# Please Don’t Invest In Hedge Funds. You’ll Crowd Me Out.

I discourage investors from investing in anything they don’t understand. Hedge funds are fairly complex as far as investment strategies go, so I often discourage investors from investing in them unless they are sufficiently knowledgeable. If they want to invest in hedge funds, I tend to steer them towards funds of hedge funds or asset managers who run portfolios of hedge funds, professional hedge fund investors who can help with due diligence and portfolio construction.
The other reason is that the uninformed investor is a liability to everyone. When an investor invests in ignorance they do not react rationally to the evolution of prices or to new information. On the one hand this makes the uninformed investor an excellent provider of liquidity in their capacity as counterparty. On the other hand, they represent unreliable sources of capital if they happen to be on your side of the fence. Better to have them on the other side of the fence. And yet, an erratic opponent is not always easy to deal with. Often the best opponent is someone with a systematic bias the result of regulation or some other persistent inefficiency. Random players are not easy to play. They may lose consistently but they can also confound your best laid plans.

Another issue is capacity. The best hedge funds have capacity constraints. The best opportunities are not easy to find, and are not limitless in terms of how much can be invested in it at a time. As a result, good hedge funds often limit how much capital they will take into their fund so as not to dilute their returns.

At the strategy level also, capacity is an issue. If too many funds invest in a particular opportunity, prices tend to move in such a way as to erode the opportunity. If too many people invest in hedge funds then the superior risk adjusted returns they generate will be eroded. Professional hedge fund investors would reasonably be expected to prefer fewer investors or less capital deployed to hedge funds so as to maintain their returns. One of the phenomena just prior to the crisis in 2008 was the compression in returns on assets employed in hedge fund strategies due to the influx of capital to these capacity constrained strategies. As a result, managers seeking to maintain returns on equity capital increased their leverage and therefore their risk. Existing investors might reasonably consider themselves diluted by additional investors.

The current environment is conducive to relative value and arbitrage. The aftermath of the credit crisis has created very compelling and rich opportunities in event driven, merger arbitrage and credit strategies. Equity strategies and macro strategies have and will not have an easy time. In addition to the opportunities created by the crisis, regulation, popular opinion, political pressure and investor superstition maintain and generate a constant supply of opportunities. That investors have been slow to adopt or re adopt hedge fund strategies has helped returns. Just look at how the visible and popular strategies have done in the last 3 years. Macro and trend following strategies have done exceptionally poorly given the expectations implied by the environment. Unpopular, apparently risky, strategies like mortgage backed securities, structured credit, credit arbitrage, merger arbitrage have done well. This observer is conflicted as he surveys the landscape. On the one hand, it would be nice to see investors returning in greater mass to hedge fund strategies, but on the other, as an investor in such strategies, its is equally encouraging to see that trades are not getting crowded. Hedge funds used to be a smallish, private, sometimes secretive industry profiting the few. It’s getting to be like that again.