

GETTING PERSONAL

Funds Of Hedge Funds: Access At A Cost

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NEW YORK -- Funds of hedge funds offer cachet and the lure of smooth returns but those benefits typically come at a steep cost.

These investments aim to put hedge funds -- lightly regulated investment vehicles for the very wealthy -- into packages that are also appropriate for the merely wealthy.

While some advisors have warmed to the funds, pointing to their ability to provide attractive returns even in rough markets, others remain skeptical, citing drawbacks such as complicated rules for withdrawing money, hard-to-evaluate performance records and fees they consider too rich.

Funds of hedge funds have grown rapidly, with assets more than doubling to \$750.1 billion since 2004, according to data company Hedge Fund Research Inc. The company estimates that about one third of all the funds it tracks have minimums below \$100,000.

Minimums for funds of hedge funds tend to be lower than those of hedge funds, often in the tens of thousands of dollars rather than hundreds of thousands or millions.

While some hedge funds aim to shoot out the lights, taking risks to post huge returns, often their goal is steady gains in any kind of market. Assets in funds of hedge funds really gained steam in 2002, when many funds posted healthy returns amid a dismal year for the stock market.

"The expectation, the hope is to deliver similar returns to the public equity market with less volatility," says Paul Weisenfeld, part of a Citigroup Inc. (C) team that vets funds of hedge funds for Smith Barney financial advisors.

Weisenfeld says that, among Smith Barney clients who own hedge fund investments, allocations of 5% to 10% of their portfolios are common. The hedge-fund group maintains a slate of about 55 different funds for advisors to choose from.

Financial advisors at independent firms have to do the leg work on their own, a task that can be complicated by restrictions on hedge fund marketing and fund managers' own reluctance to reveal details of their operations.

Sam Sudame, chief investment officer of registered investment advisor Schultz Financial Group Inc., in Reno, Nev., invests in a mix of different hedge funds to create "all weather" portfolios. Without an in-house research department available to clients at a major brokerage like Smith Barney, Sudame mines for prospective investments at conferences arranged by prime brokers, firms that provide trading services to hedge funds.

He also subscribes to an online service that provides him with information about hedge fund returns, such as financial ratios. Still these tools can't be substitutes for ringing door bells.

"Every manager must be met," he says.

Restrictions, Fees: The Challenge of "Year After Year"

Along with the promise of funds of hedge funds, there are significant drawbacks. One key sticking point: restrictions on when investors can pull out their money. Restrictions on withdrawals can resemble those imposed by hedge funds, since money being withdrawn from funds of funds ultimately has to come out of hedge funds.

"At best you can get out monthly or quarterly, but semi-annually is more common" for funds of hedge funds, says Citigroup's Weisenfeld. Investors also have to plan ahead, he says, since many funds have a notice period of 30 to 90 days. The restriction can be particularly vexing because many hedge funds also wait several weeks to report results.

Many funds have reported results for August only in the past few weeks. That means investors alarmed over poor returns in that rocky month might have found out the numbers only recently and could still have to wait until the new year to exit their investments.

Fees can also be a sticking point. The classic hedge fund fee structure is "two and 20," that is, fund managers charge 2% of assets per annum as a management fee and 20% of the profits.

The bite can be lessened by "high water" and "hurdle" clauses, which limit the circumstances in which performance fees are paid. However, funds of hedge funds offer another layer of fees, often a flat 1.5% of assets a year, or another 1% management fee and another 10% of profits.

Fees can be important to investors because they create a drag on performance. Decades-old academic studies show mutual fund managers frequently fail to outperform their benchmarks largely because returns are diminished by their own comparatively modest annual fees of 1% to 2% of assets. That lesson has made some investors wary that hedge fund managers -- or even more so, funds of funds managers -- can succeed with much steeper fees.

Take a back-of-the-envelope example: under the two-and-20 scheme a fund would have to post annual returns of 20% before fees to yield 14% for investors, suggesting hedge fund managers face a tough challenge.

"There's no way someone's going to do that year after year," says Steven Podnos, principal at Wealth Care LLC, a Merritt Island, Fla., registered investment advisor.

Evaluating individual hedge funds can also be tricky. Strategies, such as those that involve jumping on small differences between prices of similar securities, can be obtuse and lack the long history of stock-picking precepts, like value investing.

Hedge fund indexes give advisors a rough estimate of how basic strategies have performed over time. But because hedge funds report their returns voluntarily, some advisors worry these benchmarks give too much weight to successful funds.

Christopher Van Slyke, managing director of Capital Financial Advisors in La Jolla, Calif., thinks hedge fund firms use tactics that have previously drawn criticism in the mutual fund industry, such as launching a large number of funds, only to shutter the ones that underperform and tout the success of those that succeed.

"They only report the performance they want to," says Van Slyke.

Kenneth Heinz, president of Hedge Fund Research, which calculates a number of hedge fund indexes, says that while not all hedge funds report returns, he doesn't think the reporting ones do

so selectively.

Other advisors say funds of hedge funds may give off more smoke than heat.

Jerry Miccolis, senior financial advisor at Brinton Eaton Wealth Advisors, a registered investment advisor in Morristown, N.J., says he and his colleagues took a close look at funds of hedge funds several years ago.

When the firm factored returns from two popular hedge fund indexes into clients' portfolios using computer models, the initial results looked good. But anticipating reluctance from clients, they also started tinkering with existing investments in assets like stocks, bonds, real estate and commodities.

"We discovered we were able to blend the portfolios just as well without them," he says.

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(Ian Salisbury is one of four Getting Personal columnists who write about personal finance; he covers topics including exchange traded funds and separately managed accounts.)