

WEALTH & INVESTING



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Six reasons to avoid hedge funds

Financial success depends on disciplined saving and investing, not fancy investment products and high returns

WHILE most people will agree about holding traditional assets like stocks and bonds in their portfolios, hedge funds are more controversial. I generally recommend sticking to stocks and bonds. This post outlines a few observations in support of my position.

Returns aren't great

The best hedge fund managers are probably skilled. According to research, hedge fund managers created up to US\$600 billion in value added from 2013 to 2019. However, this value added was calculated before fees. Net of fees, this figure is much lower, as managers capture most of the value they create, leaving investors with the crumbs. One group of researchers recently found that hedge fund fees capture 64 per cent of gross returns.

Most studies reveal that hedge fund returns are mediocre, particularly post-2008. There is no way to predict if the higher performance observed before 2008 will reoccur. Some observers claim that rising assets under management make it difficult for hedge funds to perform due to declining returns to scale, but the evidence is limited. Overall, the best hedge fund managers may have skill, but that does not necessarily translate into outstanding returns for investors.

Also worth considering is the fact that, while hedge funds generally do provide modest returns, investors tend to underperform the funds they hold by a wide margin due to poor timing of inflows and outflows.

Diversification benefits are limited

Adding hedge funds to a portfolio of stocks and bonds can improve risk-adjusted returns, as measured by traditional metrics such as the Sharpe ratio. However, hedge fund returns have declined substantially since 2008, so replacing part of the portfolio's equity component may lead to an undesired underperformance.

Further, hedge funds have an asymmetrical fee structure: the manager receives performance fees when the fund makes a profit, but does not have to compensate the fund when it loses money. Such a fee structure may induce some hedge fund managers to adopt strategies that offer regular modest profits at the cost of occasional steep losses. In other words, many hedge funds are riskier than they appear.

Fees are way too high

I find hedge fund fees horrendous. Paying performance fees beyond the already pricey 1.5 per



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cent average base fee is bad enough, but 86 per cent of hedge funds' performance fees are not subject to any hurdle rate. There is no merit in earning a return that only exceeds base fees.

In addition, one-third of hedge funds do not have a high-water-mark feature to prevent managers from charging performance fees on a losing fund. But even with a high-water-mark feature, investors may pay performance fees on poor-returning funds when deep losses follow early successes.

For investors looking to invest in a diversified hedge fund solution, funds of funds will increase the burden of costs with a second layer of fees over and above those of each constituent product.

Another problem arises when investors hold a diversified pool of hedge funds, with winning and losing funds. While the winning funds may legitimately charge performance fees, the losing funds reduce the total pool of profits generated by the hedge fund portfolio in aggregate.

As a result, the investor could be paying a much higher rate than the contractual performance fees. A study surveying a pool of almost 6,000 hedge funds found that while the average performance fee of this pool was 19 per cent, investors paid nearly 50 per cent of the aggregate funds' gross profit.

Complexity is not your friend

Hopefully, this series has persuaded you that hedge funds are way more complex than basic

stock and bond funds. Research has demonstrated that financial firms increase their profit margins by purposely creating complex financial products. Complex products create information asymmetry, enabling highly informed financial firms to negotiate from a position of strength with relatively less informed clients.

Financial firms can make complex products look attractive by exploiting investors' cognitive biases, such as myopic loss aversion, recency effect and overconfidence. As economist John Cochrane once said: "The financial industry is a marketing industry, 100 per cent." Investors beware.

Attempts to predict outperformers will likely fail

Research suggests characteristics such as manager ownership, strategy distinctiveness or not being listed in a commercial database may help identify winning hedge funds. But any filtering strategy will likely produce dozens or even hundreds of candidate funds from which to choose. These candidates will include several false positives.

For example, Larry Swedroe in a 2024 article highlighted that a small minority of outperforming funds heavily influences the positive alpha observed in non-listed funds.

Most hedge fund literature also finds performance persistence only over short horizons, which is not helpful for long-term investors' fund selection. Even if you select a superior hedge fund, it will not necessarily accept money from you. Many choose to work only for large institutions, and others refuse new capital as they have reached their full capacity to generate alpha.

Finally, even some of the most resourceful investment organisations gave up hedge funds, often because they could not find enough alpha to justify their high fees, opacity and complexity.

Personal experience

Other reasons for shunning hedge funds come from personal observations. Financial success depends on disciplined saving and investing, not fancy investment products and high returns. Evidence suggests investors are not very good at picking winning active fund managers, and I have not seen evidence that hedge fund selection is any easier.

Investors often build and preserve wealth because they sense "enough" and, to some extent, favour prudence over extra profit. In contrast, damaging losses sometimes occur when investors stretch their portfolio risk for "a little more return". This is particularly true when dealing with opaque and complex investment products.

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