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GETTING GOING
By JONATHAN CLEMENTS



How Much -- Really -- Is That Hedge Fund In the Window? You Don't Want to Know

July 26, 2006; Page D1

These investments are too rich for my taste.

Wealthy families often hire private money managers, pony up for hedge funds and set up a slew of trusts. And we ordinary folks look on, figuring we're missing out.

And, of course, we are missing out -- on a fistful of costs that could wreak havoc with our investment returns. Feeling envious? Maybe you should feel sorry instead.

• **Hedging your bets.** Among investment status symbols, nothing can quite rival hedge funds.

But this is a status symbol with an eye-popping price tag. A hedge fund might charge 1% or more of assets each year, while also taking 20% of all gains above a specified level, such as the Treasury bill rate.



It's even more costly if you buy funds of funds, which make money by investing in a range of hedge funds. These funds levy a second layer of fees, which might be 1% a year, plus 10% of all profits above some target rate.

Hedge funds pursue a variety of exotic strategies, including trading currencies and commodities, employing leverage and shorting stocks in a bet they will fall in price. Result: A hedge fund should perform quite differently from conventional stocks and bonds, thus reducing a portfolio's overall risk level.

But star-struck small investors don't swoon over the diversification benefits of hedge funds. Instead, they lust after outsized returns.

On that score, they're likely to be disappointed. Consider a study by Princeton University's Burton Malkiel and Analysis Group Managing Principal Atanu Saha that appeared in the November/December 2005 issue of the Financial Analysts Journal.

The study found that hedge funds can be excellent diversifiers. But it also found that, from 1996 through 2003, average hedge-fund returns lagged behind the Standard & Poor's 500 index, with

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some funds performing dismally, often prompting them to go out of business.

• **Going separate ways.** Just as hedge funds can help reduce risk, so there are real advantages to separately managed accounts, where a private money manager buys stocks and bonds just for you.

Andrew Gardener, president of Houston's Tanglewood Legacy Advisors, notes that a separate account gives you greater control over when to realize taxable gains. You can also customize the account. For instance, if you're in the software business, you might exclude technology stocks, because your job already hinges on the industry's success.

But let's be honest: For many folks, investing in separate accounts is mostly about snob appeal. Mr. Gardener recalls a broker at a major Wall Street firm telling clients that "mutual funds are the bus and separate accounts are the limo."

Problem is, this limo can be a tad expensive. If you invest less than \$1 million in separately managed accounts through one of the big brokerage firms, your total costs could easily run 2% a year or more.

It's hard to overcome such costs and earn decent returns. Chicago investment researcher Morningstar Inc., which made its name analyzing mutual funds, started tracking hedge funds and separately managed accounts in recent years.

"The results that people are getting from hedge funds and from separate accounts are often much weaker than you could get from a good low-cost mutual fund," says Don Phillips, a Morningstar managing director. "Investors imagine there are wonderful things on the other side of that curtain that separates economy from first class. But often, that just isn't the case."

• **Matters of trust.** As with hedge funds and separately managed accounts, there are some solid reasons for setting up trusts. A living trust can help your estate avoid probate. Credit-shelter trusts and life-insurance trusts can save a heap of estate taxes.

But when folks think of trusts, they tend to think of "trust-fund babies" who float through life buoyed by a magical stream of monthly checks. The reason the trust provides this income, however, is because somebody once funded it with a truckload of money.

"The trust helps ensure that your wishes are followed," says Art Canter, an investment adviser and accountant in Boca Raton, Fla. "But from an investment point of view, there's nothing magical about a trust."

In fact, trusts can prove mighty taxing and mighty costly, says Pittsburgh accountant and attorney James Lange, author of "Retire Secure," due out next month.

To be sure, you can keep down a trust's costs by naming your sister as trustee and having the money invested in low-cost mutual funds. But if you use a bank-trust department, you could run up total annual costs of 1% or 1.25% on a \$1 million trust, and possibly much more.

Paying 1% might not sound so bad. But remember, we are talking about \$1 million -- and at that asset level you could own a diversified index-fund portfolio for around 0.1% a year.

Moreover, "you have to file a tax return for the trust," Mr. Lange says. "If the trust distributes its

income, then that money is taxable to the beneficiary. But if the trust retains its income, then it's taxable at the trust's income-tax rate, which is the highest rate going." Indeed, if a trust retains more than \$10,150 in total income, it could find itself in the top 35% federal-tax bracket.

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