



## Ruminations on Hedge Funds

We don't currently invest in hedge funds and don't anticipate doing so, but there is an interesting lesson to be learned from the way they charge their clients. At Financial Architects we have tried hard to align our interests and our client's interests so we are all working toward the same goal, and I think we have largely succeeded. People seem to be attracted to hedge funds because they have an aura of exclusivity, like buying designer handbags or exotic cars. Currently, in order to invest in hedge funds, you must have a net worth of \$2.5 million, and most funds have a \$1 million dollar minimum. In practice, since it wouldn't be prudent to put a large percentage of your portfolio in one fund, you would need much more.

The fees we (and others like us) charge are on average approximately 1% of the account annually. On larger accounts it would be even less. Hedge funds are widely reported to typically charge 2% *plus* 20% of all profits. The table below shows a wide variety of gross returns a typical investment advisor like Financial Architects might earn and the gross returns a hedge fund (assuming a 2% and 20% of profits structure) would have to earn for their clients to break even with our clients:

FA	Hedge Fund	Difference
0.00%*	1.00%	1.00%
5.00%	7.00%	2.00%
10.00%	13.25%	3.25%
15.00%	19.50%	4.50%
20.00%	25.75%	5.75%
25.00%	32.00%	7.00%
30.00%	38.25%	8.25%

\*For any returns under 1% the hedge fund would have to outperform by 1% for their clients to break even.

As you can see, the headwind at higher market returns is considerable.

This isn't the biggest problem however. While no compensation method is without its conflicts of interest, it is always useful to think of the incentives that are created. In the case of hedge funds, the fees get so large with large returns that the incentive (in spite of the name "hedge") is to make very large, very leveraged bets. If they win, the managers get large profits while if they lose, they don't share the losses (other than to their reputations).

Here is an example using insurance rather than the derivatives or other vehicles that a hedge fund might use. (This is just to keep it understandable, the principle is exactly the same – large though infrequent loss possibilities are disastrous to the clients but good for the fund management.)

Imagine you are an insurance company insuring homes on the gulf coast and you know that on average every 10 years a hurricane will hit and wipe out your policyholders costing you \$1 billion in claims. Assuming investment returns on that \$1 billion cover overhead costs, smaller claims, etc. you could charge \$100 million per year (1/10th of \$1 billion) in premiums and on average *break even*.

If your structure was like a hedge fund, you would get investors to put up the \$1 billion needed to cover the risk then you would collect \$100 million in premiums from the policyholders. If there is no hurricane, that is all profit and you collect 2% plus 20% of the profits (\$36 million). This leaves a

profit of \$64 million for the investors. That is an excellent result – 6.4% return with no volatility from the investor's perspective. The problem is the year the hurricane comes, the investors lose 100% of their investment – and we have no way of knowing what year that will be. If the investors leave their earnings with the company which in turn underwrites increasing amounts of insurance, then no matter how long it is between hurricanes, the investors always lose 100% of their money *including* the prior earnings!

This may be a very good system for the fund manager (\$36 million dollars per year in profits) yet it is disastrous in the long run for clients because they are *completely* wiped out. The lessons we can draw from hedge funds are: 1) incentives matter, 2) simple and straightforward approaches frequently beat exotic approaches, 3) costs matter, and 4) your portfolio is the wrong place to try to appear stylish.

**Notes:**

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