Hedge Fund Investors: Gluttons for Punishment? A reply to The Economist

Hedge fund investors are gluttons for punishment. So says the economist in their May 14, 2009 article where they claim:

1. That hedge funds spectacularly failed to achieve the absolute returns that were supposed to justify their high fees.
2. That hedge funds ran liquidity mismatches between the assets in their portfolios and their volatile funding and investor terms.
3. That hedge funds suspended redemptions or gated investors attempting to redeem.
4. That funds of hedge funds were only marginally less useless than Madoff's auditor.
5. Yet, says the Economist, a recent survey of most of the world's big hedge fund investors conducted by Goldman Sachs, suggest that investors remain surprisingly happy. Also there is anecdotal evidence that redemptions are slowing and that money is actually flowing back into the industry.
6. The Economist also finds that there does not appear to be much appetite to reform the structure of hedge funds. They also point out that there is scepticism or at least a tepid take up of managed account structures.
7. The Economist finally suggests that hedge funds will slowly but surely become more like the old-fashioned asset managers they once threatened to usurp.

Lets deal with the charges.

1. Hedge funds did indeed fail to generate absolute returns in 2008. But was the playing field a level one? From Dec 2007 to June 2008, hedge funds were almost flat, the HFRI Index returning -1.6%. Once Lehman collapsed and bans on shortselling were established, once FNMA and FRE were bailed out arbitrarily within their capital structures, hedge funds' losses accelerated resulting in a return of -19% for 2008. Long only equity indices, credit indices, commodity indices, real estate indices would have lost between 30 – 45% for the year.
2. Some hedge funds did indeed run liquidity mismatches between their assets, their funding and their equity bases. Macro hedge funds and equity strategy managers did not have this problem. However, barriers to entry were low in the last few years leading to a proliferation of mediocrity, to a contamination from long only mindsets and expertise and thus correlation of industry aggregate indices to long only indices. A good hedge fund manages the downside as much as the upside. Examples abound of managers who have protected capital in the turmoil suggesting again the importance of due diligence and manager selection. As for downside from illiquid positions, this afflicted mostly the special situations, mezzanine finance, quasi private equity strategies which while historically at the fringe of hedge funds had gained popularity in the last few years.
3. Suspensions and gating. Guilty as charged. Some strategies cannot be run in open ended hedge fund format. They require lock ups and in some cases they just need a closed end fixed term self liquidating vehicle. However, once an ill structured investment vehicle has been hit in the crisis of 2008, there are basically 2 choices to be made. 1. Liquidate to meet redemptions, liquidate at all cost, even at firesale prices, and 2. Suspend redemptions and undergo an orderly liquidation. The devil is in the details and the behavior of the manager in such a liquidation. It is

hard to swallow that a manager continues to charge fees of any kind during a suspension or liquidation. Open and frank communications are also in order in a liquidation. And next time, if there is a next time, if you want to stick illiquid assets into a portfolio, let investors know before hand and structure the investor vehicle to lock in the equity capital and the financing. Otherwise, get ready for some misrepresentation suits.

4. Funds of funds are of varying quality. One broken down car doesn't mean that all automobiles are unreliable. More importantly, funds of funds serve specific purposes. They are provide a service not only to the investor but to the hedge funds as well. For a more detailed treatment of see my earlier article The Future of Funds of Funds.
5. Why do investors remain relatively happy with hedge funds? Look at the numbers. Sure, hedge funds didn't exactly do what they said they would do in terms of protecting capital in the midst of one of the worst financial crises in recent history. But they would have lost only half of what they would have lost had they been long only. Investors are only reacting rationally.
6. That there does not appear to be appetite to reform the hedge fund industry is disturbing because for all the outperformance of hedge funds versus traditional and other alternative investments, the hedge fund industry is in need of reform. Hedge funds terms and structure are not always optimal for the strategy; often they are driven by what sells, in other words, what investors want. How ironic is that. Investors have always wanted more liquidity than the portfolio could bear. Hedge fund managers pandering to investors gave them what they wanted. Standards of transparency and clarity and alignment of interest need to be addressed. While there has not been much visible activism in terms of reforming hedge fund terms and manager behavior, witness CalPers new policies for investing with hedge funds. Also, the

near halving of assets under management in the industry from some 2 trillion USD to 1 trillion USD over the last 2 quarters is evidence of investors policing the market.

7. Will hedge fund managers come to resemble old-fashioned asset management companies? I hope that hedge funds become more accessible to investors of all types. Including retail. More choice can only be better. Of course intermediaries will be required to manage the added complexity of hedge fund strategies, and here funds of funds are challenged to step up to the plate. I hope that hedge fund techniques of investment become more mainstream and widespread. Leverage and short selling can only improve market efficiency. I hope that hedge funds find traction among retail investors as much as sophisticated ones. Hedge funds have proven their worth in 2008 relative to other investments. And retail investors by reason of their size and numbers represent a more predictable and stable asset base and are therefore good for the stability of hedge funds.

The hedge fund industry has come under considerable fire since the financial crisis of 2008. The reasons, however, are many, and complex, and in some instances are justified and in some, not. For those of us who have invested in hedge funds, we have been encouraged by some and disappointed by others, but by no means have we lost faith in the industry as a whole. Most of us would like to help the industry grow and develop to be stronger and more investor and market friendly. Some of the blame does fall on the hedge fund manager, where they have been arrogant, stubborn or self serving, some of the blame must go to the regulators for legislating before understanding, but some of the blame is the investors’ as well, where they have been ignorant, negligent, lazy, or behaving blindly as a herd. Most of all, the hedge fund industry suffers from a PR problem, as will any industry which is inherently complex. Unfortunately, so many features of this industry cannot be overly simplified, try though the mainstream press might.