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THE INTELLIGENT INVESTOR

Invest With the Upper Crust and Sometimes You Just Get Crumbs

The 'performance' fees that hedge-fund managers charge can walk off with most of your return

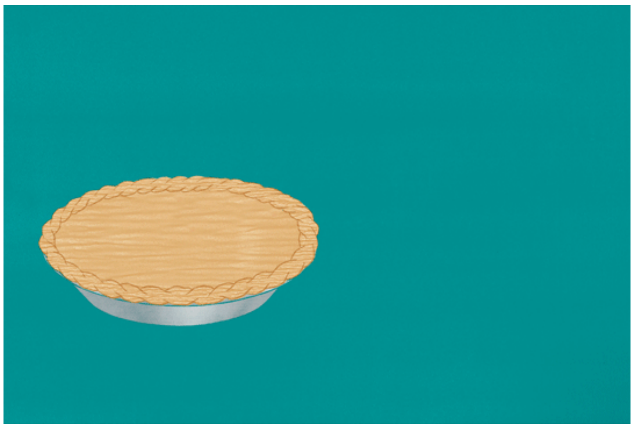

PHOTO: ALEX NABAUM

By

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June 19, 2020 12:50 pm ET

Investment performance can be fleeting, but fees are forever.

That's the lesson from a recent reversal at a prominent fund. Chaotic markets can cancel years' worth of gains in days, but expenses don't dwindle when profits disappear. And, new research shows, those costs can be even higher than they look.

Consider SkyBridge Multi-Adviser Hedge Fund Portfolios LLC, a fund of funds, or a basket of hedge funds that are run by about two dozen different managers. Normally you'd have to put up millions of dollars to be allowed into any of these portfolios, but you can invest in them through SkyBridge with as little as $25,000.

For many years, returns were outstanding. From 2009 through 2013, SkyBridge earned an average of 14.5% annually after expenses. That crushed the portfolio's benchmark, the HFRI Fund of Funds Composite Index, by almost 10 percentage points annually—and ended up not far behind the stock market's return with a smoother ride.

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This March, however, SkyBridge lost 24.7% as the coronavirus pandemic pounded the underlying hedge funds that hold its favorite asset: structured credit, or bundles of corporate and consumer borrowings.

That one blow obliterated most of the fund's gains. As of the end of February, $100,000 invested in SkyBridge had grown to nearly $186,000 over the prior 10 years, more than double the average rate of return at similar hedge funds. By the end of March, that 10-year gain had shrunk to less than $137,000—well below what you could have earned in a high-quality bond fund. The fund has since rebounded a bit, up 0.6% in April and 2.2% in May.

Fees didn't fall, however.

To SkyBridge's credit, its expenses are unusually transparent—and much lower than at many competitors. Unlike nearly all hedge funds and private investment pools, SkyBridge files detailed public disclosures.

Out of its 1.5% management fee, SkyBridge pays approximately 0.85% annually to the brokerage and investment-advisory firms that sell the fund. Those payments, I estimate, reached $380 million over the past 10 years.

That's not all. The underlying funds bundled into the SkyBridge portfolio pass through much higher expenses. Their management and incentive fees total 5%, pushing SkyBridge's total costs past 7.1%—even though it doesn't charge a performance fee itself.

The coronavirus credit crunch in March was "a direct meteor strike on our portfolios," says Anthony Scaramucci, SkyBridge's founder and co-managing partner. "I think pre-pandemic there was a lot of value for everyone. The pandemic will definitely hurt our numbers, but so did 2008. But 2009-2014 was worth waiting around for, net of fees."

Yes, that's the same Anthony Scaramucci who served briefly as communications director in the Trump White House in 2017. But we're looking at fund costs, not politics, and your feelings about Messrs. Trump and Scaramucci—positive or negative—should have nothing to do with judgments about investment expenses and returns.

A small stake in SkyBridge—say, 3% to 8% of an investor's total portfoli—is "a return stabilizer" in the long run, says Mr. Scaramucci. Its favorite asset, structured credit, is "going to do phenomenally well in a recovery," he says, and clients who "make the decision to stay through the recovery" should be amply rewarded.

SkyBridge's fund of funds also offers a way "to get exposure to great managers like Howard Marks [of Oaktree Capital Management] and Steve Cohen [of Point72 Asset Management LP]," says Mr. Scaramucci.

He adds, "This is like an Hermès Birkin bag [which retails for thousands of dollars]. You're invested with some of the most successful money managers in the world, and you're paying additional fees for that. You could invest elsewhere for much lower costs, the same way you could get hundreds of pocketbooks at Walmart for the cost of one Hermès Birkin bag."

According to new research, though, paying up for such access comes with a twist. From 1995 through 2016, hedge-fund investors shelled out an average of 3.44% annually in management and incentive fees, according to a study by finance professors Itzhak Ben-David and Justin Birru of Ohio State University and Andrea Rossi of the University of Arizona.

The study finds that investors earned net returns of only 1.96% annually—meaning they paid $1.76 in costs for every dollar they got to keep.

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Prof. Ben-David and his colleagues measured those net returns against the funds' performance hurdles—which, often, an earthworm could easily clear. When Warren Buffett ran a private partnership six decades ago, he charged a performance fee of 25% of any gains over 6%. Nowadays, many hedge funds take a hefty cut of any return above zero, so long as the portfolio isn't below its previous high.

Between 1995 and 2008, the hedge funds in this study produced cumulative losses, before expenses, of $1.3 billion—but still generated almost $52 billion in performance payments to their managers.

That's largely because most hedge funds assess performance fees when they make money, but don't charge negative fees or give back past fees when they lose money. When returns vanish, the expenses don't.

All told, 64% of the excess return of the hedge funds in the study went to the managers in the form of expenses. Of every $3 the funds earned, the managers kept $2, leaving investors with $1. That doesn't take into account the extra risk at many of these funds or the taxes their investors incurred.

Pay up, then, if you want the status of exclusive access. But remember that returns, and the prestige they offer, aren't permanent. Costs are.