"The Lost Decade": Hedge Funds - Are you getting your money's worth?

"The way we see it, the only loss that was incurred this past decade was the excess fees paid to "hedge fund" operators who did not deliver the promised results."

Scott Santin, Principal

At the beginning of the past decade investors were faced with a deteriorating equity market (bursting of the tech bubble), and large defaults in the corporate bond market (Enron & Worldcom). Investors began to question traditional portfolio strategies that were not holding up well in a bear market. They looked to hedge funds as the answer for higher returns.

For nearly 75 years a small community of active investors managed private partnerships for wealthy individuals and select institutional accounts. "Hedge funds", as they were called, are partnerships designed to provide maximum investment flexibility for the managers, while they agree to work for a share of the partnership profits. The basis of the value proposition offered by the hedge fund manager is that the typical institutional manager was constrained by an industry imposed "style box" or benchmark mandates. By eliminating the constraints placed on a manager, allowing the manager to invest in their best ideas, the likelihood for better performance was improved. Additionally, the hedge fund manager would be allowed to utilize additional portfolio management tools such as leverage (borrowed money), short sales, concentrated positions and many other tactics. All of this is draped in the private partnership structure, such that the hedge fund manager provides limited transparency in terms of individual holdings. In concept, this is an ideal arrangement for a successful manager and profitable for an investor.

As with most sound ideas within the investment community, this was turned into a "product" that was mass marketed by the financial services industry. A cottage industry, hedge fund-of-funds ("HFOF") managers, was created to help investors select a portfolio of hedge funds. As investors became intrigued with the mystique of hedge funds, HFOF's began to raise institutional size dollar amounts without significant changes to their overall pricing structure to reflect greater assets under management. How did the HFOF index perform over the last decade? For the financial services industry (hedge funds, funds-of-funds, prime brokers, etc.) they performed extremely well. For the institutional investors that jumped on the bandwagon they had mixed results at best. It seems a significant amount of the "excess" performance that was promised was actually consumed by the higher fee structure of the hedge fund complex.

Diversified Portfolio Returns Trump Hedge Fund Returns

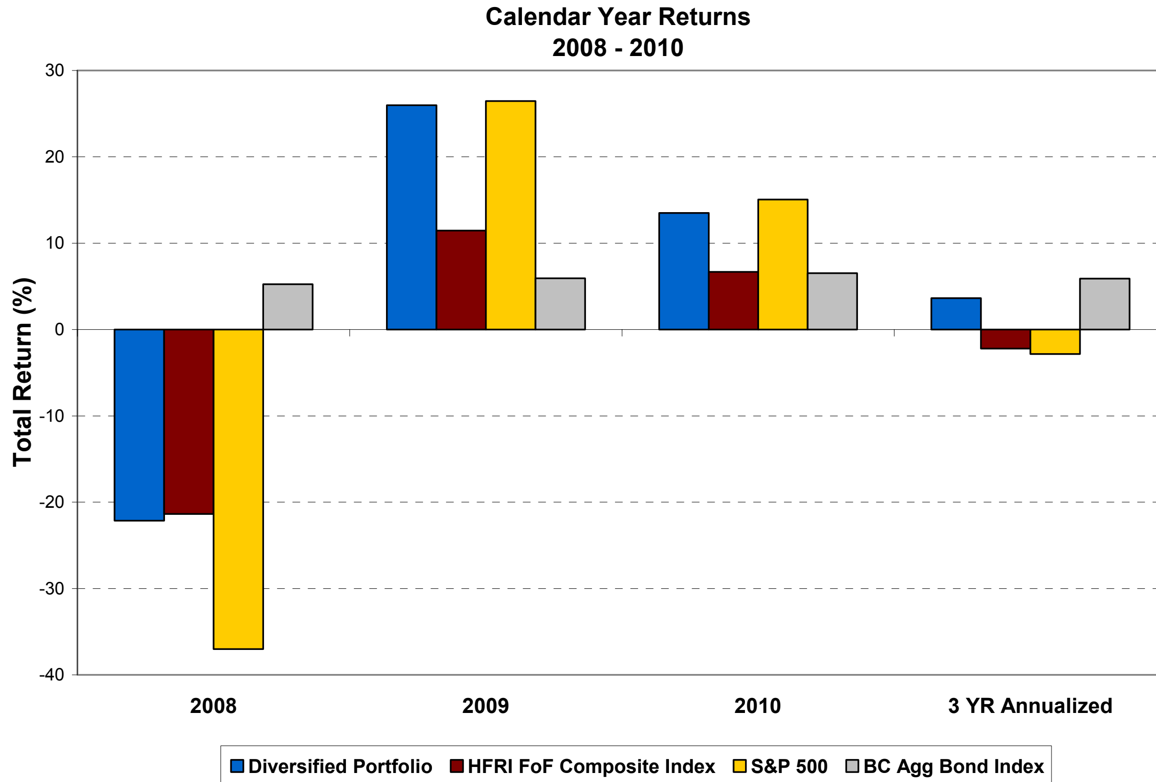
	Total Ret 1 Yr	Total Ret Annlzd 3 Yr	Total Ret Annlzd 5 Yr	Total Ret Annlzd 10 Yr
Diversified Portfolio*	**13.50**	**3.64**	**6.07**	**5.92**
HFRI Fund of Funds Composite Index**	**6.68**	**-2.21**	**2.62**	**4.24**
S&P 500 TR	15.06	-2.86	2.29	1.41
Russell 2000 TR USD	26.85	2.22	4.47	6.33
MSCI EAFE NR USD	7.75	-7.02	2.46	3.50
BarCap US Agg Bond TR USD	6.54	5.90	5.80	5.84

All returns data as of 12/31/10

***Diversified Portolio**: 30% S&P 500, 15% MSCI EAFE, 10% Russell 2000, 30% BarCap US Agg, 10% BarCap US High Yield, 5% BofAML Convertible All US IG index
****HFRI Fund of Funds Composite Index,** published by Hedge Fund Research, Inc., includes over 650 equal-weighted domestic and offshore constituent Fund-of-Funds that have at least $50 Million under management or have been actively trading for at least twelve (12) months; all returns net of fees in USD.

As you can see in chart above, the traditional balanced portfolio has generated better returns for the time periods illustrated. The so called lost decade, was not "lost", when viewed in terms of a balanced portfolio, with total annualized return of 5.92% per year. The index of hedge fund of funds generated an annualized ten-year return of 4.24%. What happened to the supposed excess performance? We suspect a good portion went to fees, with internal management expenses of a HFOF that can approach 400-500 basis points (4%-5%) a year. The fee for an indexed, traditional portfolio is approximately 15 basis points. In fairness, one of the selling features of the hedge fund community was the proposition of lower risk. In fact over the past 10 years, the volatility of the HFOF index as measured by standard deviation was approximately 5.4 per year, while the balanced index was 10.3. To most people, standard deviation numbers do not mean much. So, let's look at how the HFOF performed over the past three years during the market meltdown and subsequent rebound.

As you can see on the chart below, the results do not favor the HFOF index versus the traditional model. The performance of the two strategies was nearly identical in 2008, with the HFOF index not participating as much in the recovery in 2009 & 2010.



Are investors getting their money's worth from hedge funds? Based on total return data it does not appear that way. In fact, it appears on average that investors are paying higher fees, and accepting a lack of transparency and illiquidity, that has not paid significant dividends. This is no small matter seeing that nearly $1 trillion has been raised over the past decade for the HFOF complex. The way we see it, the only loss that was incurred this past decade was the excess fees paid to "hedge fund" operators who did not deliver the promised results.

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