



Investment Myth Versus Reality

Top 10 Hedge Fund Myths...

By: Tristram Lett

Just how risky are hedge funds? For all too many plan sponsors, the response is 'too risky.' Indeed, such concerns have been top of mind recently for plan sponsors kicking the proverbial tires of hedge funds in search of all-important alpha. Fiduciaries who find it difficult to reconcile the complex world of hedge funds with their own due diligence procedures are expressing worries over everything from transparency to fund selection to bubbles. But, given the lack of clear information on hedge funds available in the marketplace, the question becomes 'how can investors separate myth from reality?'

In an effort to address the complex mythology that has developed around the hedge fund industry, I polled 150 hedge fund managers from around the world and asked them to tell me what hedge fund myths they most commonly encounter from investors. The following is a list of the 10 most cited responses. Are these myths fact or fiction? And what can investors do to ensure that hedge funds are right for them? Read on and find out...

Myth 1: "Hedge funds are too risky..."

Long Term Capital Management (LTCM) did a lot of damage to the reputation of the hedge fund industry and its demise is, to a great extent, responsible for the prevalence of the myth that hedge funds are much riskier than so-called 'traditional' investments. For the record, hedge funds are risky – but so are stocks and bonds. Indeed, investors dealing with interest rate risk or who got burned by blue-chip blow-ups such as Enron will understand just how risky these 'traditional' asset classes can be.

One of the great strengths of hedge funds is their incredible diversity, which provides a portfolio manager with optimal ingredients to create well-structured, well-balanced, and better diversified portfolios. Such a portfolio, when constructed properly, has the potential to provide the highest frequency of positive returns to its investor over time.

To fully reap the diversification benefits of hedge funds, plan sponsors need to understand exactly where the risk lies and what steps to take. As the LTCM debacle showed us, there are risks at the manager level that need to be taken into account along with those at the portfolio level when it comes to fund of funds. As a rule of thumb, investors should monitor risk by looking at factors such as the depth and frequency of draw-downs and the length of time for their resultant recovery. Similarly, the time dependence of correlations should also be calculated and assessed.

Ultimately, an effective approach to hedge fund risk should look at as many statistical risk measures as possible, as each will provide a slightly different perspective. For example, traditional Sharpe ratio calculations aren't always the best way to go. And, as with any investment, diversification is key. Consider that no fiduciary would ever oversee a portfolio of two or three stocks – it's no different for hedge funds.

Myth 2: "Hedge fund fees are too high"

Hedge fund fees are definitely high in an absolute sense. However, compared to your typical long-only manager, investors should understand that they add a lot of value, particularly at the individual hedge fund level. In fact, there is a near exact correspondence between active risks incurred to earn performance and the fees charged for it, compared to a traditional long only manager.

When determining whether or not the fee structure of a hedge fund is fair, plan sponsors should be wary of paying active management fees for passive returns. Many hedge fund managers have exposure to one or more sources of market risk so investors need to look closely to understand what they are paying for.

Myth 3: “Hedge Funds are secretive and opaque...”

It's true that, for many years, hedge funds have given investors the image that they aren't transparent. Much of that is due to the SEC's ban on hedge fund advertising and marketing in the United States – something that drove them offshore and thickened the veil of secrecy.

Today, hedge fund managers are beginning to realize that greater transparency is key. But for fiduciaries looking for familiar holdings report and transaction journal, hedge funds still present a challenge. They're more complicated, for one thing, and the mix of long and short positions are linked to many multi-asset security positions that depend on what the portfolio manager is hedging.

Fiduciaries can and should request a risk report that distills the complex security positions into an intelligible breakdown of risk and a notion of what the worst case outcomes might be. They can also ensure that the information is presented in a format they can understand, a service that an increasing number of managers are willing to provide.

Myth 4: “Leverage is bad – and overdone...”

Yes, leverage that is overdone is bad, because it means that negative outcomes can be as pronounced as positive outcomes. However, in reality, many hedge funds don't have any leverage. In fact, most of the rest have very controlled conservative levels. Overdone leverage is reasonably rare and should be easy to spot in the due diligence process.

In addition, recent studies indicate that while around 72 per cent of hedge funds embody leverage, only 20 per cent have balance sheet leverage ratios of more than 2:1. Overall, the majority of them utilize quite conservative leverage by most measures.

Bottom line: defining a fund's leverage must always come from a risk perspective, not just an accounting perspective. Finding a comfort level with leverage must, in large part, be analyzed in the context of the overall portfolio of managers and how it works with overall diversification parameters.

Myth 5: “Hedge funds have a high failure rate...”

Again, the ghost of Long Term Capital Management lurks at the root of this myth. Without a doubt, hedge funds do have a high failure rate, especially among startups. Widely varying numbers estimate that between 10 and 25 per cent of start-ups fail within their first year. However, once a fund has passed the three-year mark, the failure rate drops off significantly to around five per cent per annum as recently estimated by veteran hedge fund consultants, Hennessee Group in New York.

Investors who are very concerned can hire funds of funds. Or search out an experienced firm. Just remember, as with traditional investments, sound diversification of managers is your number one protection strategy.

Myth 6: “Hedge funds are all the same...”

There is no hedge fund cookie-cutter – instead, investors are confronted with an enormous variation among fund styles. In fact, the diverse nature of hedge funds is a major advantage and the correlation among different styles can be very low (and, often, negative), making them an excellent portfolio candidate. Creating a diversified hedge fund portfolio is actually a straightforward process resulting in very little investment risk.

There are a couple of things to keep in mind when it comes to creating a diversified portfolio of hedge fund investments. To start, plan sponsors looking to create their own portfolio of hedge funds should do so with no less than five different styles. They should also ensure that the managers' results are uncorrelated through different types of market environments.



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Myth 7: “There are too many hedge funds to effectively manage the selection process...”

The large number of hedge funds out there makes selection a daunting task – there are 7,000 funds globally and in Canada alone there are 200. Performance varies across different market situations. Often, the best way to get started is through a fund of funds which provides a turn key service for investors.

While hedge funds are viewed by many as too complicated to truly comprehend, a good manager should be able to explain the fund and its strategy to you. If they can't, then don't buy. Bottom line: never invest in anything you don't understand – a rule that certainly applies to all investing, including hedge funds.

Myth 8: “Hedge funds are unregulated in Canada...”

While hedge funds are subject to fewer rules than mutual funds or securities, they aren't unregulated in Canada. Currently, hedge fund managers are required to be registered with the appropriate securities regulator, as with anyone who manages people's money. And increased regulation is on the way – something which will help to put investors at ease in future.

Myth 9: “Hedge funds are a bubble...”

Since hedge funds are investment strategies, not asset classes, they are not subject to the kind of bubble conditions we've seen throughout history (Tulip mania; the Dot.com bubble). However, too much money flowing into hedge funds does have the potential to reduce the amount of alpha being earned and that is a concern for investors.

While this is a concern harbored by many plan sponsors, the more likely outcome would be a rise in the amount of available alpha as borrowers create securities to cater to the hedge fund industry and various commercial and financial agencies try to offload their business risk to a willing market. Because these markets tend to be inefficient when first introduced, there is positive alpha to be earned by the nimble investor.

Myth 10: “Hedge funds are always hedged...”

The implication here is that there is full hedging occurring in all hedge funds – but that is misleading. Investors must first ask, “what is being hedged?” In other words, what investment risks are being removed and what risks are left?

For example, looking at two equity market neutral managers, one would easily presuppose that they had both effectively removed equity market risk from their strategy. Not so, since this is nearly impossible to do. While relative value strategies have less 'market' risk than directional strategies, there are other, more complicated forms of risk that they are exposed to. Almost all hedge funds have some element of hedging going on, but the magnitude and type of the risks being hedged vary widely.

Potential hedge fund investors must be careful to understand what is being hedged and what isn't. One way to ascertain that is to ask the manager what the worst-case scenario might be for his style. Ask the manager how they could hedge that risk and what the implications of hedging it are. The answers will be quite revealing – and can help investors to ensure that the hedge funds they invest in are going to perform over the long run and achieve the alpha they need in order to meet their liabilities in challenging times.

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