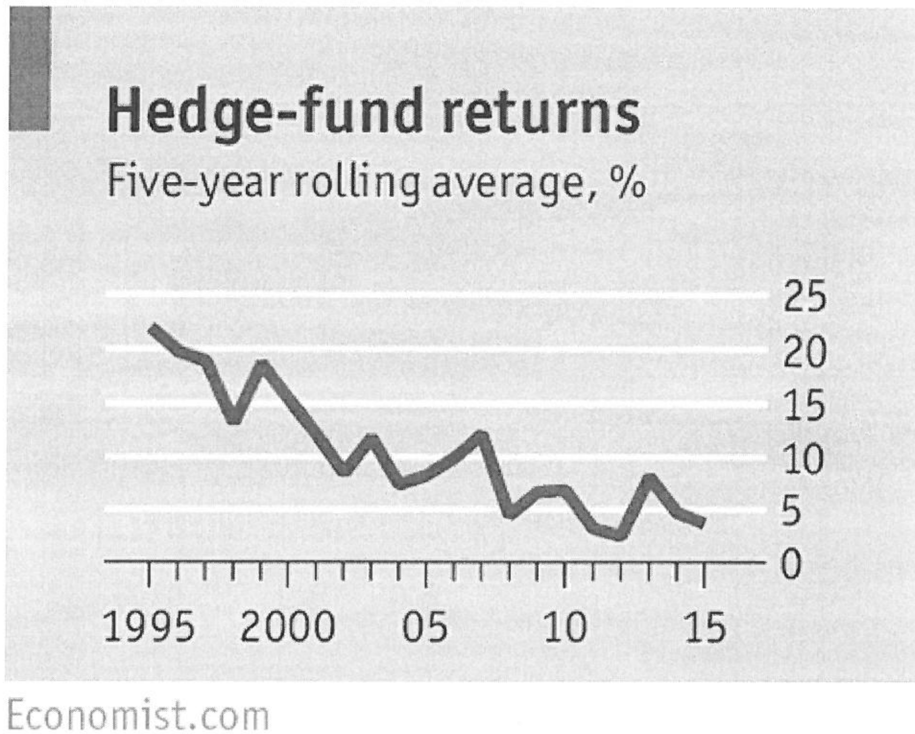
The Economist

## Hedge funds

# Fatal distraction

**Pension schemes should avoid an expensive form of fund management**

Aug 1st 2015 | From the print edition




THEY are sometimes portrayed as invincible, with enough cunning to outfox financial markets and enough clout to outgun governments. But hedge funds have been bested by an unassuming rival: exchange-traded funds (ETFs). These claim no special expertise, just the ability to make average returns at minimal cost. In 1999 ETFs controlled a mere tenth of the assets of hedge funds; today they have more money under management. The rise of ETFs is welcome, but hedge funds, which frequently charge both a 2% annual fee and 20% of performance, are still raking in money. For the pension schemes that are the hedgies' latest target, handing over cash makes no sense.

Delta blow

For one thing, the hedge funds' performance does not justify a large inflow of new money. Since the golden years of the 1990s, their average return has been disappointing (see article (http://www.economist.com/news/finance-and-economics/21660169-exchange-traded-funds-have-overtaken-hedge-funds-investment-vehicle-roaring) ). The industry used to promote itself as being able to make profits whether the underlying markets were rising or falling. In fact, in the financial crash of 2008 it suffered big losses. In recent years the average return of hedge funds is remarkably similar to what a portfolio of bonds and equities would yield—with the disadvantage that higher fees are deducted.

Naturally, no self-respecting hedge-fund manager would consider himself to be merely "average". It is indeed possible that hedge funds in specific niches may enjoy superior returns: betting on the outcome of mergers, for example, or investing in the bonds of companies on the verge of bankruptcy. But such opportunities are too small to boost the entire industry. Likewise, some very talented hedge-fund managers can earn exceptional returns from conventional assets such as equities and government bonds—at least for a time. The difficulty lies in spotting these managers in advance. If that were easy, why would investors give any money to the rest?

After the financial crisis, the industry refined its pitch. Instead of aiming at the very wealthy, it now targets institutions such as pension funds. And it emphasises not the absolute size of its gains, but the benefits of diversification and less volatile short-term returns.

Yet for pension funds this rationale makes little sense. Because their liabilities are long-term, they can ride out volatility. That is an argument for investing in illiquid assets such as property or private equity. It is not an argument for backing hedge funds.

In addition, the industry is too small to make much difference to pension funds and endowments. Its assets are $3 trillion, compared with the $36 trillion invested in pension funds around the world. If pension schemes had 10% of their assets in hedge funds, and if they earned two percentage points of additional return, that would add only 0.2 percentage points to total returns. Meanwhile failures and fraud are not unknown, so pension funds need to devote a lot of time to understanding the strategies of hedge-fund managers and assessing their risks. Small wonder that CalPERS, a giant American pension fund, has concluded that putting money in hedge funds is not worth the bother.

The worry is that some pension funds in America are allocating money to hedge funds out of desperation. Many public-sector funds are heavily in deficit and are aiming for unrealistic returns of 7.5-8%, at a time when Treasury bonds yield just over 2%. For all the talk of a better balance between risk and reward, such pension funds are actually hoping the hedge funds will get them out of the hole. They won't. What schemes in deficit need to do is increase contributions or reduce benefits. Investing with hedge funds is a distraction.

From the print edition: Leaders