the EDUCATED INVESTOR

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FOCUS
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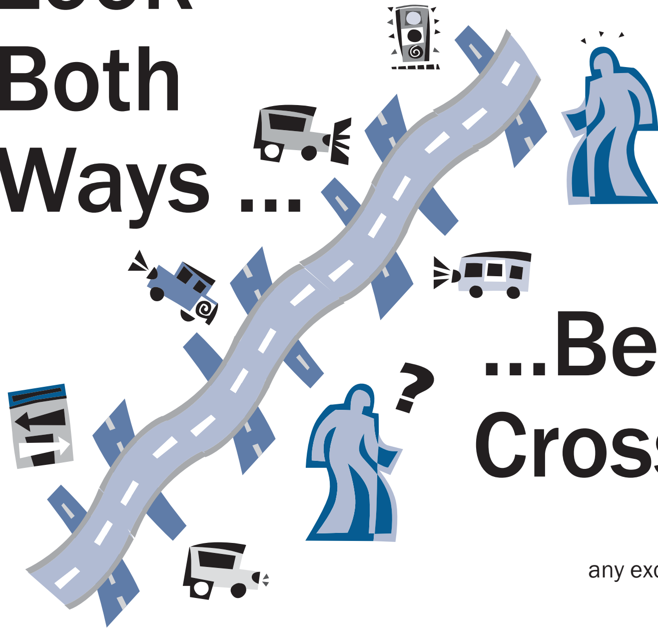
Look Both Ways ... ...Before Crossing



The goal of the financial industry is (or at least should be) to help investors accumulate and/or preserve their wealth. But how do you identify solid financial direction versus misguidance in disguise? For *all* investors, "buyer beware" is good advice. For affluent investors, the stakes — and thus disservices proffered — can be even greater.

As one's wealth accumulates, perhaps it's human nature to believe affluence should open up access to exclusive investment vehicles unavailable to the average investor. Yet many of these vehicles turn out to be more expensive than they are expansive for the investor's portfolio, too often designed to ensure the seller's profit regardless of the buyer's gain. And if the product is well-received, its promoters often find ways to expand availability anyway, negating any exclusive appeal it may have had to begin with.

This issue of *The Educated Investor* explores three approaches we've seen heavily marketed to unwary investors — initially to the affluent and then to a widening audience:

1. Managers of Managers: Can the Best Man Win?
2. Hedge Funds: Less Than Meets the Eye
3. Private Equity Markets

Managers of Managers: Can the Best Man Win?

It might appear that a "manager of managers" could perform valuable services: picking the best separate account managers, watching their performance and replacing them when they underperform. Unfortunately, for an approach too often popular among individual and institutional investors alike, there's a fly in the ointment.

Because past performance is not a reliable predictor of future results, the approach is not expected to consistently outperform the overall market. Further, for trustees, the fiduciary standards to which they are held are more likely satisfied by building a passively managed, effectively diversified portfolio with an eye toward reduced expenses.

A manager of managers, in contrast, adds a layer of expense while pursuing an active approach, seeking to select the next winning managers (who in turn add their own layer of costs as they typically attempt to time entry and exit from the market and/or pick future winning stocks or sectors).

Well-known managers of managers include Frank Russell, Callan Associates and **SEI.** As among the largest of such services, SEI should be a good test case if we compare its returns to those of Dimensional Fund Advisors' (DFA's) passive asset class funds.

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Hedge Funds: Less Than Meets the Eye

Hedge funds are expensive, complex investment vehicles with considerably less transparency and less regulatory oversight than is required within the mutual fund industry. Yet their popularity grows. Why are such risky ventures also so tempting? And why do we suggest that investors avoid their siren song?

In his book, *Unconventional Success,* Yale University CIO David F. Swensen defines hedge funds as follows:

> Hedge funds encompass a range of investment approaches so broad as to preclude classification … In spite of significant differences in management strategy, hedge funds generally share a common legal structure (limited partnership), a comparable fee structure (base management fee plus profits interest), and an overwhelming dependence on active management.

In short, hedge fund investors accept all of the inherent downside risk, but they generally receive less than 80 percent of any reward; fund managers typically take 2–3 percent per year in fees and expenses, plus 20 percent compensation on any profits.

In addition, a hedge fund's active approach allows broad latitude to place long or short bets on and to drastically leverage almost any type of asset. For prudent investors who are pursuing a core, long-term strategy, hedge funds are simply too speculative an investment vehicle for achieving unique financial objectives via a carefully balanced globally diversified portfolio.

The popularity of hedge funds seems to rest in large part on successful marketing campaigns that tout attractive, market-beating returns and an exclusive, club-like nature, with availability limited to the high-net-worth investor. Yet a plethora of academic papers (as well as a number of responsible financial journalists) are exposing hedge funds as less than meets the eye, despite their popularity.

Studies have demonstrated that publicly reported hedge fund track records (upon which many investors rely) are loaded with biases that present a misleading picture. Here we analyze survivorship and self-selection/backfill bias.

Survivorship Bias

Poorly performing fund data can escape being reported when fund managers eliminate a fund out of existence, and/or fail to report final returns on defunct funds. For example:

- A December 2002 *Journal of Asset Management* study by Gregoriou summarized contemporary survival rate analyses. Various studies concluded that approximately 30 percent of new hedge funds did not survive beyond three years; attrition rate was almost 15 percent per year; and as many as half of new hedge funds didn't make it to a sixth year following initial reporting.
- A January 1999 *Journal of Business* study by Brown, Goetzmann and Ibbotson concluded that survivorship bias, such as described above, resulted in a 3 percent overstatement of publicly reported returns.

Self-Selection and Backfill Bias

Because hedge funds self-select when to begin reporting to a database, poorly performing funds may never be reported. Or fund managers can choose to begin reporting shortly after a particularly strong run for their fund, using backfill data from that particularly favorable period.

Thus the data can become biased when poor returns are under-reported or outperforming periods are self-selected. A 2003 working paper, "A Reality Check on Hedge Fund Returns," concluded that instant histories created by backfill bias overstated returns by more than 4 percent per annum.[1]

To add insult to injury, the claim that hedge funds are an investment to which only the affluent can gain privy is dissolving amidst formation of "funds of hedge funds" with reduced minimums and fewer limits on eligibility.

Not that it much matters who can or cannot gain access to them. Accounting for all of their risks and realizing that these risks have not resulted in risk-adjusted return premiums, we conclude that hedge funds, or funds of hedge funds warrant no position in a well-structured, globally diversified portfolio — regardless of the investor's net worth.

[1] Posthuma, Nolke and van der Sluis, Pieter Jelle, "A Reality Check on Hedge Fund Returns." July 8, 2003. http://ssrn.com/abstract=438840.

Private Equity Markets

Its name alone may be offering a leg up for those seeking to appeal to affluent investors. After all, "private," as well as traditional multimillion dollar minimums typically required to participate, connote a corner of the equity market unavailable to the common man.

The problem is, while it seems reasonable to assume that high-risk, illiquid investments such as private equities would be priced to deliver significantly higher expected returns than less risky, publicly traded securities, apples-to-apples comparison indicates otherwise. In addition, as their popularity has taken off, some private equity funds have begun to lower their minimums to encompass a wider, less "private" audience.

Defining Private Equities

As described within a recent *Wall Street Journal* article, "Private equity is a catchall term for money used to invest in any private company, with the potential for big returns if and when the company goes public or is bought out."[1] They share characteristics with but are not the same as hedge funds. There is typically a long lockup period, during which investors cannot access their capital, thus private equity investors forgo a great deal of liquidity. Private equity investments also are relatively non-transparent, lacking daily pricing information.

In general, the most appropriate benchmarks for private equity are considered to be small-cap value and microcap (very small-cap) stocks. Companies seeking private equity capital tend to be small, risky endeavors whose success or failure, either way, has an increased potential to be spectacular. Private equity investments can be further categorized into the following sectors, roughly from most to least risky (and thus from highest to lowest expected returns):

- Seed and early stage venture capital
- Later stage venture capital
- Leveraged buyouts (LBOs)
- Mezzanine financing

Show Us the Money

So, how have they performed? Several studies have assessed private equity returns compared with small-cap value and microcap benchmarks, as well as with the (large-cap) S&P 500 Index. In theory, to make the investment worthwhile, private equity returns should comfortably exceed their appropriate benchmarks and should significantly exceed less risky, more liquid and transparent investment vehicles that capture large-cap returns. Following are annualized returns for the 20-year period ending June 30, 2005:

Fama-French Small-Cap Value	16.8 %
Private Equity	**13.8 %**
S&P 500 Index	12.3 %
CRSP 9-10 (microcap stocks)	12.1 %

Sources: Venture Economics/Dimensional Fund Advisors

Private equity outperformed microcap stocks and the S&P 500, but its returns were well below those of small-cap value stocks.

Additional data is available for the same period for these private equity sectors:

Early Stage/Seed Venture Capital	20.2 %
Venture Capital (overall)	16.0 %
Later Stage Venture Capital	13.8 %
LBOs	13.8 %
Mezzanine Financing	9.1 %

Source: Venture Economics

Venture capital overall nearly matched the 16.8 percent return of small-cap value stocks. Seed venture capital and early-stage funds provided the highest return. But of course they also represented the very riskiest of a risky investment.

Early stage and seed venture capital represents investments made in start-up companies and businesses through their first few rounds of funding. In recent years, funding for such ventures has declined, perhaps due to investor fears about potential losses in reaction to the 2001 tech bubble burst. A business journalist commenting on the trend observed, "Rather than laying risky wagers on unproven startups, [private equity investors are] placing safer bets on growing mid- and late-stage companies."[2]

Additional studies analyzing varying periods are consistent with the above findings.

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Worth Repeating
Worth Repeating

"The basic building blocks for investor portfolios come from well-established, enduring marketplaces, not from trendy concoctions promoted by Wall Street financial engineers. … As a general rule of thumb, the more complexity that exists in a Wall Street creation, the faster and farther investors should run."

— David F. Swensen
Yale University Chief Investment Officer and
Author, *Unconventional Success*

Managers of Managers: Can the Best Man Win? (Cont.)

To do so, we compared one-, three- and five-year live data returns for January 2001–December 2005 within the six broad asset classes of large-cap, small-cap, large-cap value, small-cap value, emerging markets and international (small-cap and large-cap). The period began in a bear market and ended amidst a bull market. In the case of international funds, SEI had one international large-cap fund and one emerging markets fund. DFA offered funds in additional asset classes, allowing for broader, more effective diversification.

For the five-year period, SEI funds underperformed DFA across all asset classes. The underperformance ranged from 4.2 percent per annum to 15.9 percent per annum, and averaged 7.9 percent per annum. There were 48 single-year data points during which DFA funds outperformed SEI funds, and only seven single-year data points (less than 13 percent of the time) when SEI outperformed.

Also noteworthy — the SEI funds were costlier. The expense ratios of the SEI funds ranged from 0.85 percent to 1.95 percent, while the DFA funds had expense ratios ranging from 0.15 percent to 1.04 percent.

Many studies have demonstrated that individual investors and professional money managers alike struggle to achieve market returns. Thus, we would suggest that the financial markets are functioning as expected according to the academic wisdom on the subject. Focusing on manager selection rather than asset allocation (which academic evidence has demonstrated is the overwhelmingly major return determinant) detracts from the primary objectives of portfolio construction — maintaining a globally diversified portfolio according to the investor's unique risk tolerances as well as meeting fiduciary standards for those managing trusts.

Private Equity Markets (Cont.)

If anything, the preceding private equity returns are optimistic, for at least two reasons. They include returns from the heady "dot.com" era, which represents one of the greatest venture capital booms in U.S. history. In addition, the data may contain inherent upward biases. For example, the study may contain survivorship bias, in which poorly performing funds are closed and their lower numbers end up being omitted.

In general, while private equity strategies have performed well enough, we would argue that the returns have simply not been commensurate with the considerably higher risks involved. As with hedge funds, they seem to us to be products that make more sense to those who are selling them (and earning a commission) than to the investor purchasing them. The more prudent strategy is to take equity risks by increasing allocation to riskier stocks such as small-cap and value, using low-cost and tax-efficient passively managed mutual funds to do so.

[1] *Wall Street Journal*, August 2, 2005.
[2] *Business 2.0,* October 2005.

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Our Basic Tenets

Our objective is to design portfolios using passive asset class funds that maximize investors' returns within their tolerance for risk. Here is what sets us apart:

- Fee-only investment management
- A disciplined investment strategy
- Access to institutional no-load passive asset class funds
- Fixed income expertise
- An academic Nobel Prize-winning investment approach
- Continued access to academic research
- A tax-efficient focus, with valuable tax and estate-planning ideas
- Risk tolerance assessment
- Periodic portfolio rebalancing
- Regular communications and state-of-the-art reporting
- **MOST IMPORTANT ... A TRUSTED ADVISOR RELATIONSHIP**

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