

OUTSIDE THE FLAGS

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Hedge of Darkness

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It's true. Big money *can* be made from hedge funds. If you run one, that is.

That's the conclusion of a new book that says people who invest in hedge funds would have been better off over the past nine years if they had stuck to a broadly diversified portfolio of vanilla stocks and bonds.

The book is *The Hedge Fund Mirage: The Illusion of Big Money and Why It's Too Good to be True*, by Simon Lack, an asset manager who formerly chose hedge funds for major US bank JPMorgan.

Lack argues that the 18% return on hedge funds in the nine years to November 2011 was easily beaten by the total 29% gain from the S&P 500 index. The gap was even starker for investment grade corporate bonds, which in the same period gained 77%, as measured by the Dow Jones Corporate bond index.

Of course, the underperformance of hedge funds over this period is even greater once the customary 2% management fee and 20% performance fees charged by hedge fund managers are taken into account.

If individual hedge fund managers are generating the desired "alpha," or additional returns above the market, then the benefits of that skill tend to go to the managers themselves rather than to investors.

In fact, Lack estimates that from 1998 to 2010, the hedge fund industry captured at least 86% of the returns it earned for its customers. This might explain why yachts cruising the Caribbean tend to be skippered by hedge fund managers, not investors.

For anyone who has followed the hype surrounding hedge funds for many years, this is not really a surprise. A good proportion of the investing public—egged on by the financial media—genuinely wants to believe that consistent market-beating returns are achievable without taking on additional risk and paying excessive fees.

From a marketing perspective, at least, the appeal is fairly evident. After all, the more exclusive you make a club, the more likely people will pay a premium for joining it.

While the hedge fund industry no doubt would contest the findings of Lack's book, one doesn't have to agree with his numbers to still harbor reasonable doubts about risking one's hard-earned savings by investing in hedge funds.

In a recent white paper¹, Dimensional senior associate in Research Ronnie Shah explains that, due to the lack of disclosure around returns, it is difficult to determine how much alpha, if any, hedge funds generate.

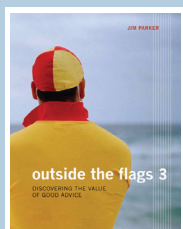
Industry groups that report hedge fund returns rely on voluntary disclosures by the funds themselves on the returns they generate. Shah notes this creates potential for biases in the data, such as the omission of poor returns or the dropping out of the returns of failed or discontinued funds.

This is in addition to other drawbacks of hedge funds, such as illiquidity, relative lack of oversight, the additional costs of leverage and derivatives and, of course, the substantial fees charged by the managers themselves.

Shah's paper concludes that the highly uncertain payoff from hedge funds, the high expense ratios, and the lack of disclosure around them mean investors should exercise caution before investing in them.

Starting one up is another matter altogether.

1. Ronnie R. Shah, "Demystifying Hedge Funds: A Review," (white paper, Dimensional Fund Advisors, December 2011).



"Outside the Flags" began as a weekly web column on Dimensional Fund Advisors' website in 2006. The articles are designed to help fee-only advisors communicate with their clients about the principles of good investment—working with markets, understanding risk and return, broadly diversifying and focusing on elements within the investor's control—including portfolio structure, fees, taxes and discipline. Jim's flags metaphor has been taken up and recognised by Australia's corporate regulator in its own investor education program.

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