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Intelligent Money

Current thinking from Haven Financial Advisors

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Special Notes of Interest:

Studies have shown that genetics account for 20 to 30 percent of life expectancy until about age 80. However, after that age, it becomes close to 100 percent.

The three most commonly held stocks in hedge funds as of 12-31-12 were Apple, Google, and AIG.

Hedge Funds, Fact and Fiction

Most casual investors have heard the term *Hedge Fund* used in the financial news. These investment vehicles gained popularity in the aftermath of the dotcom bust just over ten years ago. Today, nearly $2.4 trillion is invested in them, a quadrupling of assets since 2000. Once the province of wealthy individuals, Hedge funds now draw two thirds of their money from institutional investors, up from 20% in 2000. Consequently, the financial health of many Americans is directly affected by their fortunes. Hedge funds collectively exert considerable financial influence. This edition of *Intelligent Money* will take a critical look at it.

What is a Hedge Fund?

Despite the name, “hedge” funds need not reduce portfolio risk. A hedge fund is an investment pool, typically organized as a limited partnership. It is therefore a structure rather than an investment strategy. Its investment managers are its general partners. Participation as limited partner is typically restricted to high net worth individuals or organizations.

Because its investors are presumably more sophisticated, management compensation and investment latitude is less restricted. Hedge fund investment strategies involve more frequent trading and often the use of leverage to increase the size of their bets. The underlying theory here is that hedge funds employ better money managers who should have more freedom and resources to act.

The partnership organization form of the hedge fund has been fairly robust for over 60 years. However, there has been some recent innovation. The Dodd-Frank act required hedge fund managers to register as investment advisors with the SEC. In response, some hedge funds are now organized as registered investment companies. As such, they have access to more investors but have greater regulatory supervision.

Hundreds of hedge funds quietly operated until the 1990s. The early investment strategies of hedge funds were almost exclusively “long/short”. Managers attempted to earn money in the stock market regardless of direction. They would buy stocks they liked and sell short stocks that they didn’t. As long as they could differentiate between the good and the bad, investors could make money in any market.

In 1998, one of the flagship hedge funds, Long Term Capital Management, collapsed in spectacular fashion. Its liquidation required direct intervention by the Federal Reserve to prevent a major crisis. For many casual investors, this was their introduction to the heretofore secretive world of hedge fund investing.

Investment styles among hedge funds have proliferated in the past two decades. Managers now specialize in a range of strategy genres that are recognized within the industry. They might include “arbitrage” strategies focusing on mispricings among related securities. “Event driven” funds exploit inefficient reactions to market events such as merger announcements. “Global Macro” managers focus on broad trends that might increase or decrease the value of one currency relative to others.

Hedge funds are commonly marketed as investments that generate positive returns regardless of the direction of the broader stock market. Sometimes hedge fund returns are described as “non-correlated” as they do not follow the ups and downs of the S&P 500. They do so by trying to identify underpriced or overpriced assets. It is an open question as to whether they, as a group, add value to their investors. We’ll consider this later.

Certainly, hedge fund managers themselves make money in any market. The compensation structure is very lucrative. The average fund charges about 1.5% of assets under management annually plus about 20% of the profits. Ibbotson, Chen, and Zhu estimated that total annual compensation for hedge fund managers amounted to 3.43% of assets from 1985 through 2009.

Growing Institutional Acceptance

At the turn of the millemium, hedge fund investors were primarily wealthy individuals. Institutional investors such as foundations, endowments, and pension funds tried to make money the traditional way – by hiring active fund managers that invested in the public capital markets for stocks and bonds. That changed with the dotcom bust in 2000-02.

Investment committees began to move money from active managers to index funds. At the same time, larger amounts of money were channeled to alternative asset managers that invested in private equity, real assets, and …hedge funds.

Effectively, a sharper line was being drawn between assets devoted to conventional financial markets and those deployed in alternative, less liquid, markets. Investment flows to hedge funds skyrocketed in the last decade as more and more institutions started chasing non-correlated returns. The following chart, compiled by Citibank, offers insight into the explosive growth of institutional participation in the hedge fund universe.

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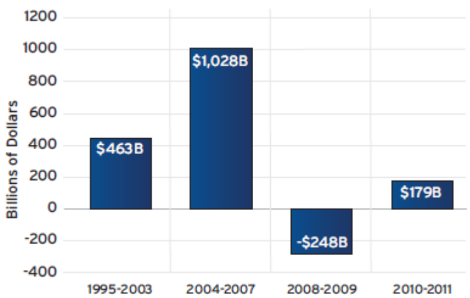
Money Flows to Hedge Funds



Source: Citi Prime Finance Analysis based on HFR data 1995-2003; eVestment HFN data 2003-2012

Measuring Hedge Fund Performance

There are obstacles to the construction of reliable hedge fund performance indices. The trouble lies primarily with biases inherent in the reporting to the databases which track them. Mutual fund performance reporting is mandatory while the comparatively unregulated hedge fund universe relies on voluntary participation.

That presents some problems. If reporting is voluntary, why would anyone report poor results and shine a bright light on their failure. A number of industry and academic observers have tried to quantify the biases in these voluntary databases. Some of the research techniques are ingenious.

One way to gain insight into the true performance of hedge fund managers is to investigate funds of funds. That's not a misprint. Funds of funds are investment vehicles that utilize a team to select from among the "best of breed" hedge fund managers. Of course, this layers in more management cost. The benefit to researchers is that funds of funds must report their performance. The universe is a bit smaller but the performance numbers should be more reliable.

Academics Aiken, Clifford, and Ellis used a database of funds of funds that consisted of hedge funds that reported to major databases and many more that did not. They found a substantial difference in performance between the reporting funds and the non-reporting funds. The reporting funds did about 4.5% per year!

Ibbotson, Chen, and Zhu estimated the reporting biases of hedge fund indicia to be in excess of 5%. They nevertheless found that hedge funds added value as a group. In fact, they concluded that hedge funds added 3% annually even after hedge fund costs and reporting biases were factored in.

There is a consensus that hedge fund indices overstate performance relative to the true population. However, there is no consensus as to whether they add value to their investors. Current trends suggest that hedge funds are operating in a progressively tougher environment.

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Recent hedge fund performance has been poor. Virtually every hedge fund strategy lost money in 2008, even those that purported to implement strategies that were market neutral. Since then, performance has trailed the conventional markets dramatically. There is hard data to support this conclusion.

Hedge Fund Research Inc.(HFRI) maintains a composite index of hedge fund returns that mitigates the more obvious reporting biases found in many databases. For example, it does not backfill its database with the recent returns of newly reporting funds. Nor does it delete the performance of hedge funds that close down. Its summary data is freely available on its website.

The following table compares HFRI's trailing 3 year and 5 year composite hedge fund index returns with exchange traded funds that track the S&P 500 (SPY) and the US Aggregate Bond Index(AGG). Both of these latter funds have low management fees and can be traded at any time by anyone. In effect, they serve as proxies for the "stock market" and the "bond market".

"The Rand Corporation conducted a study of the Hedge Fund's role in the financial crisis. It concluded that hedge fund losses did not lead to significant losses at prime brokers and other creditors."

"Mortality Data compiled by the Social Security Administration indicates that a woman turning 65 this year has a 12% chance of reaching age 95."

Fund Comparison through 04-30-13

Fund	3 year	5 year
HFRI	3.83%	2.80%
SPY	12.66%	5.18%
AGG	5.38%	5.39%

The recent data, not yet reflected in the academic studies, favors passive investment in public markets instead of hedge funds.

The growth of the hedge fund industry makes it unsuitable for exploiting mispricings in the capital markets. There are only so many companies issuing convertible debt or announcing mergers. Can $2.4 trillion of investment capital navigate these rather narrow investment shoals and deliver value?

Another key consideration for hedge fund investors is the liquidity of their assets. Investors cannot withdraw their money at a moment's notice as they can in the traditional public markets. In times of financial stress, they may be subject to "gate" closures on fund redemptions.

Recently, the Endowment Fund made headlines when it suspended redemptions. After several years of lackluster returns, assets in the fund plummeted due to market action and investor flight. Many of the fund's underlying investments were difficult to price and management was loath to sell at fire sale values. To stem the bleeding, management announced it would suspend redemptions for the 4th quarter of 2012. In the first quarter of 2013, investors could get up to 5% of their capital back.

"Gates" are just one impediment to investor redemptions. Hedge fund offering documents typically restrict redemptions to a small window that opens monthly or even once a year. Investors must give 30 to 120 days notice of intent to redeem. Some funds reserve the right to scale back redemptions if they are too large or to pay redemptions "in kind" with investment securities.

Hedge Funds and the Subprime Crisis

Hedge funds wield significant market influence. In addition to their huge aggregate size, they punch "above their weight" in terms of trading volume. As stated earlier, they utilize leverage to a much higher degree than conventional investment funds. Hedge funds are also one of the least regulated sectors in the world of finance.

Many observers of the recent financial crisis have been rightly concerned with the role that hedge funds played in the breakdown of the capital markets. Some funds, such as Greenlight Capital, made considerable sums betting against the toxic securities whose value plummeted in 2008. Did hedge funds contribute to the financial crisis?

Profiting from a problem is not the same as contributing to it. While hedge funds may or may not add value to investors, they are investing their own money without the benefit of a government safety net. The same cannot be said of the country's banks and its government sponsored enterprises. Hedge funds lost money but they managed not to go bankrupt or otherwise disrupt others in their value chain.

The Rand Corporation conducted a study of the Hedge Fund's role in the financial crisis. It concluded that hedge fund losses did not lead to significant losses at prime brokers and other creditors. Nor did it find that hedge funds significantly contributed to the financial crisis through the buildup of the housing bubble, deleveraging, or short selling.

Living Longer and Longer

A key element of retirement planning is insuring that one does not outlive one's financial assets. It's a simple problem but a rather difficult one to solve. And it's getting more difficult because of positive medical news. Americans are living longer.

The American Society of Actuaries (SOA) released a report last year that detailed rapid increases in life expectancy. In the past half-century, life expectancy for newborn American males improved by an average of almost two years each decade, from 66.6 years in 1960 to 75.7 years by 2010. For females, the average increase was about 1.5 years per decade, from 73.1 years in 1960 to 80.8 years by 2010.

Conditional life expectancies for Americans that have achieved retirement age have similarly increased. Mortality data compiled by the Social Security Administration indicates that a woman turning 65 this year will have a 12% chance of reaching age 95. If she has a spouse the same age, there is an 18% chance that at least one of them will survive to 95. Another surprising finding is that over 60% of retirees underestimate their true life expectancy by 2 or years when queried.

Apart from the direct financial risks imposed by longevity, modern Americans are more likely to suffer from cognitive decline as more of them reach "old age". There is roughly a 40% chance that an individual aged 85 is suffering from dementia. These cognitive impairments can affect financial decisions.

Surveys of retired couples typically reveal that there is a primary "money manager" in the partnership. Unfortunately, these same surveys reveal that couples delay a needed shift in money management after the primary "financial respondent" has reported cognitive decline.