WHITE PAPER NO. 36

HEDGE FUNDS GET SWENSENED

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"We got them steadily depressin', low down mind messin'
Workin' at the hedge fund blues."[1]

Not that we're feeling all that sorry for them, but let's face it, it's been a tough couple of years for hedge funds. Returns have fallen out of bed, at least compared to what investors were expecting (and compared to what many hedge fund managers were projecting). The Securities and Exchange Commission has decided to get tough on hedge funds, forcing them to choose between registering with the SEC or imposing long lockups on their investors. (Most prominent funds are imposing lockups – thanks, SEC.) A steady stream of frauds and blowups have occurred in the industry, giving everyone a black eye. The mainstream media has gleefully reported every problem, leaving investors with the impression that the hedge fund business is a den of thieves, that returns have been terrible, and that only fools invest in hedge funds. And, now, just to add insult to injury, David Swensen, the highly regarded manager of the Yale University endowment, has warned investors to avoid hedge funds completely and especially to avoid hedge funds of funds.

Ok, But Let's Get Real

We yield to no one in our skepticism of many of the players in the hedge fund business, and we've not been shy about expressing our reservations.[2] But what concerns us today is not the problems in the industry, but the negative impact on investors of the steady stream of bad news – and especially of Swensen's widely-reported remarks. We observe in our own client base, and we hear from colleagues around the industry, that many otherwise sensible investors are suddenly reluctant to invest in even the best hedge funds and funds of funds. As a result, investment portfolios are degrading, imposing more risk than is necessary, and investors are missing out on some of the best money managers and most sensible strategies available. Worst of all, the notion that investment strategies should be affected in any way by what appears in the media is a form of madness that needs to be stamped out before we're all locked up for our own good.

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[1] With apologies to the late Jim Croce.

[2] E.g., Greycourt Client Letter, *The Collapse of the Bayou Group Hedge Fund* (September 2005); Greycourt Client Letter, *Global Credit Markets Disruption – A Hedge Fund Crisis?* (May 2005); *Creative Capital: Managing Private Wealth in a Complex World*, by Gregory Curtis (iUniverse Press, 2004), especially Chapter 12; Greycourt White Paper No. 25 – *Hedge Fund Investing: The End of the Beginning?* (October 2002).

Let's see what we can do to separate the wheat from the chaff.

The wheat

"Where there's smoke, there's fire," and we certainly don't mean to leave the impression that criticisms of the hedge fund industry aren't often warranted. Here is what we see as legitimate about all the carping.

Returns have been lousy. "Lousy" might be too strong a word, but we'll accept it. While hedge fund investments proved rewarding throughout much of the 1990s and, especially, during the dreadful bear markets of 2000 – 2002, there hasn't been much to cheer about since then. Hedge fund returns will always appear tepid during powerful bull markets (e.g, 2003, when the S&P 500 rose nearly 30%), but they will also tend to lag during periods of low market volatility, when opportunities disappear.[3] Thus, in some real sense, investors have been legitimately disappointed, especially when we consider that as recently as the early 2000s many hedge fund managers were still predicting future returns in the 15% to 20% range.

Hedge funds need to be regulated. Though our friends in the hedge fund business will be disappointed in us, we tend to agree with this sentiment. Many funds *are* regulated, of course, if you consider CFTC[4] registration to be a form of regulation, and some hedge funds of funds have always been registered under the Investment Company Act of 1940 (the "1940 Act"). But most individual hedge funds have never been registered with the SEC, their disclosure documents (offering memoranda and the like) tend to give them carte blanche and are therefore useless, and their lack of transparency plays into the hands of the worst participants in the business. Hedge funds, unlike long-only managers, present special issues associated, among other things, with the pricing of thinly traded securities, the use

[3] Greycourt Chief Investment Officer Gregory R. Friedman has suggested that low market volatility has been driven by massive global excess liquidity, the result of central banks' easy monetary policies, excess cash held by corporations, and the rapidly growing wealth of Asian and Middle Eastern investors with high savings rates. When excess liquidity infects markets, what tends to result is a lack of discrimination among good, average and poor investments as liquidity desperately seeks a home

[4] Commodity Futures Trading Commission. The CFTC was created by Congress in 1974 as an independent agency with the mandate to regulate commodity futures and option markets in the US. Although many people view futures and options as new, alarming instruments, agricultural commodities have been traded in the US for more than 150 years and have been Federally regulated since the 1920s. More recently, of course, trading in futures contracts has expanded beyond traditional physical commodities into a wide array of financial instruments, including foreign currencies, US and foreign government securities, and US and foreign stock indices.

of leverage, misrepresentation of what the managers are doing, high fee levels, long lockups, and so on. Most worrisome of all, hedge funds assets aren't held in custody in the name of the ultimate investor, but are held in prime brokerage accounts in the name of the hedge fund. Better regulation[5] would go a long way toward professionalizing and regularizing the hedge fund business, and toward removing the high level of suspicion and mistrust that surrounds the industry. By bitterly resisting any form of regulation, hedge fund managers are doing themselves and their investors a disservice.

Hedge fund fraud is epidemic. Well, we will object to the word "epidemic" (see the discussion, below), but there is a real sense in which *any* fraud in the hedge fund business is too much. Because hedge funds are already so secretive and difficult to understand, any instance of fraud has a disproportionately large impact on investor trust and confidence. This is especially true for newer investors, but many more experienced investors are also uncomfortable with their lack of knowledge about what their hedge fund managers are doing, and when it turns out that what even a few of them are doing is fraudulent, investors' faith plunges.

Media attention. Newspapers, magazines, and even television journalists often seem to be preoccupied with hedge funds and their troubles – and why not? If we were journalists we would be jumping all over a juicy topic like hedge funds, where the most successful managers make hundreds of millions of dollars a year, where investors are, for the most part, deep-pocketed fat-cats, where frauds often make for potboiler fiction-like reading, and so on. When a hedge fund fails, everyone wants to read about it, wealthy investors as well as others (for cautionary reasons and Schadenfreude, respectively). So while all the media attention has alarmed investors, we can't blame journalists for doing what they're supposed to do: cover a topic of wide interest.

If David Swensen says to avoid hedge funds, why am I so smart? Well, it's a helluva good question. In fact, we agree with much of what Swensen has to say about hedge funds and funds of funds. Let's look, first, at his recent interview in the *New York Times*, where what Swensen actually said about funds of funds was this: "Funds of hedge funds generally aren't a good investment for the unsophisticated investor."[6] Hard to quibble with that. It isn't even controversial. After all, we know from the Dalbar paper[7] that between 1983 and the end of 2000, while the S&P 500 was returning an average of 16.3% per year, the typical equity investor achieved only 5.3%, and while long-term bonds rose 11.8%, bond

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[5] By "better regulation," though, we don't mean what the SEC has mandated. See below.

[6] Geraldine Fabrikant, "Hedge Funds Work for Yale, but Will They Work for You?" *New York Times*, November 27, 2005, page BU 5.

[7] *Quantitative Analysis of Investor Behavior* (2001).

investors got only 6.1%.[8] We can hardly expect investors who can't manage stock and bond portfolios to be great hedge fund investors. And since most hedge funds of funds don't even begin to earn their extra layer of fees, suggesting to unsophisticated investors that they invest in funds of hedge funds is almost certainly doing them a disservice.

The chaff

But that's enough wheat for one day. Chaff is much more fun and, we think, more useful to investors who have become worried about hedge funds. Let's run through the list of complaints about hedge funds one more time.

Returns have been lousy. Actually, it's investor expectations that have been optimistic – along with the expectations of many hedge fund managers. There are no investments that always produce good results, and there never will be. As we noted above, it is the very nature of a hedged product that it will not show well during powerful bull markets (2003). Moreover, because hedge funds are not, in general, looking to make money on market directionality,[9] but on exploiting opportunities largely unrelated to market direction, periods of low market volatility will also be periods of weak hedge fund performance. When stock market performance has been weak, investors don't (or shouldn't!) abandon the stock markets (indeed, once prices have dropped, it is usually prudent to buy). The same is true of hedge funds: periods of recent poor performance probably represent a useful buy signal. Finally, the main role of hedge funds in a diversified portfolio isn't on the return side, but on the volatility side. Since these funds are hedged, they typically exhibit far lower price volatility than other equity investments, and sometimes lower volatility than bonds. And all else being equal, portfolios with lower volatility will grow our wealth faster than portfolios with higher volatility.

Hedge funds need to be regulated. As noted above, we tend to agree on the need for better regulation, especially if the alternative is the unhappy combination of no-regulation-and-longer-lockups. But there is a caveat. Hedge funds are not at all like long-only managers or mutual funds or financial planners, and subjecting hedge funds to a one-size-fits-all registration and audit scheme makes little sense. What the SEC has proposed is simply that

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[8] A recent Morningstar study observed the same phenomenon. For example, for the 10-year period ended 9/30/05, the total return on the Vanguard 500 Index Fund was 9.42%, while the dollar-weighted return was only 6.72%. Even more astounding: the total return on the Vanguard Tax-Managed Growth & Income Fund (9.51%) was more than twice its dollar-weighted return (4.13%). Sonya Morris, "Even the Best Investments Must be Used Wisely," *Best of Morningstar*, December 2005 (Morningstar.com, 12/15/05).

[9] Long-only managers, on the other hand, make almost all their money on market directionality. Most managers show R-squareds of >.90 against their benchmarks, meaning that more than 90% of their return is accounted for by the market's performance.

hedge funds register as investment advisors under the rules and regulations promulgated under the 1940 Act. But since the first hedge fund didn't appear on the scene until the 1950s, and hedge funds didn't become common until the 1980s, the existing regulatory scheme is almost completely irrelevant. We shudder to think, for example, of what an SEC surprise audit (all registered investment advisors are subjected to these audits) would look like if conducted on a large, complex hedge fund. Better regulation is needed, but the existing regulatory framework seems to us inadequate and inappropriate.[10] Consider the bizarre case of hedge fund Millennium Management LLC and its founder, Israel Englander. Millennium, Englander, and other executives recently paid huge fines ($180 million) to settle charges related to rapid mutual fund trading. Englander was barred for three years from working for any registered investment advisor, *but since Millennium isn't registered, Englander keeps his job*.[11]

Hedge fund fraud is epidemic. In a word, nonsense. In a perfect world, of course, there would be no fraud at all. But we tolerate a certain amount of crime in our daily lives because the cost of eliminating crime is simply too high. We know there will be a certain amount of crime among corporate executives for the same reason. There always has been and always will be unscrupulous hedge fund managers, just as there are unscrupulous long-only managers,[12] unscrupulous mutual fund operators,[13] and so on. But if anything, hedge fund fraud appears to be declining, and fairly precipitously at that. There have been a dozen or so alleged hedge fund frauds each year for the past few years, but these frauds represent a very small and declining percentage of the 8,000 or so hedge funds in operation. Certainly hedge fund fraud is less common than corporate fraud, for example, despite the presence of extensive audits of corporate books.

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[10] The SEC's decision to require hedge funds to register has been controversial from the beginning. The Commission approved the requirement by a 3-2 party line vote, in the teeth of Congressional opposition. The SEC claims jurisdiction via an extremely expansive interpretation of the meaning of the word "client" in the 1940 Act, an interpretation which has been challenged in court.

[11] The facts of the Millennium case are in one sense appalling, but it is important to keep in mind that, unlike Richard Strong and other heads of mutual fund firms, Englander didn't owe any fiduciary duties to the mutual fund shareholders who were harmed by his fund's trading practices.

[12] Consider Alan Bond (New York), Stevin R. Hoover (Boston), Jeffrey L. Grayson (Portland, Oregon), Reed Slatkin (Los Angeles), Martin Frankel (world citizen), Stephen G. Zavada (New Jersey), Gregory Setser (Rancho Cucamonga), James P. Lewis Jr. (Orange County, California), Nathan Chapman Jr. (Baltimore), etc., etc., etc. We won't even mention the likes of Nick Leeson, who destroyed the UK's oldest investment bank, Barings; Marc Rich, the famous fugitive astonishingly pardoned by President Clinton; Sumitomo copper trader Yasuo Hamanaka, who lost $2.6 billion in five years; Procter & Gamble which, with more than a little help from Banker's Trust, lost $195 million on several complex swaps in 1994; and so on.

[13] See Greycourt Client Letter, *The Mutual Fund Scandals* (November 2003).

Media attention. In case anyone is laboring under the misapprehension that media attention is being focused on hedge funds because hedge fund fraud is exploding, let us gently point out that what is exploding is media attention, not hedge fund fraud. Here, for example, is a comparison of the incidence of hedge fraud and the incidence of media attention:[14]

	1996	*1999*	*2002*	*2003*	*2004*	*2005*
Hedge fund frauds	*1*	*3*	*19*	*18*	*13*	*12*
Media articles on hedge funds	*<25*	*<25*	*<100*	*>350*	*>300*	*>400*

If David Swensen says to avoid hedge funds, why am I so smart? Here is an interesting phenomenon. In Swensen's first book, *Pioneering Portfolio Management*,[15] published in 2000 and addressed to institutional investors, hedge funds were portrayed as playing an essential role in reducing portfolio risk and in gaining access to the most talented managers (Yale has a huge exposure to hedge funds).[16] We couldn't agree more. But in Swensen's more recent book – well, technically it's a book, but let's call a jeremiad a jeremiad – hedge funds seem to have disappeared from the face of the earth. In *Unconventional Success*,[17] addressed this time to the retail investor, Swensen mentions hedge funds only in passing, mainly complaining about their fees. What gives? What gives, we think, is that Swensen's advice about hedge funds – and our advice about hedge funds – differs depending on the nature of the investor. Here, in a (largish) nutshell, is how we would put it.

Category #1 – Investors acting on their own. As noted above, our advice to these investors is nearly[18] identical to Swensen's: don't try this at home. Most hedge fund portfolios we have seen that have been assembled by individual investors are flat-out frightening. They tend to be undiversified, there tends to be no ongoing diligence on the managers (and precious little up-front diligence), and no thought at all has been given to how the hedge fund exposure fits with the rest of the portfolio. And when individual investors invest in

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[14] With thanks to Morgan Stanley.

[15] *Pioneering Portfolio Management: An Unconventional Approach to Institutional Investment* (The Free Press, 2000).

[16] *Ibid.*, Chapter 8.

[17] *Unconventional Success: A Fundamental Approach to Personal Investment* (The Free Press, 2005).

[18] Swensen's attitude toward individual investors is so paternalistic it's virtually Soviet. He believes, for example, that hedge funds of funds should be legally banned and that all but the largest institutional investors (e.g., Yale) should be barred by law from investing in hedge funds.

funds of hedge funds, they tend to select funds that are little more than convenience vehicles, that is, that are very expensive, do little or no up-front and ongoing diligence, are chock full of conflicts of interest, and that give no thought at all to tactical exposure issues.

Category #2 – Investors who are captive clients of product vendors. When we speak with investors who are captive clients of large, product-selling financial firms, we tend to hear something like this: "Sure, the firm's products may not be best-in-class, and sure, they might be over-priced, but [insert name of voracious bank] wouldn't endanger its reputation by pushing truly awful products." To which our response is, "What are you smoking?" Financial firms that have been disciplined again and again by the Federal regulators for engaging in everything from outright fraud to conspiring with the likes of Enron are hardly going to draw the line at pushing a lousy investment product. Swensen himself gives numerous examples in *Unconventional Success*, but we'll just repeat one and a half of them. Consider the Merrill Lynch Internet Strategies Fund. For more than half a century, Merrill Lynch had been associated with a disciplined value approach to picking stocks. But as the 1990s progressed, and value fell ever more deeply out of favor, Merrill's top brass finally caved in to demands from its brokerage army and launched the Merrill Lynch Internet Strategies Fund, a mutual fund that invested mainly in dot.coms. Unfortunately for Merrill (to say nothing of investors in the fund), Merrill's timing couldn't have been worse: the new fund was launched exactly at the bubble market peak in March of 2000. Hyped by, among others, notorious Merrill Internet analyst, Henry Blodget, the fund quickly raised more than $1 billion in assets. By the fall of 2001, with the fund's performance at a sizzling -81% (that's right, a $1 million investment in the fund was then worth $190,000), Merrill quietly folded the Internet Strategies Fund into the also-toxic Merrill Lynch Global Technology Fund, which proceeded to decline another 32%.[19]

Category #3 – Investors working with objective advisors. Ok, we're blowing our own horns here,[20] but the hard fact is that investors who are working with competent, objective advisors are far more analogous to very large institutional investors than they are to the investors described in Categories #1 and #2. Open architecture advisors act as a kind of private investment office for their clients, searching for the best hedge funds and funds of funds, ensuring that appropriate diligence is done on them (and continues to be done long after the funds are bought), avoiding conflicts of interest themselves and refusing to do business with funds of funds that have embedded conflicts, and so on. In fact, very few

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[19] *Unconventional Success*, op. cit., note 13, pages 163-166. Swensen also discusses the Principal LargeCap Value Fund, which sports a dazzling 2.51% expense ratio. (*Unconventional Success*, pages 238-240.) While the Principal fund has not, to our knowledge, blown up – which does, in fact, occasionally happen to hedge funds – its investors have suffered instead a prolonged and gruesome Death By a Thousand Cuts.

[20] Greycourt is an open architecture financial advisor.

large, institutional investors can boast anything like the size, experience and talent that the best open architecture firms can deploy.

There's A Bottom Line Here Somewhere

There is no gainsaying the fact that the hedge fund community has had a difficult time recently, and that it has become a target for criticism by the knowledgeable and the clueless alike. Nor can we quibble with the claim that hedge fund investment activities are often (though hardly always) complex, opaque, and secretive. But the bottom line is the same as it usually is: investors who are poorly or corruptly advised are likely to come to grief, and the more complex the investment sector the more grief they are likely to come to. As for investors who are well advised but still worried about their hedge fund portfolios, may we offer this humble advice: stop worrying and enjoy the New Year!

GREYCOURT & CO., INC.
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