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INFORMING THE HEDGE FUND COMMUNITY

A Response to Simon Lack
A defence of what hedge funds can offer investors

CHRISTOPHER L. CRUDEN, INSCH CAPITAL MANAGEMENT AG
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This is an unsolicited review of Simon Lack's The Hedge Fund Mirage from Christopher Cruden, CEO of Insch Capital Management AG which seeks to present a more balanced and comparative view of the hedge fund industry.

Where to begin with the recent book, The Hedge Fund Mirage, by Simon Lack? The first clue is in the Press Release:

"While hedge funds did well in the 1990s, since 2002, they have failed to outperform a traditional 60/40 portfolio of stocks and bonds. They are down 8.5% for the year; the overall U.S. Stock Market is down about 2% for the year."

Good stuff there for the Journos to get giddy over but more sober investors may justifiably ask: "Why are comparisons drawn using 2002?" (If you genuinely don't know the reason and can't figure it out, then ask Nanny to put you back in the pram and take you home.) Mysteriously, 1998 is also another favorite start date of Mr. Lack.

And why, suddenly, are we being asked to compare a "traditional" 60/40 portfolio of stocks and bonds? Could it be because stocks (as measured by the more favorable S&P500) have returned an annual average of -1.29% p.a. since 2000? That's a total RoR of -14.41%. (Is "returned" the right word?) Using 1998 or 2002 is of (im)measurable help to the author in sensationalizing his premise.

Since 1998, displayed graphically, stock market performance reminds of a physical market of Christmas trees. For this reason any assessment of performance depends almost entirely on the choice of timeframe (see Fig.1). And, the 60/40 comparison is quite simply required because stocks don't measure up by themselves. He needs to add bonds, to support his premise and sell books.

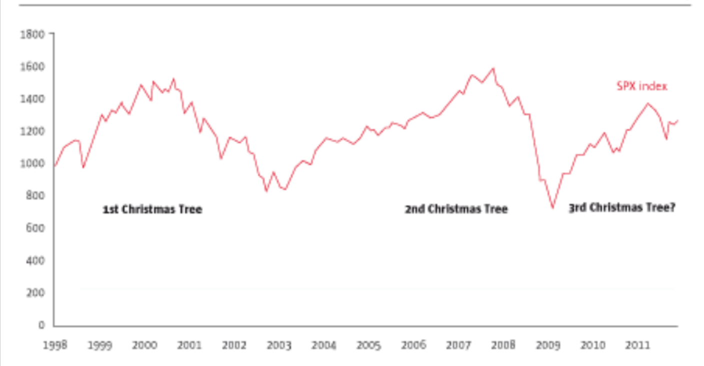

Fig.1 SPX Index

Oh, and apparently, if investors had put all their money in treasury bills, they would have done twice as well as Hedge funds. Leaving aside the fact that his math is wrong, I would like to know if that's what he was advising JPM clients to do for the 23 years he was there. When did JPM find out about it?

Here is an even more startling piece of investment news: if investors had put all their money on the winning horse in the Grand National every year since [fill in the blank] they would have done even better than any financial asset.

Astoundingly helpful, right?

Unfortunately, the Press Release was a forewarning of things to come: The book contains highly selective numbers and time-periods that are just a teensy-weensy bit misleading but highly likely to elicit a headline. In other words, the sort of thing we are more used to see from the "traditional" asset management community.

Here are the actual numbers on stock markets. Let's see how they compare with Mr. Lack's chosen Hedge fund index (see Table 1 and Table 2). Ahem, quite. Still think the Hedge fund 2011 return of -4.83% was a bad year? Wanna swap?

Table 1 2011 Index Return *Source: HFR*

INDEX NAME	2011 INDEX RETURN	2011 HFR INDEX RETURN*	PERFORMANCE DIFFERENCE
S&P 500	0.003%	-4.83%	-4.833%
FTSE 100	-5.55%	-4.83%	0.72%
MSCI World Index	-7.62%	-4.83%	2.79%
SMI	-7.77%	-4.83%	2.94%
Euro Stoxx 600 (USD)	-14.03%	-4.83%	9.20%
DAX	-14.69%	-4.83%	9.86%
CAC	-16.95%	-4.83%	12.11%
MSCI Asia Pacific Index	-17.31%	-4.83%	12.48%
NKY 225	-17.34%	-4.83%	12.51%
FTSE MIB Index	-25.20%	-4.83%	20.37%

*HFRI Fund Weighted Composite Index

Table 2 2000 - 2011 Index Return *Source: Hedge Fund Returns Inc.*

INDEX NAME	2000 - 2011 INDEX RETURN	2000 -2011 HFR INDEX RETURN*	PERFORMANCE DIFFERENCE
MSCI Asia Pacific Index	-9.99%	95.12%	105.11%
S&P 500	-14.41%	95.12%	109.53%
DAX	-15.23%	95.12%	110.35%
MSCI World Index	-16.77%	95.12%	111.89%
Euro Stoxx 600 (USD)	-16.80%	95.12%	111.92%
FTSE 100	-19.59%	95.12%	114.71%
SMI	-21.58%	95.12%	116.70%
CAC	-47.00%	95.12%	142.12%
NKY 225	-55.34%	95.12%	150.46%
FTSE MIB Index	-64.58%	95.12%	159.70%

*HFRI Fund Weighted Composite Index

In the interest of balance and to contextualize this, using an admittedly small but representative sample of the traditional asset management industry, let's take a look at the six largest listed managers on the LSE. In particular, their OEICS funds. The qualifying funds cover all the IMA sectors for fixed income and stocks and have an AUM of approx £41.3 billion ($64.1 billion). This figure makes the sample 256 times larger than the average hedge fund. The average traditional fund in the sample is 2.6 times larger than the average hedge fund.

Over the last five years, the average annual return of these OEIC funds has been 1.94% (equally weighted). The total return has been 11.50% (equally weighted). Investors who paid the average "sales charge" of 4.79% would have received an average annual return of 1.21% and total return of 6.18% for the whole five year period.

The average annual return of hedge funds was 2.65% and the total return 13.95% (HFRI Fund Composite index) over the same period. This is more than twice the OEIC average. Fully 67% of the OEIC funds failed to match hedge fund returns. The OEIC funds have an average fee of 1.44% p.a. The amount that the traditional asset managers have extracted in management fees has been £596.3 million ($925 million). Add the average of 4.79% sales charge and the figure coughed up by investors comes to £2,557.5 million ($3,968 million). This number - the fees and charges paid out of investor's capital for under-performance - is greater than 99% of hedge funds even have under management.

If there is a sensational financial scandal, it is not with hedge funds.

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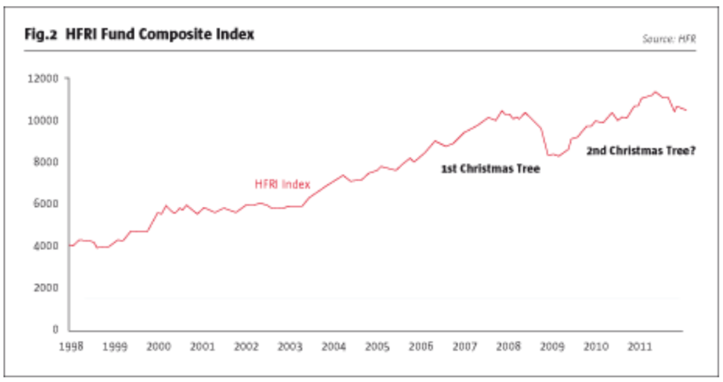
No doubt Mr. Lack, a Hedge Fund "insider", accumulated some fascinating views and brilliant insights during his stellar career at JPM. Perhaps, one day, he will put them in a book.

Curiously, as a career long hedge fund "outsider", I am in basic agreement with what is said in the non-attention seeking parts of this book… Personally, I hold no candle for the hedge fund industry (especially the big names, as has been made abundantly clear in the past) or the detestable Fund of Fund industry (as has been made even clearer), but there is very little that is new in this book and even less that bears real, informed scrutiny. There are some reasonable chapters in the book (nothing new or particularly brilliant) and there are a couple that seem to deliberately court a copy-selling headline. And that's a pity.

If you already believe - or want to believe - that hedge funds are crooked and offer a bad deal, then parts of this book will be of enormous help in confirming your views and providing you with all the ammo you need to be even more boring at the next dinner party. For example, one of his primary arguments is that the bigger hedge funds have lost more than they have made for investors and that investors would have been better off investing with smaller managers. This is hardly an original thought or discovery and it certainly pre-dates Boyson in 2008.

Obviously, if a manager has $1mil and makes a 10% return, he has made $100,000. When/if that manager gets to $100,000,000 and loses 10%, he has lost $10,000,000. If a $10 stock goes up 10% it has made investors $1. If a $100 stock goes down to $90 it has lost investors what percent? Investors buy or sell a NAV or share price. Their returns are based on what they paid versus what they receive on disposal. The math is not hard, people.



The comparison with a hedge fund's NAV and a stock exchange listed company's share price is perfectly valid in this regard. The only point to be made is that losses are larger in size and more prevalent in traditional markets.

Hedge fund Managers, inevitably and obviously, are aware of this (many, it may surprise you to learn, are quite numerate) and change their focus to being a "manager of fees" rather than taking the same risks as they did previously. Who wouldn't? They are, at heart, businesses. To some, this may not be a particularly attractive capitalist tendency but please don't feign surprise. (Those of a sensitive or nervous disposition will find Redemption Forms towards the rear of the Prospectus). And how about the costs/fees/expenses argument? Basically, hedge funds take a management fee and a performance fee. There are other costs too: Brokers, Administrators, Auditors, Custodians, Lawyers, Compliance Consultants and an assorted rag-bag of other "service providers" (parasites?). Why all these extra costs? Well, basically, because (we are told) investors demand all of these things. It's a funny old world but these people don't work for free. So investors have to pick up the tab. Fancy that.

Have you ever tried to figure out what the overhead costs and expenses are of the average S&P500 company? Is it more, or less than 2/20%? (At a guess, I'd say it's more. Much, more.) In any case, whatever it is, shareholders pick up the tab.

Lack's headline-grabbing observation is that the "costs" of hedge funds have, due to drawdown, exceeded investor returns. On that basis, should we call for the employees of publically traded companies to return their salaries if their share price falls? And how about traditional asset managers returning their fees? Would you rather invest in a business with lower costs than any of the businesses in the S&P500? Of course you would. Hedge funds are such companies. And you are free to do so. Or not, if you choose.

If you really insist on lower costs, open a managed account with a bank or broker you trust (!) and give an LPOA to a manager who will (infrequently) trade deep and liquid bi-directional markets at low cost. Not a fund of any kind.

Why don't hedge funds offer Managed Accounts? Because investors (we are told) like funds better. Because the so-called Fund of Fund industry likes funds better. Because the regulators like funds better. (UCITS anyone?) - By the way, Bernie Madoff could never have done what he did, in the way he did or in the size he did, with a managed account structure. The fund structure made it possible and more likely.

If you genuinely Lack (sic) the ability to open a managed account, go and buy a stock mutual fund and amuse yourself by keeping score of how often your manager beats his (carefully selected) benchmark. Despite what you might have heard, it's not a free world.

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Another old-saw that these kind of books drag out is the "Survivor Bias" of the Hedge Fund industry indices. This is hardly a new discovery and hardly an original premise. All the more reason to present it fairly. Can anyone think of another index with survivorship bias? How about the best known and biggest Big Daddy of all of them: The S&P500... Or for that matter, any other stock market index. Are Enron and WorldCom still in the S&P500? Is Lehman? Could that be because of survivor bias? Then of course, there is the "fraud/miss-management" allegation. Hmmmm.... An interesting one this and, yes, there have been frauds. Is this also true of stocks? How about the aforementioned Enron and WorldCom? Anyone out there who took up the RBS rights issue in 2008?

How much money has been lost by hedge fund frauds and miss-management compared to the money lost in stock market fraud and miss-management? (Not the common-or-garden "pump and dump" variety, I mean the ones that were actually once components of, say, the FTSE100 or the S&P500?) Anyone know if it's a bigger or a smaller number? Anyone like to take a guess?

Curiously, there is one thing that Mr. Lack seems not to dwell on: the reason (in my view at least), that hedge funds have been so disappointing from the performance perspective is primarily due to the make-up of the hedge fund industry itself. Because of the financial crisis, and the resultant sackings and lay-offs, many asset managers have sought to transport their obvious genius into the hedge fund industry.

With baited breath, we await the next influx of new trading “talent” into the market. (As Lack points out, it pays better.) Whether or not the wallets of investors can withstand another onslaught of genius remains to be seen. (Apropos of nothing, Mr. Lack founded his Hedge Fund after the financial crisis in 2009). In my opinion, the next periodic phenomena of migration will not be a “good thing” and may even be a very “dangerous thing” for two main reasons.

The first reason is that the asset managers generally tend to do the same thing the same way. Never mind the capacity of global stock markets: Is the entire galaxy big enough to accommodate yet another market neutral/arbitrage/convertible/absolute/long/short /short/long/macro strategy? I think not. Their strategies are all way too stock-centric and come at a time of declining stock market participation. Already the correlation between stock markets and hedge fund indices is at an all-time high. (Now, why would that be?) Far too many hedge fund strategies have ceased being Alternative. In the final analysis, the biggest, most damming criticism of hedge funds is that they have become too much like traditional asset management in terms of people, strategies, markets and… (wait for it…) …inevitably, performance. Who out there didn’t already know that? (Bernstein identified this years ago.)

The second reason is that (again, in my opinion at least) most of these people are not fundamentally suited, in temperament, background, culture or technique to be hedge fund managers. There is an old saying: “Markets tend to take on the personalities of their participants. If the participants are biased or easily spooked, so too will be the market.” If true, steer clear of stock markets and hedge fund managers who trade in them. Stock-centric hedge funds are, themselves, a crowded trade in an environment of declining liquidity.

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Whether intentional or not, in headline form, this book perpetuates the notion that hedge funds are, in some way, “naughty” or outside the law. They are not. There is absolutely nothing morally, legally, technically or spiritually wrong with moderately leveraged, bi-directional investment using the most cost-efficient and liquid instruments. That being the case, those who agree would be far better advised to look at the CTA and Managed Futures industry than the miss-named and lumpen Hedge Fund industry.

Basically, what Lack says is almost true and well said but something is lacking in the book? What Lack lacks is any (exhibited) ability to compare like with like. I suppose a “level playing field” comparison would not sell many books. But, hey, does that matter? Personally, for $34.95 list price, I think it does. If, on the other hand, the real purpose of the book was so that the author could promote and publicize SL Advisors and their 3 month long track record (CEO Mr. S Lack), and what appear to be some back-tested simulations of stock-centric strategies, well that would be a pity.

Oh, dear… “The publicity has steadily mounted, with TV appearances in London followed by New York and with reviews expected shortly in the mainstream financial press (most recently the Financial Times)” he writes breathlessly…

This book will be devoured by the Traditional Asset Management industry. It confirms EVERYTHING they KNEW about hedge funds. They will send it to all their sales people and all their best clients. Just until they are able to launch their own range of hedge funds. (Remember, as Lack points out, it pays better).

When they do, just as with this book, caveat emptor...