Pensions&Investments

Commentary: Hedge funds do not offer value to pension funds and other investors

Michael A. Rosen

When I began investing in hedge funds, more than 30 years ago, the value proposition was absolute return: modest but positive returns regardless of market conditions. One percent per month was the oft-cited promise. It turns out the only hedge fund that was able to deliver 1% per month was Bernie Madoff, and that was only because it was a fraud.

The internet bubble of 2000 punctured the myth of absolute returns in hedge funds. Then the promise turned to equity returns with bond volatility. That promise was shattered in the detritus of the global financial crisis of 2008. Then the value proposition changed to strong risk-adjusted returns. That too has been unfilled.

Commentary: RMS — a better mousetrap to deploy hedge fund strategies

In the 10-year period through June 30, 2023, the S&P 500 index returned 12.7% per year and the Bloomberg U.S. Corporate High Yield index returned 4.4%. The HFRI Equity Hedge index returned 5.7%, the HFRI Fund Weighted index returned 4.7% and the fund-of-funds index returned 3.4%.

There is no combination of stocks and high-yield bonds that did not outperform hedge funds. In the past decade, equities outperformed hedge funds in every calendar year but 2022, and are well ahead again this year.

It's been a long time since hedge funds provided absolute returns, kept pace with equities with lower volatility, and offered attractive risk-adjusted returns, since investors could create superior risk-adjusted performance through any combination of low-cost ETFs of stocks and bonds.

Hedge funds have simply not delivered on any of their promises for the past 30 years. The problem is not merely poor execution; it is structural, that is, it is unlikely hedge funds can, much less will, deliver an attractive value proposition. The reason is fees.

Fees are too high a hurdle

Fees are simply too high a hurdle for hedge fund managers to offer an attractive return to investors. Simple math will prove the point.

Let's assume a hedge fund fee of 1.3% of assets plus 16% of any positive return. This is close to the average hedge fund fee. If the underlying benchmark — stocks, bonds or any combination therein — returns 5%, then the hedge fund will have to earn 2.1% above the benchmark to provide the investor with a comparable net return of 5%. If the underlying benchmark return is 10%, the hedge fund will need to add 2.9% above that to provide the investor with a comparable return.

There simply isn't enough alpha (excess return) to justify these fees. And these hurdles, 2.1% and 2.9% in the examples above, are merely the required break-even alphas that hedge fund managers must deliver. To justify these fees, managers will need to earn well in excess of these hurdles. There is little (well, actually, no) evidence that hedge fund managers can generate these alphas.

Fees are not the only hurdle with hedge funds. Poor liquidity and often a lack of transparency add to the problem.

There is no justification for any illiquidity in strategies (primarily equity long-short) investing in listed securities. Yet, most such funds limit quarterly redemptions and retain the unilateral right to suspend even that. Even the less liquid areas of the fixed-income markets can be liquidated over the 90 days of notification hedge funds typically require.

Yet, many hedge funds not only limit quarterly redemptions but often require more than a year for a full redemption. In public securities! To accept these unjustifiable liquidity provisions, investors would need to be adequately compensated. As we've shown, they have not been.

Transparency is another unjustified imposition by some hedge funds. At Angeles, we require some degree of position transparency. We have signed NDAs, we have agreed to examine the books on-site, but we insist on being able to see all the positions in the portfolio. We consider this to be a fiduciary responsibility, and we are fiduciaries.

This transparency requirement would have helped investors avoid a number of headline disasters. Amaranth Advisors was a $9 billion hedge fund that had posted very strong returns and gathered money from the largest banks and pension funds in the country. They refused to show potential investors their books on-site, even under an NDA. They reasoned that they had many prominent investors willing to invest without this transparency so there was no reason to open their books. You know what happened: In 2006 the firm blew up as it had the majority of its assets in a single bet on natural gas futures that went against them.

Requiring transparency would have helped investors avoid the frauds at Madoff (discovered in 2008) and at Westridge (uncovered in 2009).

Yet, institutional investors, and their consultants, continue to invest in funds without receiving full transparency.

With about $4 trillion invested in hedge funds and total fees at about 2.5%, investors are paying hedge fund managers an estimated $100 billion per year in fees. In return, investors have received poor performance, limited access to their money, and the periodic leverage blow-up and outright fraud. The case for investing in hedge funds does not withstand scrutiny, and investors are well-advised to allocate elsewhere.

Michael A. Rosen is chief investment officer of Angeles Investments, based in Santa Monica, Calif. *This content represents the views of the author. It was submitted and edited under Pensions & Investments guidelines but is not a product of P&I's editorial team.*