

INVESTING

How to Beat Hedge Funds

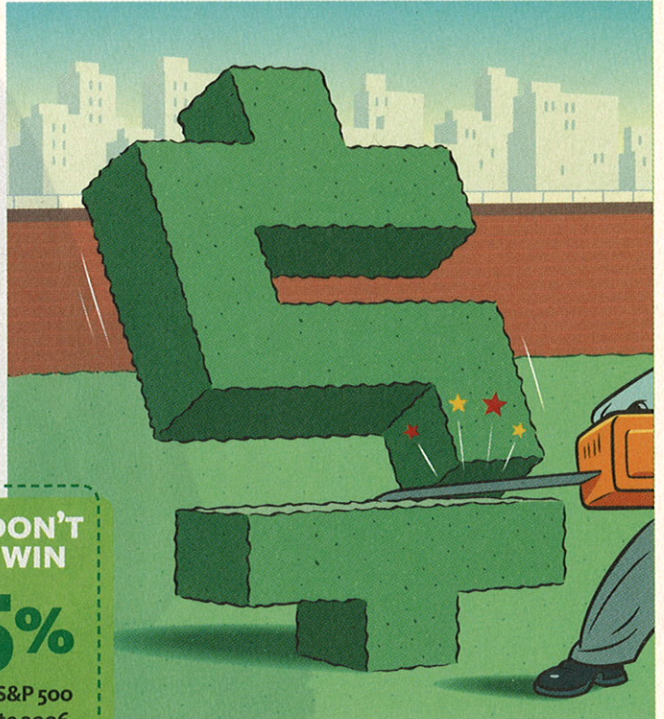
Good news for the average investor: You can do better than the über-rich BY JASON ZWEIG

FOR THE PAST SEVERAL YEARS, the hottest thing on Wall Street has been mostly off-limits to Main Street: hedge funds. These portfolios for the rich—you need not apply unless you earn at least \$200,000 a year or have a net worth of \$1 million or more—are barely regulated, don't have to say what they own and are not obligated to let you cash out whenever you want. They can invest in anything from stock in Microsoft to uncollectible credit-card bills in Kazakhstan. Hedge funds can also profit by betting that investments will go down, not just up (a tactic called short-selling). Thus they often thrive in bear markets, when falling prices make this technique pay off. From 2000 through 2002, as the U.S. stock market sank 37%, the average hedge fund gained 21.5%, according to the Barclay Group.

The result was a mad dash for the entrance. Roughly 9,000 hedge funds now manage more than \$1.2 trillion. And the people who run them make ungodly sums of money: This year nearly one out of every 20 billionaires on the Forbes 400, the roster of the richest people in America, is a hedge fund manager.

But Wall Street never learns from its own history, which proves that every good idea, taken too far, turns into a bad one. Yes, some hedge funds make gobs of money. But with 9,000 of them swarming over the same markets, they can't all be successes. "Hedge funds have probably come too far too fast," admits Cliff Asness, who himself hedges more than \$9 billion at AQR Capital in Greenwich, Conn. Sure enough, so far this year, as the U.S. stock market gained more than 8.5%, the average hedge fund rose only 6.8%. (It's worth noting too that hedge funders use notoriously fuzzy math in calculating returns; a Yale study estimated that average performance may be overstated by up to five percentage points a year.) So what does all this mean for Average Joe investor? That you didn't miss much by not being invited to the party.

► **HOW TO OUTPERFORM THE HEDGE FUND AVERAGE** Fairly recently, us normal folk have been offered a foot in the door via "retail hedge funds" or "fund of hedge funds," portfolios that sample the hedge fund market at lower minimum investments. If a broker tries to sell you on these, tell him to go fly a kite. The



HEDGES DON'T
ALWAYS WIN

8.5%

Return on the S&P 500
for year-to-date 2006

VS.

6.8%

Average hedge fund return
for year-to-date 2006

SOURCES: S&P, Barclay Group. NOTE: Year-to-date figures through September 2006.

fees are so high (often 20 times what an index mutual fund costs) that the managers would have to be geniuses to overcome the expense burden. (And the brains of the biz would generally rather work with the likes of Bill Gates.) These retail hedgies start in the hole in another way: Historically, the market is up two of every three years, while hedge funds, as the name implies, "hedge" against decline. So in the long run, the market offers

better odds. If you want the downside protection of a hedge fund with better luck for up years, spread your risk in a diverse portfolio and stay with it. Many hedgies trade as though their underpants are on fire, holding "investments" for days—sometimes hours—at a time. But in markets like these, patience is a virtue. It keeps your taxes, brokerage costs and emotions from running amok. As veteran Wall Street watcher James Grant says, "You can do what the professionals can't afford to do: nothing." \$

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