Why Hedge Funds Destroy Investor Wealth

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If all the money that's ever been invested in hedge funds had been put in Treasury bills instead, the results would have been twice as good. So claims Simon Lack – a former JPMorgan executive whose job was once to help steer billions into hedge funds – in his recent book, [The Hedge Fund Mirage: The Illusion of Big Money and Why It's Too Good to Be True]().

You'd think hedge fund advocates would immediately pounce on this and refute it; but it's irrefutable.

Even Andrew Baker, the chief executive of the hedge fund lobbying organization, the Alternative Investment Management Association (AIMA), could come up with only a lame rebuttal – arguing, essentially, without solid evidence, that the same analysis would show that investments in other asset classes do just as badly, because similarly dumb, trend-following investors invest in them just as they invest in hedge funds.

Why, then, will so few investors actually believe Lack's conclusion, and act on it? And why do wealthy, supposedly savvy individual investors keep wasting their money on hedge funds, and – worse still – why do institutional investors like public pension funds, abetted by irresponsible consultants, continue squandering the middle class retirement assets that they oversee to make hedge fund managers phenomenally rich?

Perhaps part of the answer lies in this quote from Lack's book:

> When I first moved to the United States in 1982 I noticed a subtle difference in attitudes toward wealth between Europeans and Americans. In Britain, an accountant/doctor/lawyer parking his S-Class Mercedes would cause onlookers to comment disapprovingly at how he must be ripping off his clients in order to afford such a car. In America, the same scene would cause most to conclude that the individual must be successful and therefore worth doing business with! Although hedge funds and their investors are global, the American attitude toward wealth, to staying close to winners, has prevailed, as with so many American values.

When I interviewed Mr. Lack before writing this review, and remarked upon this statement, his reaction was interesting. A Briton transplanted to the US, he found Americans' upbeat outlook rather refreshing – he was a little tired, I gathered, of the British suspicion of wealth.

It's fine to admire those who accumulate great wealth and not be suspicious of them; but, be that as it may, to try to stay close to them at the cost of your own wealth, and to the detriment of those who have entrusted their wealth to you, is taking things too far.

The battle over hedge fund performance measurement

Lack's book disposes of the belief that hedge funds have achieved superior performance, by explaining how that performance should be measured. Before taking up his approach, let me first briefly summarize some of the more blatant errors in hedge fund performance reporting that others have previously explored.

Studies of overall hedge fund performance have long yielded wildly divergent results. Unfortunately, the financial media uncritically pass on to the public the simple averages of reported hedge fund performance assessments that are spun out by database providers, without noting the deeply flawed nature of those figures.

An often-cited study is "The ABCs of Hedge Funds" by Roger G. Ibbotson, Peng Chen, and Kevin X. Zhu. In it, the authors find that when biases inherent in the hedge fund databases are corrected, average performance during the period 1995-2009 falls by more than 7% annually. But they consider only survivorship bias and backfill bias. (Survivorship bias stems from the fact that performance data for funds that were later closed are not among the database figures. Backfill bias stems from the fact that funds that try out their strategy for a while before deciding that their numbers are good enough to go live backfill their trial performance into the database once they do.)

Ibbotson, Chen, and Zhu point out, however, in an endnote, that they did not account for every source of bias. "Another bias often cited in the hedge fund literature is selection bias, which refers to not having a representative sample of funds," they observe. "Back-end bias can also be a problem if hedge funds stop reporting after a bad month. In our study, we concentrated on survivorship bias and backfill bias."

Hedge funds demonstrably do stop reporting after a bad month. Long-Term Capital Management's sudden decline in 1998 did not appear in the databases, and, as Lack himself notes with respect to the Bernie Madoff fraud, "Madoff represented more than 3 percent of the entire hedge fund industry in 2008 … Madoff typically isn't included in the returns for that year reported by most databases – the year was already quite bad enough." (Madoff's fund was, strictly speaking, not a hedge fund, but the point is relevant nonetheless.)

Selection bias is difficult to assess because all the major databases, of necessity, allow hedge funds to report their performance numbers only if they want to. This means that the average performance numbers reflect only averages of self-selected, willing reporters of their own performance. However, in an earlier *Advisor Perspectives* article, which covers all the biases in hedge fund databases, I reported the findings of another study ("Out of the dark: Hedge fund reporting biases and commercial databases," by Adam L. Aiken of Quinnipiac University and others), which used a data source untainted by self-selection (funds-of-funds that register with the SEC and hence must report the performance of all the hedge funds they invest in) and found that self-selection bias alone slices 4% off of hedge funds' average performance. When combined with the biases already mentioned, that's enough to wipe out any trace of alpha.

Nevertheless, star-struck chroniclers of the hedge fund industry, such as Sebastian Mallaby, cite an isolated figure in the Ibbotson, Cheng, and Zhu article. While Ibbotson, Cheng, and Zhu find that hedge funds actually underperformed the S&P index over the period 1995-2009 on a risk-unadjusted basis, risk-adjusted they achieved on average an alpha of 3%.

But even this supposed alpha, in the first place, does not account for the 4% correction for self-selection bias found by Aiken et al. In the second place, many hedge fund investments are illiquid and not easily priced; this leads not only to some shading of prices (which are assigned by the reporting fund managers themselves) in the fund's favor, but also to smoothing that artificially lowers risk measures like volatility and beta, resulting in spuriously high risk-adjusted returns.

Simon Lack's hedge fund performance observation

And yet Mr. Lack's assertion about the relative merits of hedge funds and Treasury bills is not even based on any of these database flaws. Instead, it is a result of the fact that most hedge fund investors put their money in hedge funds only after the funds' performance – or at least their apparent performance – was good; but funds' performance often becomes awful after they are bloated with that new money. That alone is enough to support Lack's statement that the average dollar invested in hedge funds underperformed what it would have earned in US Treasury bills.

This was not always so. Lack writes, "In the first three years of the new millennium, the compounded return on the S&P 500 was -37 percent, while hedge funds (as measured by HFR Global Hedge Fund Index [HFRX]) generated a compound return of +30 percent."

We need to adjust the HFRX number way downward to account for all those biases, but it still seems justified to say of hedge funds, as Lack does, that "from 2000 to 2002, they genuinely added value."

In the years 2000-2002, however, the total dollar amount invested in hedge funds, according to BarclayHedge, averaged only about $300 billion. By 2007-2008, the amount invested was more than six times that, just in time for a negative 23% return in the year 2008. Hence, much more money was invested in hedge funds when they performed poorly than when they performed well.

This way of looking at it – calculating the return that the average dollar invested in hedge funds has realized historically – is called an asset-weighted return. It is calculated differently from the rates of return that most hedge fund performance studies report. Those studies use time-weighted returns, which, roughly speaking, assume that the same amount is invested in every period. Hence, in those studies, the 2007-2008 down period counts the same as the 2000-2002 up period, not six times as much, as it does in Lack's calculations.

That is why Lack's critic, AIMA chief executive Andrew Baker, says in his article, "asset-weighted figures tell us more about investor behavior than manager performance." What he means is that if investors choose to plunk six times as much money into hedge funds just before a year when hedge funds happen to perform abysmally, that's their fault and not the managers'.

Lack argues that the problem is that hedge funds perform well only when they are small; when they grow big, they can't perform as well. (He doesn't quantify how small is advisable.) Hedge funds performed better ten years ago because, according to Lack, "Funds were smaller and, as a result, many strategies were available that simply don't scale with the size of today's industry." As for the hedge fund investors, "Small hedge funds got them interested, but large funds are where they go" – because the ones that have grown large are the ones that are better-known for their past performance. Managers abet this trend. Even though they are partly compensated in proportion to their performance, fund managers can still maximize profits by accepting more and more assets and performing less well – and they do.

If it is true that small hedge funds perform better, but most of investors' funds are in the large ones, then the standard average hedge fund performance measures are truly unrepresentative of the performance of the average dollar. Those measures usually equally weight hedge funds – thus giving equal weight to the small ones and the large ones, not greater weight to the large ones – and they weigh the earlier years of hedge fund performance equally with the later years, giving the same weights to the period when the total amount invested in hedge funds was small and the period when the amount was much larger.

I do have some doubts about Lack's thesis about small hedge funds. Certainly, the ones that do best are likely to be small – their mission is to find an inefficient market niche in which unusual returns can be realized as the market becomes more efficient, and such strategies can only scale up so much. But there are certainly many small funds that never get off the ground and we never hear about; I have myself been informed about fledgling funds that I knew for sure were applying a senseless strategy. So just because a fund is small is not reason enough to invest in it. Smallness is not a sufficient condition for a hedge fund to execute a highly successful strategy, though it may be a necessary one.

Mr. Lack's other enlightening insights

Because of Mr. Lack's once-central position in the hedge fund industry, he is able to shed light on some interesting questions. There are too many to relay them all here, but I will highlight one – the central position of large banks like JPMorgan and why they are able to make so much money.

Mr. Lack's job at JPMorgan, during the period he recounts in the book, was to select promising hedge fund managers for JPMorgan to invest in. The process is called "seeding" a hedge fund – if a hedge fund manager wants to start a fund, or accumulate more assets for a small fund that is already launched, the manager can go to JPMorgan (and other seed-funders) to try to get one of them to seed the fund with a substantial investment. In the case of Lack's operation, the seed funding was $25 million, which it would invest to help a fund get started with a pool of assets. In return, JPMorgan would receive 25% of the fees levied by the fund. If the fund was successful, JPMorgan's share of the fees often dwarfed whatever it earned in investment returns on its $25 million seed investment.

Meanwhile, a large bank that seeds a fund can introduce the fund to its clients and prospects – thus lending the fund an imprimatur that enables it to attract investors much better than it could without the backing of the bank's brand.

This introduction process that some banks practiced, known in the industry as "cap intro," has to be handled with great discretion. Lack says in his book: "The regulations around hedge fund marketing and the legal liability for the banks are both so onerous that everybody involved signs forms agreeing that no actual marketing is going on, that nobody's recommending anything, and that hedge funds are very risky."

As long as it abided by the legal restrictions on hedge fund marketing, a bank can leverage its brand to sell hedge funds that it has seeded to its clients, then reap enormous fees in return. (Few are aware that Harvard's endowment fund, managed by Harvard Management Company, also benefits from similar seed-funding practices.)

It should be readily obvious what a conflict of interest this represents, as well as what enormous profits.

Then what should investors do?

Lack believes that, although to invest in hedge funds you need to be an above-average selector of managers, consistently picking good managers is extremely difficult – not least because there is so little return persistence. He says he can't really offer any "formula" for that, though he says smaller funds are generally better, and investors should be willing to invest in less-common strategies. He also believes diversification among hedge funds does not make sense, because it dilutes results.

"Selecting simply the best 2-3 funds one can find may well be the best approach," Lack told me when we spoke. "In response to the obvious charge that this is far too concentrated and therefore foolhardy, the response is that the overall hedge fund portfolio must be correspondingly smaller. Rather than 10% of an institution's portfolio in 20 hedge funds, they should be thinking in terms of 2% in just two or three. This fits in with the notion that the industry is just too big to generate the returns today's investors expect."

Lack's account is of a hedge fund industry containing many extraordinarily smart people. His indictment is not of the intelligence of the participants, or their ethics, just of the results. "It's tempting to condemn hedge fund managers as representing the worst excesses of Wall Street," wrote Lack in his book. "Few would argue that the efficient allocation of capital requires the creation of today's hedge fund fortunes in order to be carried out effectively. *But that philosophical question is for others.* Investors are all voluntary clients. Hedge funds are meeting a clear demand from the market."

The emphasis is my own, not Lack's. I would argue that, quite the contrary, those who meet the market's demand have a responsibility to debate that very question, and to inform their clients if what they are demanding is not in their interest. Consultants who are supposed to have their clients' interests at heart too often tell the clients what they expect to hear – that they should invest in hedge funds, for example – even though they may know that their advice is unlikely to benefit the client. But, as Lack writes, "There's little demand for consultants or advisers who profess skepticism, and no doubt those individuals who do simply make their careers elsewhere."

Perhaps the industry needs to reform itself *en masse* and agree to start telling clients the truth.

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