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Clipped but not quite

Warren Buffett is more often right than wrong, but maybe not on hedge funds ›**BY ARTHUR SALZER**

WARREN BUFFETT recently won a US$1-million bet after predicting that the S&P 500 would outperform a basket of hedge funds over a 10-year period. Investors watching the bet may therefore think that hedge funds have no place in a portfolio; they would be wrong.

The reasons Buffett won seem at first glance to revolve around the total fees paid when investing. It's relatively easy to find an exchange-traded fund that tracks a major equity index for a fee of 0.1% (10 basis points) or less. Hedge funds, on the other hand, tend to have much higher total fees that combine an average fee of 1.5% to 2% per annum on the assets under management, along with 20% to 50% (in some rare cases) of the trading profits. Seems like an easy win for Buffett. Furthermore, market volatility has reached all-time lows and many of the world's stock and bond markets have been putting in a strong showing, with the exception of resource-laden stock markets such as Canada's over the past few years.

Why then would an investor consider adding hedge funds, whether singly or in combination, to the family's investment portfolio? The answer is a combination of a few factors, but it has much to do with the 30 years of declining interest rates that we have experienced. In general, when interest rates go down, the value of bonds, equities and real estate goes up. Should we expect interest rates to skyrocket to the highs we experienced in the 1980s? No, but it appears that interest rates on a global level bottomed a year ago and are beginning to grow slowly but surely over an extended period. Some of this trend will be due to central banks reducing or eliminating their easy money polices (a.k.a. quantitative easing) that have caused seemingly impossible occurrences, such as negative interest rates in Europe.

One of the consequences of negative interest rates is that the non-investment grade debt, or junk bonds, issued by European companies trade at the same interest rates as 10-year Treasuries that are guaranteed by the taxation and money printing abilities of the United States government. Some may say the U.S. has its work cut out for it in repaying its debts, but there is simply no comparison to a BB-rated company. Therein lies the opportunity for some hedge funds.

For hedge funds that specialize in credit trading, some managers have the ability to short European junk bonds and buy U.S. Treasuries. It's even easier to match cash flows in this trade today, given that both underlying securities have the same interest rates. This trade sounds simple enough for do-it-yourself investors or even portfolio managers at a brokerage or investment counsel, but it's actually very difficult to do and be profitable. In general, the broker either does not have the expertise to provide the trade and/or will charge large spreads along with retail rates of interest. It is the ability to borrow securities and cash at wholesale rates through prime brokers that give hedge funds their advantage and, in many cases, the necessary leverage to magnify the returns of a trading strategy. Suffice to say, it is best not to try this at home.

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Many investors probably can't just replace their fixed-income assets with a selection of credit hedge funds anyway. Access to hedge funds has been getting easier over the past few years, but they are complex investment structures with various fee structures, liquidity conditions and minimum investments. Unless an investor has a single family office with its own chief investment officer, it is best to deal with a competent and objective advisory firm that has an open architecture investment platform that is indifferent to the investment solutions used in their clients' portfolios. These types of firms operate as outsourced chief investment officers (OCIO) and have the experience and ability to perform initial due diligence on a hedge fund manager as well as on an ongoing basis. In addition, these OCIOs can access the best hedge funds at reduced minimums and/or reduced fees, which in many cases compensate an investor for the fee to the OCIO. In no situation should an OCIO be earning commissions.

Buffett may have won his bet, but there is a case to be made to invest in hedge funds on a selective basis in order to complement a portfolio's existing stock and bond investments. For most investors, however, accessing hedge funds should be obtained done through an objective (fiduciary) and experienced advisory firm. **FPM**

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