Are Hedge Funds Still for Suckers?

Come on, people.

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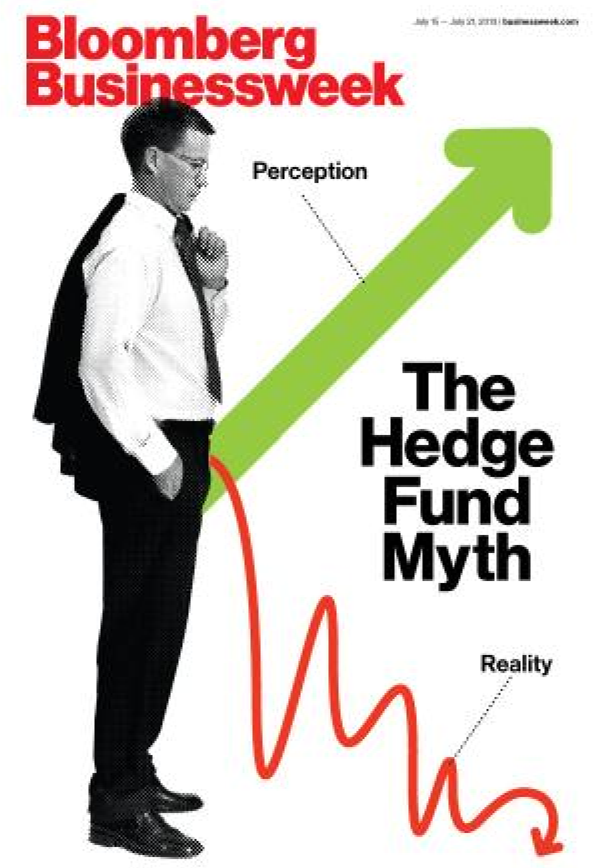
Photograph: Getty Images

Every time the market plunges, I smell cigar smoke. It filled the halls where I once worked as an analyst for a hedge fund. The fund next door was primarily a short fund, betting heavily that certain stocks would go down. The further the market fell, the thicker the smoke.

A similar scenario has played out over the past month, when markets stopped what had become a vertiginous ascent, driven largely by a bubble of low interest rates, and started behaving erratically. Concerns about interest rates rising became more acute, and currency markets spiraled downward. Then China suddenly devalued the yuan, triggering a huge selloff. Panic was in the air. It was time for hedge funds to shine.



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Based on the information available so far, though, that's not exactly what happened. As I suggested here, maybe hedge funds are for suckers.

A number of the industry's biggest names had a difficult, some might say brutal, time in August. It's not surprising, considering that several days brought enormous swings in the market that caused even the most long-term-minded investors whiplash.

David Einhorn's Greenlight Capital flagship fund fell 5.3 percent in August, putting it at –14 percent so far for 2015, according to Bloomberg News. Third Point, run by Daniel Loeb, saw a 5.2 percent decline in its main fund in August. Ray Dalio of Bridgewater Associates saw his macro fund decline 6.9 percent last month. These superstars performed more dramatically badly than the HFRX Global Hedge Fund Index, which was down 2.2 percent in August and 1.42 percent for the year. The Standard & Poor's 500-stock index lost 6.3 percent in August and is down about 4 percent in the year to date.

Hedge funds were conceived as boutique investments for the wealthy designed to shield a slice of one’s portfolio from market volatility and provide steady returns. In exchange for this rather esoteric and highbrow service, most funds charge handsomely: a management fee of 2 percent of assets, plus 20 percent of the profits. The pricing model transformed a generation of stock traders into billionaires.

But while hedge funds overall have outperformed the broader market this year, it comes after years of lagging far behind. In 2012-14, when the S&P 500 rose 13 percent, 29.6 percent, and 13.5 percent, respectively, the HFRX index was up only a few percentage points each year, if that.

“August was a fair test, and many hedge funds had a tough time,” Simon Lack, author of *The Hedge Fund Mirage*, told the *New York Times*. They “failed to beat a 60/40 [stock and bond index] mix every single year since 2002, and they’re on track to repeat this year.”

The California Public Employees’ Retirement System last year announced it was pulling its entire $4 billion out of hedge fund investments, arguing that they’re hard to understand and too expensive to justify the returns they provide. Expectations at that time ran high that other big pension funds and endowments would follow. The opposite happened.

There is now almost $3 trillion invested in hedge funds. Perhaps this latest market upheaval has a silver (another underperformer) lining, and more investors will ask if they’re worth it.