NewsTimes - Richest Investors Make Hedge Funds Pay Out

By Rob Varnon: December 6, 2011

The rich really do get richer when it comes to investing with hedge funds, as the wealthiest endowments outperform middling peers by 2.5 percent, according to the **Greenwich Roundtable**.

The **Roundtable**, a 150 member investor-focused group with more than $2.2 trillion in assets under their control, published their latest research on alternative investment strategies earlier this month. Perhaps the most provocative finding in the report, titled "Managing Complexity," is that good returns on alternative investments, which include hedge funds and private equity, are mostly borne out of a commitment to due diligence.

"If you don't have the resources to do this, one should not try. It is very, very complicated," **Stephen McMenamin**, the group's executive director, said in a phone interview.

Large endowments and wealthier investors have the funding available to hire staffers who understand the complexities of alternative investments, **McMenamin** said, noting that larger investors also have the ability to take on more risk.

According to the report, university endowments of $1 billion or more earned about a 5.8 percent return on alternative investments over 10 years, while endowments of $25 million to $50 million saw a return on average of 3.3 percent. There was also a difference in the size of investment in those products as the $1 billion endowments allocated 60 percent of their funds to alternatives, compared with about 17 percent for the smaller, under $50-million funds.

Size and appetite for risk tend to attract the top talent, **McMenamin** noted, as the best managers prefer sophisticated clients, giving the larger investors access to better performance.

But returns on alternative investment vehicles could face challenges, according to **McMenamin**, depending on the success of the hedge fund industry itself.

Hedge funds are set up to exploit inefficiencies in the market, but as more have come into the marketplace, those inefficiencies have declined.

That's why it’s important to find the best managers and to monitor their strategy and actions.

"We're not buying instruments, we're buying people," he said

The report notes that some managers become tempted to take on more investors than they should as a way to increase their income from fees.

A key point investors need to understand about their alternative investments is how liquid it is, how much leverage is involved and what's at risk. Investors also need to be aware of any limits on cashing out of a fund and whether the opportunities a manager was exploiting have dried up.

In the meantime, the hedge fund industry hasn't had its best year, off by 2.82 percent through October, according to Chicago-based Morningstar Research, which tracked the performance of 8,000 hedge funds.

Josh Charney, director of alternative investment research at Morningstar, said expectations heading into 2012 are for consolidation within the industry.

"Going forward, the top performers are going to carry more weight in the index," he said.