April 2015

What's Trending Now?
Hedge Funds: BIG Promises, Little Return

Over the last two decades, hedge fund investing has been heralded as a way to avoid stock market volatility. Any investment strategy that delivers on such promises cannot be ignored! Now the task is to find such an investment. It will not be easy, since the number of hedge funds has soared in recent years. At the end of 2014, there were more than 8,000 hedge funds managing a cumulative $2.8 trillion, a threefold increase in assets over a decade, according to HFR Inc., an industry researcher.[1]

Hedge fund managers pride themselves on their ability to spot trends and extrapolate returns from taking bets on different investments. The investments within hedge funds are not constrained by the normal expectations of money managers or the marketplace. In spite of the popularity of hedge funds, they are closing in record numbers (Figure 1).

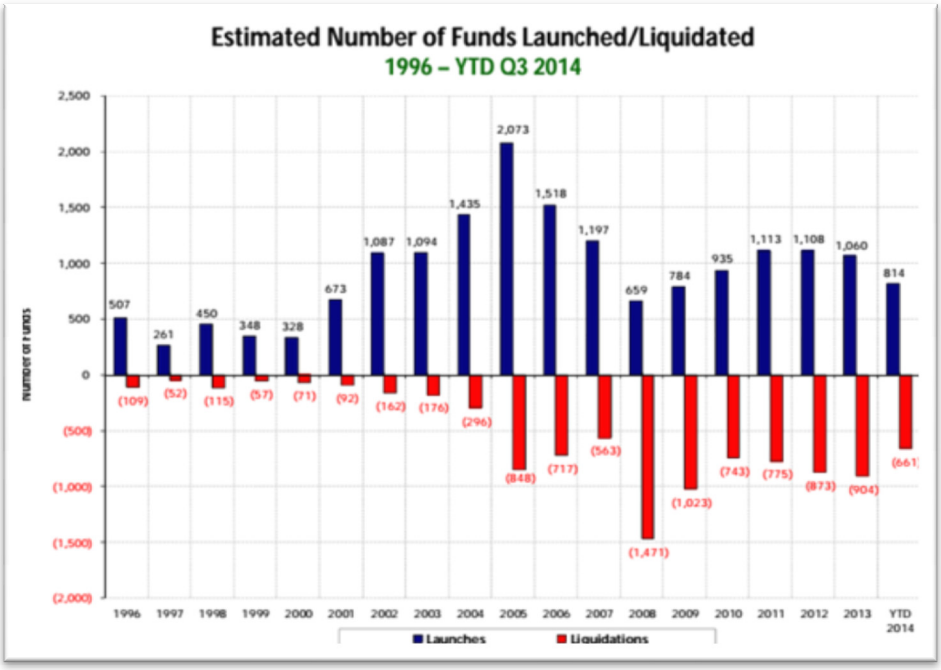

Figure 1: Number of hedge funds launched/liquidated
Source: Hedge Fund Research

In fact, 461 funds closed in the first half of 2014. Recently, funds have struggled to bring in new clients and/or have become casualties of the oil price drop. This is the highest number of closings since 2009.

[1] Full article at http://on.wsj.com/1FN6Lfe

Because of recent underperformance, many new and existing managers are rebranding their offerings. Instead of labeling themselves as hedge funds, which carry a negative connotation, they utilize terms such as "alternative asset managers" or "investment holding company" or "private partnerships." In fact, only 1,176 firms use the term hedge fund in the "about us" section of their SEC investment adviser registration, according to data from research firm Convergence Inc.[1]

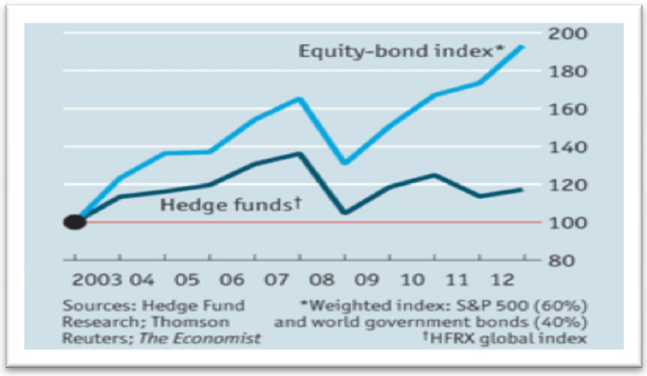

Figure 2: Return comparison between a balanced index and hedge funds.

As is the case with most trends, the primary drawback to these investments is their unacceptable performance numbers (Figure 2).

With the risk that many hedge fund managers take, investors expect their performance to beat or at least match that of the market. In the current cycle, the passive market index has been a strong performer. Managers who place strategic bets or try unconventional methods of mitigating risk have lagged the popular indices. Many times, fund wagers turn out to be home runs or strike outs. A middle ground is hard to find.

The fees charged by hedge funds also add to lagging performance. These fees are not only high, but often layered, as funds choose other managers to sub-advise assets. The average fees charged are 2% of assets, plus a 20% performance fee. When this level of fees is paid year in and year out, the negative compounding effect to investor returns is substantively harmful.

Hedge Fund Drawbacks

- **Inconsistent Performance**
- **High Fees**
- **Illiquidity**
- **Lack of Transparency**

A third problem with hedge funds, or alternative asset strategies, is that they get to choose whether or not they want to be registered with the SEC. Regulators give hedge funds this choice. The registered funds provide more information to investors, but the unregistered ones opt for less disclosure and investors must blindly trust the past performance of the fund to increase their wealth.

Adding to the angst investors feel about hedge funds is their illiquidity. Often orders to liquidate must be placed months ahead of time, with no knowledge of what the liquidating value is going to be in the future. There are limits on how much you can cash out at one time as well.

So, what option might be better than the popular hedge funds? Warren Buffett has always discouraged investors from being involved in hedge funds because of the exorbitant fees they charge. At the 2006 Berkshire Hathaway annual meeting, Buffett challenged hedge fund managers to a battle of returns. His premise was that low-cost investing would win out over high-cost investing in the long run. Protégé finally took him up on the challenge. In fact, he went so far as to make a "Million Dollar Bet."

> **Prediction:** Over a 10-year period commencing on Jan. 1, 2008, and ending on Dec. 31, 2017, the S&P 500 will outperform a portfolio of funds of hedge funds, when performance is measured on a basis net of fees, costs, and expenses.[2]

Buffett agreed with this prediction, while Protégé Partners disagreed. Figure 3 shows the success of each strategy. The hedge funds have two years to make up their current shortfall!

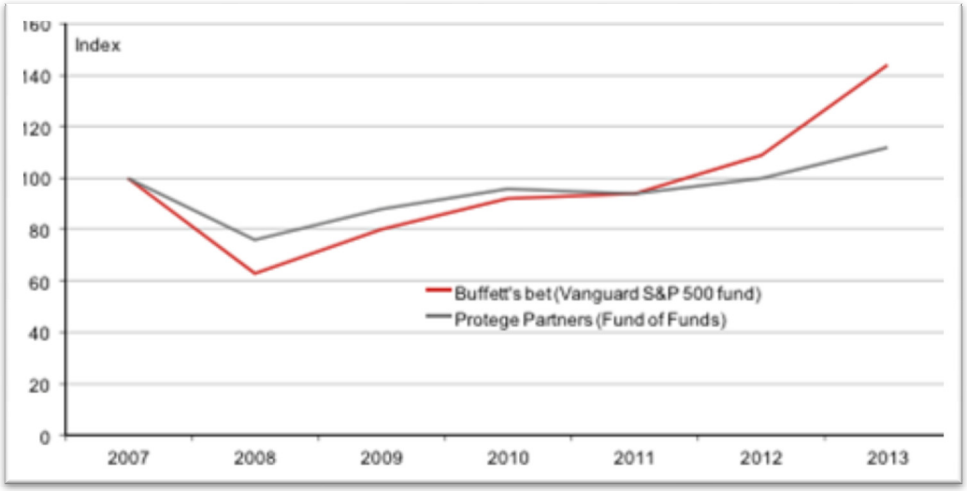

Figure 3: Buffett's bet vs. Protégé Partners' hedge fund
Source: Bloomberg New, Fortune.com, Nomura

Of the 8,000 choices, the best-run hedge funds are those that are low volatility, absolute return strategies. These managers endeavor to match the risk-free rate of return (Treasuries) utilizing non-traditional assets. If proven over time, these strategies provide the uncorrelated returns that are part of a well-diversified portfolio. Instead of trend investing, Summa strives to pick and choose strategies that will dampen volatility while enhancing return. Carefully chosen alternative investments can provide us with such an opportunity.

- Rachel Wakefield, CFA

[2] Details at http://www.longbets.org/