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## **Are hedge funds suitable for individual investors?**

**By Benjamin Deschaine, Federal Street Advisors**

Hedge funds have long played a material role in the investment portfolios of ultra high net worth individuals in the United States. There has been a metamorphosis in hedge funds since Alfred Winslow Jones pioneered the concept back in 1949. Initially, hedge funds were designed to be focused on returns first and risk second. As more and more institutions have made their way into the marketplace, the emphasis has shifted from being return-focused to risk-focused. This shift, ironically, has made hedge funds less suitable for individuals.

The role of hedge funds in the portfolios of the ultra high net worth individuals (loosely defined as assets in excess of \$50 million) is notably different from that of large institutional investors (a substantial percentage of which are tax-exempt). Larger institutions tend to be focused on stable and consistent returns, whereas many wealthy individuals are looking for excess return above the market. Institutions tend to favour stable returns because they have to make substantial annual payouts (5% for foundations and up to 7.5% for some pensions) and budget for future expenditures.

Wealthy individuals, on the other hand, often live on a small fraction of their asset base and can wait for their returns to come in lumps. It is worth pointing out that most hedge funds are not appropriate for non-wealthy individuals. Their circumstances more closely resemble those of institutions, in that payouts tend to be a significant percentage of their total asset base, but they are subject to taxes. Thus the exponential growth in the hedge fund industry, fueled by meeting the investment needs of the institutional marketplace, has resulted in a shortage of appropriate hedge fund choices for ultra high net worth individuals.

### **Best before tax**

While both individuals and institutions are investing in hedge funds for alpha generation, they are looking for it in different ways. The institution seeks alpha created by way of low standard deviation, while it is more appropriate (as discussed below) for the individual to earn alpha through excess return.

By definition, alpha is the difference between the predicted return on an investment and the actual return. Simplistically, we can look at alpha in two different ways. Alpha can be generated either by earning a market-like return by taking less risk than the market, or by taking market-like risk and earning an above market return - the market in this case often being the broad equity markets.

For example, using the capital asset pricing model, one can predict what an investment's return should be by using beta as a proxy for expected future risk. If the model predicts a return of 10% and the actual investment return is 15%, then the alpha is 5%. Conversely, one can also have an alpha of 5% with an expected return of 5% and actual return of 10%. Academically speaking, an investor should be indifferent to these investment

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choices. From a practical standpoint this is not entirely true because of the investor's attitudes towards taxes and risk.

When assessing the suitability of hedge funds for individuals, an assumption about taxes must be part of the consideration. Hedge funds by their very nature are tax-inefficient investments. Because of their opportunistic nature, most hedge funds tend to turn over their positions well before they become long-term for tax purposes. Shorting is also tax-inefficient because it always results in short-term gains or losses, regardless of how long a fund holds the position.

To see the tax implication of hedge fund investing more clearly, let's assume that 50% of the returns generated by hedge funds are short-term, and that an individual investor is in the highest US tax bracket (assuming a 35% federal tax rate on ordinary income, 15% on long-term capital gains, and a 5% state tax rate). On a 10% annual return the investor gets to keep 7.0% after accounting for taxes. An institution in this case would receive the full 10%.

If we look at actual historical returns the case becomes even more evident. (Because funds of funds are the most common way for individuals to access hedge funds, I will use the HFR Composite Fund of Funds Index to represent hedge fund returns.) For the 15-year period ending June 30, 2005, the HFR Composite Fund of Fund Index has returned 9.6% net compared with 7.1% for the Lehman Brothers 10 Year Municipal Bond Index.

After accounting for taxes (based on our prior assumptions and assuming that almost all bond interest from the index is taxable in the investor's state of residence) the high net worth investor gets to keep 6.7% from the Fund of Funds Index and 6.8% from the Municipal Bond Index. On an after-tax basis the investor is better off investing in the Municipal Bond Index especially when factoring in liquidity considerations.

(As a side note, I believe the 50% short-term gain assumption is conservative: Deutsche Asset Management recently published a study entitled 'Do Hedge Funds Belong in Taxable U.S. Portfolios' that assumed that 75% of the gains from hedge funds are short-term. What I have found is that the hedge fund managers who are taking on more volatility (that is, equity long/short) have had more favourable tax characteristic and the portion of their short-term capital gains has been less than the 50% assumption. Naturally, as the portion of gains classified as short-term falls, the after-tax investment returns retained by the investor increase.)

### **A better diversifier**

A common argument for funds of funds is that they offer diversification to equities. However, from a diversification standpoint, municipal bonds serve as a better diversifier against the S&P 500 than the Fund of Funds Index. The correlation to the S&P 500 for the Municipal Bond Index is 0.09, but it is 0.45 for the HFR Fund of Fund Index.

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From a risk standpoint, the individual would be better served by the municipal bond index as well. Standard deviation over the 15-year period ending June 30, 2005 has been 4.5% for the Municipal Bond Index and 5.7% for the Fund of Fund Index.

Furthermore, from a drawdown perspective, the Municipal Bond Index had a worst drawdown of -7.6% during this period compared with the Fund of Funds Index with a worst drawdown of -13.1%.

From a portfolio construction perspective, it is clear that the Municipal Bonds would have played a more effective role in equity diversification than the Fund of Funds Index. It is also worth noting that the additional fees charged by most funds of funds cause them to be extremely costly investments. Fees for funds of funds typically include a 1% management fee and 10% performance fee but do vary widely. For the purpose of the above example the returns were net of all fees.

I should also point out that funds of funds do add diversification to both municipal bonds and equities. Using the same time periods that I discussed above, the correlation of the S&P 500 to Fund of Funds Index is 0.45 and the correlation of the Municipal Bond Index to the Fund of Funds Index is 0.13. That said, most wealthy individuals do not have a significant portion of their assets in bonds to take advantage of this dual level of diversification. The majority of truly wealthy individuals are substantially invested in equities.

## **Two views on risk**

Does this mean that hedge funds are not suitable for individual investors? I do not believe that to be the case at all. In my view, for an individual investor to reap the true benefits of hedge fund investing, the investor needs to target a return of at least 5% above the broad equity indices. Assuming that stocks return 10% over the long-term, the investor should expect 15% from his/her hedge fund managers. Based on the tax assumptions discussed earlier, this would produce a return of 10.5% compared with an after tax return on stocks of 8.0% (assuming all gains are long-term as in an index strategy like the S&P 500 Index).

Based on the way that most funds of funds are constructed, as fixed income substitutes, this dismisses them as suitable investments for individuals. As funds of funds have evolved, they have moved from equity substitutes to bond substitutes and I fear if the trend continues they will end up being cash substitutes (of course, with much less liquidity).

The investor's principal measure of risk is the true differentiator between the suitability of hedge funds for individuals and institutions. Risk for institutions is best exemplified by the traditional measure of risk, which is the standard deviation (or consistency) of the returns. Institutions tend to be focused on risk from this perspective because of their liquidity requirements and their need to budget for future liabilities over an extended time period.

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High net worth individuals, on the other hand, do not have the same liquidity needs or future predictable spending demands as institutions. They tend to live on a tiny fraction of their total assets, so the consistency of returns is not necessarily the best measure of risk for their situation. Risk for individuals is better measured by the potential for drawdown return (defined as a series of negative returns), which can lead to large loss of capital if allowed to compound over time.

This is not to say that individuals can withstand any amount of standard deviation. Their emotional risk tolerance tends to be much lower than their actual financial risk tolerance. Hedge fund managers who can keep pace with the market as it is running up and contain losses to half (or less) of the overall market when it is selling off are incredibly compelling for the individual investor.

That said, hedge fund managers with these characteristics are not easy to find. Investors are unlikely to find these manager characteristics in funds of funds because of their modest return targets and over-diversification in underlying managers. The strategies that best lend themselves to high net worth investors from a tax perspective are those that have a long-term holding period for the stocks they buy. Overwhelmingly, investors can find these managers in the long/short equity space. These managers typically have a high net long bias, and they short stocks both as a risk management tool and as a source of generating additional return. They have the ability to participate in up markets as well as to preserve capital in down markets.

### **When to risk it**

When it is all said and done, the criteria for determining whether a hedge fund would be appropriate for a wealthy investor really come down to a few critical factors. Firstly, after accounting for fees and taxes, what does the investor get to keep? Hedge funds, unlike individual stocks, bear hefty management fees (typically 2%) and carried interest (usually 20%).

Secondly, can the investor get the same risk-return profile through a traditional investment vehicle? Hedge funds, especially long/short equity funds, are not a separate asset class but rather an alternative approach to investing in a traditional asset class. So when considering investing in hedge funds, the investor also needs to be aware of the traditional investment options.

Because hedge funds are largely unregulated investments, there is a certain degree of business risk on the part of the underlying manager. This risk can be mitigated by proper manager research, but it can never be completely eliminated. There is no need to engage in this risk if it is possible to get a similar risk/reward tradeoff in a traditional investment vehicle.

The decision to include hedge funds in the portfolio of wealthy individuals is ultimately determined by their individual circumstances. Hedge funds only become appropriate when the risk/return tradeoff is unavailable through traditional investment options.