Chapter 1

The Truth about Hedge Fund Returns

If all the money that's ever been invested in hedge funds had been put in treasury bills instead, the results would have been twice as good. When you stop for a moment to consider this fact, it's a truly amazing statistic. The hedge fund industry has grown from less than $100 billion in assets under management (AUM) back in the 1990s to more than $1.6 trillion today. Some of the biggest fortunes in history have been made by hedge fund managers. In 2009 David Tepper (formerly of Goldman Sachs) topped the Absolute Return list of top earners with $4 billion, followed by George Soros with $3.3 billion (according to the *New York Times*). The top 25 hedge fund managers collectively earned $25.3 billion in 2009, and just to make it into this elite group required an estimated payout of $350 million. Every year, it seems the top earners in finance are hedge fund managers, racking up sums that

dwarf even the CEOs of the Wall Street banks that service them. In fact, astronomical earnings for the top managers have almost become routine. It's Capitalism in action, pay for performance, outsized rewards for extraordinary results. Their investment prowess has driven capital and clients to them; Adam Smith's invisible hand has been at work.

How to Look at Returns

In any case, haven't hedge funds generated average annual returns of 7 percent or even 8 percent (depending on which index of returns you use) while stocks during the first decade of the twenty-first century were a miserable place to be? Surely all this wealth among hedge fund managers has been created because they've added enormous value to their clients. Capitalism, with its efficient allocation of resources and rewards, has channeled investors' capital to these managers and the rest of the hedge fund industry because it's been a good place to invest. If so much wealth has been created, it must be because so much more wealth has been earned by their clients, hedge fund investors. Can an industry with $1.6 trillion in AUM be wrong? There must be many other examples of increased wealth beyond just the hedge fund managers themselves.

Well, like a lot of things it depends on how you add up the numbers. The hedge fund industry in its present form and size is a relatively new phenomenon. Alfred Winslow Jones is widely credited with founding the first hedge fund in 1949. His insight at the time was to combine short positions in stocks he thought were expensive with long positions in those he liked, to create what is today a long/short equity fund. A.W. Jones was hedging, and he enjoyed considerable success through the 1950s and 1960s (Mallaby, 2010). Hedge funds remained an obscure backwater of finance however, and although the number of hedge funds had increased to between 200 and 500 by 1970, the 1973 to 1974 crash wiped most of them out. Even by 1984, Tremont Partners, a research firm, could only identify 68 hedge funds (Mallaby, 2010). Michael Steinhardt led a new generation of hedge fund managers during the 1970s and 1980s, along with George Soros, Paul Jones, and a few others.

But hedge funds remained a cottage industry, restricted by U.S. securities laws to taking only "qualified" (i.e., wealthy and therefore financially sophisticated) clients. Hedge funds began to enjoy a larger profile during the 1990s, and expanded beyond long/short equity to merger arbitrage, event-driven investing, currencies, and fixed-income relative value. Relative value was the expertise of Long Term Capital Management, the team of PhDs and Nobel Laureates that almost brought down the global financial system when their bets went awry in 1998 (Lowenstein). Rather than signaling the demise of hedge funds however, this turned out to be the threshold of a new era of strong growth. Investors began to pay attention to the uncorrelated and consistently positive returns hedge funds were able to generate. By 1997 the industry's AUM had reached $118 billion[1] and LTCM's disaster barely slowed the industry's growth. Investors concluded that the collapse of John Meriwether's fund was an isolated case, more a result of hubris and enormous bad bets rather than anything systematic. Following the dot.com crash of 2000 to 2002, hedge funds proved their worth and generated solid returns. Institutional investors burned by technology stocks were open to alternative assets as a way to diversify risk, and the subsequent growth in the hedge fund industry kicked into high gear. It is worth noting that the vast majority of the capital invested in hedge funds has been there less than 10 years.

Digging into the Numbers

To understand hedge fund returns you have to understand how the averages are calculated. To use equity markets as an example, in a broad stock market index such as the Standard & Poor's 500, the prices of all 500 stocks are weighted by the market capitalization of each company, and added up. The S&P 500 is a capitalization weighted index, so an investor who wants to mimic the return of the S&P 500 would hold all the stocks in the same weights that they have in the index. Some other stock market averages are based on a float-adjusted market capitalization (i.e., adjusted for those shares actually available to trade) and

[1]BarclayHedge

the venerable Dow Jones Industrial Average is price-weighted (although few investors allocate capital to a stock based simply on its price, its curious construction hasn't hurt its popularity). In some cases an equally weighted index may better reflect an investor's desire to diversify and not invest more in a company just because it's big. On the other hand, a market cap-weighted index like the S&P 500 reflects the experience of all the investors in the market, since bigger companies command a bigger percentage of the aggregate investor's exposure. The stocks in the index are selected, either by a committee or based on a set of rules, and once chosen those companies stay in the index until they are acquired, go bankrupt, or are otherwise removed (perhaps because they have performed badly and shrunk to where they no longer meet the criteria for inclusion).

Calculating hedge fund returns involves more judgment, and is in some ways as much art as science. First, hedge fund managers can choose whether or not to report their returns. Since hedge funds are not registered with the SEC, and hedge fund managers are largely unregulated, the decision on whether to report monthly returns to any of the well-known reporting services belongs to the hedge fund manager. He can begin providing results when he wants, and can stop when he wants without giving a reason. Hedge fund managers are motivated to report returns when they are good, since the main advantage to a hedge fund in publishing returns is to attract attention from investors and grow their business through increased AUM. Conversely, poor returns won't attract clients, so there's not much point in reporting those, unless you've already started reporting and you expect those returns to improve.

This self-selection bias tends to make the returns of the hedge fund index appear to be higher than they should be (Dichev, 2009). Lots of academic literature exists seeking to calculate how much the returns are inflated by this effect (also known as survivor bias, since just as history is written by the victors, only surviving hedge fund managers can report returns). And there's lots of evidence to suggest that when a hedge fund is suffering through very poor and ultimately fatal performance, those last few terrible months don't get reported (Pool, 2008). There's no other reliable way to obtain the returns of a hedge fund except from the manager of the hedge fund itself, so the index provider has little

choice but to exclude the fund from his calculations (although the hapless investors obviously experience the dying hedge fund's last miserable months).

Another attractive feature of hedge funds is that when they are small and new, their performance tends to be higher than it is in later years when they're bigger, less nimble, and more focused on generating steady yet still attractive returns (Boyson, 2008). This is accepted almost as an article of faith among hedge fund investors, and there are very good reasons why it's often true. As with any new business that's going to be successful, the entrepreneur throws himself into the endeavor 24/7 and everything else in his life takes a backseat to generating performance, the "product" on which the entire enterprise will thrive or fail. Small funds are more nimble, making it easier to exploit inefficiencies in stocks, bonds, derivatives, or any chosen market. Entering and exiting positions is usually easier when you're managing a smaller amount of capital since you're less likely to move the market much when you trade and others are less likely to notice or care what you're doing. Success brings with it size in the form of a larger base of AUM and the advantages of being small slowly dissipate. Academic research has been done on the benefits of being small as well (Boyson, 2008).

An interesting corner of the hedge fund world involves seeding hedge funds, in which the investor provides capital and other support (such as marketing, office space, and other kinds of business assistance) to a start-up hedge fund in exchange for some type of equity stake in the managers' business. If the hedge fund is successful, the seed provider's equity stake can generate substantial additional returns. A key element behind this strategy is the recognition that small, new hedge funds outperform their bigger, slower cousins. Almost every hedge fund I ever looked at had done very well in its early years. That is how they came to be big and successful. So there's little doubt that surviving hedge funds have better early performance. Sometimes I would meet a small hedge fund manager with, say $10 to $50 million in AUM. In describing the benefits of investing with him, he'd often assert that his small size made him nimble and able to get in and out of positions that others didn't care about without moving the market. I'd typically ask what he felt his advantage would be if he was successful in growing his business. How nimble would he be at, say, $500 million in AUM when

the success he'd enjoyed as a small hedge fund (because he was small) had enabled him to move into the next league of managers. Invariably the manager would maintain that his many other advantages (deep research capability, broad industry knowledge, extensive contacts list) would suffice, but it illustrates one of the many conflicting goals faced by hedge funds and their clients.

Investors want hedge funds to stay small so they can continue to exploit the inefficiencies that have brought the investor to this meeting with the hedge fund manager. And the manager naturally wants to grow his business and get rich, so he strives to convince the investor that he won't miss the advantages of being small if and when he becomes bigger. In fact, while small managers will tell you small is beautiful, large managers will brag about greater access to meet with companies, negotiate better financing terms with prime brokers, hire smart analysts, and invest in infrastructure. There can be truth to both arguments, although it's sometimes amusing to watch a manager shift his message as he morphs from small to bigger. The result of all these challenges with calculating exactly how hedge funds have done is that generally the reported returns have been biased higher than they should be (Jorion, 2010).

The Investor's View of Returns

The problems I've described are faced by all the indices of reported hedge fund returns. However, in assessing how the industry has done, what seems absolutely clear is that you have to use an index that reflects the experience of the average investor. While individual hedge fund investors may have portfolios of hedge funds that are equally weighted so as to provide better diversification, clearly the investors in aggregate are more heavily invested in the larger funds. Calculating industry returns therefore requires using an asset-weighted index (just as the S&P 500 Index is market-cap weighted). Hedge Fund Research in Chicago publishes dozens of indices representing hedge fund returns. They break down the list by sector, geography, and style. A broadly representative index that is asset-weighted and is designed to reflect the industry as a whole is the HFR Global Hedge Fund Index, which they refer to as

HFRX. Using returns from 1998 to 2010, the index has an annual return of 7.3 percent. Compared with this, the S&P 500 (with dividends reinvested) returned 5.9 percent and Treasury bills returned 3.0 percent. Blue chip corporate bonds (as represented by the Dow Jones Corporate Bond Index) generated 7.2 percent. So hedge funds handily beat equities, easily outperformed cash, and did a little better than high-grade corporate bonds.

What's wrong with this picture? The returns are all based on the simple average return each year. The hedge fund industry routinely calculates returns based on the value of $1 invested at inception. And it's true that, based on the HFRX if you had invested $1 million in 1998 you would have earned 7.3 percent per annum. Hedge funds did best in the early years, when the industry was much smaller. Just as small hedge funds can do better than large ones, a small hedge fund industry has done better than a large one. When you adjust for the size of the hedge fund industry (using AUM figures from Barclay-Hedge) the story is completely different. Rather than generating a return of 7.3 percent, hedge funds have returned only 2.1 percent. There were fewer hedge fund investors in 1998 with far less money invested, but based on the strong results the few earned at that time, many more followed. It's the difference between looking at how the average hedge fund did versus how the average investor did. Knowing that the average hedge fund did well isn't much use if the average investor did poorly.

Here's an example that shows the difference between the two. You can think of it as the difference between taking annual returns and averaging them (known as time-weighted returns) and returns weighted for the amount of money invested at each time (known as asset-weighted returns). If more money is invested, then that year's results affect more people and are more important. This is why hedge funds haven't been that good for the average investor, because the average investor only started investing in hedge funds in the last several years.

Imagine for a moment that you found a promising hedge fund manager and invested $1 million in his fund (see Table 1.1). After the first year he's up 50 percent and your $1 million has grown to $1.5 million. Satisfied with the shrewd decision you made to invest with

Table 1.1 The Problem With Adding To Winners

Year 1
You invest $1 million
HF return is 50%
Your investment is worth $1.5 million
Your profit is $500 thousand
Year 2
You invest another $1 million (total investment now $2.5 million)
HF return is −40%
Your investment is worth $1.5 million
Your loss is $1 million

him, you invest a further $1 million in his fund bringing your investment to $2.5 million. The manager then stumbles badly and loses 40 percent. Your $2.5 million has dropped to $1.5 million. You've lost 25 percent of your capital. Meanwhile the hedge fund manager has returned +50 percent followed by −40 percent, for an average annual return of around +5 percent[2].

Now let's take a look at how these results will be portrayed. The hedge fund manager will report an average *annual* return over two years of +5 percent (up 50 percent followed by down 40 percent). Meanwhile, his investor has really lost money, and has an internal rate of return (IRR) of −18 percent. IRR[3] is pretty close to the return weighted by the amount of capital invested. It assigns more weight to the second year's negative performance in this example than the first, because the investor had more money at stake. The hedge fund is showing a positive return, while his investor has lost money. In fact, his marketing materials will likely show a geometric annual return of +5.13 percent, while if his investors had all added to their initial investment in this same way in aggregate they would have all lost money.

[2]The geometric return is 5.13 percent

[3]IRR is the discount rate at which all the cash flows from an investment have a net present value of 0. Describing it as the weighted average return is not precisely correct, but is a reasonable approximation.

So is this performance good? Which measure of performance is a more accurate reflection of the hedge fund manager's skill? Should a year of strong performance with a small number of clients be combined with a year of poor performance with more clients without any adjustment for size? In private equity and real estate, if your clients have lost money your returns would reflect that, since they'd be expressed as an IRR. However, the hedge fund industry reports returns like mutual funds and apparently nobody has seen fit to challenge that. As a result it's perfectly legal, and is industry practice. But since hedge fund managers claim to provide absolute returns, and can turn away money, isn't it more fair to show the whole story? While nobody can claim to make money every year, part of what hedge funds are supposed to be providing is hedged exposure. Unlike mutual funds and other long-only managers, hedge funds can not only hedge but can also choose to be under-invested or even not invested. In fact, arguably that is part of the skill for which investors are paying, a hedge fund manager's ability to protect capital, to generate uncorrelated returns, to generate *absolute returns* (i.e., not negative). Hedge funds are even referred to as absolute return strategies and most managers will claim some insight about whether they should be taking lots of risk or being more defensive.

While our investor in this case clearly had unfortunate timing in adding to his position, the hedge fund manager apparently knew no better. One very shrewd hedge fund investor I used to work with would sometimes ask a manager for the aggregate profit and loss (P&L) on his fund. He might see a series of annual returns such as +50 percent, +10 percent and −6 percent with strong asset growth every year and question whether the lifetime P&L is positive or negative. In other words, how have all the investors done? In the example described in the table above, the P&L would be negative $500,000 (i.e., what our investor lost). It may or may not be relevant information. Few investors ask for it—in my opinion many more should.

While the numbers in this example are exaggerated to illustrate the point, this is exactly what investors in hedge funds have done as a group. Although they've come to believe that strong early performance with small size is a reliable part of most hedge funds' history, they've forgotten to apply that same rule to the industry as a whole. Like many individual hedge funds, the industry did best when it was small.

How the Hedge Fund Industry Grew

Table 1.2 shows hedge fund performance conventionally, with annual returns from stocks, bonds, and cash alongside for comparison. In the late 1990s when the dot.com bubble was building and then during the subsequent bear market in 2000–02 after it burst, hedge funds truly added value. They protected capital and indeed made money. It was this performance that created the surge of client interest in hedge funds that followed. But the strong relative performance that the industry generated when it was small was not repeated as it grew. Following some fairly mediocre years during the middle part of the decade, the Credit Crisis of 2008 led to a 23 percent loss for the year, with only a partial rebound in 2009 and modest returns in 2010. Hedge funds are represented by the HFRX Index. This is an asset-weighted index, which means that the underlying hedge funds it represents are weighted based on their size. Larger hedge funds impact the results of the index more than small ones. Since we're interested in how investors in

Table 1.2 Hedge Fund Industry Growth and Asset Class Returns

Year	Hedge Fund Industry Assets (Billions)	Hedge Fund Returns (HFRX)	S&P 500 (with dividends reinvested)	Dow Jones Corporate Bonds	Treasury Bills
1998	$ 143	12.9%	28.6%	10.3%	5.1%
1999	$ 189	26.7%	21.0%	–2.9%	4.8%
2000	$ 237	14.3%	–9.1%	9.4%	6.2%
2001	$ 322	8.7%	–11.9%	10.7%	3.9%
2002	$ 505	4.7%	–22.1%	11.3%	1.7%
2003	$ 826	13.4%	28.7%	9.9%	1.1%
2004	$1,229	2.7%	10.9%	6.2%	1.3%
2005	$1,361	2.7%	4.9%	1.3%	3.2%
2006	$1,713	9.3%	15.8%	3.8%	4.9%
2007	$2,137	4.2%	5.5%	5.2%	4.8%
2008	$1,458	–23.3%	–37.0%	1.8%	1.7%
2009	$1,554	13.4%	26.5%	17.6%	0.1%
2010	$1,694	5.2%	15.1%	8.8%	0.1%

AUM data from BarclayHedge; HF Returns from Hedge Fund Research; S&P 500 data from Bloomberg; Corp Bonds from Dow Jones; Treasury Bills from Federal Reserve

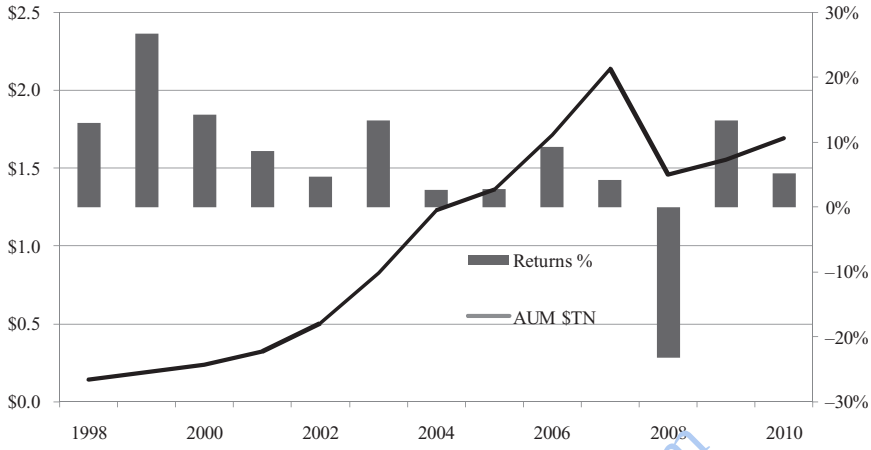

Figure 1.1 We were better . . .

aggregate have done, it makes sense to use an asset-weighted index, since large hedge funds figure more prominently both in the index and in investors' results. Figures 1.1 and 1.2 compare hedge fund returns and size of the industry in two ways.

Figure 1.1 presents returns conventionally, so each bar represents the annual return for that year.

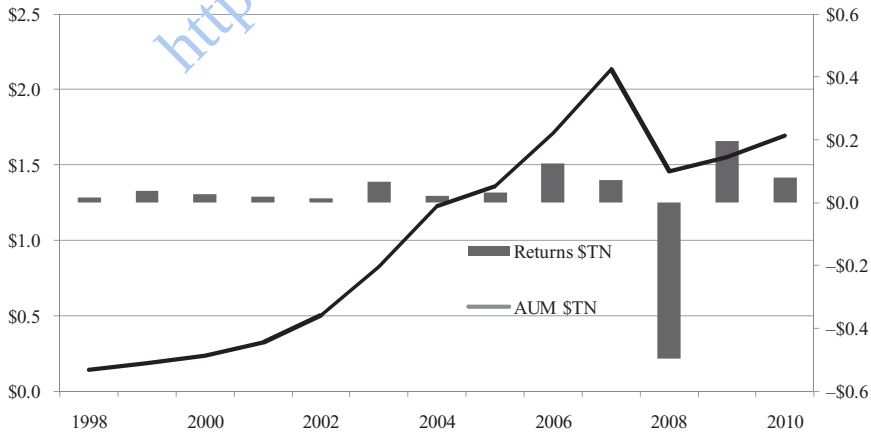

Figure 1.2 . . . when we were smaller

Figure 1.2 converts annual returns to profits and losses based on the AUM in the industry at each time. It shows the annual returns in money terms to hedge fund investors each year. In 2010 two academics, Ilia Dichev from Goizueta Business School at Emory University in Atlanta, Georgia, and Gwen Yu from Harvard Business School in Cambridge, Massachusetts, produced a research paper ("Higher Risk, Lower Returns: What Hedge Fund Investors Really Earn") that performed a similar though more detailed analysis of hedge fund returns. Their study went back to 1980 and arrived at the same conclusion, that overall industry returns had been a disappointment for hedge fund investors. This chart illustrates just how catastrophic 2008 was for investors since the losses from that year dwarf previous returns.

The strong returns of the late 1990s were nice for the investors that participated, but there weren't that many of them and their allocations were small. By the time the Credit Crisis hit with full force in 2008 a great many new investors had "discovered" hedge funds without having benefitted from the strong returns of the past. *In fact, in 2008 the hedge fund industry lost more money than all the profits it had generated during the prior 10 years.* Although it's not possible to calculate precisely, it's likely that hedge funds in 2008 lost all the profits ever made. By the end of 2008, the cumulative results of all the hedge fund investing that had gone before were negative. The average investor was down. For hedge fund investors it had been an expensive experiment. Although performance rebounded from 2009 to 2010, it didn't dramatically alter the story.

Hedge funds have indeed done better than stocks. The IRR from the S&P 500 over the last ten years from 2001–2010 is only 1.1 percent (this assumes that hedge fund investors had put all their money in stocks rather than hedge funds during this time). Equities had a bad decade. But corporate bonds did much better, generating an IRR of 6.3 percent—or more than five times what the average hedge fund investor received. Since most investors hold portfolios with both equities and bonds in them, virtually any combination of stocks and bonds would have turned out to be a better choice than hedge funds. And perhaps most damning of all, if all the investors had not bothered with hedge funds at all, but had simply put their hedge fund money into Treasury bills, they would have done better, earning 2.3

percent. And this doesn't include the cost of investing in hedge funds. Deciding which Treasury bill to buy is not a particularly taxing job, but selecting hedge funds requires either a significant investment in a team of hedge fund analysts, risk management, due diligence, and financial experts, or the use of a hedge fund of funds that employs the same expertise. Either way, it costs an additional 0.5 to 1.0 percent annually for an investor to be in hedge funds, whether through fees paid to the hedge fund of funds manager or increased overhead of an investment team.

The Only Thing That Counts Is Total Profits

Now, we've just calculated that hedge fund investors as a whole have not been particularly well served by their decision to invest in hedge funds, based on weighted-average-capital invested, or IRR. Is this a fair way to calculate results? The hedge fund industry and the consultants that serve it have stayed with the since-inception, value-of-the-first-dollar approach. While there's little doubt that hedge fund investors haven't done well, is that the right way to look at it? 2008 was a terrible year for just about any investment strategy apart from government bonds. Hedge funds weren't the only group to have lost money, and some investors expressed relief as results rolled in during 2008 and into 2009 that their hedge funds hadn't done worse! Investors facing portfolios of equities that had lost more than a third of their value, high-yield bond positions for which no reliable market even existed, and private equity investments that had stopped generating cash from liquidity events might be forgiven for regarding being down 23 percent as an acceptable result.

2008 was in so many ways a thousand-year flood, although amazingly for many investors, already so committed to the inclusion of hedge funds in their portfolios in spite of the evidence to the contrary, it represented acceptable performance. Most of the hedge fund industry, including the managers themselves, the investors, the consultants that advise them, the prime brokers, and private banks are all heavily invested in the continued success of the industry. I'll simply note that hedge funds became popular as absolute return vehicles, meaning that

they were expected to make money (i.e., an absolute return, not one with a negative sign in front of it) and were uncorrelated with other markets. In 2008 they failed on both counts, but it turns out hedge fund investors are a fairly forgiving lot and while there were some modest pro-investor changes that followed, the investors generally stuck with it.

But what about the use of IRR, or dollar-weighted returns, to assess how the hedge fund industry has done. Is this a fair way to analyze it or not? In general, if an investment manager doesn't have much control over asset flows in and out of the strategy, it's reasonable to calculate returns based on the value-of-the-first-dollar method. This is commonly the case with mutual funds. Since money flows into and out of mutual funds based on investors' appetite, it seems fair enough to judge a mutual fund manager based on the first dollar. He generally can't control whether his sector is in favor or not, and the vast majority of mutual funds are long-only, meaning they're not hedged. Market movements will typically determine most of a mutual fund's returns, and that's beyond the control of a mutual fund manager. On the other hand, private equity and real estate funds are routinely evaluated based on IRR. This also seems fair, since the typical structure requires a commitment of capital to the fund with the investment manager deciding when to call that capital over time. Since the commitments are usually quite long term, three to 10 years, and the manager of the fund decides when he wants the money (presumably when an attractive investment opportunity is available) it seems fair to judge him on total dollars invested, since he controls the timing.

Hedge Funds Are Not Mutual Funds

So should hedge funds be judged like mutual funds, based on the first dollar invested? Or like private equity, based on total dollars? Hedge fund managers always have the option to turn away investors. The industry has largely marketed itself as focused on absolute returns, but within each strategy there are good and bad times to be invested. Indeed, many of the largest hedge fund managers have in the past closed to new capital, either because they felt the opportunities they were

seeing weren't that great or because they felt that adding to their AUM would reduce their investing flexibility and dilute returns.

Often in such cases the hedge fund manager is himself the biggest single investor in the fund, so his desire to avoid diluting returns is not only good for his current investors but of course good for his own investment too. In other cases a hedge fund will announce some limited capacity available to current investors before closing. Rather like jumping on the train before it leaves the station, this can often draw in additional assets from investors who fear being unable to add to their investment later on. The point is that hedge fund managers are much more like private equity managers in that they can control whether to accept additional money into their fund or not. The bigger, more established funds generally have more clout in this regard than smaller funds, and of course the bigger managers are by definition more prominently figured in an asset-weighted index like the HFRX.

The hedge fund industry has grown on the basis of generating uncorrelated, absolute returns and having insight into when to deploy capital into and out of different strategies, sectors, and opportunities. If every hedge fund investor asked each hedge fund manager prior to investing whether this is a good time to be investing, the responses would vary but would rarely be no. But hedge fund managers have routinely turned away investors and even returned capital if they felt it was in their investors' interests or their interests, or both. Sometimes that was to the investors' subsequent benefit. In 1997 Long Term Capital Management decided to return some capital to their investors (Lowenstein). They had earned so much in fees that were reinvested back in their own fund that the clients' capital was making them too big and diluting returns. This illustrates another negative optionality hedge fund investors face; if you select a hedge fund manager that is wildly successful, you'll wind up paying him so much in fees that he'll no longer want or need to manage your money. Successful hedge fund investing can be its own worst enemy! However, fortunately for the investors in LTCM, the return of capital, while unpopular at the time, saved many of them from greater losses when the fund eventually destroyed itself with leveraged bets gone bad in 1998.

In general, individual hedge fund managers have exercised much greater control over their size than many mutual funds; the hedge fund

industry is much closer to private equity in this regard, and therefore assessing results in the same way as private equity seems to make sense. And on that basis, while the hedge fund industry has generated fabulous wealth and created many fortunes, it has largely done so for itself. To use that oft-repeated Wall Street saying, where are the customers' yachts? Most of us can probably name a few billionaire hedge fund managers, but who can name even one hedge fund investor whose fortune is based on the hedge funds he successfully picked? David Swensen, who manages Yale University's endowment and led its shift into hedge funds in the 1990s, grew Yale's endowment substantially through this early move. By 2005 his investment picks were credited with having generated $7.8 billion of Yale's $15 billion endowment (Mallaby, 2010).

No doubt David Swensen is a very talented investor, and Yale had the foresight to invest in hedge funds earlier than most other institutions. But $7.8 billion is around 3 percent of all the profits investors earned from hedge funds since 1998 (and given the industry's small size prior to this, probably in their entire history). Yale's hedge fund portfolio at its peak was probably around $10 billion, less than 1 percent of the industry. If Yale has earned a bigger share of the hedge fund industry's profits than the size of their portfolio deserves, then others must have done worse. Clearly, few other hedge fund investors have done as well as Yale.

Summary

Hedge fund investors in aggregate have not done nearly as well as popularly believed. The media focus on the profits of the top managers has obscured the absence of wealthy clients. Although the industry performed well in the 1990s, it was small and there weren't many investors. In recent years as its rapid growth has continued, results have suffered and many more investors have lived through mediocre returns compared with those enterprising few that found hedge funds when the industry itself was undiscovered. The control that managers have over when to take clients as well as the reliable drop in returns that occurs with increased size mean that assessing aggregate returns across

all investors is a fair way to assess the results. Now let's take a look back at what it was like investing in hedge funds 15 or more years ago, when Peter Lynch was still the best known money manager having retired from running the Magellan mutual fund at Fidelity in 1990, and only an elite cognoscenti even knew where to find a hedge fund manager.