Why Hedge Funds Are a Losing Bet
By Robert J. Mintz, JD

Are hedge funds a smart choice for today's investor? Hedge funds have certainly been in the news a lot lately. You've no doubt heard about the woes of the subprime market, but no one knows at this point how wide and how deep this iceberg will turn out to be. Hedge funds have invested hundreds of billions of dollars in subprime loans by buying packages of these loans from the original lenders. But now, with homeowner default rates skyrocketing, the value of these portfolios have been decimated. Some of the largest hedge funds have already filed for bankruptcy and many others are on their way to a similar fate. Although the smart and the lucky may have already taken their money off the table, new investors are pouring in daily. For example, the Teacher Retirement System of Texas recently announced that it will shift about one-third of its $112 billion in assets to hedge fund investments, hoping to boost its returns.

What Are Hedge Funds?

The number of hedge funds has exploded over the last five years, doubling to nearly 10,000 funds managing more than $1.7 trillion in investments. A hedge fund is like a mutual fund, but with several key differences. Hedge funds are largely unregulated and are open only to wealthy individuals and institutions. Unlike mutual funds, they often rely on leverage--plenty of borrowed funds--in order to juice returns. Also, instead of just investing in stocks or bonds, hedge funds use a variety of exotic contracts and specialized loan arrangements called derivatives, which are not traded on any market. Most importantly, while mutual funds generally charge investors a service fee of 1-2%, hedge funds charge both a management fee and a performance fee. That is, they get 2-3% of invested assets as well as 20-30% of the annual net profit. Investors make this deal hoping for above average returns, even after deducting the large performance fee. A hedge fund that earns 20% in a year, less a 20% performance fee, still gives the investor a 16% return. Not bad when risk-free government bonds are paying less than 5%.

Performance Fees

The problem is that the performance fee paid to the hedge fund manager creates a serious conflict between the ambitions of the manager and the goals of the investors. The overriding concern of the hedge fund manager is to make a big profit for the year because his performance fees are calculated on an annual basis. That means that he wants to make trades that have a high probability of short-term success regardless of the ultimate outcome. For the investors, however, short-term profits are meaningless if their entire investment is at risk. A compensation system skewed to short-term profits creates an incentive for managers to adopt trading strategies that may work spectacularly well for a few years but eventually lose far more money than they ever made. I'm sure most managers would prefer trades that make money for themselves and their investors, but that is not an easy task. So most will settle for the next best thing, and as they say in the business "One out of two ain't bad." Four or five good years can set up a manager for the rest of his or her life, so seeking good returns in the first few years becomes very attractive and can trump concerns for the long-term prospects for a fund's strategy.

Hedge Fund Strategies

The most popular of these short-term strategies is known as a "carry trade." The hedge fund borrows money at a low rate, say 5%, and invests in securities paying a higher rate, maybe 7-8%. With the expanding world economy there is no shortage of potential borrowers in the US, China, India, and Latin America. Banks and other financial institutions earn their fees by originating these loans with borrowers and then selling them to the hedge funds. Knowing that they always had a ready buyer to assume the risk, the lenders continually lower their credit standards until no standards exist. During the last five years, virtually anyone wanting to borrow money for business or real estate has been handed a blank check. The highest-risk loans, with the greatest chance of default, were then handed off to the hedge funds, which were guaranteed huge profits as long as interest rates held steady and economic conditions were perfect.

The New World

But now conditions are not so perfect and it's starting to appear that scooping up all the risky loans in the world may not work out so well for the hedge funds. The declining real estate market is causing record foreclosures and the hedge funds holding these mortgages have been decimated. Hedge fund managers--at least those who got in early enough--made spectacular profits, but most of the investor money has been wiped out. It's too early to know what the larger impact of these losses will be and whether the subprime debacle will spread to other types of loans and other markets around the world. It is clear that, for those looking for big and fast returns, the easy money days are history and the smart approach is to sit on the sidelines and wait until the smoke lifts to see the shape of the new investment horizon.

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