The Nonsensical Growth of Hedge Funds

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by Larry Swedroe

Hedge funds are investment pools that are relatively unconstrained in what they do. They are relatively unregulated (for now), charge very high fees, will not necessarily give you your money back when you want it, and will generally not tell you what they do. They are supposed to make money all the time, and when they fail at this, their investors redeem and go to someone else who has recently been making money. Every three or four years they deliver a one-in-a-hundred-year flood. They are generally run for rich people in Geneva, Switzerland, by rich people in Greenwich, Connecticut. – Cliff Asness

Behavioral economists have provided us with many examples of anomalies in investor behavior, such as a preference for investments with lottery-like distribution despite their very poor historical returns. But the greatest anomaly is that despite decades of poor performance and the failure to effectively hedge exposure to conventional security classes, assets under management among hedge funds have grown from about $300 billion 25 years ago to about $5 trillion today.

The following table provides the returns of the HFRX Global Hedge Fund Index over the one-, 10- and 20-year periods ending December 2022:

	2022 Annualized Return (%)	2013-2022 Annualized Return (%)	2003-2022 Annualized Return (%)
HFRX Global Hedge Fund Index	-4.4	1.8	1.7
Domestic Indexes			
S&P 500	-18.1	12.6	9.8
MSCI US Small Cap 1750 (gross dividends)	-17.8	10.1	10.5
MSCI US Prime Market Value (gross dividends)	-5.3	10.9	9.0
MSCI US Small Cap Value (gross dividends)	-9.6	9.3	9.8
Dow Jones Select REIT	-26.0	5.7	8.6
International Indexes			
MSCI EAFE (net dividends)	-14.5	4.7	6.4
MSCI EAFE Small Cap (net dividends)	-21.4	6.2	9.0
MSCI EAFE Small Value (net dividends)	-15.0	5.8	9.0
MSCI EAFE Value (net dividends)	-5.6	3.5	6.0
MSCI Emerging Markets (net dividends)	-20.1	1.4	8.7
Fixed Income			
Merrill Lynch One-Year Treasury Note	-1.0	0.7	1.5
Five-Year Treasury Notes	-9.4	0.8	2.7
20-Year Treasury Bonds	-26.1	0.7	4.0

Over each of the one-, 10- and 20-year periods, hedge funds destroyed wealth because their returns were below the rates of inflation. Over the last 20 years, hedge funds barely managed to outperform virtually riskless one-year Treasury bills, and they underperformed traditional 60% stock/40% bond portfolios by wide margins. Surely, anyone who foresaw those results would have predicted that assets would flee the industry.

Yet, in a triumph of hype, hope and marketing over wisdom and experience, assets grew dramatically.

Another problem for investors is that the evidence demonstrates that hedge funds, in general, don’t hedge anything.

Hedge funds don’t hedge

In 2022, hedge funds managed to outperform equities and longer-term Treasury bonds. But by earning negative nominal returns, they once again demonstrated that the term “hedge fund” is an oxymoron – most hedge funds don’t hedge anything. While they may offer some diversification benefits, they are not hedges, which by definition increase in value when the assets they are supposed to be hedging lose value.

The anomaly that is the growth of the industry is even stranger given that the performance of hedge funds has dramatically worsened over the past 25 years. For example, William Bernstein, author of the mini book, *Skating Where the Puck Was: The Correlation Game in a Flat World*, examined the returns of hedge funds, applying a three-factor analysis to the Hedge Fund Research Global Returns series for the period 1998 through 2012. Bernstein found that while hedge funds did produce large alpha in the first third of the period, as investor assets chased those returns, alpha shrank and then turned negative. From 1998 through 2002, hedge funds produced an incredible alpha of 9.0%. However, from 2003 through 2007, their alpha was -0.7%. And from 2008 through 2012, the alpha was -4.5%. The above table shows how poorly they have done since then. Yet assets continue to pour in.

While investors have ignored the poor performance, academic researchers have not.

Empirical evidence

Nicolas Bollen, Juha Joenväärä and Mikko Kauppila, authors of the 2021 study, "Hedge Fund Performance: End of an Era?," examined hedge fund performance over the period 1994-2016 and found a marked decline in performance over time. For example, the percentage of hedge funds with positive and significant Fung and Hsieh alpha fell from about 20% to 10% over the sample period, while the percentage with significantly negative alpha increased from 5% to about 20% at times. Their findings led Bollen, Joenväärä and Kauppila to conclude: "In sum, we confirm reports that hedge fund performance has weakened considerably over the past decade." They also examined whether investors could use any of a set of predictor variables to select subsets of hedge funds that perform satisfactorily out-of-sample despite the general decline over time. They concluded that their results indicate "that an overall deterioration in hedge fund performance cannot be overcome by using the predictors."

Bollen, Joenväärä and Kauppila's findings are consistent with those of Rodney Sullivan, author of the study, "Hedge Fund Alpha: Cycle or Sunset?," published in the winter 2021 issue of *The Journal of Alternative Investments*; Javier Estrada, author of the 2021 study, "No Hedge Funds, No Cry"; and David Forsberg, David Gallagher and Geoffrey Warren, authors of the 2022 study, "Capacity Constraints in Hedge Funds: The Relation Between Fund Performance and Cohort Size," who found significant decreasing economies to scale in the hedge fund industry.

Investor takeaways

In 1998 Charles Ellis wrote *Winning the Loser's Game.* He presented evidence that while it's possible to generate alpha (risk-adjusted outperformance) and win the game of active management (individual security selection and/or market timing), the odds of doing so are so poor it's not prudent to try. The surest way to win a loser's game – like craps and roulette – is to choose not to play. In investing, that means using passively managed funds (funds that *don't* engage in individual security selection and/or market timing and do use systematic approaches to implementation) such as index funds.

My book, co-authored with Andrew Berkin, *The Incredible Shrinking Alpha*, presented the evidence and the explanations demonstrating that, since Ellis published his book, winning the loser's game has persistently become more difficult. The four themes explaining the deterioration in hedge fund performance, and active managers in general, are:

- Academic research has been converting what was once alpha into beta.
- The pool of victims that can be exploited has been shrinking, as individual investors directly own a shrinking share of public equities.
- The competition has been getting tougher – today's active managers are far more skilled and have far greater resources.
- The supply of dollars chasing alpha has increased.

The evidence reviewed begs the question: Why have hedge fund assets continued to grow and why have investors ignored the evidence? One possible explanation is the need by some investors to feel "special," that they are part of "the club" that has access to those funds. Those investors would have been better served to follow Groucho Marx's advice: "I wouldn't want to belong to a club that would have me as a member." Another explanation is that investors were not aware of the evidence.

Larry Swedroe is head of financial and economic research for Buckingham Wealth Partners.

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