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The Sound Investor Series #66

Hedge Funds – The Good, the Bad and the Ugly

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Hedge funds continue to make headlines – both good and bad. On the positive side, at least for the industry, it was recently reported that in the second quarter over \$42 billion poured into these funds, the largest quarterly increase in three years.

On the negative side, it was just revealed that Amaranth Advisors, located in Greenwich, had huge losses. In the span of a week, the fund lost over \$4 billion, or half its money. The losses resulted from “sophisticated bets” in the natural gas market, one of the more volatile commodities.

While Amaranth is certainly the biggest debacle in a number of years, many funds have had trouble and over 500 have closed their doors in the past two years, most due to weak results. In fact, hedge fund returns have been lackluster for a few years and 2006 is no exception.

Even with the mediocre returns of the last few years, hedge funds continue to garner capital. Large institutional investors, like pension plans, are chasing after the excellent returns hedge funds earned a few years ago. This is just like the behavior we see from some individual investors, who chase after and buy mutual funds that have had good investment performance.

One example of an institution chasing performance is the \$8.2 billion Teachers’ Retirement System of Oklahoma. Last week the fund announced it would start investing in hedge funds and put up to 5 percent of its money, or \$410 million into these vehicles. I wish them well, but as P.T. Barnum said, there’s a sucker born every minute.

While I believe most individual investors should avoid hedge funds, they exert a big influence on the market. The rest of this article discusses the overall industry and another article in the near future will describe some hedge fund investment strategies in detail.

The first hedge funds were organized during the 1960s and grew fairly slowly. By 1990, less than \$40 billion were invested in these funds. Over the last ten years, the popularity of hedge funds exploded and now there are over 7,000 funds with assets of \$1.2 trillion.

Hedge funds got their name due to the fact that they try to be profitable in markets when they are rising and when they are falling. Unlike most mutual funds, hedge funds are

able to sell stocks short and profit if the stock falls. Therefore, if a fund owns or is long some stocks, and is short other stocks, they are “hedged” and theoretically won’t be hurt by a falling market.

Hedge funds are also called absolute returns funds because they expect to make money in all market conditions. This contrasts with mutual funds that buy stocks and anticipate outperforming the market in the long-run, but realized they are likely to be down in periods when the market falls.

Today, the term hedge fund has evolved to apply to all pools of money managed by organizations that are not regulated by the government. Some of the funds, may in fact be hedged, but most are not.

A critical difference between mutual funds and hedge funds is how they charge customers for services. Actively managed mutual funds generally collect a fee of around 1.25 percent of assets invested in the fund. Hedge funds, on the other hand, charge substantially more. First, they often take 2 percent of the assets for “management” expenses. Then on top of that, they take 20 percent of the profits the fund earns. You might hear investors at cocktail parties refer to this fee structure as 2 and 20 for the 2 percent management and 20 percent profit sharing. Extremely successful funds may demand retaining up to 50 percent of the profits.

Another important difference is that hedge fund investors are not allowed to withdraw their money on demand, as they can with mutual funds. Many hedge funds only allow withdrawals on a monthly or quarterly schedule. New, or start-up funds, are often even more restrictive, and “lock-up” investors money without allowing any withdrawals for 3 years.

Hedge funds also attempt to make extra money for their investors and themselves by leveraging their investments. Most funds borrow money so their investments in the market are two or three times their assets. This leverage can juice returns when investments go well, but as we see with Amaranth, the leverage can also destroy wealth in a flash.

Given hedge funds rich fee structure, the ability to lock-up funds and use leverage, it is easy to see why many fund managers want to start them. Not only do managers get well paid, but they get a share in the profits, without being liable for any loses. It’s a pretty good deal ... for them.

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