

# Through the Looking Glass into Public Pension Accounting

The Economist has an interesting piece in Buttonwood this week about how U.S. public pensions do their accounting. Basically, they discount their liabilities using the expected return on their assets. It results in some curious outcomes. For example, since holding cash typically drags down return expectations, if a pension fund simply gave away its cash (or burned it as The Economist posits) by raising its expected return on assets (no longer burdened by the cash drag) they would reduce the value of their liabilities. Their funded status might appear better even with fewer assets.

This perverse accounting treatment got me thinking about why pension funds continue to invest in hedge funds seeking 8% returns, even though it's been many years since hedge funds made 8% and it's not likely they will in the near future either. Certainly not with over \$2 trillion competing for opportunities. Based on the accounting, including an asset with an 8% return target helps reduce the value of their liabilities even if the 8% return expectation is an unreasonable one. So the motivation for a pension fund trustee could be to include hedge funds because of their helpful impact on the discount rate on their liabilities even while their continued failure to achieve that target doesn't cause huge immediate problems. Far better than lowering the discount rate to a more appropriate level and revealing the true shortfall with all its political consequences.

This is how the \$3 trillion underfunded position is growing. Sometimes accountants can cause a lot of damage.

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# **The Hedge Fund Con Explained**

My thanks to Ben Chu of The Independent for articulating the case against hedge funds so clearly.

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# **A Hedge Fund Journalist with Integrity**

My friend Josh Friedlander, Editor at Absolute Return, has written a very good essay in the Hedge Fund Intelligence Global Review 2013. Unlike most journalists covering the sector who offer uncritical praise of their subjects, Josh asks some very pertinent questions about the future of the hedge fund industry. He's asking the right questions. Hedge fund investors would benefit from more critical thinking like this.

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# **Direct or indirect, the hedge fund industry can't deliver**

Here's a piece AR Magazine invited me to write.

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# Skating Where the Puck Was

This is the title of a “mini-book” by William Bernstein. I just came across a review of it by Larry Swedroe. I haven’t yet read Mr. Bernstein’s book (I just ordered it this morning) but Swedroe’s review caught my attention. It looks as if a three factor analysis of hedge fund returns has arrived at the same conclusion I did in my book – that hedge funds used to be great, that early investors did well, and that the industry today is overcapitalized.

David Hsieh, Professor of Finance at Duke’s Fuqua School of Business suggested that alpha is finite, and that’s why today’s hedge fund investors will continue to be disappointed. Makes perfect sense to me. So now we have some real academics weighing in on the debate, as opposed to the pseudo-variety hired and paid for by AIMA in London. Mediocre returns delivered at great expense continue, providing additional support for the critics.

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# More Debate on Hedge Funds

My thanks to Joshua Rogers, a contributor to Forbes, for wading in to the debate on hedge funds. You can read his post [here](#), and scroll down to see my comment in response.

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# Debating Hedge Funds on CNBC

Here's a brief spot I did earlier today.

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## Wall Street Journal Best Business Books of 2012

I had inexplicably missed this on Dec 14th, but The Hedge Fund Mirage made it on to this list.

[Click Here](#) for the article.

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## Hedge Funds Limp To The Close of a Lousy Decade

The Economist, without doubt my favorite weekly magazine (or newspaper as they refer to themselves) has brought its clear thinking and analytical skills to hedge fund returns. As usual they've provided a balanced perspective that includes important points. They note the poor decade hedge funds have had relative to a simple 60/40 stocks/bonds portfolio. They suggest that most likely hedge fund fees have exceeded the returns earned by investors (in fact fees have completely swamped overall returns for investors as I've noted in my book and on this blog). "The average hedge fund is a lousy bet" they note, and this is true. There are great hedge funds and happy clients, but this is not the norm.

The vast majority of hedge fund professionals have sensibly stayed away from this debate. Defending a diversified portfolio of hedge funds as vital to an institutional portfolio requires nimble debating skills given the absence of factual data in support. And I continue to find many open minds among hedge fund allocators and investors. The industry has drawn people with highly developed commercial skills and most recognize well the need to transfer more of the investment skill that does exist to their clients with less drag from high fees and mediocrity. I have no doubt that business models will evolve and improve in response to the sorry decade of results. Hedge funds will not disappear. The many problems with the existing structure will eventually be solved to the benefit of the clients.

However, Tom Schneeweis, a Finance professor at UMass Amherst, has offered some criticisms of my book, including describing it recently as, "...baby hedge fund analysis 101 at best." I imagine among the Ivory Tower crowd this must represent quite an insult. Further demonstrating Mr. Schneeweis isn't overly reliant on hedge fund returns to provide a comfortable retirement, he asserts that investors should be indifferent to fees. He says that, "...if an investor is receiving a positive benefit from owning a product, the net profit to the creators of the product may be regarded of secondary concern." That may pass for accepted wisdom in the classroom, but out in the real world investors care deeply about the fees they pay. The long-standing trend towards greater disclosure of fees in Finance is a natural response. Mr. Schneeweis sounds like someone who hasn't spent much of his own money on hedge fund fees, just other people's.

Fortunately, The Economist with its substantially wider readership is providing investors with more thoughtful advice.

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# Amazon Features The Hedge Fund Mirage

Amazon asked me to write a piece for their blog promoting certain books, so I was happy to oblige. You can find it [here](#).