Even Regulators and Investment Professionals Don’t Get Hedge Funds

Hedge funds don’t make investors rich, they preserve the wealth of the investor who is already rich. Most hedge funds are aware of and carefully manage downside risk and volatility. Long only mutual funds have benchmarks to which they tend to cling. A volatile benchmark can seriously injure an investor’s portfolio.

Given that hedge funds are in fact lower return and lower risk, why is it that both regulators and professional intermediaries both consider them to be more risky than long only mutual funds? This is fact. Ask any regulator or professional investment intermediary and they will always allocate more hedge fund exposure to aggressive risk client’s portfolios and less exposure to conservative client’s portfolios. This absurdity is lost on all but children and rational individuals untainted by the superstition perpetuated in the financial industry. Clearly the regulators and financial intermediaries cannot be well informed. On the other hand, we may ask how a hedge fund manager invests their own capital since they are unlikely to get rich from investing in their own risk controlled strategies. The hedge fund manager must either have made his money elsewhere and is seeking to now preserve his wealth, or he is trying to get rich by charging the usual high fees associated with hedge funds, which he can only do if he attracts sufficient third party fee paying investment capital. A hedge fund manager trying to get rich investing in his own strategy should attempt to apply significant leverage to his own investment in his fund. He should not apply leverage within the fund, but should apply it to his own investment portion only, since if he leveraged he fund, he would only be diluting his fees, and scaring away a lot of less sophisticated investors. Regulators who understand these dynamics should therefore not prohibit less sophisticated investors from investing in hedge funds but rather regulate the degree of leverage investors of various levels if sophistication may apply to investments in general. They may achieve this by regulating the borrower or the lender. One way of regulating the lender is to withdraw the lender of last resort from the system since poor credit standards would injure the lender.