

What You Know That Just Ain't So: *Alternative Assets*

"It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so."

-Mark Twain

Over the course of their investing lives, most owners of substantial pools of capital will hear a large number of mis-statements, partial truths, and out-and-out whoppers about investing. These ideas are typically part of a well-rehearsed sales pitch, often by someone who has a financial interest in getting investors to believe them. They may sound very seductive. Some have been bandied about so widely that they've almost reached the status of folk wisdom.

At best, such misinformation can cause investors to spend time and energy chasing after the unattainable — high return with no risk, for example. At worst, investors can end up losing money, and sometimes lots of it.

This paper is part of an ongoing series¹ by Beekman Wealth Advisory ("BWA") addressing common misconceptions about wealth management and investment practices. The goal of the series is to correct erroneous ideas, and to set forth the reality of what can and can't be achieved. Taking these flawed ideas with a large grain of salt will help investors steer clear of some potential dangers to their portfolios.

This paper covers two dubious ideas about investing in alternative assets that "just ain't so"²:

1. *Alternative investments like private equity and hedge funds are the best-returning assets.*
2. *You should invest like Yale.*

Dubious Idea #1: Alternative investments like private equity and hedge funds are the highest-returning³ assets.

When traditional stocks and bonds produce shockingly bad results, such as during the fourth quarter of 2008, the marketing of private equity and hedge funds — in

industry parlance, "alternative assets" — as the solution for investors' woes often ramps up considerably. Many of the marketing presentations for these investments imply that private equity funds are the best way to hit a particular return target, or suggest that hedge funds can make money in down markets as well as up markets.⁴

But we believe it's worth thinking a little harder about such claims. Private equity represents an ownership stake in a business, from which any return is derived from dividends and capital gains — exactly the same sources of returns as for publicly-traded equities. The main differences between private equity and public equity are that:

1. Fees on private equity investments are typically **much** higher than what one pays for the management of public equities. A common fee structure on private equity funds can be as high as 2% of the assets, annually, and 20% of all the cumulative profits. This compares with fees that typically range from roughly 0.40% to 1.50% of the assets, annually, for the management of investments in public equity.⁵

¹Additional presentations in this series may be accessed at www.beekmanwealth.com, or via request to info@beekmanwealth.com.

²Beekman Wealth Advisory ("BWA") may recommend allocations to carefully-vetted alternative assets for those clients for whom such assets are appropriate. However, BWA receives no compensation from money managers, or from anyone other than the direct client. All BWA clients pay fully-disclosed, flat-dollar retainer fees, which are not affected by the mix of assets or managers recommended.

³Future market returns are inherently unknowable. Nothing in this paper should be construed to provide any prediction or guarantee of future returns or outcomes.

⁴This writer once listened to a presentation in which it was stated, quite emphatically, that all of one's money should be invested in hedge funds because "stocks are too expensive; bond yields are too low; commodities are too risky; and there are no good real estate managers". The speaker was, of course, the proprietor of a firm that markets hedge funds. Only hedge funds.

⁵Management fees vary by investment format and asset class. For example, fees on index funds investing in the S&P 500 can be as low as 0.10%, while much higher fees are typically charged for active management of non-U.S. equities. Usually, only this asset management fee is charged; there is no additional levy on profits.

2. Private equity is illiquid; the money an investor (for legal purposes, often a “limited partner”) commits is usually locked up and inaccessible for eight years or more.
3. Private equity fund managers often take an active role in managing the businesses of the private companies they control, while public-stock investors are usually passive (non-managerial) holders.

Investors should understand that there is nothing inherent in the act of paying higher fees and giving up access to their money that magically causes returns to rise. To the contrary, paying higher fees will, all else being equal, *reduce* after-fee returns to investors. General partners must be able to buy cheaply, sell expensively, and/or manage portfolio companies to greater profits during their holding periods. Otherwise, there is little reason for investing in private equity.

Similarly, hedge funds are a format for investing that usually includes (1) the use of a limited partnership legal structure (for taxable U.S. investors); (2) a fee structure that, as with private equity funds, includes a percentage of the asset base plus a percentage of the profits; and (3) broad investment latitude to own and short securities, often in all asset classes, globally, and frequently using leverage.

As with private equity, there is nothing inherent in this format that causes it to be profitable in all markets. The investments *inside* hedge funds will come from five basic asset classes: stocks, bonds, real estate, commodities, and cash, and variations thereon — because that’s *all there is* to invest in (See BWA’s *What You Know That Just Ain’t So: Conventional Wisdom on Building a Portfolio* white paper for more on these asset classes). And hedge fund managers can be just as wrong as, say, mutual fund managers; paying a manager higher fees doesn’t make him or her any smarter or more skilled than s/he already was.

Actually, hedge funds have the potential to get *more* wrong than mutual fund managers: Mutual fund managers typically err only by buying securities that subsequently decline in value. Hedge fund managers can err this way too, but can also lose by short selling securities that rise in price. Doing so with leverage can produce investment disaster.⁶

So, as with private equity, wise investors should be very confident about the skills of a hedge fund manager before plunking down their cash. Hedge funds and private equity funds can — and do — lose money.⁷ Mistakes made in selecting hedge fund and private equity managers can be much costlier and harder to remedy than mistakes in selecting traditional separate account or mutual fund managers.

BWA Truth #1: Investment formats do not create returns. Some private equity and hedge funds are stellar — while others are simply overpriced, illiquid, and/or prove mediocre.

Dubious Idea #2: You should invest like Yale.

Investment fashions usually don’t turn over quite as fast as investment gurus seem to do (See *What You Know That Just Ain’t So: About Investment Professionals* white paper), but these, too, come and go. Trying to “invest like Yale” has become a favorite theme among investment industry practitioners, given the successful results the University’s endowment plan has achieved over the long term.

While there are good reasons as to why the Yale endowment has been a very successful investor, and its long-time chief, David Swensen, has earned his acclaim, investors should be wary of investment products marketed as a means of replicating Yale’s track record.

All too often “invest like Yale” has come to mean “invest in hedge funds and private equity”— sometimes without having a lot of expertise in these complex assets. Further complicating the matter is the fact that today these investments are often offered in the form of prepackaged “funds of funds”. While there has been a proliferation of new hedge funds and private equity fund offerings, only

⁶For an amusing — though scary — take on this, consult the online “Hedge Fund Implode-O-Meter”, which tracks hedge fund disasters. The website’s tagline reads: “Hubris, extreme leverage, and other people’s money”.

⁷A few minutes after writing the first draft of this paragraph, the writer received a marketing email from a hedge fund manager whom she doesn’t know or recommend. Attached was a letter disclosing the hedge fund’s results for August of 2011: a loss of -28.0% for the month alone, and -41.7% for the year through August. This makes the point quite well.

a few have proven to be attractive deals for the investors who raced in to buy.

Very few private investors truly have the ability to invest like Yale. Most private investors shouldn't even try. Here are some of the advantages Yale and other large institutions have that private investors are unlikely to be able to match:

1. The Yale endowment has a **full-time staff of expert buy-side analysts**⁸ to vet potential investments. Private investors rarely have the expertise to perform an independent evaluation of the merits of the particular funds being pitched — or enough of a comparison base to know how each fund stacks up against the competition.
2. Yale has a **much better opportunity set** than private investors do. Even wealthy private investors don't usually have the ability to invest \$50 million or more in each investment — which is often what it takes to get the choicest opportunities.
3. Yale often gets a **"seat at the table"** in setting deal terms such as fees and liquidity. Most private investors, on the other hand, have no negotiating leverage and must accept as the price of access whatever terms the general partner imposes.
4. Yale has **enough assets to choose its own investments one at a time**. It does not need to use packages of funds put together by outside parties, such as investment banks. These outside parties charge a second layer of fees, in addition to the layer of fees charged by the underlying hedge funds or private equity funds. Fees on fund-of-funds can reach as high as 3% of the assets per annum plus 30% of the profits — a level that makes it very hard for outside investors to achieve high after-fee returns.

The table below illustrates the level of return that must be earned by the underlying investments in order to provide a 10% pretax return to investors in a typical fund-of-funds.

Flow of Value in a Typical Fund-of-Funds: Gross Return Required to Generate 10% Pre-Tax Net Return

Return on underlying investments	16.41%
Less: Management fee to underlying hedge fund manager, at 2% of assets	(2.00%)
Less: Incentive fee to underlying hedge fund manager, at 20% of profits	(2.88%)
Equals: Return after underlying hedge fund manager fees	=11.53%
Less: Management fee to fund-of-funds manager, at 1% of assets	(1.00%)
Less: Incentive fee to fund-of-funds manager, at 5% of profits	(0.52%)
Equals: Pre-tax return to investor	=10.00%

Needless to say, it is very, very difficult to produce a 16.4% gross return on an ongoing basis.

5. **Yale doesn't pay taxes.** Private investors do. Taxes on hedge funds are often particularly onerous, because most of the return is characterized for tax purposes as highly-taxed ordinary income or short-term capital gain.⁹ Thus, from the hypothetical return shown above, another 3 to 4 percentage points might be dissipated by taxes. In total, nearly 40% of the gross return (39%, which is 6.41% / 16.41%) is paid as fees, and another 18% or more of the gross return as taxes.

⁸Full disclosure: This writer served as a buy-side analyst for the Princeton University Investment Corporation, which invests Princeton's endowment fund, from 1993 to 1995. Vetting investment managers and funds was her job.

⁹Profitable short sales are always taxed at short-term gain rates, regardless of the holding period. Additionally, many hedge funds employ trading and other strategies that result in turnover before long positions have been held long enough to qualify for more favorable long-term capital gain treatment.

6. The Yale endowment has a theoretically *infinite life*, and can therefore afford to lock up significant portions of its assets for long time periods. People have finite lives, and they tend to need their money along the way.
7. Yale and other endowments can *raise more money through capital campaigns*. Most private investors cannot — alas! — increase their capital pools simply by asking.

For all these reasons, any attempt to invest like Yale may provide an investor with an education — but, too often, the education may take the form of an expensive lesson in what not to do.

BWA Truth #2: You probably can't invest like Yale.

Summary

Wise investing can be both harder and easier than these and other “dubious ideas” would suggest. Harder, because there is no magic to be found: Nothing and nobody wins all the time (not even Yale). Easier, because, having given up the search for magic, investors can concentrate on what really matters to their financial lives: maintaining sufficient “rainy day” reserves; keeping spending under control; making sure that investments earn their places in portfolios; evaluating investment claims with a skeptical eye; and so on. Not sexy, not exciting, but, ultimately, the best way to preserve and grow your wealth.



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