

Demystifying Hedge Funds

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An index fund can be explained in a sentence. Most mutual funds can be explained in a paragraph. Hedge funds can be explained in a book—a lengthy book with an appendix and multiple footnotes. That’s because no two hedge funds are exactly alike. In its most easy-to-understand form, a hedge fund is a relatively illiquid private investment portfolio that’s actively managed using long strategies, short strategies, leveraging, derivatives, stocks, bonds, and just about any other store of value the fund manager is comfortable using.

1. The Origin of Hedge Funds. Initially devised in 1949 by *Fortune* magazine’s Alfred Winslow Jones, hedge funds started as private investment partnerships. With a limited number of investors (Jones had 99 total), the manager bought stocks, then leveraged and shorted to hedge against a bear market,¹ of which there had been 14 since the 1929 crash.² Hedge funds have since expanded their investment strategies. Some concentrate on managed futures, others on convertible arbitrage, and in recent years hedge funds have been buying foreclosed homes by the thousands.³ The ways that hedge funds invest now is virtually limitless.

¹ <http://www.hedgeco.net/hedgeducation/hedge-fund-articles/the-history-of-hedge-funds/>

² <http://www.gold-eagle.com/article/history-us-bear-bull-markets-1929>

³ http://therealdeal.com/issues_articles/hedge-funds-try-to-turn-a-profit-one-home-at-a-time/

2. The Dow Jones Industrial Average's Effect on Hedge Funds. 52% of all

Americans own stock either directly or as part of a mutual fund holding.⁴ Therefore, a hedge fund manager can't disregard what is happening in the stock market if he or she wants to bring value to the investor. Hedge funds provide opportunities that don't correlate with what an investor can find in a stock or a stock fund. Not only does this diversification allow the investor to be hedged against a bear market, but it also opens up many new avenues for growth.

3. Only The Very Rich Can Invest in Hedge Funds. As of 1982 hedge fund

investors needed \$1 million in net worth as well as \$300,000 annual household income or \$200,000 for an individual.⁵ Those numbers haven't changed, never mind that \$1 million in 1982 is equal to \$2.34 million today.⁶ Hedge funds differ from a stock fund or a bond fund in that they're private contracts between the investor and the fund manager. But that doesn't mean they're limited only to the well heeled, as retail investors of more modest means can now invest in what's called a "fund of funds" that allows them access to a hedge fund with less cash than would normally be required.⁷

4. Hedge Fund Fees Are Like Legalized Robbery. Yes, the fees that investors pay

for hedge funds is high—a 2% management fee on top of a 20% performance fee

⁴ <http://www.gallup.com/poll/162353/stock-ownership-stays-record-low.aspx>

⁵ <http://www.forbes.com/2000/07/15/feat.html>

⁶ http://www.nytimes.com/2012/01/14/your-money/deciding-whos-rich-or-smart-enough-for-high-risk-investments.html?pagewanted=all&_r=0

⁷ <http://www.barclayhedge.com/research/educational-articles/hedge-fund-strategy-definition/hedge-fund-strategy-fund-of-funds.html>

was long the industry standard.⁸ The performance fee reflects profits from investments made as carried interest, or “carry.” But those numbers have come down in recent years⁹ as hedge funds manage more money and investors negotiate more favorable terms. Smart investors do not have these fees stolen from them; they choose to pay these high management costs because hedge fund managers offer them investment opportunities and returns they can’t get anywhere else.

5. Hedge Funds Are Long-Term Investments. In spite of the image of high-flying hedge fund managers trading in and out of positions minute-to-minute, a hedge fund can be an exceptionally stable long-term investment. Since a hedge fund has very little correlation to the Dow Jones Industrial Average, for example, it can produce consistent growth when there’s the inevitable market correction. Even though a recent study found hedge funds’ and the S&P 500’s performance nearly identical over the past two decades at 8.6%, the lack of volatility in the Credit Suisse Hedge Fund Index¹⁰ reveals that hedge funds may be just the tonic for the long-term investor seeking consistent growth and no drama.

6. Who’s Watching? If the financial services industry isn’t the most regulated in the world, it’s close. Hedge funds are falling under more and more scrutiny every day. Not only are they subject to the same trade reporting and record-keeping requirements as other investors in publicly traded securities; they’re also saddled

⁸ <http://www.bloomberg.com/news/2013-09-09/oaktree-s-marks-says-average-hedge-funds-to-cut-fees.html>

⁹ <http://online.wsj.com/news/articles/SB10001424127887323893004579054952807556352>

¹⁰ <http://www.businessinsider.com/hedge-funds-and-sp-500-nearly-identical-2013-8>

with additional regulations and restrictions like the number and type of investors each fund may have.¹¹

7. You May See A Hedge Fund Ad During the Super Bowl. But you probably won't. As part of the Jumpstart Our Business Startups (JOBS) Act passed in September of 2013, hedge funds can raise investment money publicly. That doesn't mean hedge funds will start producing splashy television spots, however, since it makes no sense for them to advertise broadly to a nation where the average per-capita worth is \$38,786.¹² Look for hedge funds to use a more targeted approach in coming years, communicating with potential investors via social media.

The very term "hedge fund" has become a pejorative in the popular press. Ill-informed reporters use the phrase to imply that someone involved in a hedge fund lives at Downton Abbey amidst a bevy of servants. The fact is that hedge fund managers are savvy managers who have written the book on strategies that help an ever-growing number of Americans invest toward a safe and secure retirement.

¹¹ <http://www.managedfunds.org/issues-policy/issues/globalhedge-fund-regulation/>

¹² <http://www.middleclasspoliticeconomist.com/2013/06/us-median-wealth-only-28th-in-world.html>