

Do Hedge Funds Make Money?

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Professor Burton Malkiel has recently attracted a good deal of attention with a paper claiming that many of the familiar hedge fund databases and indices suffer from survivor bias, backfill bias, and other problems. Many in the hedge fund business will view Malkiel's paper as an attack on the foundations of what they do. We have been investing in hedge funds since the 1970s, and we agree with much of what he has to say. However, we would like to place his claims within a broader context.

Our experience has taught us three important lessons about hedge funds:

1. Nobody really knows whether hedge funds, in aggregate, make money. Indeed, we suspect that the aggregate hedge fund pool does *not* make money. But that is not a problem: even if the aggregate pool does make money, the careful investor should believe otherwise.
2. If the aggregate hedge fund pool does not make money, but the familiar indices have made money, then it follows that the indices are not totally representative, partly for reasons that Malkiel emphasizes. There is, however, one index, the EACM 100®, which our firm launched in 1996, that was explicitly designed to avoid Malkiel's problems. But our index sacrifices breadth in order to achieve accuracy.
3. Even if the average hedge fund does not make money, a well-diversified portfolio of hedge funds can still be a prudent investment. In this respect the hedge fund business is exactly similar to the venture capital business...