth. The fund had a big bet that the spread between natural gas futures for March 2007 and April 2007 would rise. Instead, it collapsed. As the *New York Times* points out, "Once the trade went sour, Amaranth was trapped: selling into a falling market, scrambling to meet margin calls from nervous lenders, stuck in a position in a market where — to use a common phrase on Wall Street — 'you get your face ripped off.'"[24]

By the time Amaranth sold its energy book, the fund informed its investors it had fallen 65 percent — or $6 billion — in a single month. Nicholas Maounis, the fund's founder, summed up the spectacular collapse during a conference call with investors shortly afterward: "Sometimes, even the highly improbable happens."[25]

Conclusion

Hedge funds are complex investment vehicles with less transparency, and their management has been subject to less regulatory oversight than mutual fund managers. The exclusive nature of these products combined with the potential for exceptional rewards trumpeted by those in the industry may tempt some high net worth investors, who would not normally consider investing in such risky investments.

Hedge fund investors accept all the downside risk inherent in such funds; yet they generally participate in less than 80 percent of the reward, as fund managers receive their typical 20 percent upside compensation. A considerable and mounting body of data suggests that hedge funds have not outperformed their appropriate benchmarks, partly due to the prevalence of excessive fees (for hedge funds and funds of funds), use of higher-risk strategies to achieve above-market returns, and incorporation of additional risks, such as agency risk. Taking all the hedge fund's uncompensated risks into account — and realizing that these risks have not resulted in risk-adjusted return premiums — we conclude that hedge funds more closely resemble speculative products than prudent investment vehicles, and that they warrant no position in a well-structured, globally diversified portfolio, regardless of the investor's net worth.

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[3] William Jahnke, **Hedge Funds Aren't Beautiful**. *Journal of Financial Planning*, February 2004.
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[20] Jahnke.
[21] Jenny Anderson, **Betting the House and Losing Big**. *New York Times*, September 23, 2006.
[22] Ibid.
[23] Ibid.
[24] Ibid.
[25] Ibid.