FINANCIAL POST

Hedge Fund Report Card: The good, the bad and the mostly mediocre

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The current compensation structures incorporated into hedge fund offering documents are a cesspool of the past executive abuses that were thought to have been extinct

Jeff Banfield is a former hedge fund manager who made a very controversial speech a few years back - titled Heads They Win, Tails You Lose - about hedge fund compensation.

In that speech, to a hedge fund manager's conference, he said that "the current compensation structures incorporated into hedge fund offering documents are a cesspool of the past executive abuses that were thought to have been extinct.. the need to change the way managers are compensated, how they treat their investors' capital, and how they provide liquidity and transparency has never been more important than it is today."

Banfield argued against the 2/20 rule where managers get an annual 2% management fee plus a carried 20% interest if, but not always, certain performance hurdles are reached. That combination helped "encourage managers to negatively impact long-term returns by increasing overall risk to investors; at the same time, the structure allows managers to reduce their own risk exposure."

Banfield, who now spends his day managing his own investments, is still at it: he runs a research firm (JMO Research) that focuses on hedge funds. As part of that work he measures their performance to see if the managers do what they set out to achieve - and if they are worth what the clients pay them. In his view, a hedge fund should generate at least market returns while incurring less risk than the market. (Otherwise investors are better off investing in an ETF where they get market return, market risk, but better liquidity.)

On that measure - and the December 2012 report has just been completed - not all managers achieve their goals. About two thirds of the 53 funds he analyses, achieve a score of at least 50% (the minimum pass.) and a mere four funds (Curvature, GFI Investment Counsel, Ross Smith and Broadview Capital) achieve an A grade (Curvature was rated A+) while nine record an F grade.

In Banfield's words: "Everyone that tries to run a hedge fund isn't necessarily qualified, because your job as a hedge fund manager is to provide higher returns for less risk. Some of the hedge funds aren't delivering even the market return but they are delivering a higher risk."

Banfield says he has culled a number of funds from his report card because they were serial failures, but “ I'm always looking for new funds."

Banfield arrives at those conclusions by a series of calculations. (To help with the methodology, he enlisted the skills of a number of math professors.).

First he uses 24 months of data, arguing that such a time is relevant because over time as a manager's assets grow the original investment strategy changes. After five years of managing and growth of assets "none of the strategies reflect what you were doing five years ago. It's pretty easy to make a decent return on $10-million. It's a challenge to replicate that on $300-million," noted Banfield. "My results focus, on a sliding scale, the current strategy and the current statistics. The calculations really emphasize the last 12 months and for 24 more sections it slowly adds out the older data."

He talks to the managers to obtain their actual benchmark. Given the nature of the investment strategies employed, only five of the 53 funds he analyses uses the S&P/TSX index as the benchmark while three use the S&P 500. Those benchmarks are published. Most managers use a blended benchmark. A fund's price risk is determined by comparing a fund's monthly volatility to the benchmark's volatility.

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