
HEDGE FUND HOOPLA

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Hedge funds are all the rage. Ten years ago, they were the exclusive plaything of the very wealthy and of a few sophisticated university endowments and foundations. Two years ago industry observers put the number of hedge funds at around 5,000. Today, even though more than 1,000 fail every year, the best estimate is that there are about 8,000. Even more impressive - or frightening, depending on one's point of view - has been their asset growth. Even the most conservative analysts put their assets under management at well over \$1 trillion. Hedge funds have so caught the public eye that Wall St., loathe to miss such an opportunity, has begun rolling out hedge mutual funds: anyone with a few thousand dollars can join in the fun.

Up to now, few Taft-Hartley plans have invested in hedge funds, and most of those which have, have invested only relatively small amounts. At the same time, many of these plans face serious funding problems stemming from their large 2000 - 2002 market losses. Encouraged by their investment consultants, an increasing number of Taft-Hartley funds are now beginning to take a close look at hedge funds.

The purpose of this paper is not to argue whether hedge fund investing is wise or foolish, or whether hedge funds are the only means to return plans to health. Nor do I prognosticate whether the hedge fund phenomenon is another market bubble in the making, and the emergence of retail hedge funds a sure sign of imminent collapse. Instead, my concern is procedural: Given all of the hedge fund hoopla and faced with recommendations to invest in them, what is a trustee to do?

Deciding to invest in a hedge fund (or fund-of funds) is a fiduciary decision. As always when making such decisions, the right course is to ignore market frenzy and to follow a prudent procedure. Particularly with hedge funds - which come in all shapes and sizes - it is critical that this procedure start with asking oneself several key questions, none of which is novel, but in the current environment are all too easy to ignore.

1. *Do I understand hedge funds in general and the particular one(s) under consideration sufficiently well to make a prudent investment decision?*

Legal and incentive structure aside there is no such thing as a generic hedge fund. Not only are there at least as many distinct hedge fund strategies as there are equity strategies, but the differences among them are much greater. Managers might invest in mergers and acquisitions, distressed debt, bankruptcies, foreign currencies, trade finance, convertible bonds, derivatives, fixed income securities of all types in all markets, etc., and in any combination.

Given this variety, a brief introduction to the various types is on order. An immediate complication is that there is no complete agreement on how to categorize hedge funds, or for that matter, whether a particular strategy (e.g., active futures management) is properly classified as a hedge fund at all. With this caveat, the table below lists some of the more common varieties and briefly describes their basic strategies.

STRATEGY	BRIEF DESCRIPTION
Convertible Arbitrage	Buying a company's convertible debt and hedging it by selling short its common stock
Dedicated Short Bias	Stock portfolios with variable net short positions
Emerging Markets	Buying securities of companies in emerging markets
Equity Market Neutral	Long/short common stock portfolios designed to minimize one or more market wide risk
Event Driven	Investing to take advantage of anticipated corporate events, e.g., merger, acquisition, bankruptcy, reorganization
Fixed Income Arbitrage	Trading on perceived temporary price discrepancies among fixed income securities
Global Macro	Long/short positions in a variety of instruments (including currencies) in anticipation of economic developments
Long/Short Equity	Long/short stock portfolios, tactically net long, neutral or short with respect to market wide risks
Managed Futures	Investing in financial and/or commodity futures
Multi-Strategy	Opportunistic investment in one or more of the above

Given this variety, few professionals are expert in more than a handful of these strategies; and the number of Taft-Hartley trustees possessing even a superficial acquaintance with them is vanishingly small. In short, the work required to understand hedge funds as a class is non-trivial.

2. *Am I willing to put in the time and effort?*
It is easy to say Yes. But how willing are you really? Listening to your consultant give a talk on the subject at a board meeting is not remotely good enough. Even the simplest hedge fund is complex; and even if you understand its basis mechanics, it is quite another thing to develop an appreciation of its risks. The fact is that most trustees - union and employer - are way too busy to devote enough the time or attention to one of the more complex parts of the investment universe.
3. *Should I simply rely on my consultant's knowledge and advice?*
After all, boards routinely rely on professional advisers. No one expects (and nothing requires) that trustees be actuaries, ERISA attorneys or investment consultants. So what's wrong with deciding to invest in hedge funds on the advice of your investment consultant even if you don't understand them? Isn't reliance on the consultant sufficient to establish prudence?

Without pretending to give expert legal advice, but based on my experience as an expert witness in numerous ERISA cases about procedural prudence, I am not at all sure that the answer is Yes. No matter how much responsibility you as trustee delegate to an adviser, you retain oversight responsibility. It is not very plausible to claim that you oversee

hedge fund investments absent reasonable understanding of how they work. And further, even if reliance on your investment consultant were legally defensible, if things went wrong, just how comfortable would you be testifying in public before your members or employer that you voted for an investment that you didn't understand?

4. *How much reliance can I place on my consultant's expertise in this area?*

I think it safe to say that all serious investment consultants read the hedge fund literature, listen to manager presentations and attend conferences. Even so, analytically useful hedge fund data is hard to come by (much less interpret). As a result, evaluating hedge fund strategies and managers depends much more on non-quantitative judgment than is even the case with stocks, bonds or real estate. But, since hedge funds are fairly new to Taft-Hartley investors, few consultants have much live experience on which to base their intuitions and recommendations. In fact, many investment consultants actually subcontract hedge fund research, analysis and evaluation to consultants supposedly specializing in such work. It is not at all clear just what their experience is either.

But even the most experienced consultants have to contend with the reluctance of many hedge fund managers to disclose details of their strategy and operations. Lacking this information no one can make a knowledgeable evaluation.

5. *Should I focus on funds-of-funds?*

Funds-of-funds are actively managed commingled vehicles which, by investing in a number of different funds and/or strategies, provide a convenient way to construct a diversified hedge fund portfolio. But they are not panaceas. First, evaluating a fund-of-funds is no easier than evaluating individual hedge funds. Second, a fund-of-funds adds a second layer of costs on top of the high fees charged by the underlying hedge funds. While these additional fees may not be perceptible when your return is 15%, it can loom quite large when it is only 1% or 2% above money markets. Third, fund-of-funds tend to be "hot money" investors, chasing the latest winners. As a result, many established hedge funds are becoming reluctant to accept large investments from them.

6. *What can I expect in the way of risk and return?*

Sad to say, hedge funds have not repealed the law of no free lunch. In all but the rarest of circumstances, the higher the expected return the higher the risk. Moreover, hedge fund risks are typically much less obvious than those associated with straight stocks and bonds. The questions are whether the type and level of these risks are consistent with your plan's policies, and more fundamentally (since policies can be changed) whether your board is comfortable with them. I think that once the risks are fully understood, in many cases the answer to both would be No.

The hedge fund risk/return spectrum is very wide both across and within strategies. For example, according to Credit Suisse/Tremont, from January 1994 through November 2005, net asset weighted returns by strategy have ranged from nearly -2% per year for

dedicated short bias to approximately 13.5% for distressed debt and global macro. But in the most recent 1 year period, short bias was one of the best performing strategies.

At the low risk/return end of the spectrum, risk largely comes from short positions, questionable credit quality, unexpected calls, failure of price relationships to return to “normal”, illiquidity and directional exposure (net long or short market positions). With expected returns in the range of cash plus 1 - 2%, these funds are really only of value as part of so called “portable alpha” strategies (e.g., enhanced stock indexing). Such strategies are attractive, but they aren’t what generate the hedge fund excitement.

At the high end of the risk/return spectrum, hedge funds aim for (but do not always get) returns of 20%, 30% or more. In addition to all of the risks mentioned above, one typically finds risks of unexpected currency movements, bankruptcy, hidden optionality, failure of prices/spreads across markets and currencies to revert to “normal” levels and the collapse of merger/takeover deals. But what really makes the difference between one end of the spectrum and the other is the use of borrowed money: while low end funds are unlevered (or perhaps levered 2 to 1), at the high end leverage of 5 or 10 to 1 is common.

7. *What are the relevant performance benchmarks?*

It is not that there are no benchmarks, but rather that none of them agree with one another either in how they categorize funds or in the numbers they report. Pick any strategy and you will find that over all periods there are large differences among the appropriate index returns reported by Credit Suisse/Tremont, S&P, Hennessee, HFR, MSCI/BARRA and Barclays, to name just a few leading index providers. Clearly, they are not defining strategies or grouping managers in the same way. Is your hedge fund manager doing well compared to his peers or his index? Much more than is the case with stock, bond or real estate managers, there is no clear answer.

8. *Are my expectations consistent with my plan’s policies and my Board’s risk tolerance?*

Since policies can always be amended, the ultimate issue is how comfortable you are with some or all of the risks involved in the different strategies. If you would need to amend plan policies to accommodate one or another type of hedge fund, just how far are you willing to go? E.g., if you would permit leverage would you set the maximum at 2 to 1, 5 to 1, 10 to 1? Consider real estate which, for all its complexity, you probably understand better. If your plan invests in real estate, I would be very surprised if you don’t prohibit leverage greater than 2 to 1.

9. *How much (what percent of my fund’s assets) am I willing to invest?*

The reason to add a new investment is to try to increase expected return, reduce risk or both. But as in any overheated market, I suspect that what drives interest in hedge funds is expected return, not risk management. After all, if hedge funds yield 10% (net) over the rest of your portfolio and a 5% allocation increases its total return by 0.5%., just think what a 20% allocation will do!

But how likely is it that your hedge fund(s) will produce such high incremental returns? First, if you are not willing to leverage your investment, incremental returns are going to be very small. Second, even within the same strategy hedge fund returns vary widely - much more widely than a universe of similar stock or bond funds. How likely is it that you will be in the right fund(s)? Third, a consequence of the flood of money into hedge funds is that average returns for all of the main line strategies are decreasing.

10. *What is my tolerance for “headline” or litigation risk?*

The pressure to improve returns and the headlines about (past) performance make the attraction of hedge funds almost irresistible. If you invest plan money in them and you succeed, you may be a hero; but what if something goes wrong? More hedge funds than stock, bond or real estate managers simply go out of business each year; and many more of these cases involve outright fraud. If your plan is unlucky enough to be in one of these (and especially if your investment was large enough to have a material impact on plan performance), plan participants, contributing employers and quite possibly the Department of Labor are all likely to start asking rather pointed questions. The risk may be small, but shouldn't be ignored.

11. *What are the implications for my fiduciary insurance?*

Insurers are squeamish about risks that they themselves can't evaluate or estimate. Some are sufficiently nervous about hedge funds that they exclude them from policies they write for investment consultants. So while a small investment may not bother your carrier, one that is large enough to materially impact your plan's returns might well do so.

12. *Are hedge funds my only attractive investment option?*

Though they lack the buzz of hedge funds, real estate, timber, oil and gas partnerships, commodities, emerging market equities and venture, mezzanine or buyout private equity, all generate returns comparable to hedge funds, all diversify straight stock/bond portfolios, most are as liquid and all are much easier to understand than hedge funds. Do these have a place in your portfolio? And if not, then why do hedge funds?

Perhaps the above Q and A suggests that I am strongly opposed to investing in hedge funds. I am not; indeed several of our clients invest in them, and more are likely to do so in the coming years. My point is not that you should ignore genuine opportunities in the rapidly developing hedge fund market, but rather that you should look carefully before you leap. Ask your investment consultant for his candid advice. This is one area in which you definitely want to make him earn his keep.