Effective Hedge Fund Investing

Though cliché, "unsophisticated investors" really should tread carefully because effective use of hedge funds is impossible without a comprehensive understanding of where they take risk. This article explains why.

The term "hedge fund", as most professionals know, is semantically flawed. Private investment vehicles are so named only because the first one happened to be in the habit of short selling stocks as a "hedge" against market downturns. Half a century later, the term has come to refer to any private investment vehicle as opposed to one that is particularity partial to "hedging". The extent to which these vehicles really hedge anything is actually determined by how they are employed in a larger context. In practice, many investors use hedge funds incorrectly to their own detriment. Their mistake is to ignore the effect hedge funds have on their larger portfolio when this is in fact of paramount importance. Essentially, ignorance of the true nature of hedge fund risk results in the selection of inappropriate funds which degrades the portfolio and ultimately reduces returns.

As an analogy, consider the question of whether to add Intel's stock to a existing equity portfolio. The answer depends as much on the nature of the current portfolio as it does on the earnings and growth potential of Intel. If the portfolio contains nothing but mining stocks, Intel would be a sensible addition as it improves the overall risk/return characteristics. On the other hand, if the portfolio currently contains only chipmakers, then Intel's addition offers little benefit. Intel might be one of the best buys on the market and still the wrong choice for this portfolio.

Hedge fund investing is analogous to selecting stocks. A high quality fund is not necessarily a good addition to any and all portfolios. If it is sourcing risk and return from somewhere the portfolio has no representation, then it is indeed a good candidate for inclusion. If not, it simply increases the existing bet (at high fees.) This is why all hedge funds must be judged in the context of the portfolio they are destined for. The investor must not only evaluate the manager in an absolute sense, but also must discern the fund's effect on the portfolio it is meant to augment.

To do this, an intrinsic comprehension of the true nature of the risk and return of various hedge fund strategies is essential. The investor must thoroughly understand what the hedge fund is doing to know if it is of any value to her portfolio. This however is difficult because hedge fund strategies are notoriously complex thus obfuscating the exact source of risk. The skill is hard to find simply because it is product of years of experience in an otherwise young industry. But despite the barriers, the capacity to translate a complex strategy into basic risk factors is an essential tool for building a quality portfolio because it allows for the selection of hedge funds that truly compliment existing exposures instead duplicating them.

The absence of this skill is precisely why so many hedge fund investors are unsuccessful. They inevitably invest in funds—perhaps good ones—which don't meet their needs. And what they need, quite simply, are hedge funds offering diversification vis-à-vis their existing investments. Unable to determine

what is ultimately driving the returns of particular hedge funds, they have no idea if they are getting any diversification at all. It's like adding Intel to a portfolio of chipmakers.

An investor who learns the science of hedge fund strategies will not make this mistake. She will be equipped to choose funds which improve her portfolio and will eschew funds which repeat her existing investments. Furthermore, those who seek a deep understanding of hedge fund strategies will soon learn a critical lesson: Many of the most complex hedge fund strategies are ultimately dependent on the same economic factors that drive stocks and bonds. This is why hedge funds taken as a group have an annoying habit of failing exactly when the rest of the market does. There is nothing surprising about this to those in the know. The majority of hedge funds cannot generate positive returns in adverse market conditions simply because their strategies are not designed to do so. Which is why they are useless additions to traditional portfolios.

For example, "equity long short" hedge funds rarely improves a traditional equity portfolio because they are usually net long the stock market. They are typically more long than short simply because being short is expensive and, on average, unprofitable. The manager could be quite good at the strategy, but ultimately the fund offers an investor something she presumably has plenty of already: exposure to general health of the stock market. Adding this type of hedge fund to an existing equity portfolio achieves little towards improving the overall risk return profile. The investor is paying high fees for exposure she is already getting elsewhere for less.

With equity long short, it is quite straightforward to see why hedge funds employing the strategy may do little to improve an equity portfolio. Only when an investor achieves a similar instinct for the core risks of other hedge fund strategies can she then proceed to build a quality portfolio. She will then be equipped to identify hedge funds engaging in strategies which bear little resemblance to her core equity portfolio.

Attaining such skills can be learned by any competent investor by devoting time and resources to the goal. Alternatively, an investor might simply choose to pay for help. In this case she should seek a hedge fund consultant with many years of experience on the inside of hedge funds. She should also insist on independent advise from someone who is not also selling certain hedge funds, or funds of funds, or indices. This does limit the options, but there are some highly capable consultants who are also completely independent. The cost of getting this kind of help is often easily justified compared to the cost of approaching hedge funds naively.