



## Hedge-Fund Horrors

**Small-fry investors can now bet on these risky investments along with the big-money crowd. If fiascoes like Bayou Securities don't scare you off, the fees you'll pay should.**

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Sept. 26, 2005 issue - Once upon a time, the word "hedge" was used to describe shrubbery, such as those nifty privet hedges that make such wonderful boundary plantings. But these days, the word has taken on a financial cast: hedge funds, the legendary investment vehicles that allowed the likes of George Soros to make billions for themselves and their investors.

But instead of restricting itself to a handful of rich investors, as it once did, the hedge-fund industry is now going downscale. Sort of. Securities laws require that anyone buying a hedge-fund stake be a "qualified"

investor with a net worth of at least \$1.5 million or an investment of at least \$750,000 in the fund. Now, regardless of your net worth, some fund companies will let you buy a stake in regulated mutual funds that invest in hedge funds, which are largely unregulated.

This lets you buy indirectly what you're not considered rich or sophisticated enough to buy directly. But, hey, owning shares in such a mutual fund lets you brag about your hedge-fund holdings at parties, which has got to be worth something. Beware, though. If you're an average retail investor—which most of us are—you should avoid these things unless you really know your way around the investment world.

This has nothing to do with the occasional hedge-fund disaster, the most recent of which is Bayou Securities. That fund, now out of business, claimed to have \$440 million of assets and a fine performance record. As regulators and lawsuits now make clear, however, Bayou was a fraud that fooled even some experts who help investors decide which hedge funds to buy. But Bayou's demise isn't the hedge-fund problem I'm worried about. If you invest in a mutual fund that owns a diversified portfolio, one disastrous holding won't wipe you out. My problem with hedge-fund investments for small fry involves costs. Hedge funds now typically ask investors to pay an annual fee of 2 percent of assets, plus 25 percent of the profits that the fund makes. So if a hedge fund earns 15 percent a year—a pretty good return these days—you're left with less than 10 percent after the managers take their 2 percent off the top and 25 percent of what's left. Throw in another layer of expenses if you're investing through a mutual fund that buys stakes in hedge funds, and close to half the return goes for fees and costs.

Back when hedge funds were far less popular, investors had a much better chance to do well. The typical fees were much lower than today's: 1 percent of assets and 20 percent of profits. But now—with 8,000 hedge funds, higher fees and mediocre markets for most stock and bond classes—hedge-fund investors are doing less and less well relative to the market.

Even sophisticated players with billions to invest and access to first-rate information don't expect to make anything like past returns. Take General Motors, whose \$100 billion pension fund has one of the best investing records on the planet. "Our expectations are not the 15 to 20 percent [a year] of the '90s. It's more like 8 to 10 percent," Allen Reed, head of GM Asset Management, told me in a recent interview. He's talking returns after fees, of course. And—trust me on this—Reed is getting a better deal on fees from the creme de la creme of

hedgies than you're going to get. If Reed, whose target return is 9 percent a year, is hoping to make maybe 10 percent on GM's hedge-fund investments, what do you think you're likely to make on yours? Hint: it's a lot less than 10 percent a year.

Susan Wyderko, head of the Securities and Exchange Commission's office of investor education, warns investors to beware. "Although funds of hedge funds offer more diversification than investing in a single hedge fund," she says, "they still can be riskier and more expensive to own than traditional mutual funds."

I'm all in favor of intelligent, informed investors' being allowed to take intelligent risks with their money. But I fear that hedge funds have had such a glorious history (and sound so sexy) that naifs will buy into them and get burned.

And wait, there's more. Because far too many pension funds invest based on past performance, pension money has been flooding into hedge funds the past few years, even as hedgies' performance has deteriorated. Lots of pension funds are treating hedge funds as something in which to invest a certain percent of their assets, rather than as complicated, tricky investments that should be analyzed individually. This can't possibly end well.

So unless you really know what you're doing, use your hedge-fund money to purchase privets. Those investments, at least, are almost guaranteed to grow.

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