On Course Financial Planning
Facing the Future with Optimism and Courage
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The Hedge Fund Mirage

In last month's newsletter, I mentioned Hedge Fund Research, Inc (HFR) and their HFRX Global Hedge Fund Index which tracks the performance of thousands of hedge funds and is designed to be representative of the overall composition of the hedge fund universe. I compared the dismal performance of the average hedge fund to the satisfactory returns of the Lazy Golfer Portfolio which consists of five Vanguard index funds-- allocated 40% to the Total Stock Market Index Fund (VTSAX), 20% to the Total International Stock Index Fund (VTIAX), 20% to the Inflation Protected Securities Fund (VIPSX), 10% to the Total Bond Market Index Fund (VBTLX) and 10% to the REIT Index Fund (VGSLX). It has an annual expense ratio of 0.10%. Rebalance the portfolio on your birthday and ignore the stock market for the rest of the year.

This month, I came across an article in Institutional Investor that took exception to the HFR data – "*Most hedge funds above $1 billion in assets don't share their data to the commercial databases — it's voluntary after all. But without these funds, hedge fund performance looks dismal. Once these hedge funds are added to the data set, average performance rises by more than two percentage points.*" So, to be fair, I added 2.5% to the performance of the HFRX Index and here are the results -

	1 Year	5 Year	10 Year
HFRX Index + 2.5%	8.2%	5.9%	4.1%
Lazy Golfer Portfolio	15.0%	8.0%	7.2%
	Data from HFRX	and Morningstar	through 3/31/24

Hedge funds are available only to "sophisticated investors". The Securities and Exchange Commission (SEC) defines a sophisticated investor as an individual who has either --

- Net worth (or joint net worth with a spouse) in excess of $1 million (excluding primary residence).
- Income exceeding $200,000 in each of the past two years (or joint income with a spouse exceeding $300,000) and a reasonable expectation of the same income in the current year.

How does a certain level of net worth or annual income prove that someone is financially savvy enough to invest in obscure, illiquid investments such as hedge funds? I know many people who satisfy the SEC's definition of a sophisticated investor but are not astute investors by any stretch of the imagination.

In 2012, Simon Lack, a former member of the hedge fund due-diligence team at J.P. Morgan, published the book, The Hedge Fund Mirage: The Illusion of Big Money and Why It's Too Good to Be True. In it he stated that the hedge fund hey-day is long gone and noted that hedge funds lost more money in 2008 than their combined profits of the prior ten years -- perhaps more than all the profit ever made by hedge funds. This is hardly what you would expect from funds that claim to have the world's best managers -- who supposedly can make money in all markets.

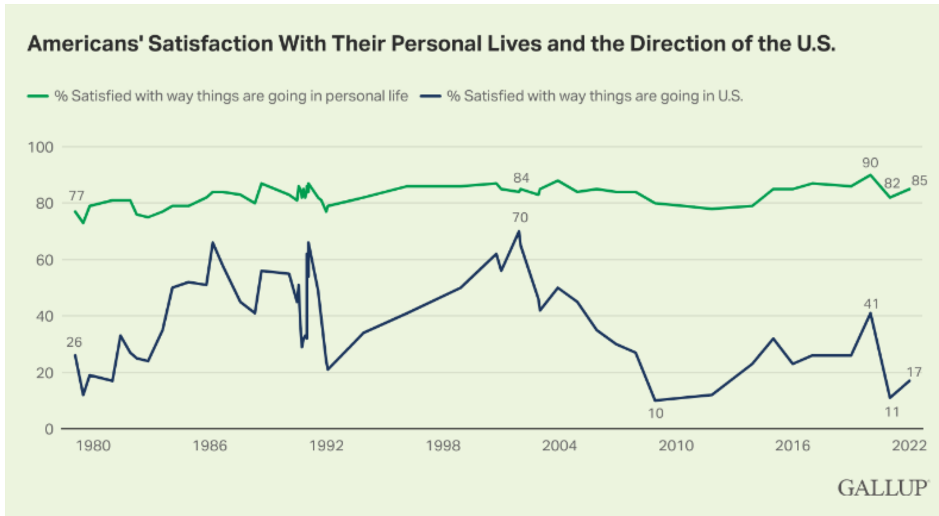
Bridgewater Associates is the largest hedge fund manager in the world, with $97 billion of assets in its three hedge funds, as of June 2023. Bridgewater generally requires clients to have at least $7.5 billion of investable assets. Its investors include pension funds, endowments, charitable organizations, and investment companies. Its founder and chief investment officer, Ray Dalio, is a well-respected, renowned hedge fund billionaire. Bridgewater's much touted All Weather fund is designed to perform well under different economic environments using a "risk-parity" strategy. It attempts to outperform a 60% global stocks/40% global bonds portfolio using short selling, leverage and complex quantitative calculations to determine optimal asset allocations. How this is done is never explained in a comprehensible way to mere mortals, including your humble scribe. It remains the fund's Secret Sauce.

In late April, news reports appeared that institutional clients of Bridgewater Associates were complaining about poor investment performance. According to an article in Bloomberg: *"It was an irresistible pitch. Give us your money, executives at Ray Dalio's Bridgewater Associates and other hedge funds said, and we'll funnel it into a money-minting, sure thing strategy for the long haul. But now after five years of subpar returns, many of the institutional investors who sunk large sums into risk-parity funds, as they are known, are demanding the money back.*" According to the

Bloomberg article, for the 10 years 2014 – 2023, the total return of Bridgewater's All Weather fund was 43% (3.6% annualized) and that the 10-year total return of the benchmark 60/40 portfolio was 90%. Not to brag, but the 10-year total return of the Lazy Golfer portfolio was 96.7% (7.0% annualized) according to Morningstar.

It seems that in the hedge fund world if you can attract enough money to make billions from your fees, you're considered an investment genius even if your investors underperform a simple balanced index fund. Owning a portfolio of index funds gives you nothing to brag about. But put your money into hedge funds and you've got something to boast about to your golfing buddies. My advice is brag about your kids or grandkids instead of your portfolio.

In the News



Gallup has released the results of its latest Satisfaction Survey. As in past surveys, there is a disconnect between the 85% satisfaction that most Americans feel about their personal lives and the 17% satisfaction that we feel about our collective American life. So, what's going on here? Some of these sentiments are political. Republicans are more positive when a Republican president is running the show and more negative when a Democrat is in charge. The same is true for Democrats, in reverse. Surely, the pandemic and ensuing inflation have tended to depress sentiment. But I think the biggest reason is that the news media is demoralizing us. The world has always been a mess. There have always been awful people. There have always been problems. The difference is that now we are being constantly reminded of them. We've accelerated the information gathering process in recent decades with the internet, social media, and smartphones. Our brains can't process the amount of information thrown at us every day. And it's not just information overload. It's the fact that so much of the information we see is relentlessly negative. If it bleeds, it leads is the old saying about newspaper headlines. Bad stuff happened in the past at an alarming rate. The difference is that our ancestors were blissfully ignorant of most of it. We might blame the news organizations and social media bloggers for spreading all of the negativity, but they're just giving us what our actions show that we want. Constantly watching the news is sure to make you more negative and depressed about the state of the world. And Heaven help you if you watch the financial news to get investment ideas.

Congress passed the Social Security Act of 1935 to create a safety net to prevent the financial devastation experienced by many elderly Americans during the Great Depression. The American public was divided on the objectives for the proposed program. Should benefits be based on a worker's contributions or should the program provide equal benefits for all? Eventually, Social Security combined both features. Benefits are proportional to a worker's pre-retirement earnings but replace a higher percentage of earnings for lower wage earners. Since then, Social Security has expanded to include disability insurance and spouse and child survivor benefits.

Social Security benefits are funded by pay-as-you-go financing, meaning that current benefits are paid from current tax revenue. Consequently, unlike traditional pension plans, its ability to pay benefits is not affected by the ups and downs of financial markets. Social Security is funded primarily through a 12.4% FICA payroll tax. Workers and employers each pay 6.2%. If you're self-employed, you pay both portions. For several decades, FICA tax revenues exceeded benefit payments, and the surplus was invested in a Trust Fund containing interest-bearing, special issue US Treasury securities. This was done in anticipation of the increase in payments that would occur when baby boomers started receiving benefits. In recent years, benefits have exceeded tax revenues, and the Trust Fund is slowly being depleted.

Each May, the Social Security's Board of Trustees presents a report to Congress containing an actuarial look at Social Security's financial health and its ability to pay promised benefits for the next 75 years. (Man plans, God laughs.) This gives Congress an early warning of potential problems and time to consider appropriate solutions. Changes can be phased in gradually, giving those most affected by the changes time to plan accordingly.

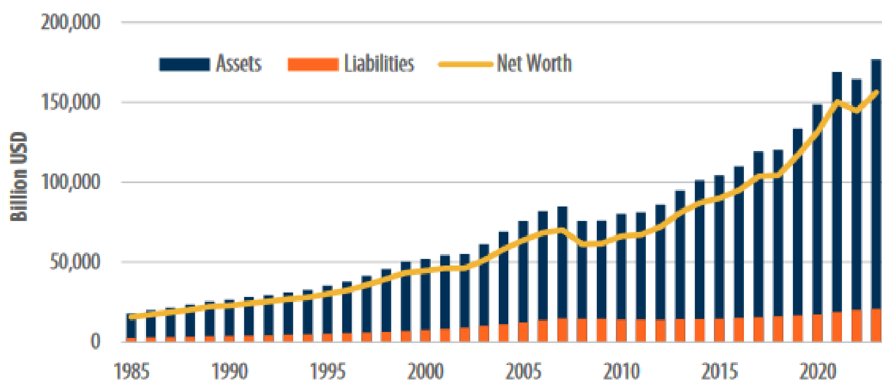
This year's report projects that the combined Social Security Trust Funds for disability and retirement benefits are expected to be depleted by 2035, one year later than last year's report. In 2035, if nothing is done, FICA taxes paid by workers will cover only 83% of the promised benefits. The last few Trustees' reports showing the deterioration of Social

Security's finances have created doubts about the dependability of benefits and caused undue alarm among many retirees. The Social Security funding shortfall will be remedied by one or more of the following options –

- Raising the payroll tax for employees and employers above the current 6.2%.
- Lifting the cap on earnings subject to the payroll tax (in 2024, only the first $168,600 is taxed).
- Increasing the full retirement age (FRA) for younger workers from the current 67.
- Reducing the benefits of higher income earners - essentially means-testing Social Security benefits.
- Slowing the growth rate in benefits by lowering the annual cost of living adjustment.
- Cutting spending elsewhere and diverting that money to social security – don't hold your breath.

Nearly half of senior citizens receive 50% or more of their income from Social Security. One in 5 people 65 or older gets 90% of their income from the program. To some people, Social Security is a supplement to other sources of income. To others, it's their main source of income. So why isn't Congress doing any of these things? Because 2035 is a long time from now, and the main goal of most politicians is to stay in power. And the best way to stay in power is to stay clear of the "third rail of politics." Which means that the most likely scenario is the continuation of the status quo until a crisis is imminent.

My pet peeve of the month concerns how the financial media describes stock market returns. There are two components to equity returns. The first is price appreciation — the rise in the price of a stock over time. The second component is dividend income — the portion of profits that are paid out by a company to its shareholders. Most reporting mentions price appreciation only – without the inclusion of dividends. The important figure is the total return which combines price appreciation and dividend income. In a few weeks, you'll read reports noting the performance of popular stock market indexes for the first half of 2024. To get an accurate measure of performance, look for data that notes "total return" and not just the change in the level of market indexes.



Source: Federal Reserve Board, First Trust Advisors. Annual data 1985 -2023.

This chart, from First Trust Advisors shows that net worth for households and nonprofit organizations hit record highs in 2023, rising 8% from 2022 to $156 trillion. This increase was fueled by a $12 trillion increase in assets, with equities providing a $7.9 trillion gain in market value. Additionally, household real estate saw an increase of $2.2 trillion. On the other hand, liabilities experienced a relatively modest rise of $560 billion, or 2.8%, with residential mortgages contributing $356 billion of the increase

It was widely noted in the financial media that The Dow Jones Industrial Average reached 40,000 in intraday trading for the first time May 16—and then closed above the mark the following day. The benchmark has since pulled back, but it has more than doubled from its pandemic low in March 2020. The S&P 500, a much better proxy for domestic stocks, has made 25 new all-time highs this year through June 7. All-time highs often lead some investors to wonder whether now is a good time to be in stocks—or do record levels foreshadow an upcoming decline? The historical data provides useful insight. According to Dimensional, "*Since 1926, the US market has ended the week on a new high in 933 out of 5,099 weeks, slightly more than one out of every six. Periodic record setting should be expected for an asset class with high historical average returns. Interestingly, the average return for weeks following these new highs was 0.26%—very close to the average return of 0.22% across all weeks.*" So, the next time that you hear that the stock market is at a new all-time high - be happy and stay the course.

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