Is the Emperor Dressed? Hedge Funds Continue to Struggle

In the fairy tale written by Hans Christian Anderson, “The Emperor’s New Clothes”, a vain emperor always wants the newest fashions. A few hucksters come along and convince him the clothes they sell are of such high quality only people who are “elevated” can see them. They pocket the money and materials and pretend to weave the clothes. Because the emperor cannot admit he is not “elevated” he wears the “clothes” in the palace. In reality, he is naked (actually he is in his underwear, but you get the point). Everyone bows down to him and compliments his “clothes” because they are afraid to contradict the powerful emperor.

Then he takes it a step further. He leads a parade to show off his new clothes to the people (perhaps he thought all his people were elevated)? Everyone in the parade pretends to admire his clothes except one little boy, who finally yells out “the emperor has no clothes!” (got to love children’s candor).

Does this story sound familiar? Because of pretentiousness and social hypocrisy, do people pretend to agree with certain ideas because it makes them look better? It was out of fear of being ridiculed that everyone admired the “non-existent clothes”, which very well may be the same reason certain people invest a certain way – and why some of our hedge fund titans may be modern-day emperors.

Overview

Like mutual funds, hedge funds are pools of underlying securities, but with noticeable differences. Hedge funds are not regulated by the Securities and Exchange Commission the way mutual funds are. As a result of being relatively unregulated, hedge funds can invest in a wider range of vehicles than mutual funds. While traditional funds generally stick to stocks, bonds and cash (sometimes commodities and real estate) hedge funds often stray to more “sophisticated” (i.e. complex and risky) investments, including futures, options and currencies. Certain hedge funds also attempt to hedge against declines by investing in stocks and later “shorting” them. And many hedge funds employ “leverage” by investing with borrowed money which increases the risk. The full scope of hedge fund strategies are way beyond the scope of this article, but the main point is that hedge funds are complex and risky. And to add insult to injury, the added complexity and risk has not resulted in better outcomes. In fact, hedge fund outcomes have been much worse than traditional funds.
Underperformance

A recent article in the Wall Street Journal¹ displays the recent results of 18 different hedge fund strategies - plus the Barclays hedge fund index. None of the hedge fund strategies or the hedge fund index exceeded the 13.42% return of the S&P 500 total return over the last five years. None even came close, except the “collateralized debt obligations strategy” which earned 11.07%. Most of the strategies earned 2% - 5%.

Andrew Hallman, the author of The Millionaire Teacher, wrote an interesting blog post² which covers a much longer time horizon. Andrew compared the performance of the surviving hedge funds to a portfolio made up of global stocks and US bonds, starting the comparison in 2002, ending in 2016. If $10,000 were invested in the average surviving hedge fund, it would have grown to $12,330 while a portfolio containing a global stock index (70%) and a US Bond Index (30%) would have turned that same $10,000 into $27,116.

I went even further back, comparing the performance of a basic 60/40 “kindergarten portfolio” (60% Vanguard Total Stock/40% Vanguard Total Bond) with the HFRX Index, which is designed to be representative of the overall composition of the hedge fund universe. Below is a comparison of the two strategies over the last 20 years.

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Finally, an article from the *Atlantic*\(^3\) explains hedge fund underperformance with concision:

*There are some ideas worse than putting your money in a hedge fund – like burning it – but not many. Indeed, the supposedly smart money has not been so for the past decade, at least not for actual investors. Hedge funds have cumulatively underperformed a simple 60-40 stock-bond index going back to 2003 – and underperformed it badly.*

**Modern Day Emperors**

Here are specific examples of some “modern-day emperors” that had many investors believing they were elevated and in the finest weaved clothes, but it turned out they were naked:

**Bill Ackerman** was a silver-haired “hedge fund titan” who built his reputation as a stock picker and hardball activist. His approach was to buy up shares in the business and “shake up management” hoping to raise the stock price. For a while, it worked as he generated good returns and astronomical fees for himself and his firm Pershing Square. So no one would doubt he was well dressed and elevated. But then he made the biggest bet of his career in a pharmaceutical company “Valeant”. When skeptics began dumping Valeant, he bought more. Valeant dropped from $200 a share to as low as $8.00. By the time Ackman threw in the towel and sold his firm’s shares in the company, the fund lost 4 billion dollars.

**Richard Perry** has long been long considered one of the hedge fund industries most successful investors. Who would dare question the garments of a Wharton graduate, with an MBA from NYU who started his career at Goldman Sachs and is the nephew of former Bear Stearns CEO James Cayne? Many did not until he shut the doors to his hedge fund Perry Capital in 2015 after billions of dollars in losses. Perry's fund lost 60% from 2014 – 2016. In his letter to his former believers, he wrote about “the timing for success in our positions too unpredictable” – a glimpse into the obvious.

And finally, we have **John Paulson**. The emperor of all emperors known as “one of the most prominent names in high finance”. The billionaire philanthropist from Harvard business school. The Paulson Partners Enhanced fund crashed about 70% from 2014 – 2017, partly because it used leverage (borrowed money) to “double down” on its bad bets.

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\(^3\)O’Brien, Matthew “Don’t Invest in Hedge Funds”. The Atlantic (July 10, 2013)
The Benefits

Notwithstanding all of this bad news and my chiding emperor analogy, hedge funds may serve some very important functions within our society; many experts believe that their trades can “bully” mispriced securities back in line with reasonable valuations. And there is no question that because hedge funds trade so often – and in such exotic fashion – that they provide needed liquidity to the system. Further, it is likely that hedge funds improve the overall quality of the capital markets and may even influence the culture of a company positively with their clout. The following excerpt is from “The Economics and Finance of Hedge Funds”

Critics of hedge funds often label hedge funds as greedy corrupt and highly compensated villains.. proponents of hedge funds view them as informed traders who improve market quality and corporate governance

The Solution

Despite all the problems pointed out in this article and by others, hedge funds have been growing at an astonishing pace; according to the website “Seeking Alpha” in 2003, there were 5,065 hedge funds with 218 Billion in assets. As of Q3 - 2017 there were 8,255 hedge funds with $4.470 Trillion in assets. Whether that growth continues is anybody’s guess, but it appears that hedge funds are here to stay. The solution then, in my view, is simply to utilize hedge funds appropriately.

Are you an institutional investor or pension fund or manager? Do you manage a sovereign wealth fund on behalf of an entire country? If so, perhaps you should consider investing in a hedge fund. If you are ultra-affluent; $50,000,000 or $100,000,000 of investable assets and fully understand leverage, options, futures and derivatives and want to try to boost returns, maybe a hedge fund makes sense. But for the rest of us, we should avoid the fees, complexity and risks associated with hedge funds, because the people we entrust our financial future to should be fully dressed.

Evan M Levine ChFC is an SEC-registered investment advisor and the founder of Complete Advisors, a full fiduciary fee-only retirement income planning and wealth management firm. Call with any questions: 516-240-6161 or e-mail evan@completeadvisors.com

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