

Hedge funds are not for the faint of heart

By Don Martin

ALTERNATIVE INVESTMENTS

The 2005 Standard & Poor's 500's total return was 5 percent. In an effort to increase earnings, some investment advisers put clients' money into "alternative investments" (such as hedge funds, private equity, venture capital, timber farms, emerging markets, mortgage notes, real estate, oil and gas drilling ventures, commodity futures and collectables) instead of traditional stocks and bonds.

One strategy of a hedge fund is to do a "paired trade" where they "short sell" one security and buy another similar security, profiting on the convergence between the two securities, while keeping risk under control with the "long-short" strategy.

For example, they might short GM stock and go long on Ford, believing that GM is overpriced compared to Ford. Because the short position may offset the risk of the long position; the hedge-

fund manager thinks the risk is OK, so they use leverage to increase their return. This makes hedge funds very risky. Leverage may be 50 percent to 75 percent loan-to-value.

The theory is that no matter what happens to the market, the hedge fund is protected because of the offsetting hedge position. However, a perfectly correlated hedge position is very hard to obtain.

Hedge funds typically have a minimum investment – such as \$1 million – although recently some funds have begun offering lower minimums. Hedge funds often require a commitment of several years during which clients' funds are locked up. Some hedge funds do allow withdrawals after only a few months. Fees are high – often 2 percent of

assets and 20 percent of profits.

Choosing a hedge-fund manager is tough. It's a nonquantitative search requiring emotional intelligence, lots of face time and trust. The key to success is finding a fund with managers who have the best skills.

Hedge funds ignore certain investment principles, for instance, that one should avoid leverage and high fees. It's a risky strategy that should only be tried by those who have plenty of money – money they can afford to lose.

While some experts believe hedge funds will produce an expected return in the 7 percent to 9 percent range, you as investor need to weigh the risks against the potential rewards.

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