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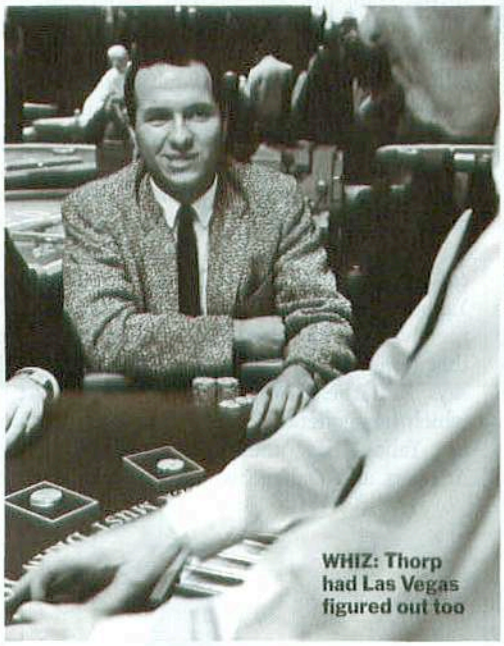
Hedge Funds Head for Mediocrity

Alpha hedgie Ed Thorp beat the Street. Most of the new guys won't

IN 1962, A GOVERNMENT STUDY OF MUTUAL FUNDS REVEALED that they were, on average, average, or worse. This was an affront to many on Wall Street who assumed that, of course, professional investors beat the market. It was left to legendary investor Benjamin Graham to explain in a speech to securities analysts that "neither the financial analysts as a whole nor the investment funds as a whole can expect to 'beat the market,' because in a significant sense they (or you) are the market."

At the time, the pros controlled only 15% of the U.S. stock market (the figure is now more than 60%). But they did the bulk of the trading. They moved the market. And therefore they could not, as a group, beat it. The mutual-fund industry's attempts to move this boulder by taking bigger risks ended badly. When the stock market plunged in the 1970s, the funds followed.



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WHIZ: Thorp had Las Vegas figured out too

As mutual funds traveled this trail of tears, Southern California math professor Ed Thorp was delivering positive, usually double-digit, returns every year to investors in the fund he launched in 1969. Thorp, probably best known for figuring out how to beat the house at blackjack, did this by programming computers to identify small price discrepancies between securities that should have been trading in tandem. Then he borrowed tons of money to bet that these discrepancies would disappear. Such strategies were off-limits to mutual funds, but Thorp's Princeton Newport Partners was a hedge fund—an unregulated investment partnership catering to the rich.

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Today Thorp's progeny are everywhere, catering not just to rich people but also to pension funds and college endowments—and to not-so-rich people through listed hedge-fund stocks and hedgelike mutual funds. Thorp's was not the first hedge fund, and the term now covers all manner of investment beasts. But the approach he pioneered accounts for the bulk of the $1.43 trillion that Chicago-based Hedge Fund Research says hedge funds had under management at the end of the year. That's still puny compared with the $20 trillion in mutual funds worldwide. But because most hedgies trade avidly, usually with borrowed money that amplifies their clout, it is they who set the prices in many global markets. In a significant sense, they are the market, which means their days of beating the market must end.

This raises an important question: Are hedge-fund managers going to react as their mutual-fund peers did 40 years ago, taking bigger and dumber risks in a continuing quest to justify their paychecks? Or are they going to slide calmly into respectability and mediocrity? Will the hedge-fund boom end in fire or in ice?

First, fire: Hedge-fund managers make epic sums of money (the top earner on *Alpha* magazine's most recent list, James Simons of Renaissance Technologies, took in an estimated $1.5 billion in 2005), which they aren't going to give up without a fight. "It really is a matter of life or death or fortune or no fortune, and the incentives to take huge risks are prodigious," says veteran money manager Jeremy Grantham.

The critical issue is leverage. Hedge funds make trades that are meant to be low risk, but do so with huge sums of borrowed money, so the consequences are magnified when the bets get too risky or too wrong. The textbook case of this was the 1998 fall of heavily leveraged Long-Term Capital Management (LTCM), which briefly threatened to take the global financial system down with it. Nowadays, no single fund commands as much clout as LTCM did then, and the banks that loaned to it presumably learned something from the debacle. But the fund industry as a whole is much, much bigger.

Thorp, who at 74 no longer runs a hedge fund but still invests in a few, doesn't worry too much about a meltdown. "My opinion is that the most likely scenario is not a blowup but rather that hedge funds as a group will gradually and continuously lose their edge (if they haven't already) over other asset classes," he writes in an e-mail. "Then they will 'top out'—like mutual funds, real estate, etc.—and then just be a fluctuating fraction of total financial assets—part of the financial landscape."

Even this, the ice scenario, is bad news for the many pension funds that are only now plunging into hedge funds. Top hedge funds are often closed to new investors, meaning that newcomers are apt to get worse-than-mediocre performance while still paying 1% or 2% of assets and 20% of the profits to the managers. There *is* a cheaper alternative: just as Vanguard launched the first stock-index mutual fund in 1976, Wall Street firms are beginning to offer low-cost funds that mimic common hedge-fund strategies. The first get-together of this nascent "hedge-fund replication" industry is happening this month in London (official slogan: The clones have landed). Mediocrity doesn't have to be such a bad thing, as long as it's intentional. ■