



## What's to love about hedge funds?

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“What’s old is new again.” No matter what your particular generations’ saying is for the aforementioned sentiment, once you’ve “been around the block” a few times, you realize that the world has two ways that it deals with new innovations. Over the long-term, we keep what works and get rid of what doesn’t.

Though not a brand new investment vehicle, hedge funds enjoyed a popularity in the last decade that was reminiscent of the dot.com stocks of the ‘90s or the junk bonds of the ‘80s. These private, non-regulated investment funds – not subject to the Investment Company Act of 1940 – courted ultra-high-net-worth investors. By combining highly touted but rarely understood mathematical diversification and other sophisticated (almost incomprehensible) investment strategies - a hedge fund company was able to command minimum investments of \$1,000,000+, high fees (2% was common), and pay itself as much as 20% of any profits. For those of you who have paid attention over the last few years, you may have rightfully surmised that things did not turn out quite as well as expected.

So this begs the question: In the aftermath of the worst market downturn since the Great Depression, how has the world judged this “new Idea?” In reality, it will take many more years before a full judgment can be rendered. However, anecdotally I have noticed some trends that may prove telling. For example, Nadia Pappagiannis, Morningstar’s alternative investment strategist, reported a \$2.7 billion outflow from hedge funds tracked by Morningstar through last year’s third quarter versus a \$17.3 billion inflow into alternative mutual funds. Why? Because the tried and true vehicle – the mutual fund – was also quietly innovating behind the scenes.

How? I think the media spotlight on hedge funds increased the mutual fund industry’s focus on broader diversification, moving them beyond stocks/bonds/cash allocations. Mutual fund managers have applied other asset classes and non-correlated investment strategies such as derivatives (which can move opposite to stocks and bonds) to create more sophisticated but still transparent funds. Diversification, liquidity and transparency make mutual funds more appealing – lower to the ground, faster, but with all the safety features of a publicly traded vehicle.

Please understand that there are still hedge funds, and there are still some extremely intelligent people running them. But as some of the more glamorous hedge funds crashed and burned, many investors began to realize how little they knew about how their “shiny object” performed. Investors became most uncomfortable when they invested in funds that did poorly – **and** they had no idea why. (At least investors in “boring old funds” can generally track their investments against the market.)

So if there is something I could love about hedge funds, it’s that the public spotlight on them helped force some innovation to the mutual fund market. To use a race car analogy: analyzing crashes has created both safer and more efficient cars for all of us over the years. The mutual fund industry’s analysis of hedge fund techniques has given more opportunities for people like us to be more creative and purposeful in our investment strategies, while retaining the important ability to perform due diligence. Knowing who runs it, what the track record is, where the money is being invested, whether the expenses are reasonable, and how the performance received relates to the risk taken is critical. I have found that only when people are comfortable in these things can they relax and achieve the level of wisdom needed to focus on what matters most: your money’s true purpose, and its long-term ability to meet that purpose.

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