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Skepticism about hedge funds for taxable investors

by William W. Jennings

At 7258 Wealth Management, we are skeptical about hedge funds, as typically implemented, for our client families in taxable accounts. Hedge funds are alternative investment vehicles that often use leverage, derivatives, and advanced strategies in an attempt to generate high returns with low risk. Historically, they hedged one stock with another in order to reduce exposure to overall stock market fluctuations. More recently, the hedge fund category includes a range of strategies including tactical trading, trend following, and arbitrage between markets, among others.

Hedge funds purportedly offer a number of advantages:

- **Diversification benefits.** Hedge funds have historically promised uncorrelated returns and downside protection in bad markets.
- **Good return-risk tradeoff.** The historical promise of hedge funds, sometimes delivered, was “stock-like returns with bond-like risk.”
- **Absolute return.** Hedge funds are marketed as offering an absolute return, presumably positive, that was unaffected by stock and bond trends.
- **Best managers.** Wherever one comes down on the active-passive debate (and 7258 Wealth Management is firmly in the latter camp), it is economically sensible that more talented managers will move from traditional stock picking to the better-paid hedge funds.

However, there are some reasons to be skeptical about hedge funds:

- **High fees generally.** While some fees have declined, the norm of 2-and-20 still broadly applies. (This means hedge funds charge 2 percent of assets under management plus 20 percent of any profits. This can really add up.)
- **High fees proportionally.** These high fees mean managers take a disproportionate share of the return your assets earn.

- **No admittance.** Many of the best funds are closed to new investors. Others have such high minimum investments (say, $5 or sometimes $50 million) that even those with very high net worth cannot build a diversified portfolio.
- **Cheap talk.** While the best managers should naturally gravitate to better-paid hedge funds, it is hard to determine who is best beforehand. Alas, the high compensation attracts both the talented and the also-rans.
- **Crowded trade.** As more and more capital is attracted to hedge funds, inefficiencies get arbitraged away and the investments become more like traditional ones.
- **Illiquidity.** While liquidity terms have improved recently, initial lock-ups, and long-notice redemption policies put hedge funds at a disadvantage relative to daily-liquidity funds and accounts.
- **No secret sauce.** Much of hedge funds' historical return was readily-available factor exposures. Automated "hedge fund replication" funds attempt this.
- **What absolute return?** The hedge fund index return of a -19% loss in 2008 didn't diversify the stock market's –37% loss.
- **More correlated.** Hedge funds have proven more-correlated than expected, particularly in down markets. (This is exactly when investors need diversification.)
- **Short volatility.** This is a technical way of saying that many hedge funds lose more money in volatile down markets.
- **Asymmetric risk.** While the number of hedge fund scandals has thankfully declined recently, the risk of disaster remains. Given their advanced strategies, "left tail risk" is higher at hedge funds than with traditional investments. Given manager's incentives, hedge funds sometimes take disproportionate risks after losses, again increasing "left tail risk." Managers are particularly incentivized to take catching-up risks by funds "high water marks," which only pay fees when a fund is a net winner.
- **Non-transparency.** While disclosure has improved, hedge funds' sometimes obscure strategies effectively make them "opaque" to outsiders. They are not simple.
- **Questionable data.** The case for hedge funds is built on dubious data that is subject to survivorship and backfill biases. (Only successful start-up hedge funds "live" long enough to report their returns, and unsuccessful funds stop reporting.)
- **Iffy fund of funds.** Many hedge fund investors favor fund-of-funds to avoid single-manager risk. Alas, this adds fees to the already onerous fees of the underlying funds. Moreover, fund of funds tend to all look alike, diversify away advantages, and combine fees schedules badly.

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Taxable investors, particularly, need to be skeptical about hedge funds:

- **Tax oblivious.** Hedge funds generally ignore taxes. This problem has grown as hedge funds evolved from being a "family office asset" to being more popular with tax-exempt foundation, endowment, and pensions. A key element in 7258 Wealth Management's philosophy is to focus on after-tax returns—what you get to keep. See our blog posting on You Don't Have to Pay Taxes.
- High turnover. Most hedge fund strategies are high turnover, with concomitant tax consequences, including taxation at the highest marginal rate with minimal long-term capital gains.
- **Taxes on phantom income.** Some individual hedge fund investors must treat management expenses as a miscellaneous itemized deduction, which can be phased out at higher incomes. This treatment means paying taxes on gross returns that the investor never sees.
- **Slow reporting.** Investor's tax reports, in the form of K-1s, take time to compile. The problem is exacerbated with fund-of-funds. In our experience, individuals are more sensitive to these delays, which may require filing extensions and more CPA work.
- **Minimal contribution.** With typical, risk-aware allocation levels (say 10% of a balanced portfolio) any potential value-added from hedge funds is frequently not worth the trouble.

At 7258 Wealth Management, we continue to monitor the hedge fund industry and look for appropriate opportunities for our families. However, we do so skeptically.

William W. Jennings is 7258's external Director of Research. Dr. Jennings is Professor of Finance and Investments at the Air Force Academy. He serves the community via various investment committees with over $25 billion in pension and endowment funds, including several billion dollars in alternative investments.

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