What Every Investor Should Know About Hedge Funds

In essence, a hedge fund is an entity that holds a pool of financial assets, which may include both securities and non-securities, and may engage in a wide variety of investment strategies, which may or may not include hedging and arbitrage strategies. It is typically sold to investors as a private partnership interest. It is not registered with the Securities and Exchange Commission and is not registered as an investment company under the Investment Company Act. A hedge fund can only be sold to "accredited investors," such as those with $1 million or more in net worth.

The problems and risks associated with hedge funds include:

- Low Returns - Few hedge fund managers have been able to consistently beat an appropriate benchmark. The occasional successes often do not go beyond random successes attributable to luck. "[The] historical evidence demonstrates that once viewed on a risk adjusted basis, the average hedge fund has a hard time keeping pace with Treasury bill returns." *The Only Guide to Alternative Investments You'll Ever Need*, by Larry E. Swedroe and Jared Kizer.

- High Fees - Investors routinely pay a base management fee of 2% or more of total assets, plus a performance fee of 20% of the profits or more. Funds of hedge funds add another layer of cost to the structure.

- High Risk - The high fees and expenses erode returns and incentivize reckless risk-taking. The performance fee does not kick-in until a minimum return is generated. Since the manager does not share in losses (except to the extent of his equity stake in the fund, if any), he has a strong financial incentive to take risks to hit the minimum return with little or no countervailing incentive to prudently manage risk.

- High correlation – Claims that hedge funds generally exhibit low correlation with other asset classes are largely untrue. During difficult economic times, most hedge funds have shown high correlations to other asset classes and have experienced significant losses.

- Lack of Diversification – Hedge funds are typically concentrated rather than diversified investments.

- Complexity – Hedge funds are difficult for investors to understand as they often use extremely complex quantitative strategies, long/short strategies, et cetera.

- Opacity – Hedge funds lack the transparency of mutual funds. They are not required to file periodic reports disclosing their holdings. The performance data on hedge funds is unreliable and the returns are often overstated. Due diligence is virtually impossible. The risk of fraud and outright theft is always present in opaque investments like hedge funds. The hedge fund managed by Bernard Madoff is a prime example.

- Illiquidity – Hedge fund investors are routinely subject to lock-up periods and other restrictions on their ability to withdraw their money.

- Valuation - The holdings of hedge funds are often illiquid and can only be valued by models and guesswork.

- Tax Inefficiency - The high turnover associated with hedge funds (typically over 100%) results in higher ordinary income taxes for the investor.

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