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Hedge Funds Beckon Small Investors

As a Major Private-Money Management Firm Goes Public, Individuals Face 'Alternative' Choices of Varying Risk

By **ELEANOR LAISE**

February 14, 2007; Page D1

One of the hottest stock offerings of the past year appears to give small investors a backdoor way into hedge funds. But there may be better -- if costlier -- options for those who hope to diversify their portfolios.

Last week, **Fortress Investment Group LLC**, which manages hedge funds and private-equity funds, made its debut on the New York Stock Exchange, allowing anybody with a brokerage account to share in the fortunes of a company that manages money for the ultra-rich. Many industry experts expect similar offerings to follow.

On Friday, its first day of trading, Fortress stock closed at \$31, nearly 70% above its \$18.50 offering price. Yesterday, the stock closed at \$28.90.

Fortress investors, of course, simply own a piece of a money-management company. But the offering is one of many recent signs that hedge and private-equity funds, once reserved for wealthy investors, are seeping into the mainstream. Fund companies such as **Janus Capital Group Inc.** and Old Mutual Asset Management, a unit of Old Mutual PLC, are unveiling products that mimic the investment strategies of hedge funds -- which are private investment pools for wealthy and institutional investors -- or adding hedge-fund-like strategies in traditional mutual funds.

Yet such products often have high fees, and a number of new offerings are tacking on extra layers of expenses. What's more, many of the funds lack long-term track records, and some haven't offered the protection from market downturns that investors generally expect from hedge funds.

None of that has hurt their popularity. Hedge-like mutual funds, which typically require minimum investments of just a few thousand dollars, held more than \$16.5 billion at the end of 2006, up 58% from a year earlier, according to Financial Research Corp.

Indeed, many financial advisers recommend that their clients devote as much as 20% of their portfolios to alternative investments -- a broad category that includes hedge funds, private-equity funds, real estate, and commodities -- since such investments can behave much differently than stocks or bonds and lower the risk of an overall portfolio.

All this is happening as regulators seek to sharply curtail access to traditional hedge funds. The Securities and Exchange Commission has proposed a rule that would require hedge-fund investors to have investment portfolios of at least \$2.5 million. (They are already required to have a net worth of at least \$1 million or an annual income of at least \$200,000.)

Offerings like Fortress give investors a piece of the hedge-fund action without the high minimums, hefty fees and long lockup periods that often come with traditional hedge-fund investments. Wealth-management firm Contango Capital Advisors Inc. is considering using Fortress stock as a piece of clients' allocation to alternative investments, says Milton Balbuena, the firm's chief investment strategist. Fortress "opens up this alternative universe to a wider set of investors," he says.

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But Fortress shares are not hedge-fund shares -- and they don't have the same risks and rewards. Many investors buy hedge funds because they want to diversify their portfolios. While hedge funds generally behave differently than stocks and bonds, "Fortress is going to be an equity, when it's all said and done," and won't offer the same diversification, says David Bailin, head of alternative investments at wealth-management firm U.S. Trust, a unit of **Charles Schwab Corp.**

Since hedge-fund management companies tend to generate much of their income from fees that vary depending on the performance of their funds, their stock is likely to be quite volatile, industry experts say. "The risk is that the market prefers steady earnings rather than lumpy or inconsistent earnings" and awards a low valuation to the shares, Mr. Bailin says.

While hedge-fund investors are concerned with issues such as the manager's track record and fees, investors in a hedge-fund management firm must also examine the diversification of the firm's product offerings and the compensation of top executives. A firm that manages different types of funds, as Fortress does, is likely to better withstand the loss of asset- and performance-based fees if a single fund performs poorly, experts say.

Investors should also look for a compensation structure that ties executives' interests to shareholders', says Jeffrey Ptak, a stock analyst at investment-research firm Morningstar Inc. If a firm pays key employees too little, it may not attract top talent, and if it pays them too much, there won't be anything left over for shareholders. Generally, "folks running hedge funds are in this business to be compensated highly," says Joel Schwab, managing director of Channel Capital Group Inc., which tracks hedge funds.

Another risk: Since the Fortress offering is the first of its kind in the U.S., there's little information on how the market will value such firms over the long run. Many hedge-like mutual funds, on the other hand, have a longer track record, and recent research suggests they can help investors boost returns without taking on additional risk.

Such funds, to be sure, represent a vast array of strategies, each with its own potential pitfalls. Some devote substantial assets to "short" positions, or bets that a stock will fall, a strategy that requires especially strong stock-picking and timing.

A recent study by researchers at Georgia State University, Northeastern University and London Business School found that hedge-like mutual funds substantially outperform traditional mutual funds, though they lag traditional hedge funds by several percentage points a year.

Hedge Funds: The Strategies

A number of investment vehicles are opening the hedge-fund world to small investors, but their potential risks and rewards vary widely.

Vehicle	Strategy	Risks
Publicly-traded hedge fund or private-equity firm	Lets small investors share in the fortunes of an alternative money-management firm.	So far, there's only one listed in the U.S., and the shares may not offer the diversification of a true hedge-fund investment.
Long-short mutual fund	Combines "long" positions, or bets that prices will rise, with "short" positions, or bets that they will fall, often exchanging some gains in market rallies for better protection in down markets.	Short positions require particularly good research and timing. Over the long haul, stocks tend to go up, not down.
Market-neutral mutual fund	A type of long-short fund that tries to produce strong returns regardless of market conditions, generally by dividing assets equally between long and short positions.	With the impact of market movements minimized, fund returns depend on the manager's luck or skill—and many active managers have failed to beat the indexes over the long term.
Fund of hedge funds	Offers diversification, typically by dividing assets among a variety of managers and hedging strategies.	Total expenses can be hefty. Investors often pay fees for the fund of funds as well as underlying funds.

Source: WSJ research

Most types of hedged funds "are significantly less risky than plain old stock mutual funds," says Andrew Clark, head of research for the U.S. at fund tracker Lipper Inc. A study by Lipper published earlier this month found that both hedge funds and hedge-like mutual funds generally help

investors from stock- and bond-market slides without adding additional risk to the portfolio. The study was conducted at the request of Absolute Investment Advisers LLC, an alternative-investment manager and Lipper consulting client.

Yet hedge-like mutual funds don't always deliver the diversification and insulation from market meltdowns that investors expect from alternative investments. The Gartmore U.S. Growth Leaders Long-Short fund, for example, lost nearly 17% in 2002, the last year of the most recent bear market. Co-manager Doug Burtnick says the fund should hold up better in future market downturns. In 2002, the fund was managed by a different firm and pursued a strategy that had a larger exposure to the overall direction of the stock market, he says.

Another concern: Many hedge-like mutual funds come with high fees that can take a big bite out of returns. The average hedge-like fund charges expenses of 2.07%, compared with 1.43% for the average diversified U.S. stock fund, according to Morningstar. A number of new funds essentially act like funds of hedge funds, a structure that can tack on extra fees. The Beta Hedged Strategies fund, for example, which was launched last year, invests in a series of separate accounts pursuing various hedging strategies and charges total expenses of 3.99%.

Investors must keep close tabs on their funds' strategies to determine how much risk they're taking. The Quant Long/Short fund, for example, recently abandoned its traditional strategy in favor of one that allows it to devote 10% to 33% of assets to short positions. "There's going to be more volatility associated with this type of strategy" than with a conventional mutual fund, says Jim Johnson, the fund's co-manager.

Private-equity funds, which aim to buy companies and sell them for big gains, are also inspiring offerings geared to smaller investors. The **PowerShares Listed Private Equity Portfolio**, an exchange-traded fund launched late last year, holds companies that invest in -- or lend money to -- private businesses. A number of special-purpose acquisition companies are raising money through public offerings, typically using the proceeds to buy private firms. Meanwhile, private-equity funds of funds are available to wealthier individuals for minimum investments of roughly \$100,000 and up.

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