Hedge Funds – Some Cautions

One of the hard lessons we all learn sooner or later as investors is that there are fads or fashions in investing, as in everything else. The cycle is simple:

- A few people discover something new that makes good profits.
- Word starts to leak out and more people copy it.
- They are still successful, but usually less so than the early birds.
- Finally, the mass marketers discover it and aggressively market it to the punters.

The mass marketers care more about marketing than quality of product, so they are not too fussy about the managers they employ. Moreover, the game has moved on from a few people *picking the low-hanging fruit* to a hard competitive battle to find and keep a marginal edge. The market relentlessly arbitrages away outstanding returns as the methods become widely known.

The 1990's - 2000's saw a marketing surge on hedge funds. Hedge funds were first heard of in the 1980s. Then they grew to more prominence in the 1990s. They are high risk and were essentially an investment vehicle for high-net-worth individuals. These people employed the best hedge fund traders and relentlessly took their money away from the manager if the results slipped even temporarily. A hedge fund manager might be a rooster today, but a bad period might see him as a feather duster in no time flat.

Many of the recent investors are going into hedge funds for the wrong reason. They are there because they are looking for the high returns that were delivered by the stock market during the tech and Internet bubble in the 1990's. Now that stock market returns have reverted to the mean, they are attracted to hedge funds.

The first advantage of a hedge fund is that it trades both long and short. This is in contrast to most unit trusts that can only invest on the long side. Theoretically, a hedge fund can do better because it profits both in rising and in falling markets, whereas a traditional unit trust only profits in rising markets. The important word here is theoretically, because it is still possible to lose money trading the short side in a falling market, if you make bad decisions.

Next, hedge funds can use leverage. Essentially, this means using borrowed money to boost the return on the investors' capital. That is fine, but remember that leverage works both ways. If the fund makes bad decisions and loses on leveraged positions, the borrowings also magnify the losses.

The sudden and dramatic collapse of Long Term Capital Management, rocking the world financial system in the process, was a good example of how the brightest investors can get it wrong and lose big time in a hedge fund situation.

It should also be kept in mind that in many jurisdictions, hedge funds are not as tightly regulated as traditional investment products. That is because they were originally sold to, and intended for, professional investors, who are deemed to be big enough and ugly enough to look after themselves. In other words they have the skills and resources to do their own research on investment propositions. The average private investor is deemed not to have these skills and relies on the promises in the prospectus, so much tighter regulation is necessary to protect them.

Another factor is that high-net-worth individuals and professional investors know enough about diversification to commit only a small part of their funds – what they see as genuinely risk capital – to such high-risk vehicles. Right through history, countless private investors have put, and continue to put, inappropriately large parts of their investment capital into such risky investments. It always ends in tears for many of them. They come to truly understand that high promised return almost always equates to high risk, or there is no such thing as a free lunch.

If tempted to invest in a hedge fund, here are some guidelines:

1. Demand to see a good track record. Results are everything. The reputation of the marketer is meaningless. The only safety in high-risk investing is ability, not size, or reputation in other fields.
2. The best funds will not be widely advertised, they don't need to be, because money will be chasing them.
3. Make sure the track record was established with a fund of similar size to the proposed one. It is much easier to make high returns on a small fund than on a large one.
4. Make sure the manager or team that built the track record is still running the fund.
5. Make sure that the investment strategies that built the track record are still, and continue to be, those being applied.
6. Make sure that you understand the methods used to value the investments the fund is holding and how and when profits are brought to account.
7. Do not devote more than a small part of your investment capital to hedge funds. I would think that 10% is on the high side.
8. Monitor the fund actively. If it does not perform as promised, don't ask questions or accept excuses, do the "Wall Street walk" – that is, get the hell out of there.

I am not opposed to hedge funds as such, any more than I am opposed to most investment products. However, I am wary of mass marketing of a product that may not suit the average inexperienced investor. It pays to understand what hedge funds are and whether they are suitable vehicles to meet our investment objectives. The old rule still applies – never invest in something you don't understand.

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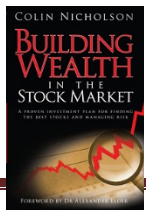

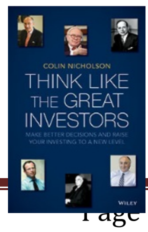

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