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HEDGE FUNDS TODAY: CAVEAT EMPTOR | By Burton G. Malkiel and Atanu Saha

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Hedge funds have become the asset class of choice of the early 21st century. Investments have risen from approximately $50 billion in 1990 to about $1 trillion today. Almost half of those moneys have been channeled into “Funds of Funds,” by far the most popular hedge-fund investment vehicles, which invest in diversified portfolios of hedge funds. There is no doubt that hedge funds are a very good deal for the people who run them: Hedge-fund managers typically collect fees amounting to 2% of the fund’s assets plus 20% of profits earned, and managers of Funds of Funds charge additional fees. But are hedge funds such a good deal for investors? Here, the case looks much less persuasive.

The putative argument for investing in hedge funds is straightforward: With higher rates of return and lower risk, they appear to be more attractive than the general stock market. Moreover, the lack of correlation between returns from hedge funds and stocks in general makes hedge funds good diversifiers. But we are not convinced. We believe that hedge funds are far riskier and provide lower returns than is commonly supposed. Why? The return indexes constructed from popular databases are tainted by biases. Correcting for those biases wipes out the advantages that hedge funds supposedly carry.

Hedge funds generally stop reporting results during the last several months of their lives. For example, Long-Term Capital Management lost 92% of its capital between October 1997 and October 1998. None of these negative returns were reported to any of the database providers. Average hedge-fund returns would be substantially reduced if the non-reported last month return was negative for funds leaving a database. While some funds stop reporting because they do not want to attract new funds, the vast majority of the funds leaving a database either failed or were merged into more successful funds.

Unlike data for mutual funds, which must report periodic audited returns, hedge funds provide information to the database publishers only if they desire to do so. Managers often will establish a hedge fund with seed capital and begin reporting results at a later date; or a fund may stop reporting to one database so that it may be included in a more comprehensive one. Only the most favorable of the early results are then “backfilled” into the database. Fortunately, data available from TASS Research, a unit of the hedge-fund group Tremont Capital Management, indicate when the hedge fund began reporting. We were able to examine backfilled returns and compare them with those reported contemporaneously -- and backfilled returns tend to be substantially higher.

The attrition that characterizes the hedge-fund industry results in considerable survivorship bias in the returns of indexes composed only of existing funds. Unsuccessful hedge funds do not tend to survive because it is difficult for them to obtain new assets. Hence, unsuccessful funds tend to close, leaving only the more successful funds in the database. In order to examine this phenomenon, we obtained from the TASS reporting service all past records of funds that are defunct (or that still exist but are no longer included in the database). A comparison of the returns from existing funds and those that no longer report reveals substantial differences.

The fairest way to judge the returns available to hedge-fund investors is to consider the returns of all hedge funds (alive and defunct) and to exclude the backfilled returns which are upwardly biased. When such calculations are made, the average hedge-fund return over the past decade turns out to be more than three percentage points lower than those available from many database providers. While adjusted hedge-fund returns were greater than returns available from the S&P 500 stock index during the bear market of early 2000 through late 2002, the returns were lower than the stock market over the entire past decade. A comparison of database indexes and new "investable" hedge-fund indexes confirms that the former, constructed from records of existing funds, overstate the returns investors have received from hedge funds.

Investors need to be aware of two other facts. There is very little persistence in the performance of hedge-fund managers. If you pick an above-average performer during one year, there is no guarantee of future superior results. The probability of repeating a winning performance next year is about the same as a coin coming up heads twice in a row. Moreover, the performance of Funds of Funds has been significantly lower than the overall returns of the hedge-fund universe. Funds of Funds provide diversification but the extra layer of fees depresses the returns available to investors.

Hedge funds tend to report less volatile returns from month to month than do general equity funds. In addition, many funds have been good diversifiers, as their results are often uncorrelated with the stock and bond markets. However, there is another dimension of risk that investors must consider. Investors need also to be concerned about the considerable variability of returns from fund to fund and the risk of choosing a fund that performs particularly poorly. The range of returns from best to worst is considerably larger than is the case for the equity mutual fund universe. Even the fund-of-funds category displays enormous variability. To be sure, the very best hedge funds have produced excellent returns. But investors in individual funds take on a substantial risk of selecting a very poorly performing fund, or worse, a failing one. And the typical Fund of Funds is even more likely to underperform low-cost index funds of stocks and bonds.

Finally, we expect that the substantial flow of funds into the hedge-fund industry may reduce returns significantly in the future. When only a limited amount of capital is pursuing arbitrage opportunities between about-to-merge corporations or between different securities of an individual company, even believers in reasonably efficient markets can imagine that limited profit opportunities may exist. But as enormous streams of investment funds enter the field, such opportunities will be attenuated. The very success of the hedge-fund industry in attracting funds is likely to make hedge-fund investing an even less profitable investment strategy in the future. Let the buyer beware.

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