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THE THREE MOST COMMON MISCONCEPTIONS ABOUT HEDGE FUNDS

1. *Hedge funds are designed to "beat the market"* – most modern hedge funds are designed to provide a diversification benefit, not beat the equity markets. It would be highly unusual, perhaps even distressing, for a hedge fund to outperform the S&P 500 in a strong bull market.
2. *The hedge fund universe is relatively homogeneous* – we show that the hedge fund universe is actually a collection of very different strategies.
3. *Hedge funds are riskier than the S&P 500* – different hedge funds have different risk habitats. Historically speaking, most hedge funds have been less risky than the market.

From time to time, we read articles or have conversations with investors that illustrate to us that there is still a good deal of education needed on the topic of hedge funds. Specifically, we have found that there are three popular misconceptions about hedge funds that we generally try to correct.

Misconception #1: Hedge funds are designed to "beat the market"

The hedge fund market has matured significantly over the last 10-15 years. Hedge funds are now largely being seen in a risk-reducing role rather than a "beat the market" role. Hedge funds can help reduce risk in two important ways: (1) by providing a diversification benefit and (2) by providing a lower-volatility return stream. Often, they will provide some of both. Occasionally they will provide neither. This is a very different goal than outperforming the S&P.

In fact, hedge funds will generally trail the equity markets in a sharp rise. This is by design. In our view, the goal of a hedge fund manager should be to emphasize Alpha and de-emphasize Beta. A natural disadvantage of this arrangement is that a low Beta investment will have a difficult time keeping up with a raging bull market. On the other hand, low Beta investments should outperform equities in a bear market. In a moderate market, our hope would be that the focus on Alpha produces enough return to "beat the market," although 2011 was a notable exception to this. Exceptions aside, we have found the above to have generally been the case historically, as you can see from the table below:

1990-2011 by Year	HFRI Index[i]	S&P 500
Positive Market Years	+15.16%	+17.41%
Negative Market Years	-8.58%	-13.31%
Moderate Market Years (0% to +10%)	+12.52%	4.51%

Source: www.hedgefundresearch.com

Misconception #2: The hedge fund universe is fairly homogeneous

Often, investors think of hedge funds as a monolithic asset class. Even experienced hedge fund investors tend to often talk about hedge funds as a single asset class for simplicity's sake if nothing else. An astute reader would accuse us of doing just that in the paragraphs above and we stand guilty as charged. But the reality is that the "hedge funds asset class" is really a collection of highly diverse strategies.

Index (January 1990-July 2012)	Correlation to S&P 500	Average Annualized Monthly Return	Annualized Standard Deviation
HFRI EH: Short Bias Index	(0.71)	1.77%	18.81%
HFRI FOF: Market Defensive Index	0.05	8.16%	5.88%
HFRI RV: Fixed Income-Asset Backed	0.16	9.69%	4.10%
HFRI EH: Equity Market Neutral Index	0.25	6.91%	3.28%
HFRI Macro (Total) Index	0.33	12.76%	7.59%
HFRI ED: Private Issue/Regulation D Index	0.36	11.26%	7.06%
HFRI Macro: Systematic Diversified Index	0.41	11.64%	7.46%
HFRI RV: Fixed Income-Convertible Arbitrage Index	0.47	8.87%	6.70%
HFRI EH: Sector - Energy/Basic Materials Index	0.49	17.74%	18.48%
HFRI Emerging Markets: Russia/Eastern Europe Index	0.50	19.42%	27.36%
HFRI FOF: Diversified Index	0.50	7.03%	6.02%
HFRI Relative Value (Total) Index	0.51	10.33%	4.43%
HFRI ED: Distressed/Restructuring Index	0.52	12.12%	6.61%
HFRI FOF: Conservative Index	0.52	6.38%	3.98%
HFRI RV: Yield Alternatives Index	0.53	8.22%	7.44%
HFRI ED: Merger Arbitrage Index	0.53	8.74%	4.08%
HFRI RV: Multi-Strategy Index	0.53	8.53%	4.42%
HFRI Fund of Funds Composite Index	0.53	7.47%	5.86%
HFRI RV: Fixed Income-Corporate Index	0.54	8.16%	6.63%
HFRI Emerging Markets: Latin America Index	0.55	16.04%	18.03%
HFRI FOF: Strategic Index	0.56	9.93%	8.71%
HFRI Emerging Markets: Global Index	0.57	12.85%	13.35%
HFRI Emerging Markets: Asia ex-Japan Index	0.57	10.12%	13.63%
HFRI EH: Sector - Technology/Healthcare Index	0.61	15.91%	16.48%
HFRI Emerging Markets (Total) Index	0.63	13.47%	14.35%
HFRI Event-Driven (Total) Index	0.70	11.76%	6.91%
HFRI Fund Weighted Composite Index CHF	0.72	9.84%	7.13%
HFRI Fund Weighted Composite Index GBP	0.73	13.17%	7.16%
HFRI Equity Hedge (Total) Index	0.73	13.13%	9.29%
HFRI Fund Weighted Composite Index JPY	0.73	8.54%	7.06%
HFRI Fund Weighted Composite Index	0.74	11.33%	7.05%
HFRI Fund Weighted Composite Index EUR	0.75	7.05%	7.15%
HFRI EH: Quantitative Directional	0.79	12.97%	13.09%
S&P 500 Index	1.00	7.44%	15.10%

Significant differentiation of strategies

Source: www.hedgefundresearch.com

Perhaps the simplest way to illustrate this qualitatively is to point out that different hedge funds invest in different assets. Some funds invest only in debt and some invest only in equities. Even funds that invest within the same asset class can have very different investment profiles. For example, an Equity Long/Short fund can be a very different animal than a Merger Arbitrage fund or an Equity Market Neutral fund. Global Macro can invest in just about anything for almost any reason.

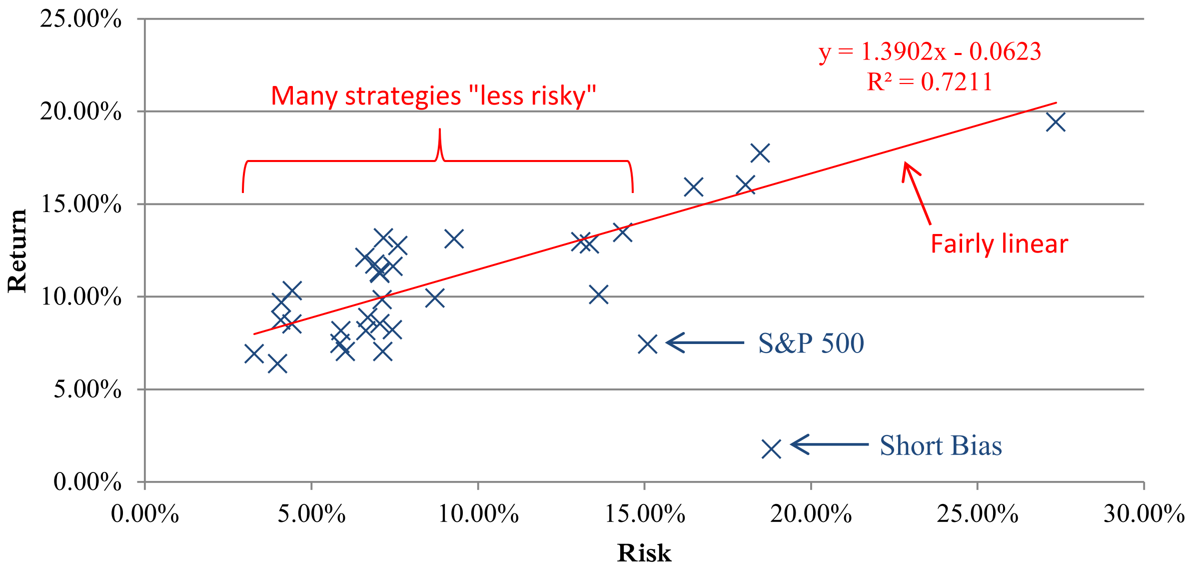
To illustrate this quantitatively, we might look at a list of the HFRI sub-indexes and observe their historical correlation to the S&P 500. As you can see from the table above, some strategies are highly correlated with the S&P 500 while some are not correlated at all. We can also see that different strategies have produced different average returns with markedly different risk, at least as measured by standard deviation. Such diverse correlation, return and risk parameters suggest that hedge fund managers pursue markedly different strategies.

Misconception #3: Hedge funds are riskier than the equity market

We would be the first to caution investors that investing in hedge funds is risky. We would even go as far to say that hedge funds are highly risky. However, we get the sense that many investors feel that hedge funds are riskier than the equity market. In our opinion, the historical data shows that this is not necessarily the case. Misconception #2 is partly to blame here because, once again, people have a tendency to think of hedge funds as a monolithic asset class.

In our opinion, different hedge fund strategies have markedly different risk habitats. Some hedge funds tend to be riskier than the S&P 500, but many have proven to be less risky than the S&P 500 over time. Perhaps even more so than other asset classes, we observe a relatively broad and linear trade-off between risk and return within the hedge fund universe. If we plot the Average Annualized Monthly Return against the Annualized Standard Deviation from the table above, we can see this broad and linear relationship more clearly. It extends from standard deviations as low as 3% all the way up to 27% with a fairly commensurate increase in return. The only points that seem to be demonstrably off the line are Short Bias (which is more of a hedging strategy) and the S&P 500.

Average Annualized Monthly Return vs Annualized Standard Deviation



Based upon the data above, we would not consider it accurate to say that "hedge funds are riskier than the equity market." A few strategies certainly are, particularly those that focus on highly volatile markets such as emerging markets or technology. However, it appears that the majority of strategies are less risky, at least insofar as standard deviation is concerned. In fact, we would even suspect that most investors, with the advantage of perfect hindsight, would say that they would rather have been in hedge funds instead of equities at the onset of the financial crisis. Thus, we feel it is more accurate to say that hedge fund investors have a broad and linear risk/reward menu with a majority of funds exhibiting lower standard deviations than the S&P 500. Although this broad array of choices may add to the confusion around hedge funds, we see it as also adding significant utility for investors who wish to more actively manage the risk/reward relationship of their portfolio.

Moving from the quantitative to the qualitative, there are certain non-return risks that have been associated with hedge funds that need to be addressed: low regulation, leverage, incentive to take risks, and poor business infrastructure. These qualitative issues are incredibly important and need to be thoroughly vetted before any investor can prudently make an investment in a hedge fund. However, the industry has come quite a long way over the past 10-15 years and we have found that many firms have taken great strides to mitigate these risks, although some have not. Fortunately for investors, these risks are relatively easy to vet during a reasonable due diligence process.

Light regulation: it has historically been the case that hedge funds were largely unregulated, but this is starting to become a non-issue with ever more stringent laws, at least in the US. Now virtually all hedge funds have to register with the SEC or a state regulatory body and are subject to all the scrutiny of a traditional asset management firm, including both routine and forensic audits. This effectively eliminates this concern at the manager level. At the product level, most investment vehicles offered to investors are still unregistered, but we find that many of the offering memos produced are effectively written to registered standards. A standard due diligence process will reveal if this is the case or not. As an aside, we feel that the prohibition on performance fees is actually hurting, not helping, retail investors by precluding hedge fund managers from offering registered product (see our memo "A case for relaxing the legislative restraints around performance fees in a regulated fund format" available at www.badonhill.com).[ii]

Use of leverage: many hedge funds use leverage to some extent. In fact, we feel excessive use of leverage was one of the most significant contributors to the financial crisis. Although it is our opinion that banks and bank proprietary trading were the main leverage offenders, hedge funds had built up leverage to fairly high levels in general during the decade. The crisis brought leverage down across the board and there is some evidence that hedge fund managers have taken the lesson to heart. Perhaps it is more accurate to say that hedge fund *investors* have taken the lesson to heart, since they have been, and should be, vocal about their managers' use of leverage. As such, we find that hedge fund leverage is generally lower now than before the crisis. This sentiment seems to be confirmed in a recent article in the *Financial Times* entitled "Hedge funds keep a lid on leverage" (Link)[iii] In the end, hedge fund managers should be upfront with the amount of leverage they intend to use, the amount of leverage they can use, and the factors and risk limits that feed into in their leverage decisions. We feel that these are basic due diligence questions that can allow investors to decide, on a manager by manager basis, if they feel the amount of leverage is prudent relative to their own portfolio.

Incentive to take risks: there has been some assertion that hedge fund performance fees incent managers to take risk. We completely agree. There is no getting around human nature. However, we feel that having a transparent, intuitive and inflexible set of risk policies and a robust risk management system can help mitigate the incentive to take inappropriate risk for personal gain. We have observed that, as the industry becomes more institutionalized, investors have rightfully demanded increased transparency and more robust risk management. Many of the higher quality hedge funds have complied. In our opinion, the risk management systems and practices at some hedge funds are more robust than at many mutual funds. This is another critical item of due diligence, but one that we feel can be reasonably well conducted.

Poor business infrastructure: historically, hedge funds have been small boutiques with limited infrastructure. Poor infrastructure, while not necessarily having a direct impact on performance, can increase business and operational risk along a large front. However, the game is changing considerably now that institutional investors are the driving force in the marketplace. Institutional investors now demand an institutional-class infrastructure. Any hedge fund seriously interested in growing their firm is now forced to spend the money to develop institutional-level infrastructures, although some certainly have not. Fortunately, it is fairly easy to identify which have and which have not and proceed according to your own sensitivity to this issue.

Overall, we think there is a clear case to be made that hedge funds are generally less risky than the equity markets from the standpoint of their historical return stream. From a qualitative standpoint, we feel that many of the non-investment risk issues of the past have either been mitigated by the institutionalization of the market or the increased regulation, or both. We also feel that a robust due diligence process is critical to investing in hedge funds, but is achievable with some effort or via a qualified third-party.

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[i] Returns are for the HFRI Hedge Fund Weighted Composite Index USD

[ii] Kendrick Wakeman, CFA "A case for relaxing the legislative restraints around performance fees in a mutual fund format" *Badon Hill Alternative Markets Update Series,* 1 FEB 2012. Link:

[iii] Sam Jones, "Hedge funds keep a lid on leverage" *Financial Times,* 9 APR 2012