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EVERYBODY'S BUSINESS

Worried About Noisy Children, and Hedge Funds, Too

By BEN STEIN

FOR my sins, I travel constantly. I enjoy it most of the time, except for going through security lines, which is always hell. But I have come to notice a few new travel horrors that I feel duty-bound to share.

First, because of the spread of mass prosperity or the accumulation of frequent-flier miles, more and more families with small children are flying in first class. (Don't bother writing to tell me that I am a bad person because I like to fly in first class. I have done my time in coach.) These small children often cry, to their parents' indifference, or, if the children are a bit older, have to be read to and played with at loud volume for five or six hours at a time. Nicht gut.

Second, and again because of the mass prosperity of Bush America (and don't bother telling me I am a creep because I like President Bush and think he's done a great job with the economy — we do have a great economy, after all), there seem to be renovations in progress at every hotel where I stay. For reasons of sheer idiocy, construction seems to start at daybreak. This is insanely inconsiderate to us as guests, and I recommend long prison sentences for anyone involved.

Anyway, as I say, I travel a lot and I keep seeing men and women who are plumb worn out from hard work, early-morning flights, long days on the road and the burden of the [BlackBerry](#), which, though it weighs just a few ounces, is as heavy as a cinder block in terms of how much it burdens its owner with responsibility while on the road. It endlessly occurs to me that I hope the teenage children of these men and women appreciate how hard their parents struggle to keep them in BMW's and whale belts. To me, traveling business executives are among the least-appreciated specimens on the planet, mostly by their own families. I just want you to know, Mr. and Ms. Traveler, that while the airlines don't care if you live or die (and neither does your teenager), I feel your pain. You see, I have a teenage son. ...

Well, this is all a digression. What I really wanted to say was that hedge funds are largely, but not always, a snare and a delusion. Hedge funds — so called originally because they can hedge, or sell short — started like gangbusters in the 1960's, died off, then came back with a rush when the tech bubble burst. They came back because they could make money by selling the technology stocks as they collapsed. In those days of ashes for Silicon Valley, hedge funds manufactured money.

But the long-term record of most hedge funds is not at all impressive. Research by Burton G. Malkiel, a professor at [Princeton](#), and Atanu Saha, a principal at the Analysis Group, found that over long periods hedge funds significantly underperform index funds, like those based on the Standard & Poor's 500-stock index.

For openers, the hedge funds they looked at — starting with 604 in 1996 and rising to 2,700 in 2003 as the funds proliferated — earned less than an S. & P. index fund in the period he studied, 1996 to 2003: an annual average return of 9.3 percent, compared with 9.4 percent for the index fund (and 10.1 percent for a simple stock-and-bond portfolio). But hedge funds also create much more tax liability because they trade so often and have so much short-term taxable income, compared with a tax-efficient index fund. And, as is well documented, they have far higher fees than index funds.

It is easy to buy an index fund that charges a management fee of only about 20 basis points — two-tenths of a percentage point — of the amount invested. A hedge fund takes an astounding fee of one to two full percentage points of net assets off the top, and then 20 percent of any profits. This cuts hedge fund returns to significantly less than those of broad-based index funds.

Dr. Malkiel and Dr. Saha calculated that even if hedge funds earned almost 50 percent more than market returns, the higher taxes and fees that hedge funds pay would whittle away their net return to investors to 20 percent less than index funds.

Other commentators, including my pal and colleague, Phil DeMuth, say that even these results overstate hedge fund results. For one thing, there is survivorship bias — always a problem in the back alleys of finance — because only the hedge funds that survive report at all. If you take into account the ones that fail, the results would be worse.

Then there are problems of self-selection, in which only the funds that feel like it report at all, and instant-history bias, in which hedge funds that are brand new and have just had one good spurt can skew all the results. And because many assets of hedge funds are illiquid, the managers can put any price they want on them for any period until they sell them (and maybe even after that). This can be used to greatly underreport volatility because the assets in question can be reported at any price the managers wish, even while comparable liquid assets are gyrating wildly.

To be sure, some hedge funds do well. Some do incredibly well, but rarely do any of them do incredibly well for a long time. As far as I can tell, in the past few years, almost none have done as well as the iShares MSCI Emerging Markets Index fund, the Dimensional Fund Advisors' U.S. Micro Cap Portfolio, Dimensional's Emerging Markets Portfolio or the wildly popular Fidelity Contrafund, all of which cost almost nothing to invest in — although the Contrafund is being closed to new investors at the end of the month, and its glory days may have passed in any event).

HEDGE funds, as Phil DeMuth says, are not necessarily a great investment, but they are a great compensation program for hedge fund managers. [Warren Buffett](#), a true god of investments, says much the same thing eloquently in his most recent annual report for [Berkshire Hathaway](#). His estimates of how much of America's corporate profits are sucked out of the system's owners, the shareholders, and diverted to investment managers is breathtaking and depressing.

So, weary travelers, worry about bad hotels. Worry about parents who will not do a thing to quiet noisy children. And worry about the sad fact that your teenagers probably don't appreciate you. (Have I mentioned this already? I wonder why.) But don't feel bad if you're not in a hot hedge fund. Hardly anyone else is, either.

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