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# The Hedge Fund Mirage: Q&A With Simon Lack


SIMON LACK, CFA

- Founded SL Advisors, LLC in 2009
- 23 years with JPMorgan, including:
  - CEO and founder of the JPMorgan Incubator Funds
  - Fixed Income Derivatives and Forward FX trading
- Author of *The Hedge Fund Mirage: The Illusion of Big Money and Why It's Too Good to Be True (2011)* and *Bonds Are Not Forever; The Crisis Facing Fixed Income Investors* (2013).


*In his 2012 book,* The Hedge Fund Mirage, *author and investment industry veteran Simon Lack argued that since the late '90s:*

- *While hedge fund industry assets grew from under $200 million to more than $2 trillion, hedge fund returns had not kept pace with Treasury Bills.*
- *Over this period, hedge fund fees totaled about $566 billion in aggregate vs. roughly $30 billion in actual profits for hedge fund investors.*
- *Limited transparency on hedge fund philosophies, processes and holdings made it difficult for investors to accurately assess a growing range of offerings.*
- *Despite these issues, hedge funds could still have a place in portfolios; but investors needed to be thoughtful about hedge fund managers and allocations.*

*Just after it was published in 2012, some industry experts and members of the financial press questioned Lack's methodology and results and sought to dismiss his findings. In May 2014, Lack presented his work at the CFA Institute Conference in Seattle where Brandes Institute Advisory Board member Bruce Grantier talked with him.*

*Grantier recently published a review of Lack's presentation at InvestorLiterature.com (available to subscribers). Grantier also helped arrange for the Brandes Institute to question Lack via email. Here, we share excerpts from that email exchange.*

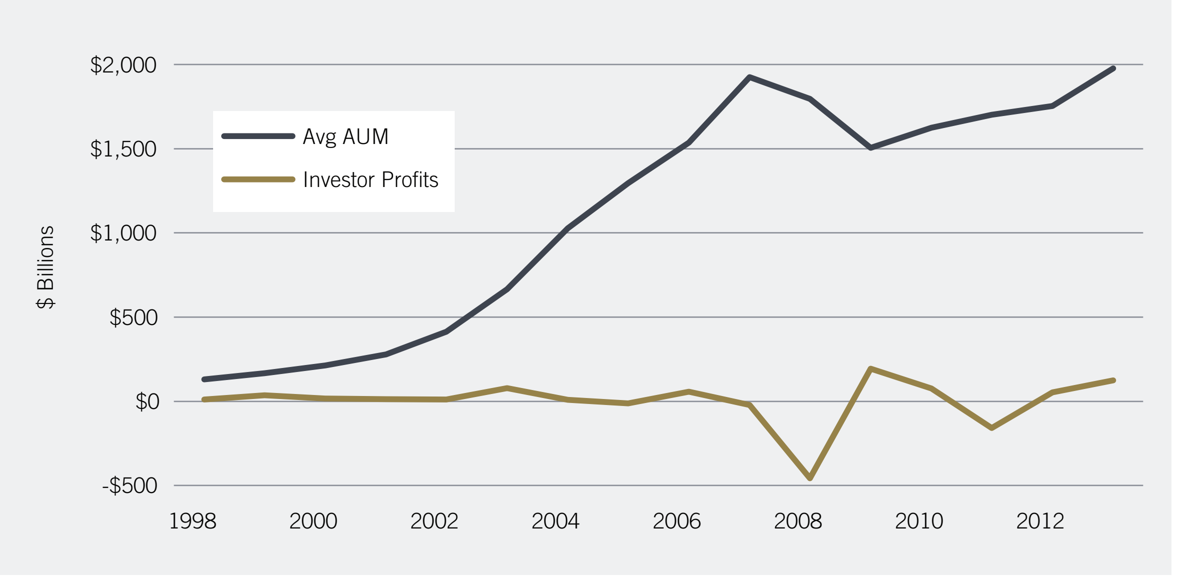
**Q:** ***You were the target of criticism when* The Hedge Fund Mirage *was first published. Do you feel your work has been vindicated?***

**A:** I think the results since my book came out have shown that I'm right. Hedge fund industry advocates have little evidence to support their criticisms beyond asset flows, which must be a highly unsatisfactory prop. They failed to consider size, and the results are relentlessly demonstrating that total hedge fund assets under management and an assessment of what is a sustainable level ought to play a part in any large allocation to hedge funds. Since the original reaction, a number of hedge fund managers have agreed that my original remarks were valid.

**Q:** ***A central tenet of your book is that it's becoming increasingly difficult for hedge funds to replicate their earlier success given the growth in collective assets under management. Do investors have to identify new, smaller hedge funds with limited capacity to have a chance at strong returns?***

**A:** I think it's almost cognitive dissonance for today's investors to fail to consider industry size when contemplating their hedge fund allocations. Everything about past returns as well as anecdotal evidence overwhelmingly support that too much money hurts returns. This is why large hedge fund allocations don't make sense–they require large individual allocations to large managers as the only plausible implementation. Once a public pension plan recognizes that 5% is a better allocation to hedge funds than 20% they're no longer relying on hedge funds to solve their funding gap, and consequently they can select more esoteric managers. This is how hedge fund investing was done during the period of time whose historic returns were generated that they're seeking to emulate.

**Exhibit 1: Hedge Fund Investor Profits and Assets under Management**




Source: Simon Lack presentation "The Fallacy of Hedge Funds: The Hedge Fund Mirage, The Illusion of Big Money and Why It's Too Good To Be True." May 2014.

**Q:** ***You have been critical of hedge fund fees. In your opinion, what is wrong with the current fee structure? And what fee arrangement would you suggest for hedge funds?***

**A:** Fees are simply too high, and although they're coming down somewhat they still appear to average around 1.9% and 17.5% of profits (vs. the popular 2.0% and 20.0% arrangement). I think incentive fees should be subject to a hurdle. Even with near zero interest rates it's ridiculous for managers to earn a fifth of the gross nominal return, but even more so in years past when risk free rates were 2-5%. I think the difficulty is hedge funds are heterogeneous and few investors think about negotiating fees until they've completed their due diligence. At that point they're in a weak negotiating position as they've identified their chosen hedge fund and failure to agree to terms leaves them with no near-identical alternative. Nonetheless, I think large allocators should set out their maximum terms in an RFP and eliminate managers from consideration whose terms don't match.

**Q:** ***Beyond returns, investors often have turned to hedge funds for volatility reduction. How have hedge funds done as a diversification tool?***

**A:** The fundamental problem is investors are trying to obtain too much out of hedge funds at too great a cost. The correct objective is to obtain a little alpha and portfolio diversification, but not to use them as a core holding. Also, returns have clearly shown that hedge funds have beta, i.e., in total, they are not at all neutral to markets. Today's big investors are making a substantial error in this regard.

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**Q:** ***If investors follow that advice, what should they look for in a hedge fund manager? Is it a blend between quantitative and qualitative factors?***

**A:** Historically, managers provided so little transparency there was little material on which to perform quantitative analysis beyond the returns. Transparency has improved and this allows for more quantitative analysis on return attribution which therefore makes interviews slightly less important.

However, the traditional institutional bias against style drift, which is an important component of portfolio construction, can reduce or eliminate the skill some managers have of identifying opportunities away from their core competence. Small allocations can tolerate more style drift which could well produce more satisfactory results for investors.

**Q:** ***Assuming one can find good managers, how much should institutional investors consider allocating to hedge funds?***

**A:** I really think 2-5% across 1-10 managers. There's an interesting CAPM (capital asset pricing model) perspective on this, in that diversification is good if the asset class has a positive excess return. Hedge funds reverse the paradigm in that the excess return is poor. Therefore, skill in manager selection is vital (whereas you can allocate to equities with no security selection insight). Under these circumstances, a hedge fund investor by definition believes he possesses manager selection skill. If true, diversification dilutes that advantage and draws the overall hedge fund return toward the mediocrity of the average. If you don't have skill at manager selection, then be diversified, except that of course if you don't have that skill you probably shouldn't be invested at all!

Hedge fund managers are a pretty shrewd crowd. I find it notable that very few of them advocate substantial allocations to hedge funds. Many hedge fund managers have privately agreed with the thrust of my book. They totally appreciate the limits to size. The smartest people in the entire hedge fund industry, who are the hedge fund managers themselves, advocate their own individual funds and typically don't speak to portfolio allocations.

**Q:** ***Is there a breakeven point where it is more cost effective for an institutional investor to manage the assets themselves?***

**A:** I always thought there was a natural evolution in that an institutional client began their hedge fund investing experience via fund of hedge funds and then eventually graduated toward direct investing as they gained experience and decided to invest in their own team of analysts.

Based on my prior working experience in the hedge fund industry, the overhead of all the operational issues related to managing the client assets was substantial. From a business model perspective, much of it was justified simply to prevent the investors from knowing the full composition of the portfolio—or else they would invest directly. It always seemed to me that having to withhold information from your clients wasn't a great way to be in business.

### Key Points from *The Hedge Fund Mirage*

- A 20-fold increase in assets among hedge funds between 1998 and 2013 has coincided with a decline in hedge fund returns. Weaker recent returns ('03 to '08) reflect declining opportunities for uncovering inefficiencies vs. earlier years (late '90s to early '00s).
- The standard "2 and 20" fee structure for hedge funds makes it difficult for them to consistently outperform other asset classes.
- Typically, hedge funds lack transparency, making it difficult to assess potential issues.

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