Investment

Are Hedge Funds Worth Higher Fees?
The Straight Story: Hedge Funds

By: Sam Wiseman

While hedge funds are capturing more and more attention from the investment community, Wiseman, of Wise Capital, is not certain the industry has the resources to adequately asses hedge fund industry.

In an unregulated environment, with so many entering this area, hedge funds have attractec of:

- Pension plan sponsors who need to juice returns as a result of low expectations of returns or assets
- Individual investors who are attracted by the occasional astonishing return and are increasin minimum investment qualifications
- The investment community, in general, which needs and wants to understand what is going
- Consultants who are overwhelmed by the vast number and complexity of this booming indus
- Regulators, seeing high profile funds disappearing, who want to protect the public

However, the lack of regulation and little transparency is also attracting the attention of num unscrupulous entrants.

Are hedge funds worth the awesome high fees? Can they repeatedly deliver on high perfor are they so hard to analyze?

Let us look at new research that is just beginning to give us answers to these questions.

Lack Of Transparency

By their nature, hedge funds lack transparency. That is the critical factor that signals to expe knowledgeable participants to beware. The lack of transparency manifests itself when one attempt standardize performance, risk measurement, or due diligence.

From their point of view, hedge fund managers want to protect their proprietary investment p They are not obliged to reveal holdings or even meet with the typical client.

The holdings are audited annually but turn over many times in the year, commissions are fi a prototype long fund, and, hence, it is impossible for an outsider to measure the risk. Hedge funds in their business interest to appear to be wizards hiding behind the curtain.

This lack of transparency is an advantage in attracting some skilful managers to the industr want consultants looking over their shoulders, telling them that they are changing their style or taki risk against the benchmark.

The high fee structure is very attractive to managers and salesmen. A recent study shows th
traditional long-only investment management, hedge funds have 10 times the fees at one-fifth the s
incentive bonuses do result in gaining of performance. And that's why studies reveal that a shoot-t
year of performance is followed by three years of very plain performance.

Different Game

To the mainstream investment industry, which is extremely conservative, the challenge of fi
tracking hedge fund managers is proving too great. The quantitative tools available are inadequate
manage the risks of hedge funds. The interviewing skills and due diligence cannot, before the fact
detect failing strategies or unscrupulous individuals. Efficient frontiers, assumptions of normality, tl
work for a simple reason, these managers are selling short! Traditional investment tools break dov
just as you cannot use a hockey stick in a baseball game – it's a completely different sport!

The quick answer of Value at Risk (VAR) doesn't cut it either. VAR assumes log normality,
underestimates the true risk of hedge funds when there is short selling.

When the manager shorts, there is an unlimited downside. When the manager gets his sho
short position increases. He is fighting the natural upward trend of the market. Shorts have a small
and need constant replenishment, and many stocks cannot be practically shorted. Also, there are
rules to follow and you are fighting management when you sell their stock short.

Few track records go back 10 years. Back tests are particularly unrelated to actual performa
low correlations shown against conventional benchmarks.

New research shows returns have a 2.43 per cent annual survivorship bias. In long-only ec
that's the difference between the median manager and the best long-term managers. Total fees in
performance fees take another 5 percent(Ennis and Sebastian, Journal of Portfolio Management S
So over a longer term timeframe, the average hedge fund has at most a 2 percent a year annualize

The standard deviation of the hedge fund manager universe is nearly as high as equities. A
reduced by having a group of managers? Research shows five to 10 managers gives you a 75 pe
diversification. However, adding managers often increases risk by adding different market exposu
not hedging in a multi-manager program. When the sponsor is investing in long funds, adding add
managers normally covers more of the market and reduces risk.

Furthermore, there is a herd effect by hedge funds making similar bets. For example, recen
been following long gold and oil. Because they are enigmatic, they are often misclassified by man
potential investors. Hedge fund managers still swim in the same waters as other investment mana
not diversifying so much as they are merely applying different and large bets in selected investme
the immense probability of negative surprises, the Sharpe ratio does not measure the skill of hedg

Another principle of finance that cannot be readily applied is that of time as a diversifier. Ov
period, a disciplined long-only manager will normally achieve his performance objective as risks c
Research shows this is not the situation for hedge funds, largely because of insolvency risk.

Losing all of your money is certainly risky. That's not simply having a short-term volatility in
And 10 to 20 per cent of the hedge fund universe goes bust in any given year. Some high profile b

Long Term Capital Management, Manhattan Capital Management, Maricopa Investment Corporat
Convertible Arbitrage. At an AIMR conference earlier in 2003, a well-respected senior portfolio ma
that 80 per cent of current hedge funds will disappear within a few years. Funds break down from fr
misrepresentation of investments, unauthorized trading, and insufficient funding.

Lack Of Due Diligence

To make a difference in traditional risk/return tradeoff analysis, investors need to allocate 20
their money to hedge funds, studies show. This requires awesome support of consultant knowledg
available. Perhaps a couple of the very biggest consultants can follow some hedge funds, but, for
consultants simply cannot afford the infrastructure to do a proper job to educate themselves on the
strategies and track the 4,000 managers in any prudent depth.

One bad manager easily wipes out all the benefits of a hedge fund allocation. So several m
required in a program. The search must be diligent as it is an unregulated industry, where few mar
known by a reliable analyst. An on-site check, the smell test of sophisticated institutional investors
is a waste of time in hedge funds because the inspector rarely has the knowledge.

The investor must pick several different types of managers, not based on track record. The
hedge fund strategies alone can fill a long list. It can even include strategies that rarely short sell. I
fund-of-funds limit managers to $200 million in any strategy as an optimal size to be nimble and sc
the amount to $20 million.

Institutions are more often dealing with the opportunity to invest in hedge funds by delegatir
diligence to fund of funds. But these managers of managers, despite adding an additional layer of
astronomical high fees, are not usually doing significant due diligence. If there are great risks in th
are compounded by having fund-of-funds.

Long/short

The first hedge fund model was long/short equity hedge funds. About half of the hedge func
be identified by this description. They tend to invest in equities, both on the long and the short side
generally have a small net long exposure. This alone still is more risky than long-only.

They are genuinely opportunistic strategies capitalizing on stock picking skill. A subset of th
neutral hedge funds' that seek to neutralize certain market risks by taking offsetting long and short
instruments with actual or theoretical relationships. These are essentially long/short equity hedge
maintain long and short portfolios of the same size and/or risk. It is nearly impossible to be 100 pe
neutral in every period. There is no toolkit or model available to offset all risks, so that it is a long/s
but it is only a question of degree of the magnitude of the long direction.

In brief, the industry is handicapped by few resources to cover the 4,000-something hedge f

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