HEDGE FUNDS: MYTHS & FACTS

By Ed Easterling
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Never has an industry so extensively studied by "experts" produced such a surplus of myths, misunderstandings, and half-truths. Many of these myths could easily be clarified with a call or two to knowledgeable industry professionals. Too often, a seemingly logical statement that *sounds-good-when-you-say-it-fast* becomes accepted conventional wisdom despite the reams of evidence weighted against it. Although many of these experts are well-intentioned, they may not be sufficiently well-informed. The solution lies in enhanced collaboration between academia, industry, and the press.

WHAT ARE "FACTS"?

In the rapidly evolving hedge fund industry, unqualified facts are hard to determine. There is so much variability across the many issues related to the hedge fund industry, that even generalizations are often accompanied with an extensive list of exceptions. Nonetheless, there are a series of fairly obvious myths that generally have been accepted as fact and, therefore, perpetuate a series of misunderstandings about the hedge fund industry. The purpose of this article is to remand those myths back to the stage of reconsideration and evidence-gathering.

> "When under-informed spectators view an unfamiliar process that operates with different principles and objectives, a natural result is myth and misunderstanding."

As mentioned above, a key objective of this discussion is to encourage collaboration between those that analyze and those that can provide first-hand direction and feedback about the methodologies and conclusions.

In the spirit of disclosure, I have managed hedge fund portfolios (fund of hedge funds) since 2001, have used the experience and contacts as an investor in the industry to conduct research about issues affecting the hedge fund industry, and have taught a graduate-level course about the hedge fund industry since 2004 (requiring a dedication to the principles of informed and balanced education).

The myths typically emanate from three sources: (1) academics that are misapplying principles of finance and markets to hedge funds or that are repeating seemingly-logical perspectives, (2) high-profile observers from outside the hedge fund industry that lack actual knowledge, and (3) critics of the hedge fund industry that relish in attempting to discredit it.

THE TOP TEN LIST…AND BEYOND

Before we jump into the list, it's important to differentiate between the "many" and the "major." Over the past decade, as the hedge fund industry has grown in numbers and assets, there has been an expanding bifurcation of the industry. Bifurcation refers to the widening differences between larger and smaller funds—the institutional and the entrepreneurial. An increasing amount of the capital invested in hedge funds is coming from large investors (e.g. pensions, endowments, fund of hedge funds, etc.). Most of their capital, for a series of regulatory and structural reasons, is being allocated to the larger hedge funds—as a result, the big are getting bigger.

In general, the smaller funds tend to have more individual investors and less sophisticated operations. The larger funds tend to have more institutional investors and more sophisticated operations. There are clearly exceptions. For example, some larger hedge funds reflect the personality of the manager and can appear to be quite entrepreneurial, yet at the same time they generally have fairly developed infrastructure and often attract highly-sophisticated institutional capital. Therefore, the terms "institutional" and "entrepreneurial" are not intended to apply to all aspects of large and small hedge funds; rather they are indicative representations of the broader trend in the hedge fund industry toward a widening bifurcation between larger and smaller funds. If the SEC succeeds in raising the hurdles that would limit certain lesser-wealthy investors from accessing most hedge funds, it will serve to further accelerate this trend.

MYTH #1: POOR PERFORMANCE

One of the most prevalent myths relates to the performance of hedge funds—that they generally don't make enough returns. This myth has two elements: wrong conclusion and wrong benchmark. When markets are down, hedge funds often underperform the often-supposed benchmark of 10% returns. When markets are up, hedge funds often underperform the market. Therefore, so the myth goes, if hedge funds are always underperforming, then they must be poor investments.

EVIDENCE:

Most often, hedge fund performance is often compared to stock market returns—despite the fact that many hedge funds do not even use equity securities and many of those that do use stocks often hedge away much of the general stock market risk. This benchmark error may be a legacy from more than a decade ago when there were far fewer hedge funds and many of them were considered to be a riskier addition to a traditional portfolio. As a result, it probably seemed appropriate back then to compare hedge funds to the riskiest financial asset class: equities. More recently, investors are using diversified hedge fund portfolios (either internally-developed or through fund-of-funds) to replace a portion of both the stock and bond allocations. Today, when investors add or increase their allocations to hedge funds, they more often reduce the allocations to both stocks and bonds. Therefore, a more appropriate benchmark for hedge funds should be the return and risk related to the assets that are being replaced. As a result, the benchmark should be the return and risk of a combined stock and bond portfolio rather than simply stock market returns.

When hedge fund performance is compared to a traditional portfolio of stocks and bonds, hedge funds not only have generated superior returns over time, but also they have delivered the superior returns with lower risk (as measured by volatility, drawdown, and other measures of loss). Markets, including stocks and bonds, typically have a wide range of performance—big ups and downs that ultimately average to their historical level of performance. Diversified portfolios of hedge funds are impacted by market volatility as they seek returns from a wide variety of skill-based strategies. In declining markets, hedge fund returns are often below their historical average—yet they often accomplish a key objective of not losing money. In rising markets, hedge funds benefit and often receive a bit of extra return, yet generally not enough to beat-the-market. When investors avoid or reduce losses, they do not need to match or exceed financial market returns in positive periods to exceed the market over time. The market return results from experiencing 100% of the downside and 100% of the upside. When investors avoid the downside, they generally need a fraction of the upside to match market returns over time. As for empirical performance, the historical data shows that the typical fund of hedge funds has better returns after fees than a blended portfolio of stocks and bonds before fees.

MYTH #2: FAILURE RATE

The conventional wisdom is that 10-20% of hedge funds fail each year—quite a blow-up risk for hedge fund investors.

EVIDENCE:

When the studies are reviewed more closely, it is apparent that the percentage relates to the "attrition" from hedge fund databases, not the "failure" rate of poor performers from the industry. The confusion occurs because many people falsely transfer a concept from the mutual fund industry to the hedge fund industry.

For mutual funds, the only reason that they leave the databases is that they go out of business. Yet for hedge funds, which voluntarily report to one or more databases, they stop reporting for two reasons: (1) poor performance and (2) good performance. Unlike mutual fund databases, hedge fund databases are generally private listing services that introduce hedge funds to qualified investors. As a result, hedge funds that choose to post returns are generally doing so to attract investors. Good performance often leads to asset growth which in turn causes many hedge funds to stop reporting. In two prior research studies, Crestmont Research found that twice as many hedge funds stop reporting after good performance compared to those that stop reporting after poor performance. As a result, the 15% 'attrition' rate reported by some academic studies actually relates closely to the 5% 'failure' rate reported by some industry groups and by anecdotal evidence from fund of funds, auditors, and attorneys in the industry.

Detailing this myth to a further level of relevance for most investors, almost every industry constituent agrees that the failure rate (whether 5% or other) is highly concentrated among relatively small hedge funds that don't make enough money to survive—very few of them are the larger funds that reside in most institutional or fund-of-funds portfolios.

The failure rate myth fails for two key reasons: First, most hedge fund failures relate to fairly small funds (often the ones that are not significant in institutional or fund of funds portfolios). Second, many of the hedge fund failures result in relatively modest, if any, loss of capital. Clearly, there is occasionally a large, spectacular failure (just as we see in corporate America), yet large failures do not occur in sufficient numbers to materially impact industry returns. Therefore, in terms of the impact of failures on most investors' returns, this issue has much more bark than bite.

MYTH #3: TAX INEFFICIENT

Almost universally, outsiders to the industry think that hedge funds are not tax efficient since they supposedly trade actively—all of the income must be either short-term gains or interest income.

EVIDENCE:

A call to tax professionals in the industry would reveal that hedge funds are much more tax efficient than most people realize. Clearly, some hedge funds are inefficient and others are highly efficient; yet, the typical diversified portfolio of hedge funds provides aggregate income with some favorable tax attributes.

So you might ask: What are some of the drivers of tax efficiency? There are three primary items. The first is that some securities (e.g. index options, futures contracts) have automatic tax benefits (i.e. the previous examples provide 60% of their income as long-term gains or losses regardless of how long they are owned). The second is that most hedge fund managers have significant personal investments in their funds, and thus have a personal interest in their fund's tax efficiency. The third and probably most significant is that the typical 20% profit allocation from hedge fund partnerships to the manager carries the same tax attributes that the investor receives. In other words, if the investor receives tax-favored long-term capital gains then the profit participation from the partnership to the manager carries the same benefit. As a result, the hedge fund manager has millions of incentives to drive favorable tax attributes for investors.

MYTH #4: SURVIVORSHIP BIAS

This myth implies that the hedge fund indexes reflect artificially high returns since they often do not include the poor performance of the funds that have moved to the graveyard. As a result, the myth-sayers state that actual hedge fund returns are generally 2% to 4% lower than the reported indexes.

EVIDENCE:

In the evidence to Myth #2, we dispelled the notions about high failure rates. Many of the same issues and dynamics impact the concept of "survivorship bias" in hedge fund returns. Hedge fund returns actually may be higher than the returns reflected by the indexes. Why? Many of the best hedge funds don't report their returns—they don't need database marketing for new investors. Also, more good funds stop reporting than poor funds—thus the dropout factor may actually have a positive effect. Finally, when we look at net returns from fund of hedge funds, which don't often fail and do reflect the full impact of non-reporting funds and failures, the results are often comparable to the broad hedge fund indexes after adjusting for fees.

MYTH #5: HIGH LEVERAGE
Supposedly, hedge funds use high levels of leverage to amplify returns.

EVIDENCE:
Most surveys within the industry reflect leverage between 1.2 and 1.5 times the capital base. Yet averages can be deceiving, as some arbitrage strategies employ higher leverage with minimal risk, while other can have less than 100% of the capital invested. Regardless, the notion of high leverage appears to be the legacy of Long Term Capital Management. Most hedge funds employ modest or no leverage and relatively few use leverage to boost returns from general market exposure. Actually, most funds use leverage (under a loose definition of the term) to add hedges to the portfolio and to reduce risk.

MYTH #6: SPECULATIVE
Hedge funds are often believed to be speculative investors that take high risks to seek returns that are greater than the stock market.

EVIDENCE:
For a diversified portfolio of hedge funds, the historical results and the monthly measures reflect volatility that is one-third of the historical volatility for the stock market and one-half the volatility of bonds. Volatility is one generally accepted measure of risk for financial assets. Likewise, hedge fund portfolios deliver lower drawdowns and other measures of risk than the traditional asset classes.

When the source of hedge fund performance is dissected in relation to the overall financial markets, much of the ultimate performance results from reducing losses in adverse markets and achieving a modest level of positive returns during good periods.

A misapplied concept of risk and return leads many people to assume that the higher returns from hedge funds must be driven by higher risk. The prior financial market models (e.g. Modern Portfolio Theory, etc.) assumed perfectly efficient markets and left no room for skill. Today we know better, that financial markets are an efficiency process rather than a consistently efficient condition. Superior hedge fund performance is driven by the skills of execution and risk management in markets that present mispricings and inefficiencies.

MYTH #7: EASY TO START A FUND
Outsiders often quip: “Anyone can start a hedge fund…and they’re all doing it!”

EVIDENCE:
Lots of people are starting hedge funds. The attorneys, auditors, prime brokers, and administrators have developed cookie-cutter procedures to enable managers to start hedge funds in relatively short order. The one ingredient that most challenges the aspiring manager is capital. That provides a challenge that makes the Great Wall of China look like a country fence. To start a hedge fund, it requires commitments from a series of people willing to trust you with their money—people that have the ability and choice to invest with your start-up or alternatively to invest with a host of other

established, successful funds. Realistically, it takes quite a pedigree of relevant experiences and success to launch a hedge fund. And then, once you've launched, you'll need the means to survive until you can consistently produce the returns and build the assets to become sustainable. In reality, not everyone can start a hedge fund; just as not everyone has the means and ability to start a business.

MYTH #8: HIGH FEES

This 'penny-wise and pound-foolish' myth asserts that the high fees at hedge funds prevent them from delivering satisfactory returns.

EVIDENCE:

Hedge funds reside in a category of investment known as "alternative investments." This category also includes private equity, venture capital, real estate, oil & gas, timber, etc. All of these investments, including hedge funds, share a similar characteristic—the element of skill-based drivers for returns. The fees associated with hedge funds are relatively similar to the other alternative investments. Further, considering the level of net return and controlled risk provided by hedge funds, the fees are generally commensurate with the value received. If the value was not evident in hedge fund performance, there would not be the continued flows of capital into this sector.

Keep in mind that many of the sophisticated and knowledgeable hedge fund investors are using hedge fund portfolios to replace a portion of the stock and bond allocations. The <u>net</u> result from diversified hedge fund portfolios (or funds of hedge funds) provides a return profile that exceeds the blended <u>gross</u> return profile of stocks and bonds while also contributing a lower risk/volatility profile. The further "cherry on top" benefit is that hedge funds generally have low correlations to stocks and bonds; thus, their addition further lowers the overall variability of returns and increases the diversification of the portfolio.

In summary, the fees are consistent with other alternative investments and the net returns from hedge funds more than cover the additional cost. Hedge funds provide investors with an enhanced return and risk profile compared to stocks and bonds as well as providing additional diversification.

MYTH #9: HIGH-WATER MARK CLOSURES

If a hedge fund loses money, then supposedly the manager will just close the fund and start over to eliminate the need to make up losses before getting new performance fees.

EVIDENCE:

This is one of the easiest to dispel, as it naïvely assumes that a poor performing hedge fund can either (a) return funds to disappointed investors and then dupe them into reinvesting into a new fund that is similar to what the investor had, or (b) find a set of completely new investors to launch again despite the recent failure and poor record. If we assume that hedge fund investors are completely irrational, then this myth might have a chance to be true—but in reality it is not accurate in the real world.

MYTH #10: LOW TRANSPARENCY
Critics cry that hedge funds should be avoided because they are not required to disclosure their holdings and investors have no way of knowing what the fund is doing.

EVIDENCE:
This myth generally emanates from frustrated outsiders that are unable to find out what individual hedge funds are doing. This is rarely a complaint from existing investors in hedge funds. Hedge funds have no obligation to provide open access to outsiders, especially those most likely to expose their proprietary work. Asking a hedge fund to publicly disclose its positions and strategy is like asking a company to publicly list its customers and marketing plan. Hedge fund investors actually appreciate this—they certainly don't want the fruits of their manager's work diluted by poachers. Most hedge funds provide a relatively high degree of access to relevant data and analyses about the fund and its holdings for their investors—if they didn't or weren't willing to provide sufficient transparency, the investor could make the choice to not invest or to withdraw. Ironically, most of the larger hedge funds complain that securities laws unfairly require them to publicly list their positions—regulations and Form 13D require funds (including hedge funds) with more than $100 million to provide publicly each quarter a list of all stock positions.

MYTH #11: SOURCE OF RETURN
Most of the returns from hedge funds are driven by the trends in various financial markets; investors receive little skill for their excessive fees. Often this myth appears, for example, when critics say that hedge fund returns include a lot of general stock market return (so-called 'beta').

EVIDENCE:
This myth has gained a lot of traction over the past few years. As a matter of fact, since there is supposedly so little skill involved, the hot topic in 2006 and 2007 is the use of computer models to replicate hedge fund returns by using a mix of securities across a variety of markets. Almost all markets have trended higher over the past four years. Likewise, hedge funds have made solid returns. Therefore, (here comes the freshman mistake in statistics), hedge funds must be correlated to the markets… Memories must be short to have forgotten that hedge funds weren't very correlated in the three years before 2003. While the stock market was falling during that period (and plunging in 2002), diversified portfolios of hedge funds were ringing the proverbial register for their investors. Upside correlation that later reverts to non-correlation when markets decline will show itself to have been coincidence and not a fundamentally-driven relationship. Since hedge funds are generally profitable, they often reflect higher apparent correlation in rising markets. When we next have a period of declines, it will reveal whether the recent correlation is fundamental or if it is coincidence. Unless the new models can predict reversals in the markets and go short, there will not likely be a computer-generated mix of securities that will profit <u>when</u> the market next falls. Watch for the models that are now trying to replicate hedge fund skill to start "refining" their strategies when they don't work in the next downturn.

MYTH #12: LONG LOCK-UP PERIODS

Another criticism relates to the provision in most hedge funds that requires investors to stay invested for a year or longer, so-called “lock-ups.” Some believers of this myth say that investors should demand an illiquidity premium, or avoid hedge funds entirely.

EVIDENCE:

Many hedge funds do have lock-ups; most commonly for one year. This is rarely an issue for hedge fund investors, as they do not seek to invest for short periods and generally perform enough due diligence to commit for one year. This point has been cited in numerous articles and was recently emphasized by a bank trust officer in criticism of hedge funds. The officer of more than thirty years, after being asked, acknowledged that he had never fired a stock or bond manager within the first year of hiring them. He said that it takes something really bad, or very poor screening, to terminate an investment manager that quickly.

Within a diversified hedge fund portfolio, even if there were a delay in redemption from a recent addition, it would have a minimal impact on the overall portfolio. Ironically to this myth about illiquidity, a key advantage to hedge funds as an alternative investment is its high degree of liquidity compared to the others in the category.

As for illiquidity premiums, although the investment structure limits a hasty exit, the underlying assets are generally quite liquid. Further, if this is a serious concern, there are many hedge funds to include in portfolios that do not have lock-ups or provide liquidity for a small redemption fee during the first year.

In some ways, longer lockups are occurring more often than they did in the past. As the hedge fund industry has become more sophisticated and the larger funds have become more institutional, there are now more firms offering longer lock-up or redemption periods for a slightly lower fee structure. Some others, as they near capacity for additional capital, only accept capital that commits to longer investment horizons. Hedge funds in general remain by far the most liquid alternative investment. They provide far greater redemption terms than private equity, venture capital, real estate, timber, energy production, and the variety of other investment classes that seek returns from the skill of the firm or manager rather than primarily from the performance of the stock or bond markets.

MYTH #13: TOO MANY FUNDS

There are now more hedge funds than listed stocks. With so many funds, the critics claim that there must be limited opportunities for future profits.

EVIDENCE:

Hedge funds are just one type of investor in the stock market. The relative size of the hedge fund industry can be measured in a couple of ways. First, the number of hedge funds is a small fraction of the number of investors. Further, some industry reports reflect that there are as many as 8,000 or more hedge funds. However, most professional firms directly servicing the hedge fund industry believe that such large counts are actually lower when duplicate investment vehicles at the same firm are eliminated. For example, domestic and offshore clones of the same hedge fund are often both listed in databases that generate the totals.

Additionally, the asset size of hedge funds is still about 1% of the total financial markets within which they invest. As for the comparison to the number of listed stocks, there are numerous styles of hedge funds that don't even use stocks in the first place. Most of all, as for actual current evidence of whether there are too many hedge funds, there are major signs that there is still significant capacity. First, demand for funds was strong in 2006 with well over $100 billion raised by existing and new hedge funds. In addition, the total number of hedge funds grew in 2006. Yet, despite the fact that there were more hedge funds and a record level of capital in 2006 than ever before, hedge fund returns in 2006 were some of the best in years. It appears that the hedge fund industry may have quite a bit of capacity remaining.

MYTH #14: HEDGE FUNDS ARE NOT REGULATED

Hedge funds often are said to be unregulated or lightly regulated. The perception is that hedge funds are cowboys taking advantage of the wild-west financial markets without a sheriff in town.

EVIDENCE:

Hedge funds are required to comply with every rule, regulation, and law that affects virtually all investors in the public and private financial markets. Further, hedge funds are subjected to a variety of investor-related laws and regulations that impact who can qualify to invest with hedge funds. Additionally, there are a variety of state and federal laws that can require some managers to register as investment advisors—thereby invoking a series of additional regulations and requirements, including periodic regulatory examinations and filings. When the topic of regulation arises in the hedge fund industry, managers are far from being cavalier about the existing and continually proposed regulatory requirements.

MYTH #15: HEDGE FUNDS ARE FAST TRADERS

Hedge funds are believed to be active traders, constantly slinging stocks in and out of their portfolios.

EVIDENCE:

Turnover from hedge funds appears to be relatively similar to the turnover within mutual funds. A report by Goldman Sachs, titled "Hedge Fund Trend Monitor—1Q2007 Analysis," assessed turnover across a large set of hedge funds. According to the report, "Turnover has remained low for 5 years. We measure hedge fund turnover as the percentage of stocks that remain within a portfolio from one quarter to the next regardless of position size. On average, hedge funds turn over 35% of their holdings each quarter. 'Core' positions, measured as the top quartile of stocks ranked by position size within the portfolio, have a 22% turnover rate."

There clearly are some hedge funds that rapidly trade stocks, yet the turnover rates for most hedge funds appear to reflect a more stable portfolio approach. If a hedge fund only retains 65% of positions from quarter to quarter, then the portfolio would have 27%

of the same names in the portfolio from year to year…a 77% turnover rate for names. On a dollar-weighted basis, hedge fund turnover would be closer to 65% considering that larger core positions have turnover of only 22% quarterly or about 50% annually.

From an Investment Company Institute (ICI) report, mutual fund turnover averages 120% per year. ICI identifies, however, that there is a smaller group of higher-turnover mutual funds that skew the simple average. As a result, excluding the high-turnover mutual funds, portfolio turnover for mutual funds averages 60% annually. Although the Goldman Sachs report does not provide the details, a relatively smaller group of high-turnover hedge funds could be distorting the averages in the Goldman Sachs report also.

In summary, hedge fund portfolio turnover annually according to Goldman Sachs appears to be near 50% to 70%. Mutual fund portfolio turnover according to ICI appears to be 60% to 120%. Could it be that mutual funds have higher turnover in their portfolios than hedge funds?

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CONCLUSIONS

In general, hedge funds represent a style of investment—the absolute return approach. Absolute return investors have different objectives than the buy-and-hold, track-the-market investor seeking relative returns. Absolute return investors measure success in term of consistent profits and they measure risk in terms of losses (which hedge funds work hard to avoid). Under existing securities laws, there are significant advantages to employing the absolute return approach through private investment vehicles. As a result, most hedge funds are private. Further, existing laws and regulations preclude private funds from discussing publicly their activities. Therefore, not necessarily by their choice, hedge funds appear exclusive and elusive. When under-informed spectators view an unfamiliar process that operates with different principles and objectives, a natural result is myth and misunderstanding. The solution lies in enhanced collaboration between academia, industry, and the press.

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