Beware the great hedge fund boondoggle and property spruikers

By Graham Middleton, BA, MBA

"You can make big money from hedge funds... especially if you run one, but average investors in them often face stiff fees which eat away at their returns...."

The trustees of self-managed superannuation funds have a target on their backs. The groups trying to harpoon them include hedge fund managers and all manner of international funds, together with property spruikers. Additionally, there are misleading comments breathed into the press by industry superannuation funds and managed funds who have been losing market share.

The hedge fund promoters had nothing to do with the successful investment strategies and careful financial planning that has built SMSF funds to 30% of the total superannuation pool at 30 June 2013. Due to the timing of superannuation fund returns, investment balance statistics are always one year behind, but it is likely that the 30% has increased to a greater percentage in the twelve months to 30 June 2014. No less than the Deputy Commissioner of Taxation, responsible for administering self managed superannuation funds, has indicated that the investment class is growing strongly and is well administered with a high level of compliance indicated by auditors. As Scott Teller points out in an article published by Morningstar, you can make big money from hedge funds... especially if you run one, but average investors in them often face stiff fees which eat away at their returns.

The hedge fund fee effect

A decade-long bet between investment legend Warren Buffet and a New York-based investment manager - Protégé Partners - was to the effect that an index fund nominated by Buffet would outperform a pool of hedge funds nominated by Protégé over a long term.

Each put up US$320,000 invested in zero coupon bonds worth $1 million at the end of the contest quite a few years into the future. The loser is to present their $1 million to a charity pre-nominated by the winner.

Buffet used a low-cost Vanguard 500 index fund, Admiral Shares. Earlier this year, Buffet's index fund was up 43.8% from the start of the bet six years ago. Protégé's portfolio of hedge funds reflected a gain of only 12.5% after fees, so it's looking good for Buffet's charity.

Buffet's index fund charges a mere 0.05% but the hedge funds typically charge a 2% management fee and additionally take 20% of the above market returns. When hedge fund managers do generate above market returns, they take 20% off the top as well as 2%, but they still get the 2% whether they gain or lose money.

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From 1998 to 2010 according to Teller, hedge funds captured an estimated US$379 billion in fees versus investor gains of US$70 billion.

Hedge funds tend to be illiquid, offer limited windows to withdraw invested money, receive a lack of regulatory oversight and bear the additional costs of leverage and derivatives that vary with fluctuations in underlying assets. Only a few hedge funds outperform market averages. However, lots of them collapsed during the global financial crisis as counter parties were no longer able to write the exotic financial derivatives they used and investors screamed for the return of money.

Phineas T Barnum

Despite the hype surrounding them, hedge fund payoffs are uncertain, their internal expense ratios high and they are characterised by a lack of disclosure.

I am mindful of American circus promoter Phineas T Barnum's quote that:

"There's a sucker born every minute."

Phineas knew that he could always sell tickets to see a two-headed lady or the Indian rope trick. Of course, his customers knew that they were seeing illusions; they just couldn't figure out how the illusions were done.

Snake oil salesmen

Remember those old movies set in the American west with the spruiker selling exotic cures from a colourful wagon? The cures were claimed to be made of snake oil and other mysterious ingredients and were able to cure everything from baldness to rheumatism. The trick was that by the time the purchasers found the snake oil to be useless as a cure, the salesman had moved his wagon on to far distant places. Recently, Australia has had a spate of publicity generated by hedge fund promoters telling us that in order to create real wealth we must learn to invest the American way, i.e. to use their hedge funds. In reality, the way hedge funds work is that the hedge fund manager reaps the cream and the investor takes the losses. US$375 billion in fees to hedge funds versus US$70 billion investment gains over a twelve-year period is a damning ratio.

Reporting or industry propaganda?

With the financial meltdown of Fairfax Media Ltd, much of what is assumed to be journalists reporting facts is actually written externally and inserted into the Fairfax press. We owe this revelation to ex-Age journalist Ben Hills, who wrote a book chronicling the mismanagement of Fairfax over recent years. Fairfax publishes *The Age, The Sydney Morning Herald* and the *Australian Financial Review*. These once-great papers have each deteriorated massively in size and the quality of their content and employ far fewer journalists. So when I read an article in the *Australian Financial Review* explaining that hedge funds are going to help Australian SMSFs make better investments, I am immediately suspicious that what I am reading is not based on journalists' carefully researched writing, but rather may have been placed by hedge fund industry promoters.

Global Wealth Partners Fund (GWPF) IPO flop

A representative of 2020 Investments, proclaiming itself an "ADA partner service" wrote an article in the ADA journal indicating why dentists should invest in the above company's IPO. In turn, the company was to invest via an Australian subsidiary of the US-based Moelis Group, Moelis Australia Asset Management Ltd (MAAM), in four US-based hedge funds which do not disclose their investments, but which received generous fees. A close reading of its prospectus revealed that it had some unusual features. One feature was a poison pill arrangement whereby if GWPF sought to terminate the investment manager, MAAM, in the first ten years it would have to pay MAAM a fee of 10% of assets. It would seem to be a case of slam, bam, thank you MAAM!

Unless it triggered the poison pill, GWPF would have virtually nothing to do because all of its money was passed to MAAM who invested it in the four hedge funds. Its chairman, media personality David Koch, was to be paid $125,000 per year to do virtually nothing except lend a respectable face to it.

However, too many of us pesky Australian investors must have actually read the GWPF prospectus, because the investment money didn't roll in as expected. MAAM was seeking to raise $300 million prior to the IPO but announced that it had received less than $100 million and cancelled GWPF's IPO. How much less was not disclosed. As a result it had to return the monies subscribed to it and David Koch will miss out on his $125,000 per year sinecure.

It has been reported that other listed investment vehicles built on hedge funds are preparing to hit the market for capital raisings to tap into the Australian superannuation funds market. Obviously buoyed by Phineas T Barnum's prophecy, the hedge funds' snake oil salesmen are rolling their wagons into Australia.

11,000 US hedge funds

Meanwhile, as reported in the *Australian Financial Review* of 25 September 2014, an article quoted wealthy Oak Tree Capital Management chairman, Howard Marks, as saying that whereas hedge funds in the 1980s and 1990s were run by a select group of highly intelligent people who (mostly) delivered superior returns to investors, today there are 11,000 hedge funds operating out of the US.

"I'm fairly confident they're not run by 11,000 geniuses," Mr Marks said.

According to the article, hedge funds have produced an average annual return of 5.3% over the past decade. Despite the unexceptional performance of many funds, most hedge funds still pocket a fee of 2% of assets under management and 20% of profits. The system is known in the industry as "Two and 20".

Oak Tree manages more than US$80 billion and specialises in distressed debt and alternative assets.

Leon Cooperman, chairman and founder of US-based Omega Advisers, said that there would be a "weaning out" of hedge funds in the next few years, after the bull market run is finished.

"There won't be 11,000 hedge funds in five years," Mr Cooperman said.

Testimonials and ethics

As an American Civil War buff, I have read a deal about the prominent leaders on both sides. Robert E Lee was considered the rising star of the United States Army and prior to the Civil War, was offered command of the Union Army when hostilities were thought to be imminent with the Secessionist States, known as the Confederate States. Lee, a Virginian, felt that ethically his duty lay with his native state of Virginia. In those days, Americans thought of themselves as belonging to a state rather than to the United States, which prior to the Civil War, were regarded as being more akin to the European Union today. Lee turned down the offer and resigned from the United States Army. Subsequently he became the most prominent Confederate General. Most of the officers serving in the US regular Army made decisions based on their sense of duty to their native states. As a result, many of the senior officers on both sides found themselves leading troops into battle against formations commanded by their West Point classmates. Many lost their lives as a result.

Lee knew that his decision was likely to cost him dearly. His wife's estate, with its fine mansion, at Arlington in northern Virginia, was close to Washington. Naturally the Union seized it and to ensure that Lee could never return to it, they turned it into the Arlington National Cemetery.

Following the surrender of his Army to Union General Ulysses S Grant on 9 April 1865, Lee was unemployed and his family near destitute. Because of his fame, he received an offer from a large insurance company to endorse its products. Lee declined on the basis that ethically he felt unable to receive payment when no work was involved. That sense of honour is lacking today. Finally, he received an offer for a lowly paid position as superintendent of the very run-down Washington College at Lexington, Virginia, a tiny university. Lee's wife was a descendant of George Washington, who had originally endowed the college. Lee spent the last five years of his life striving to improve the youth of the defeated South via education. Today, the university, still quite small, is known as the Washington and Lee University and it adjoins another famous institution, the Virginia Military Institute, a university based on a cadet corps at which another famous Civil War person, Lieutenant General Thomas (Stonewall) Jackson taught prior to the Civil War. Jackson was fatally wounded while commanding a corps in Lee's Army of Northern Virginia at the battle of Chancellorsville in 1863.

Would Lee have accepted $125,000 per year to be chairman of a company which effectively did nothing except window-dress an investment?

Property spruiking 2014 style

It was a while since I had heard a presentation from a property spruiker, so when somebody rang my home with the usual line about attending a seminar in the local area to find out how to make me wealthy, I agreed to have them send me an invitation to an event at a local golf club.

Not much has changed. After some gruesome music, the spruiker introduced himself and told the audience that he personally had created vast wealth from property and was here to share his knowledge. He was also prepared to make available the services of his group to make the entire process painless. He then offered bottles of champagne to persons who answered questions designed to lead to his key points. The audience was asked to applaud after each correct answer.

The speaker made the almost mandatory reference to Warren Buffet and in passing referred to commercial and industrial properties, but all his facts and some very optimistic figures led straight to the purchase of geared units in high-rise developments; which of course his organisation was able to provide at bargain prices before steep increases occur in the near future.

Like Henry Kaye and others before him, his organisation was able to arrange every detail including sales, financing, tax advice, property management services and a helpful group he had in mind was only too willing to show people how to set up a personal superannuation fund into which to purchase a geared property. His mantra was buy now, buy often and borrow to the maximum capacity, helped on by present low interest rates. He didn't say how much pain would occur if interest rates increased. The speaker painted a picture of population growth creating price growth in property to draw everybody ever upwards until every person in the room had a huge and profitable portfolio of property. Of course, being able to offer the complete circle of services to buyers minimised the risk to the spruiker that his targets will receive alternative advice which will probably kill his sales.

The speaker did not allude to downturns in the market. In his view, people on moderate incomes should be gearing heavily to make their property purchases. According to him, a 5% deposit was adequate as the rest was being financed with somebody else's money.

He referred to the growth in immigration, particularly in Queensland, where apparently a large number of Indian immigrants were going to arrive shortly to fill the labour shortage in the coal mining industry. He failed to mention that that very day, BHP Billiton had announced that 700 jobs were to go from its Queensland mining operations!

The speaker mentioned high-rise projects in a number of locations, all of which were, according to him, areas in which property was hot and demand was growing strongly. He showed aggregate returns from residential property for recent years, but those returns were a combination of gross rental return and property price appreciation. He did not mention that net rental returns would be much lower and hence aggregate returns would also be much lower, nor did he mention that part of the price increase in established housing was due to expensive additions to some, which found its way into sale price statistics gathered from state stamp duties offices. Even so, his figures were still below the recent calculations of the return of the Australian stock market over the past 30 years. Although he had made passing reference to industrial and commercial property, it became apparent that his job was to sell high-rise units. At the conclusion of his presentation, he invited the audience to see one of his staff to make an appointment and even hinted that if people wanted to travel across Melbourne, they could have the great gift of an appointment with himself. He also described how his group had recently held a black tie function for all its Melbourne clients at a prominent city location, complete with entertainment. I tried to imagine a room full of property investors, all with their heavily geared high-rise rental unit or two being warmed up for the next round of his offerings in buildings in which he had a special interest.

Similarities with Storm Financial

I recall that the owners of the failed Storm Financial used to organise big social events for their clients who they had double geared into the share market near its zenith. They first of all persuaded their clients to borrow as much as they could against their homes and then had them invest that money in managed equity funds, which were expanded to about two and a half times the original house loan through the use of margin loans. When the market correction hit and the margin calls poured in, forcing their investments to be liquidated in a steeply falling market, their equity in the investments was wiped out and they were left with huge loans on their homes. Many were wiped out. Synstrat has never promoted margin loans which appear great in a rising market but which create financial disasters in falling markets. High leverage works both ways.

Practically, the only difference I could see between this spruiker's organisation and Storm Financial was that the investment medium differed. The speaker spoke of showing investors how to raise equity in their homes to fund rental property, with the properties in turn being as heavily geared as possible. It's not hard to imagine that in the market downturn or in the event of an external event such as a job loss creating financial pressure, these investors too would be wiped out.

Incidentally, recent RP data shows gross rental yields on Melbourne rental properties as 3.2% for houses and 4.2% for apartments before all of the landlord expenses such as water and municipal rates charges, insurance, maintenance, letting fees and agents' management fees and, in the case of apartments, body corporate fees, are taken into account. The net rental before interest payments will probably fall in the range of 1-2%. Naturally the spruiker did not mention these percentages.

Correction imminent?

When spruikers push this hard into a market it's a sign that the market is over-heated and due for a correction. If the Reserve Bank pushes interest rates up, or forces banks to alter the loan to valuation ratios (LVR) to make it more difficult to obtain finance, it will have a substantial impact on the residential property market. The spruikers probably sense that a housing market correction is coming and are working overtime to sign up as many naïve investors as possible while the market holds.

A mere six days after the spruiker's presentation, *The Age* in Melbourne ran an in-depth coverage of the massive surplus of apartments emerging in Melbourne, with 8.3% rental vacancies in Melbourne's Southbank precinct and substantial vacancies in its Docklands precinct. Investors in apartments were having to accept huge losses to achieve sales. They were also offering inducements to potential tenants. There are many more high-rise buildings which have already been pre-sold and are under construction. Inner city Melbourne apartments are rapidly turning into a financial wasteland. Press reports indicate that inner city Sydney is headed down the same path.

Rational investors will avoid buying off-the-plan apartments as it is likely to be years before their resale value in the secondary market matches their off-the-plan price. If somebody absolutely felt that they had to buy one, a far more sensible strategy would be to search for the carnage in the real estate listings in the secondary market and buy apartments which are only a year or two old and are being resold. These are fetching prices far below their original off-the-plan price. They'll still probably turn out to be mediocre investments, but at least the price will be fairer.

About the author

Graham Middleton personally has been advising dentists on strategic, practice management, valuation and conflict resolution processes for 27 years, the last 20 as a founding partner and director of Synstrat Management Pty Ltd and Synstrat Accounting Pty Ltd. He was once a regular army officer and later Director Human Resources Manager, Attorney General's Department of Victoria. He is considered an expert on dental practice valuation and practice performance benchmarking. He has spent many years advising dentists in respect of their business and financial strategy and measuring their practice and financial performance. He is the author of Synstrat Dental Stories, the Synstrat Guide to Practice Management, 50 Rules for Success as a Dentist and Buying & Selling General & Specialist Dental Practices. He is a long-term contributor to the Australasian Dental Practice magazine. The Synstrat Group is an independent data-based organisation providing management, benchmarking, valuation, financial and accounting services to the dental profession. Synstrat Management Pty Ltd is a Licensed financial services company. Both Synstrat companies are owned by the same directors who work within the Synstrat Group. For more information, Tel: (03) 9843-7777, Fax: (03) 9843-7799 email dental@synstrat.com.au or see www.synstrat.com.au.

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