

California Dumps Hedge Funds: Lessons Learned!

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The California Public Employees Retirement System (CalPERS) recently announced that it was exiting its entire \$4 billion hedge fund portfolio, including its “funds of funds,” meaning investments in funds that in turn invest in hedge funds. Hedge funds are pools of money typically managed to provide stock and bond like returns but with less risk, often by shorting a portion of the market while investing in another portion. Compensation is performance based, typically 20% of profits in addition to a 2% management fee.

It appeared to be a movement away from hedge funds, as opposed to toward another particular investment. No precise information was given as to where the proceeds would be directed. Analysts expect many of the country’s other pensions and endowments to follow CalPERS’ lead. CalPERS, as the largest pension fund in the country, is considered very influential.

Hedge funds performed very well relative to the US stock market in the early part of this century. However, they failed to preserve capital in 2008, dropping 18%, although that loss was less severe than the S&P 500’s 37% retreat.

In the last 12 months, to June 30, hedge funds (as measured by the HFRI Fund-Weighted Composite) returned 9%, nearly 16% less than the S&P 500. The story has been much the same over the last ten years, with the hedge fund index lagging every major stock index, long dated government bonds, high yield bonds, and emerging market bonds.

Interestingly, the hedge fund index has failed over the last 10 years to keep pace with a standard 60/40 blend of stocks and bonds, returning just 5.77% annually versus the blend’s 6.64%. The HFRI Fund of Funds Index, measuring performance of those fund of funds, indicates a dismal 3.42% average annual return during the same 10 years.

In a Nutshell

One of the most influential investors in the country is exiting over \$4 billion in hedge funds on the grounds that they’re too expensive and too complicated. Investors generally should be wary of all investments that are pricey, especially if you don’t really understand what they do and how they do it.

CalPERS is also exiting hedge funds after a run of outperformance by stock indices relative to hedge funds. Unfortunately, the timing of its decision may signal some sort of market top. Although we don’t know for sure how the proceeds are to be deployed, its change of heart smacks of buying high and selling low.

Keep Your Costs Down

CalPERS cited high costs as an important factor in turning its back on hedge funds. Hedge funds normally charge a 2% management fee, plus 20% of profits, an outrageously high sum.

Contrast that with Warren Buffett's prescription for his heirs to invest his fortune in the Vanguard 500 fund, which charges a fee of just 0.05%. Assuming a 10% return, that average hedge fund fee would tally to 3.6%, or 72 times the Vanguard fee.

Many hedge fund investors counter that you get what you pay for, and it's worth the higher tab for superior skill. But, when analyzing the subpar performance of hedge funds over the last 10 years, it's hard to see the superior skill.

Unfortunately, when peering into the future, the fees you'll pay are the only certainty, while the skill displayed and the returns to come are, well, uncertain. Consider the esteemed mutual fund analyst Morningstar, whose research indicates that the best predictive factor for the performance of a mutual fund is the fee it charges. Why would it be different with hedge funds?

Keep fees and costs in mind when analyzing your investments. Past success in overcoming them is no guarantee of future success.

If You Can't Explain It to Your Twelve Year Old, It's Too Complicated

CalPERS cited complexity as another reason to exit hedge funds. Hedge funds are less regulated than publicly traded companies or mutual funds and so lack transparency for investors to understand their strategies.

Hedge funds often use derivatives, leverage, and complex trading strategies. It's not just about finding great investments, but also about trading them in less than a straight forward manner. That's not easy for investors to understand.

By exiting hedge funds, CalPERS took a page out of famed Magellan fund manager Peter Lynch's thinking, namely you should be able to illustrate what your investment does with a crayon, or explain it in 30 seconds or less. Ditto Warren Buffett, who said you need to be able to explain what a company does. So, understand your investment before you make it. Avoid CalPERS' predicament of only realizing its ignorance after having held hedge funds for years.

Picking an Outstanding Hedge Fund Is No Easier Than Selecting a Great Mutual Fund

When hedge fund experts hear about CalPERS's exit and are asked about the dismal long term returns of the hedge fund indices, the common response is, well that's just the average. If you pick the right hedge fund/hedge fund manager, you'll outperform.

That sounds good, but consider if that's easy or probable. When an institution like CalPERS, with all the resources to hire the best and brightest managers, can't seem to choose the outperformers, how will you? Consider that funds of hedge funds, which are supposedly the

most experienced hedge fund investors and are paid a fee for choosing the best hedge funds, woefully underperformed the index of hedge funds. Be skeptical that anyone can consistently select hedge funds that will outperform the average hedge fund.

Avoid Chasing the Recently Better Performing Investment/Fund/Strategy

CalPERS placed emphasis on cost and complexity in exiting hedge funds. It was not clear how they will redeploy the proceeds. Because traditional investments have recently outperformed hedge funds, CalPERS may well be committing the sin of performance chasing.

After all, the cost and complexity were there five years ago, but back then performance was different, with stocks struggling. Why did they wait until now to make the move, and wouldn't it have been more profitable to have realized the cost and complexity problems then?

Investing 101 says to buy low and sell high. That is not as easy as it sounds, because it requires buying when something is out of favor and selling when something is in favor. Arguably, despite all the resources that CalPERS has, at least in this instance, it is failing to do that.

You might wonder if a savvy contrarian would say this is actually the time to dump stocks and get into hedge funds, given stocks' raging bull market and hedge funds' lagging returns.

CalPERS, of course, has lots of constituencies to answer to. You don't, so buy low what is out of favor and sell high when it seems popular to do otherwise.

The Traditional Hedges Are Simpler and More Profitable

The time tested hedge against market volatility is to diversify your equities with fixed income, creating an asset allocation of stocks on the one hand with fixed income and cash on the other. Although fixed income and cash have historically underperformed equities, high quality fixed income has tended to rise when stocks decline, making your portfolio less volatile.

Indeed, a 60% equity/40% fixed income portfolio, using the S&P 500 as your proxy for stocks and the Barclays Aggregate as your benchmark for fixed income, significantly outperformed the hedge fund index over the last ten years. Disciplined rebalancing during this period could have added to the gains of that blend. Plus, you paid a lot less in expenses with the traditional stock/fixed income portfolio.

We believe the traditional mix of stocks and bonds is preferable to hedge funds to reduce volatility since it's less expensive and less complex. There's less risk of picking the wrong hedge fund manager.

It appears CalPERS is starting to agree.