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Investing in a hedge fund isn’t really worth the bother

Opinion: The portfolios for the wealthy are hard to find and expensive

By Mark Hulbert, MarketWatch

Bloomberg

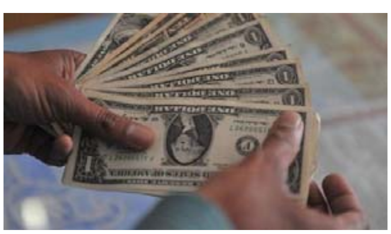
Clockwise from top left: George Soros, Bill Ackman, Robert Chapman and Carl Icahn

There are many legitimate reasons to shun hedge funds.

They are expensive — typically charging fees of 2% of assets under management and 20% of any profits. They often have lengthy lockup periods, so you aren’t always able to get your money back when you need it. And there are so many funds with inconsistent records that it is a challenge finding a manager whose performance justifies the steep fees.

Yet there is one criticism that has been leveled at hedge funds recently that is unfair: poor performance relative to the benchmark S&P 500 Index.

Since the bull market began in March 2009, the critics will point out, the average hedge fund in the Credit Suisse Hedge Fund Index has gained an annualized 8.5% through April 30, versus 23% for the S&P 500, assuming dividends were reinvested. Over the past 10 years, even a conservative portfolio that invested just 60% in the S&P 500 and kept 40% in bonds still outperformed the average hedge fund.



Jaffe: There’s a big difference between not saving enough and not saving at all.

But most hedge funds aren’t designed to outperform a rising stock market. Though some do try to shoot the lights out, performance-wise, most seek to generate steady gains — or at least minimize losses — in all types of markets.

“Hedge funds shouldn’t beat the stock market in raging bull markets, or fall as much in huge bear markets,” says Cliff Asness, founding principal at AQR Capital Management, which oversees $105 billion in hedge funds and other investments.

This was certainly the case during the bear market that lasted from October 2007 through March 2009. The Credit Suisse Hedge Fund index lost an annualized 12% over that period, compared with the S&P 500’s 39% drop.

And consider that institutions and wealthy individuals — including some of the savviest investors around — have poured billions into hedge funds in the past two years, pushing assets to a record $2.7 trillion, according to researcher HFR. Clearly, they see some value.

So, with the pros and cons on the table, here are some things you should think about if you decide to join the hedge-fund club.

What to consider

First, it is a complicated business. The wide range of strategies employed by hedge funds includes taking bets on macroeconomic developments around the world, on events such as mergers and acquisitions and on other asset classes besides stocks and bonds, such as currencies and commodity futures.

In choosing among them, you need to consider the role you want a hedge fund to play in your portfolio. Are you looking for positive returns — even small ones — in all markets, or are you gunning for potentially big gains? Or do you want to invest in assets that behave differently than either the stock or the bond market?

Then you will need to find a fund. That is hard because of the complex analysis required to determine whether a hedge-fund manager is truly adding value, according to Vikas Agarwal, a finance professor at Georgia State University who has studied the industry. For example, he said in an interview, "the techniques used to assess mutual-fund managers do not apply to hedge-fund managers."

Furthermore, the databases containing reliable information on individual hedge-fund performance can be prohibitively expensive for individuals. And even if you find one, many of the big-name fund managers with superb records may not be accepting new cash.

You may therefore want to engage the services of a financial adviser who has access to the requisite data and the statistical acumen to analyze hedge fund performance. Or you may find it easier still to invest in a fund of hedge funds. Though such vehicles have the disadvantage of adding yet another layer of fees, you get the benefit of professional staff that does the work of sifting through the thousands of hedge funds that are available.

Be aware, however, that in order to invest in either a hedge fund or a fund of hedge funds, you will need to be an "accredited" investor, which the Securities and Exchange Commission defines as an individual whose annual income tops $200,000 or whose net worth exceeds $1 million, excluding a primary residence.

You might conclude that it isn't worth the bother, however, since picking a winning hedge fund is so difficult.

'Exceedingly difficult'

Agarwal says that, in his research, he found little evidence that hedge-fund managers who add value in one period are able to repeat their success in the next. Though some other researchers have found evidence of performance persistence among the best hedge funds, he says it nevertheless is clear that it is "exceedingly difficult" to identify in advance those managers who will be able to add value in the future.

Do the professional staffs at funds of hedge funds do a better job of identifying these superior hedge-fund managers? The evidence isn't encouraging, according to David Hsieh, a Duke University finance professor. He said in an interview that, in his research, he has found that just 2% of such funds earned more than enough to justify paying their fees.

If all you are looking for in a hedge fund is reducing portfolio volatility, you might consider simply investing in a 60% stock/40% bond portfolio, which historically has been no more volatile than the average hedge fund. Two of the cheapest appropriate funds are the Vanguard Total Stock Market Index and Vanguard Total Bond Market Index, which charge annual fees of 0.17% and 0.20%, respectively, or $17 and $20 per $10,000 invested.

(Updates story to say hedge fund assets totaled $2.7 trillion.)

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