COMMITTEE REPORT:
INVESTMENTS

By **Preston D. McSwain**

Are Hedge Funds Prudent for Taxable Investors?

Inspiration from a true story

The couple had done well. Together, they'd started a business, built it and recently sold it to a strategic investor in a deal that netted them approximately $100 million in after-tax cash.

They weren't comfortable investing this wealth themselves, so they hired an independent trustee and a third-party investment consultant to help them design a coordinated wealth plan. These advisors arranged meetings with wealth management firms that could both assist with investment management and offer trust company services.

One of the firms, a large trust bank, hosted an elegant lunch for the couple, their trustee and consultant. The firm brought in an impressive team that included the president of the trust division and the chief investment officer.

After the first course, the president summarized the firm's capabilities. Particular emphasis was given to the strength of the alternatives and hedge fund selection team. He concluded by saying: "You've done well. We're here to make sure your family continues to do well over generations by building you a prudently diversified portfolio that includes global equities, bonds and a world class mix of alternative managers."

While the couple appreciated the presentation, neither fully understood the complex hedge fund strategies included in the proposal. When they questioned the necessity of these strategies, the CIO said: "To be prudent investors and good fiduciaries, it's important to invest in an endowment-style portfolio that includes hedge funds."

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Despite the persuasive presentation, buoyed, perhaps, by the knowledge that they'd built a successful business by always fully understanding strategies before executing them, the couple decided to keep it simple and not invest in hedge funds.

Prudent Approach?

The couple in this story is a real one—I was the investment consultant in the room at the meeting described above. Were my clients prudent to select a simple investment approach that didn't include hedge funds? Initially, you might think not.

The couple had set up a dynasty trust, and their time horizon for investment and distribution of funds to beneficiaries was going to be measured not in years or decades, but generations. What does that sound like? Maybe an endowment?

If trusts for ultra-high-net-worth (UHNW) families have characteristics that resemble endowments, and endowments, like say Yale's, have some of the most well respected and sophisticated long-term investment strategies, shouldn't more UHNW portfolios look like Yale-style endowments?

Why mention Yale? In the investment world, Yale is known for having a top performing endowment, which many try to replicate with what's called an "endowment model." Yale also has one of the most well respected CIOs, David Swensen. Based on his writings and his use of non-traditional investments, such as hedge funds, Swensen is a major contributor to the endowment-style investment model, which traditionally includes sizeable allocations to hedge funds.

The Tax Trap

So, what's the problem with using an endowment approach for UHNW families?

I could write about fees, or recent less than favorable

performance by some hedge funds, but how about taxes?

Yes, taxes. Regardless of your political leanings, no one likes writing a big check to the Internal Revenue Service, but unlike endowments, UHNW individuals and taxable trusts can't avoid a yearly payment to the IRS on gains.

As illustrated in the story at the beginning of this article, many investment managers and advisors now recommend endowment-style portfolios, which include sizable allocations to hedge funds or hedge funds of funds. Many of the presentations fail to point out, however, that allocations to hedge funds frequently generate large short-term gains, which now carry taxes that can exceed 50 percent in states such as California.

Strategies in a Taxable World

I specifically mention California not only because of its high concentration of UHNW individuals, but also because it's the home of the Aperio Group, which published a study that, better than almost anything else I've seen, provides sophisticated evidence to counter the endowment-style proposals of some firms.

In a white paper entitled, "What Would Yale Do If It Were Taxable?" Aperio collected endowment asset allocations, asset class returns and volatility and correlation data from multiple third party sources, including Yale's annual report and an independent study of endowments by the Commonfund and the National Association of College and University Business Offices (NACUBO).

Aperio took this data and calculated pre-tax and after-tax returns for Yale's asset classes. Then, using an allocation optimizer, they generated a tax-adjusted optimal asset allocation—evaluating, in other words, what Yale might do differently if it were taxable.

The "If Yale Were Taxable," chart on this page, illustrates some of Aperio's conclusions. The green column presumes that the equity allocation in the portfolio is available only through active strategies, while the blue presumes that indexed equities are also available.

Notice that the allocations to absolute return (a term Aperio used as a proxy for hedge funds) shift from 17.8 percent of the portfolio to 0 percent when factoring in taxes (see green and blue columns). In other words, when you properly account for the tax drag, hedge funds should have little, if any, place inside taxable portfolios.

Describing the impact of its hypothetical Yale endowment having been shifted to a taxable environment, Aperio noted that, "Given that an investor now has to pay taxes on what had been a tax-exempt portfolio, suddenly active equity and absolute return [hedge fund] allocations become far less attractive."

Aperio reached this conclusion even assuming that hedge fund strategies would otherwise benefit the portfolio by offering diversification through a low

If Yale Were Taxable

*Pre- and after-tax returns**

	Returns			Weights		
Asset Class	Yale P/T Implied Return	Yale A/T Implied Return	Yale Tax Haircut	Yale P/T Weight	Yale A/T Active Equity	Yale A/T Indexed Equity
Absolute Return	2.2%	1.7%	–0.5%	17.8%	0.0%	0.0%
Equity, Active	9.7%	7.5%	–2.2%	15.7%	0.0%	0.0%
Equity, Indexed	9.7%	9.2%	–0.5%	0.0%	0.0%	45.6%
Bonds	1.5%	0.9%	–0.7%	4.9%	35.0%	25.8%
Nat. Resources	10.7%	9.7%	–1.0%	7.9%	12.2%	0.0%
Real Estate	12.3%	10.7%	–1.6%	20.2%	13.9%	9.0%
Private Equity	11.7%	10.4%	–1.3%	32.0%	38.9%	19.6%
Cash	1.5%	0.8%	–0.7%	1.5%	0.0%	0.0%

* Please see Aperio's important disclosures about its assumptions and methodology at *http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2447403*

** Pre-tax

*** After-tax

— Aperio Group, LLC based on data for the period Dec. 31, 1998 through June 30, 2013

correlation to equities. In fact, many hedge funds, such as long-short strategies, have a relatively high correlation to equities (for example, the well-respected HFRI Fund Weighted Composite hedge fund index has a 0.88 correlation to equities), making the case for using them for diversification even less attractive. In Aperio's words:

> If a hedge fund strategy reflects the risk patterns of the HFRI index, with its higher correlation to equities, then the model never allocates anything to hedge funds.

"Don't forget that most [hedge fund investments] come with a healthy dollop of the biggest cost of all: taxes."

Lest you think that there's anything unique about Yale, Aperio performed similar analyses across the previously mentioned Commonfund/NACUBO study of the allocations and performances of all U.S. endowments. The conclusions they reached from this data were the same: allocations to hedge fund and active equity strategies shift to zero in a taxable environment.

Who else offers a similarly strong caution about taxes? David Swensen.

Following the publication of Swensen's first book in 2000, *Pioneering Portfolio Management,* many UHNW advisors started promoting the endowment model he'd helped create. The UHNW investment world eagerly embraced this new "sophisticated" approach and yet, 15 years on, still seems to be forgetting the fact that Swensen's book was designed for tax-exempt investors.

As Swensen wrote in his second book, *Unconventional Success,* (this one for taxable investors):

> The management of taxable … assets without considering the consequences of trading activity represents a … little considered scandal. A serious fiduciary with responsibility for taxable assets recognizes that only extraordinary circumstances justify deviation from a simple strategy…

Beyond Swensen's caution and the Aperio research, I've been surprised at the dearth of publicly available research on the impact of taxes on hedge fund returns.

Admittedly, coming up with metrics to evaluate returns and annual taxable gain assumptions across a range of hedge funds is difficult (transparency on returns, turnover and the mix of long-term versus short-term taxable gains is limited). I don't think it's a stretch, though, to suggest, as John Rekenthaler from Morningstar wrote in January 2015, that: "hedge funds are notoriously tax-inefficient" and that a sizeable portion of yearly returns comes in the form of short-term taxable gains.

One article of note is a piece written by Henry Blodget several years ago for *Slate* magazine called "The Wall Street Self Defense Manual." Instead of the complex analysis done by Aperio, Blodget used simple assumptions and calculations to question the appropriateness of hedge funds for individual investors.

As Blodget pointed out, most hedge funds charge a 2 percent annual fee on assets per year plus a 20 percent fee on gains. He assumed that an S&P 500 fund charges 0.2 percent on assets (this is quite high by the way—Vanguard charges only 0.05 percent) and generates a net return of 9.8 percent per year (10 percent gross less 0.2 percent in fees). Using simple math, he determined that an equity-oriented hedge fund charging "2 and 20" (that is, 2 percent of total asset value as a management fee and an additional 20 percent of profits earned) would need to produce a 15 percent gross return just to match the index fund. Looking at funds of funds that charge "1 and 10" on top of the underlying hedge funds, Blodget calculated that the return would need to be 18.5 percent to keep pace with the index fund.

Blodget then cautioned, "Don't forget that most [hedge fund investments] come with a healthy dollop of the biggest cost of all: taxes."

Offering another simple calculation, he assumed that a hedge fund generates annual pre-tax net gains (after expenses) of 10 percent per year and that 75 percent of the gains come from short-term trading. With a 50 percent total short-term gain tax liability and a 20 percent tax on the balance of the return, this would produce an

after-tax return of just under 6 percent. A 40 percent haircut. Ouch.

When you put all the costs together—fees and taxes—you get a sense of just how skilled a hedge fund manager has to be to generate an above-market after-tax return for a taxable investor. Blodget's calculation was that:

> [t]o equal the net after-tax return of an S&P 500 fund that generates a 10 percent gross return, a hedge fund would have to generate a gross return of no less than 20 percent. A fund of funds would have to post a gross return of 24 percent. Few, if any, managers are skilled enough to produce such returns consistently.

If you think Blodget's math must be off, Matthew Klein, writing for *Bloomberg View* in 2013, highlighted comparable research from Greenline Partners.[1] Greenline calculated that hedge fund investors keep only about 40 percent of returns after fees and taxes. Of the Greenline research, Klein wrote:

> To get an equivalent return after taxes and fees [to that of a low cost index fund that tracked the S&P 500, which generated 9.6% annually over the time period they used going back to 1970], an investor would have to find a hedge fund that consistently earned almost 21 percent a year. Even the best hedge funds usually earn much less than that.

Of course, some hedge fund managers are outliers and have produced attractive after-tax returns, but evidence like the Aperio study and the simple calculations above make me question the use of most hedge funds in UHNW portfolios.

As my friend Greg Rogers (a family office leader from RayLign Advisory), noted:

> For me, what keeps me up at night is overly compensating my portfolio manager friends [performance fees], Wall Street Managing Directors [trading fees] and government coffers [taxes]. A sobering stream of logic goes as follows: if 5% of the 8,000 hedge fund managers can actually deliver on the required returns to overcome fees and taxes over the long-term, then why do the other 7,600 hedge fund managers exist?

Of hedge funds of funds or endowment-in-a-box-style limited partnerships, Rogers went on to say:

> In the case of a fund of hedge funds, the investor is asking heroic results from manager selection, strategy allocation and the hedge fund managers themselves—all three competencies have proven to have limited sustainability over extended periods of time, to say the least. Not to mention that the majority of our leading list of 400 hedge fund managers are closed to new business because they realize the negative impact of managing too much capital. And frankly, they don't need your money.[2]

Where To Go From Here?

The tax practitioners among you may already appreciate that the significant tax headwind for hedge funds may have gotten even stronger. As Andy Parker and Bob Gordon of Twenty-First Securities reminded me, for investors in hedge vehicles that are categorized as "investor" funds, expenses aren't netted against income before flowing through on a K-1. Gross income jurisdictions, such as Connecticut (home to many hedge funds), only magnify the problem by not allowing any deductions for hedge fund costs, while my home state of Massachusetts, for example, further denies any deductions for interest. Stiff headwinds for sure.

So, the next time you hear the hedge fund or funds of funds endowment model pitch or the suggestion that fiduciary prudence demands that you consider an allocation to hedge funds, step back and ask a few more questions, especially about taxes.

In light of the severity of the tax drag, were the husband and wife team mentioned at the start of this article prudent to forego an allocation to hedge funds in favor of a keep-it-simple approach?

I think so.

Endnotes

1. Greenline Partners is staffed by folks who once worked at the well-regarded hedge fund Bridgewater Associates.
2. Note that Greg Rogers knows the hedge fund and alternative space better than most. Before running his own family office and RayLign, he was executive vice president and chief operating officer at the publicly traded asset management firm John A. Levin & Co. and a managing director at a leading institutional investment consultant, RogersCasey.