The book’s name, *The Hedge Fund Mirage*, suggests that the industry’s promise of high returns, low risk, and low correlations to other asset classes is illusory. Its central point is this: “If all the money that’s ever been invested in hedge funds had been put in Treasury Bills instead, the results would have been twice as good.” Digging deeper, the book makes the case that hedge funds used to live up to their promise but can no longer do so. Size is the enemy of performance. As the industry grew it sold historical performance, but it was unable to deliver future performance because too many assets were chasing too few opportunities.

Author Simon Lack’s credentials include 23 years at JP Morgan researching and seeding hedge funds. He uses industry data from Hedge Fund Research, Inc. to estimate the dollar profit that hedge fund investors and managers have made since about 1998. Lack argues that hedge fund investors fared well early on. But as the industry expanded and became more competitive, profits shrank.

Anyone who understands the difference between time- and dollar-weighted returns can appreciate Lack’s point. The industry uses a time-weighted return (i.e., the timing of cash flows doesn’t matter). The author’s calculation of total dollar profit reflects the size of the industry at the time returns were experienced. Higher returns were achieved early in the analysis period when assets were low. Lower returns were experienced later after the industry had grown (particularly a –23-percent return in 2008 when the industry’s assets under management were $1.8 trillion). “In fact, in 2008 the hedge fund industry lost more money than all the profits it had generated during the prior 10 years,” Lack writes. “It’s likely that hedge funds in 2008 lost all the profits ever made.”

Using a 2 + 20 fee1 and no incentive fees after 2008 because so many funds were below their high-water marks, Lack calculates that 84 percent of the total profit generated went to the industry, leaving 16 percent for investors. If that’s not bad enough, the author believes that survivorship or backfill bias overstate the profits. If this were a late-night TV commercial the announcer would now say, “But wait, there’s more.” For investors in hedge funds of funds, there is an additional level of fees. When these are incorporated, the industry gets 98 percent of the profits and the investors keep 2 percent.

The reader is treated to insights into the sometimes hidden costs of hedge funds. For example, early investors pay part of the costs of later investors. The first investor pays all the transaction costs for his or her trade and then pays part of the costs of the next investor and so on.

If after reading the chapters on the poor net-of-fee returns, the structure that benefits the fund managers, hidden costs, and even a chapter on fraud, you still have the stomach for hedge funds, the author devotes a chapter to selecting better-than-average funds. His advice indicates a preference for smaller, newer funds.

Investment consultants and their clients face an asymmetry of information in this respect. The profitability of the investment industry, and of the hedge fund industry with its high fees in particular, provides an incentive to its agents to represent products and funds in the most favorable light. There is little incentive for those who hold a dissenting view. To objectively represent their clients, consultants must go out of their ways to seek a balanced perspective. Given the fees and complexity of the hedge fund industry, it’s important to pay attention to works such as *The Hedge Fund Mirage*.

Endnote

1 A type of compensation structure that hedge fund managers typically employ in which part of compensation is performance based. More specifically, this phrase refers to how hedge fund managers charge a flat 2 percent of total asset value as a management fee and an additional 20 percent of the profits (often above a high-water mark).

*The Hedge Fund Mirage: The Illusion of Big Money and Why It’s Too Good to Be True*

By Simon Lack

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