After the gold rush: Are hedge funds still attractive?

Some in the media have noted the recent decline in hedge fund returns and have framed the question, predictably, in terms of a bubble. We think that a bubble is a bad analogy.

The growth in hedge funds over the last decade is more like a gold rush than a bubble. When a bubble pops, there's nothing left. Whereas in a gold rush, people actually do strike it rich. It's just not as easy or as widespread as the rumors make it out to be.

It is our hope that this paper has dispelled some of those rumors and helps investors make realistic assessments of the rewards and the risks available from hedge funds. Going forward, we believe skilled manager selection will be more important than ever, particularly as increased competition is likely to winnow out some of the weaker players.

Competition also produced a notable benefit: innovation. Given a more competitive market environment, managers responded by creating new strategies. Our studies indicate that these strategies have low correlations compared to traditional strategies. This means the potential risk reduction benefit of hedge funds remains a compelling argument for investing in this asset class.

And what about alpha? We think that the prospect of potentially earning excess returns of 2-3 percentage points will remain very attractive to a wide range of investors. For instance, these return levels are quite compelling for investors—such as pension funds—whose liabilities may be increasing even as expected returns have declined. Alternative investments generally have the potential to enhance returns and bring investors closer to the amounts needed to fund liabilities.

Other options, such as the use of excessive leverage or increasing allocations to high-return asset classes, involve a substantial increase in risk. (These strategies may be more appropriate for taxable high-bracket individuals who face 50% and higher marginal tax rates, depending on where they live.)

But institutions and other risk-conscious investors can benefit from hedge fund strategies' low correlation with traditional asset classes, which can actually decrease the expected standard deviation on the total portfolio. That is why we think hedge fund strategies remain an important tool for qualified investors going forward.