A Year Later, and Hedge Fund IRR Remains Pathetic

One year ago AR Magazine published an article I wrote which revealed how poorly hedge fund investors had done in aggregate. Today, AR revisited the topic. Over the past 12 months the hedge fund industry has continued to deliver steadily mediocre results (although there are certainly some bright spots) and investors have continued to plow money into the biggest funds. 2011 will be the ninth consecutive year that hedge funds have failed to outperform a simple blend of 60% equities and 40% bonds. It's convenient timing for my book, The Hedge Fund Mirage.

Why Kyle Bass Hoards Nickels

Kyle Bass, who runs a hedge fund called Hayman Capital Management in Texas, is gaining notoriety as an investor with the foresight to anticipate today's growing sovereign debt crisis. If eurozone governments ultimately write down their debt because the weight of supporting their banks becomes too great, Kyle Bass will go down as one of the earliest to recognize and position for that. His worldview is dire, and it's apparently prompted him to take some strange precautions such as acquiring $1 million nickels (20 million coins) because their 6.8 cents value as scrap metal exceeds their monetary worth. I listened to an interview yesterday on BBC Radio HardTalk in which he defended his views. The UK media tends to take a more populist stance with regard to hedge fund managers. It's now 14 years since George Soros's bet against Sterling preceded their leaving the European Monetary Union

and ultimately declining to join the €. How fortunate that decision looks today, but at the time UK tabloids blared that George Soros had “broken the Bank of England” and financiers have never been fully trusted in the UK ever since. So the BBC’s interviewer adopted a combative stance, for instance accusing Bass of causing the collapse in Greek bonds through his bets on credit default swaps. Her attempts to portray him as a manipulating hedge fund manager exploiting opportunities for no benefit but his own were deftly handled with facts and figures. Kyle Bass has a point of view worth considering.

I went back and reread Bass’s investor letter from February, “The Cognitive Dissonance of it All”. He reaches a similar conclusion to Jim Millstein in Tuesday’s FT, although he focuses more on government revenues, debt and interest expense. Japan, given its shrinking and aging population combined with high levels of debt could not afford to borrow at the levels of other AAA-rated nations (such as France) because their total interest expense would exceed their revenue. As Bass says, “The ZIRP trap snaps shut.” (ZIRP is Zero Interest Rate Policy, pretty much what we have in the U.S. currently). I know people have been betting on a disaster in Japanese bonds for literally twenty years, and it has so far been a disastrous bet. But it does increasingly look as if it still is just a matter of time before we reach the tipping point. After reading what Kyle Bass has to say it’s hard to feel comfortable owning long-term government bonds issued anywhere in the world.

The FT on Not-So Hedged Funds

A friend brought my attention to a recent article in the FT by James MacKintosh in which he noted how hedge funds have

increasingly been delivering returns that are correlated with the S&P500. It looks as if increasingly the search for alpha includes trying to time beta. The media isn't normally so negative on hedge funds – perhaps Mr. MacKintosh has looked at the website for my book.

One of the problems with selecting hedge funds is that so few of them consistently outperform their peers. Manager selection is really the only way to justify a hedge fund portfolio. If you can't pick funds with skill then it's best not to bother, because average hedge fund returns have trailed treasury bills . An investor can be a passive investor in equities through mutual funds and need not possess any security selection skill to justify exposure to the assets class. The same cannot be said for hedge fund investors.

But the challenge of picking good managers is compounded by the fact that returns mean revert. For the vast majority of funds, not every year is a good year. I did some analysis earlier this year for my book using data from BarclayHedge. Suppose your objective is to pick managers in the top 40% – seemingly not exactly a tall order you might think. However, of those managers that are ever in the top 40% only 7% are able to stay there for every year of their existence. The best managers have mediocre years. Whereas an equity investor can try and exploit mean reversion and sell his winners to reinvest in that year's underperformers, such an option doesn't easily exist for the hedge fund investor given the lengthy time involved in due diligence. And hedge fund managers who concluded this was their clients' strategy would quickly tire of such a flighty investor, perhaps refusing to take them back.

It's not that hedge funds are all bad – and indeed the hedge fund industry has generated fantastic results. It's just that those results haven't really made it back to the investors who provide the capital. Hedge fund investors need to do better than they have.

Among the Hedge Fund Faithful at the AR Symposium in New York

I spent an interesting morning yesterday at the AR Symposium, a well-organized get together of hedge fund industry professionals. I had been asked to chair a panel titled "What do investors want and how do they want it". A year ago I wrote an article pointing out that hedge fund investors in aggregate would have done better investing all their money in t-bills rather than hedge funds. It's a controversial statement though not hard to prove and to my knowledge no one in the industry has since disputed it. The article was one of the most read on AR's online site, and it served as the inspiration for my book, *The Hedge Fund Mirage*, available at the end of the year.

It's not that I'm against hedge funds. There are many fantastically talented managers, and hedge funds have made enormous amounts of money. It's just that the money hasn't really made it through to the clients, in aggregate. I think hedge fund investors ought to do better than they have. I am pro-investor, not anti hedge fund. But not every hedge fund professional initially interprets my message in this way.

So I shared the stage with four charming and well-informed hedge fund investors yesterday. They deftly handled my mildly provocative questions, such as, "Since hedge fund investors have in aggregate not made money, what should they do differently?" Several useful suggestions were offered. I followed up with, "If hedge funds are to meet investors' 7% return assumptions, this $2 trillion industry needs to generate $140 BN in profits annually, something they've never

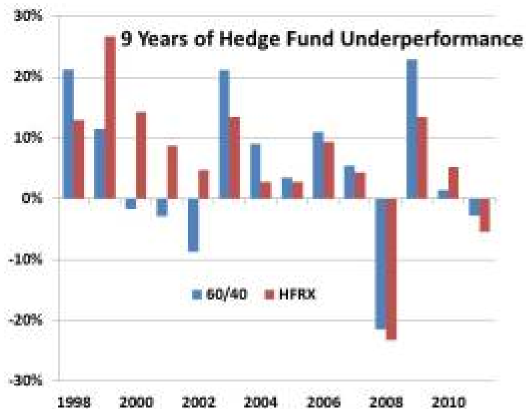
done (apart from the 2009 bounce back following 450 BN in '08 losses). Why shouldn't investors be concerned that the industry is overcapitalized?" This one was a little harder but the panel was up to the challenge and offered rebuttals. However, I do think this may continue to be a problem. And 2011 likely represents the 9th consecutive year that hedge funds have failed to outperform a simple blend of 60% stocks/40% bonds. The hedge fund faithful will continue to face such challenges, but most will persevere and new entrants will continue to arrive on the scene.

Another Disappointing Year for Hedge Funds

2002 seems like a long time ago, but that's the last time hedge funds outperformed a simple blend of 60% stocks and 40% bonds. Through 2000-02 during the dot-com collapse hedge funds added value, but since then as assets have flowed in the weight of all that money has steadily dragged down returns. Following a torrid performance in September, the HFRI Fund Weighted Index (HFRX) is down 5% for the year, compared with 3% for a simple 60/40 blend. No doubt much of the selling in September was caused by the over-leveraged becoming less so with urgency – the frantic buying of October looks like its mirror image. It's looking increasingly as if this will be the 9th straight year in which old-fashioned investing without the use of absolute return vehicles has outperformed the more modern variety.

Part of the problem lies in how some of the biggest funds have done. To take John Paulson as an example: he began the year with $38 billion in assets under management (AUM), around 2%

of the entire industry. If he's down around 40% on average across all his funds, that represents almost a 1% performance hit to the beleagured community of hedge fund investors. Given what appears to be modest return expectations among institutions of only 6-7%, that's a chunk of performance to be made up by the rest of the industry since Paulson has on his own knocked almost 1% off aggregate 2011 returns.



Carousing in Columbus, Ohio

I spent a most enjoyable day in Columbus, OH at the invitation of the local CFA Society. I should extend my thanks to Tim Steitz, Senior Investment Officer – Equities at the School Employees Retirement System of Ohio for organizing such a well attended event, and also Travis Upton, current President of the CFA Society of Columbus and Director of Portfolio Management at The Joseph Group. I talked about my upcoming book, The Hedge Fund Mirage, and hopefully offered some insights to investors growing their hedge fund portfolios. I also had several interesting discussions with investors about the alternatives to fixed income given government manipulated bond markets and the Tyranny of Low Rates.

I am finding that many investors are most interested in

discussing less conventional strategies to generate income given the poor return outlook in bonds. Master Limited Partnerships (MLPs) and our Hedged Dividend Capture Strategy were both of interest to a number of people.

Paulson's Paradox

My upcoming book The Hedge Fund Mirage explains how investors have not done nearly as well as the hedge fund managers to whom they have entrusted their capital. However, a handful of managers have genuinely created enormous wealth for their clients as well as themselves. Rick Sopher from Edmond de Rothschild Group did some research on this topic on which the FT reported last year. Among the genuinely value added managers was John Paulson, whose rare insight into the sub-prime bubble netted his clients and himself many billions. John Paulson was credited in the article with generating $33BN for investors.

So it is with genuine sorrow that I have observed reports of John Paulson’s very tough year, culminating with warnings that as much as 25% of his assets may depart by year-end. In my book I had noted Paulson’s strongly profitable performance by way of illustrating that there are some very talented managers who have truly added value to their clients. Regrettably, John Paulson is slipping from this pedestal.

High Frequency Trading's Social Utility

The [New York Times](#)reported yesterday that regulators around the world are examining High Frequency Trading (HFT) with a view to curbing its influence over short term market moves. The use of computer algorithms to execute short term trading strategies has resulted in physical proximity to stock exchanges being valuable so as to reduce latency in the transmission of orders. In other words, reducing the time that electronic pulses take to reach their destination can have a meaningful impact on results.

There is an assumption among stock market regulators generally that increased volume is a good thing. Higher volume causes increased liquidity and, so the argument goes, lowers the cost of transacting for everybody. It’s generally not an unreasonable view, and the corollary is that the cheaper is it so trade, the better off are both the savers who put money in the market and the companies who acquire those savings through equity issuance. In fact, for all the focus on short term swings in the market it’s as well to remember that its ultimate purpose is to channel capital from savers to where it can be usefully invested in productive ways. That is the point, after all, of a stock market and at its most fundamental every related activity ought to be geared to promoting that outcome.

Regulators don’t currently expose every new trading strategy or activity to that litmus test. Perhaps that’s as well. But HFT does seem to be about as far away from channeling savings to useful places as it’s possible to be. The New York Times article mentioned above goes on to note how firms routinely post thousands of orders at a time, only to cancel many of them a split second later. Firms have been fined for trying to manipulate the market through the sudden appearance

and disappearance of large orders. HFT was blamed by some for the “flash crash” on May 6, 2010.

So ask yourself if the world would miss High Frequency Trading if it just disappeared from the landscape. Who would care, other than the traders themselves and (presumably) the providers of the trading capital they use. Would stock market returns be lower? Would the cost of raising equity capital be higher? It’s doubtful.