



When It Comes to Hedge Fund Investing:

The Evidence is Clear, Avoid them at all Cost (literally)

It's no secret that investing in hedge funds will cost you (or if you are an allocator of capital, your clients) an arm and a leg – hence, the cheeky title of this essay. The weighted average hard-dollar “cost” of hedge fund investing has been shown by a CFA Institute study to be over 3.3% per year (owing to the notorious 2 & 20 fee structure in which hedge funds often charge a 2 percent management fee and a 20 percent incentive fee. [CFA Institute Hedge Fund Study](#).) However, the theory behind owning hedge funds, zigging when the market zags, overcoming the fee-hurdle to deliver market-beating performance, remains believable. The evidence, unfortunately, does not bear out the myth that hedge funds deliver superior after-fee performance. It is quite the opposite, actually.

The 2024 Hedge Fund study showed that hedge funds cost the biggest pension and endowment funds dearly, subtracting 7.6 basis points of performance for each percentage of allocation invested. With fees like 2 & 20, it isn't hard to see why. The T-Statistic of the study (a measure of statistical soundness) is 3.3, which signifies the results themselves were statistically significant, and not just caused by randomness.

In the study, it is revealed that the average reduction in return of the hedge funds in the 54-fund sample, specifically coming from the hedge funds, was 55 basis points ([CFA Institute Hedge Fund Study](#)) per year, or a little over half a percentage point, annually. This is quite a shocking underperformance, given that hedge funds as a category of these 54 funds made up less than 10% of the assets under management.

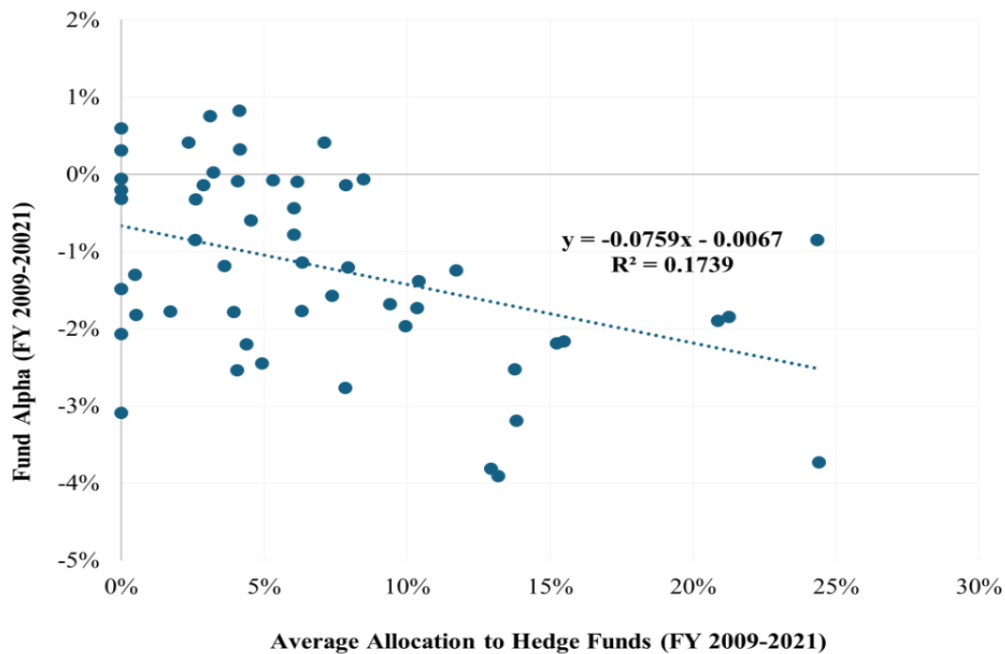
It begs the questions within the private wealth management sector, why would an ultra-high net worth team of investors, managing money on behalf of wealthy individuals, recommend any allocation to hedge funds, if the most skilled professional investors, such as those working at large pensions and endowments, have shown no ability to pick hedge funds that actually bring value to the client?



The answer most likely lies in the narrative economics, and fallacious stories that asset allocators tell themselves. While the evidence does not point to there being no talent in the hedge fund industry, it suggests that talent is rare and often too expensive. Keep in mind that it is merely the fee structure that makes hedge funds a negatively-alpha-wielding asset (they underperformed by .55% after fees, implying that if the 330-basis point “Fee Drag” on their clients were lower, actual alpha could be added to the allocation).

The bottom-line for individual investors might be something like: some hedge funds are capable of adding value some of the time, but if people who pick hedge funds professionally are unable to do it over the long-run, why would I have any confidence in my own ability to select hedge fund managers any better than they do?

Exhibit 1. The Relationship Between Pension Fund Alpha and Hedge Fund Allocation (2009 to 2021)



Hedge Funds, including funds of funds (collectively, “Hedge Funds”), are unregistered private investment partnerships, funds or pools that may invest and trade in many different market strategies, and instruments (including securities, non-securities and derivatives) and that employ different investment, hedging, leverage and arbitrage methodologies. Hedge Funds are not subject to the same regulatory requirements as mutual funds, including mutual fund requirements to provide certain periodic and standardized pricing and valuation information to investors. There are substantial risks in investing in Hedge Funds. Persons interested in investing in Hedge Funds should discuss the inherent risks of investing in Hedge Funds with their financial advisor.

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