Hedge Fund Myths & Facts. Also Foundations and Hedge Funds.

WealthManagement.com (http://wealthmanagement.com) has just published an insightful piece called “Busting 10 Hedge Fund Myths” (http://m.wealthmanagement.com/equities/busting-10-hedge-fund-myths). Here’s how they lead off:

“Genius hedge fund manager delivers alpha in good times and bad through stellar long and short stock picking, makes prescient market calls, thrives on market volatility and (unlike mutual fund managers) is perfectly aligned with their investors.

“That pretty much sums up the hedge fund ‘myth.’ This narrative initially was propagated not by hedge funds themselves, but rather by funds of funds and others who were selling them to end investors. Either way, it’s based on a number of misconceptions, and anyone who’s been paying attention knows it’s a far cry from reality.

“The simple truth is that, when you cut through the noise, hedge funds are not that mysterious. Most invest in the same stocks, bonds, futures and derivatives as everyone else. They’re run by talented, motivated investors with relatively flexible mandates. The problem is fees and expectations. When you pay 3–4 percent and expect 2–4 percent in alpha after it, hedge funds need to deliver 5–8 percent of excess returns in good times and bad – a Herculean task, to say the least. Given this, it’s not surprising that you need myths to justify the current business model.”

In the last five years the US stock market, as measured by the S&P 500 Index, has had a positive performance of almost 70%.
In the same five years, according to Hedge Fund Research (HFR), equity hedge funds, global hedge funds, macro hedge funds, and market-neutral hedge funds have had negative returns. That’s reality for this $3 trillion asset class. Sources: HFR, S&P, Bianco Research.

The bleeding continues. Here is the result from FactSet for the second quarter of this year: http://www.cumber.com/pdf/08192016_1.pdf. Hedge funds lagged again. Thanks to Phil Dauber for sending this chart link.

The Wealth Management 10 myths piece cites facts and data. Here is a reference to the 2/20 fee structure: “2/20 Aligns Incentives. Certainly true for a $20 million hedge fund; obviously false for a $10 billion fund. When 80% of alpha is paid away, investors bear risks and managers reap rewards.”

Slowly, investors are learning. HFR reports that hedge funds have had net withdrawals for three consecutive quarters. The Wall St. Journal notes that some famous large funds are shrinking headcount and losing investors. Outflows are estimated in the billions. High-profile names look nice on boards; they are not enough to stop the bleeding.

“Endowments and foundations are shying away from investing in hedge funds,” says NEPC’s Q2 2016 Endowment and Education Poll. They report that, in the last two years, “the number of respondents with zero exposure to hedge funds jumped from 2 percent to 24 percent, with respondents citing low or disappointing returns, high fees and lack of transparency.”

In defense of hedge funds we can cite some small (millions in assets, not billions) and transparent examples. One is specializing in the marijuana industry, another in potable water, a third in medical research. In these types of investment sectors, long lockout periods and incentive fees may be viewed positively, and the investments are often private or venture-related.
But the large hedge funds that purport to play more successfully than others in the public security markets are the culprits.

The charities and foundations that use those larger funds seem to be opaque on disclosure. Some may list the name of the fund. Others just list the category. It is difficult to find out how the fund investments performed for the charity or how they got into them. Were they sold? Were there placement fees? Did the funds solicit? Did brokers? Lots of questions. Few answers.

At Cumberland, we examine foundations and their investment structures on behalf of our clients. Donors and philanthropist investors want to know what a charity will do with the money it is receiving.

In examining some foundations we found a decade of lagging investment performance, some high administrative fees, rolling period performance reporting only, and no method of calculation reporting.

In some cases the foundation used a fund of funds hedge fund structure that conveys custody to the hedge fund general partner. Did donors know that when they made charitable gifts? Did they know their money would be part of a pooled fund in which almost 10% was invested in a fund of funds structure?

A hedge fund can avoid the accredited investor rule if an institutional client or limited partner is above $5 million in size. This metric has been the rule for many years and was promulgated when $5 million was considered a lot of money.

But what about a smaller 501(c)(3) charity seeking professional help or guidance that places its funds with a larger foundation? Do they know about the hedge funds in which the larger foundation invests? Do they ask? Are they told? What are the disclosures? And does the hedge fund itself stay within the accredited investor waiver if the source of the
investment is below the waiver limit?

There are more questions than answers as we continue our research into hedge fund myths and facts and as we examine the charity and foundation space to see what charities do with the money entrusted to them by well-intended donors.

At Cumberland we offer all charities, foundations, and endowments fully transparent, separately managed, and independently custodied services at discounted fees. No lockouts. A charity can see exactly what it holds and what it is worth every single day. A charity can cancel and cash out on a one-day notice.

We believe in philanthropy and practice it. We abhor financial sector agents that prey on charities. And we will assist any client in reviewing charity investment structures as they pursue their philanthropic mission.

We do not use fund of funds hedge funds.