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Opinion: Individual investors 1, hedge funds 0

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Being denied access to the funds for the wealthy, it turns out, is a good thing

Bloomberg

Hedge fund managers including John Paulson can earn billions of dollars a year, though research has shown that 2% of funds of hedge funds earned more than enough to justify paying their high fees.

CHAPEL HILL, N.C. (MarketWatch) — Call it the revenge of the small investor.

Earlier this week, the California Public Employees' Retirement System, or Calpers — the largest U.S. public pension plan — announced that it would soon liquidate all its holdings in hedge funds, and that it intended not to invest in them again. Hedge funds, of course, are the play things of the wealthy; you must be a so-called "accredited investor" to invest in them.

This is a stunning announcement, given Calpers' size as well as the leadership role it plays in the institutional investment world. Calpers was one of the earliest proponents of investing in so-called "alternative" investments, so giving up on hedge funds represents a big reversal.

Calpers doesn't deny that, among the thousands of hedge funds that are available, there won't be certain ones that will perform spectacularly. But the pension fund, in effect, is saying that it's extremely difficult to identify in advance which ones those will be.

Simply focusing on past performance isn't good enough, for example. Vikas Agarwal, a finance professor at Georgia State University who has studied the industry, says that very few hedge fund managers who add value in one period are able to repeat their success in the next.

Calpers tried to beat those odds in past years by employing a large staff of investment professionals whose job was to dig deeper in search of hedge funds worth investing in. But their results were disappointing.

That has prompted some to say that the problem lay with Calpers' staff, not with the hedge fund industry itself. But that's unfair. David Hsieh, a Duke University finance professor who has studied hedge fund performance, found little evidence in his research that funds of hedge funds add value, despite employing full-time staffs to analyze and judge

hedge funds.

In one study, for example, Hsieh found that only 2% of funds of hedge funds earned more than enough to justify paying their high fees.

Calpers also has been criticized for the timing of its announcement. Since it's unlikely that the stock market over the next five years will perform anywhere near as well as it did over the last five years, now might very well be the time when we should be decreasing our equity exposure and increasing our holdings in hedged investments.

But I don't buy that argument either, since the alternative to allocating all your portfolio to equities doesn't have to be hedge funds. If you're nervous about the stock market, for example, you can reduce your equity exposure and put the proceeds in short- or intermediate-term bonds. History suggests you will perform just as well as the average hedge fund, without incurring any excess risk.

Consider how you would have done had you been unlucky enough to put a lump sum in the market at the October 2007 stock market high, just before the Great Recession and associated bear market. In retrospect, of course, that would have been the ideal time to begin hedging your portfolio.

Yet, since then, a portfolio divided equally between a stock market index fund and a bond market index fund would have beaten the average hedge fund by 1.9 percentage points per year on an annualized basis, according to data from the Hulbert Financial Digest and the Credit Suisse Hedge Fund Index. Furthermore, this stock/bond index fund portfolio would have incurred no more risk than the average hedge fund, as measured either by volatility or drawdown.

The bottom line? Odds have always been good that you weren't missing out by being denied access to the exclusive hedge fund arena. Calpers' announcement provides yet more confirmation.

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