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In Perspective 

Stay Away From The Hedge

February 2015

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When considering hedge funds for your portfolio, you need to see beyond the well-crafted story, the glossy brochures and the distorted performance claims.

Hedge funds are much like any other pooled investment vehicle, in that they have many individual and institutional investors and invest across a range of securities, sectors and countries, applying their own unique 'skill' in the process for the added benefit of those investors (or that's the theory, at least).

Where they differ significantly from more straightforward, mainstream investment funds, however, is in some of the freedoms they enjoy, including, for example, the ability to employ unlimited 'leverage' (borrowing significant sums of money to speculate with) and a much lower level of regulatory oversight and transparency (many investors don't truly know or understand what the hedge funds are up to with their money).

Jam today, jam tomorrow

A common objective – some may even say a defining characteristic – of hedge funds is to deliver a positive return on investment, regardless of whether markets are rising or falling and accordingly (again, in theory), a much higher return than could be achieved through more traditional means.

In this context, it is perhaps unsurprising that articles regularly appear in the investment media which suggest that you may wish to consider investing in hedge funds. However, before you do, you may want to take some time to consider the wisdom of this approach.

Do they do what they say they will?

Without dwelling too much on the impossibility of consistently trying to correctly predict the future, it should not come as a surprise that like most traditional active fund managers, hedge fund managers continually get their market timing, stock selection and market direction decisions (guesses) wrong. This would be bad and costly enough, as it is in most funds, but when factoring in the size of the bets being placed and the often industrial-scale use of leverage, the results can be 'concerning' to say the least.

The evidence suggests it's a gamble that often doesn't pay off – for the investor

Plenty of independent data exists which confirms the difficulty of consistently making returns from hedge funds – or even making returns equivalent to a much simpler, less expensive, less volatile and more understandable investment approach.

According to a recent Bloomberg article[1], for example, the average return from a US hedge fund was 2% in 2014, which compares with a total return from the S&P 500 (think FTSE All Share in the UK) of more than 13%.

Bearing in mind the return of the index is the return available just for 'turning up', and that hedge funds are supposed to deliver notable outperformance even in bad times (hence their eye-watering fees, as outlined below), this is quite some price to pay for the 'exclusivity', 'insights' and 'all-weather capability' of a hedge fund.

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How much?!

Aside from the issues described above, the often poor performance of hedge funds is in no small part due to the costs associated with investing in them. Leaving aside the costs of derivatives and leverage, a common fee structure is '2 + 20', which means 2% pa management fees plus 20% pa of any increase in the fund's net asset value during the year, which is, to put it mildly, a bit racy (although not, it must be said, as racy as some of the '3 + 30' structures which exist!)

Complete transparency – when the numbers look good

Another of the problems surrounding hedge funds is a lack of truly reliable data from within the industry itself, because as hard as it is to believe, hedge funds are not actually required to report their activities in the way that mainstream funds are. As such, the industry organisations which report hedge fund returns are relying on voluntary disclosures, which is likely to mean that stated returns do not include periods of poor returns and include 'survivorship bias' distortions i.e they do not factor in those hedge funds which were closed due to poor performance or went bust completely.

It's not all bad; hedge funds can be brilliant – if you happen to work for one

Plenty of evidence also exists which confirms that those who work for hedge funds do rather nicely from them. Indeed, according to the 2015 Hedge Fund Compensation Report, employees saw double digit growth in their bonuses in 2014, while the publisher of the Report also said that there was "a reduction in the correlation between fund performance and bonus levels."

As you might imagine, the happy days enjoyed by hedge fund employees over many years have often been at the expense of their investors. In his book, Simon Lack, who used to choose hedge funds for US investment bank, JP Morgan, estimates that in the 12 years to 2010, the hedge fund industry captured at least 86% of the returns it earned for its investors![2]

All you need to know

Perhaps the best way to summarise this brief overview of hedge funds – and some of the reasons why they don't feature in our clients' portfolios – is with an anecdote from a financial planning firm that we respect greatly:

A few years ago, the firm in question was approached by a potential new client and having explained that he worked at a hedge fund, the financial planning firm expressed a certain amount of surprise that he would like to explore working with them, bearing in mind what he did for a living.

With admirable openness and honesty, the prospective client explained that aside from the range of other, non-investment related planning issues which he and his family needed to address, in his view, while a hedge fund was a great place to work, it was not a great place to have one's money invested!

And that, I think, is all you need to know about hedge funds.

Best regards

Michael

Notes

1 *Hedge Funds See Worst Year for Closures Since 2009*, Bloomberg, 2 December 2014

2 Lack, Simon; *The Hedge Fund Mirage: The Illusion of Big Money and Why It's Too Good to Be True*, January 2012

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Michael Smith *Director, Chartered and Certified Financial Planner*

In addition to being a Chartered Financial Planner, Michael holds the globally recognised Certified Financial Planner qualification and is a Fellow of the Personal Finance Society. Michael also sits on Chamberlyns' Investment Committee and produces the firm's regular series of concise 'In Perspective' articles, which consider, and provide perspective on, a range of current and timeless wealth planning issues.

Chamberlyns provides a refreshingly different Wealth Management service for executives and professionals, who want to make the most of their money and the life that lies ahead of them.

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