Hedge Funds Aren't Beautiful

by William Jahnke

With slumping long-term return expectations for stock and bond markets, the allure of high returns reported for hedge funds is drawing the attention of financial planners who need to pump up portfolio returns to meet client objectives. Hedge funds, which have been promoted as appropriate investments for sophisticated high net worth investors for several decades, are now being promoted as having an important role in a diversified portfolio for investors of moderate wealth. Advocates for investing in hedge funds point to their superior absolute returns, superior risk-adjusted returns and low correlation with stock market returns. But the claim that investing in hedge funds will increase portfolio return and lower portfolio volatility for investors is an illusion based on bad performance data, faulty analysis and wishful thinking about future prospects.

In terms of performance data, reported hedge fund performance is upward biased, incomplete and inconsistent across database vendors. Historical returns must be viewed skeptically because most vendors of performance information merely provide a conduit for data supplied by fund managers without independent verification. The impressive performance numbers reported for various hedge fund strategies create a distorted impression because participation in performance databases is elective, and one can safely assume that hedge fund managers opt to participate only after a period of good past performance. Hedge funds with poor performance are missing from performance databases, resulting in an overstatement of returns for the category as a whole.

Another source of overstatement in returns is produced by survivorship bias. Database vendors supply cumulative returns for funds that are still reporting at the time of their compilation. Since the reason for ceasing to report performance is usually due to poor performance, cumulative returns for the industry are further upwardly biased. With 10 to 20 percent of hedge funds failing each year, the upward bias in reported cumulative returns is large, numbering several percentage points annually.

Leaving aside distorted perceptions caused by upward bias in returns databases, it is unlikely that the performance of hedge funds as a whole will be repeated in the future. It is further unlikely that the industry’s performance in the future will be shared equitably with investors now entering the game. Even in the best circumstances of the past, the best opportunities are limited to a subset of hedge funds. Many hedge funds are closed to new investments and some successful hedge funds are returning capital to their outside investors. The rapid growth in the number of hedge funds raises questions regarding the quality of the talent entering the business. Less seasoned portfolio managers generally manage hedge funds being marketed to investors.

Stacked Against the Investor

The very premise that hedge funds taken together can produce attractive returns net of cost, relative to the stock market as a whole, is highly suspect. Stock market returns are generated by the pricing of systematic risk factors, while hedge funds depend on the selection skill of managers to produce performance. The evidence to date in the mutual fund industry and institutional fund management is that selection skill is scarce and there is little evidence of statistical persistence of good investment performance. While markets are not efficient, they have proved difficult to beat, especially for investors facing high costs. Given sizable brokerage and securities borrowing costs borne by hedge funds, short- and long-term capital gains taxes borne by investors, management fees generally running 1 percent plus 20 percent of profits, and funds of funds charging an additional “1 and 10,” the game is stacked against the investor.

The rapid growth of hedge funds being touted raises the questions of how all the dollars being committed can be productively invested. Many of the strategies that hedge funds employ are subject to scale limitations. Hedge funds compete for a limited supply of stocks to sell short. Spread relationships that hedge funds seek to exploit are subject to being arbitraged out of existence. Historical relationships that hedge fund strategies seek to exploit inexplicably stop working. Questionable practices, such as market-timing mutual fund closing prices, get shut down because of legal concerns and adverse publicity. Given the future investment environment for hedge fund investing and the high cost of hedge fund investments, hedge funds are unlikely to cumulatively outperform the stock market in the coming year.

While the prospective returns offered by the hedge fund industry arguably do not look attractive, some would argue that a skilled financial planner can sort out winning hedge funds from the pack. This is not a good bet. Financial planning skill does not necessarily translate into skill at choosing investment managers. Given hedge funds’ lack of transparency and their performance inconsistency, there is little upon which a financial planner can base a prediction of future performance. The problem of picking winners is further complicated because the choice of hedge funds available to the financial planner is typically limited. These limitations can’t be sidestepped by investing in a fund of funds. The evidence to date is that the fund of fund approach has failed, on average, to perform as well as the average hedge fund, largely due to the added costs.

While the promise of high absolute hedge fund returns is the primary attraction of hedge funds, the case is also made that hedge funds offer an added advantage: a higher return-to-risk ratio than stocks, bonds and cash as measured by the Sharpe ratio (the average return divided by the standard deviation). Attractive Sharpe ratios for hedge funds are overstated not only because of returns being overstated, but also because of understatement of their standard deviation. Hedge fund managers exercise wide discretion in pricing nonmarketable securities and illiquid assets, which results in a smoothing of returns and a lower-calculated-than-actual standard deviation. The survivorship bias in performance databases also results in an understatement of the reported standard deviation.

Other Measures of Risk

Those making the case for hedge funds based on their Sharpe ratio also fail to consider that there are other measures of risk that are of concern to investors. Hedge fund returns are exposed to an elevated probability of major loss, exhibiting significant negative skewness (a long left-hand tail) and excess kurtosis (a high probability of extreme outcomes). This means that standard deviation is an incomplete measure of risk, and the Sharpe ratio an inadequate description of the risk/reward relationship for hedge funds, which should be of concern to investors.

One source of skewness and kurtosis in the distribution of hedge fund returns is that a number of hedge fund strategies are based on providing credit and liquidity to the market, often accompanied by high levels of leverage. Credit and liquidity risks subject hedge funds to occasional blow-ups when credit spreads widen and market liquidity dries up. Another source of abnormality in the distribution of hedge fund returns is asymmetry in incentives and rewards: hedge fund managers take a share of the performance above the benchmark, but do not take their share of poor performance. This can encourage hedge funds to take excessive risk that can lead to the phenomenon known as “gambler’s ruin”—betting the farm trying to recoup major losses.

According to proponents, a further advantage of investing in hedge funds is that their inclusion in a portfolio along with traditional stock, bond and cash investments will significantly improve a portfolio’s mean-variance characteristics. The *piece de resistance* in hedge fund marketing is the chart that shows an upward shift in the efficient frontier that occurs when hedge funds are included in a portfolio along with stocks, bonds and cash. The notion that investors should base investment decisions on the calculation of an efficient frontier is wrong. The financial concerns for most investors cannot be adequately addressed by mean-variance analysis of investment returns and an assessment of an investor’s aversion to portfolio volatility. The investment problem that most investors face is determining an appropriate investment solution to fund post-retirement consumption. The mean-variance characteristics of investment solutions on the efficient frontier do not naturally translate to the mean-variance characteristics of funding a multi-period, post-retirement consumption objective.

Those promoting hedge funds based on their positive impact on portfolio mean-variance characteristics are given to overstating the expected returns, understating the standard deviation, and ignoring the fact that hedge fund returns are not normally distributed and serially independent. Not only do hedge fund returns exhibit negative skewness, excess kurtosis, and serial correlation, but most hedge fund strategies are highly correlated with the stock market when the stock market is performing badly. This is not because the majority of hedge funds strategies have net long exposures to the stock market, but because a significant decline in the stock market is often associated with a widening of credit spreads, an increase in market volatility, and a decline in market liquidity. Hedge funds are highly sensitive to these factors. Because of the high correlation of hedge fund returns with a poorly performing stock market, hedge funds will likely fail investors at the worst time and the mean-variance framework fails to pick up this fact. The high degree of abnormality and serial dependence in hedge fund returns is another reason that the mean-variance framework is not appropriate in assessing the suitability of investing in hedge funds.

Hedge funds are a great product for the hedge fund industry and its support apparatchik (brokers, consultants and lawyers), but are likely, on average, to produce a negative return contribution relative to a benchmark consisting of stocks, bonds and cash. In the context of funding the real financial objectives for retail investors, hedge funds are not beautiful.

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