ALTERNATIVE INVESTING

An Annual Article About Nothing

May 5, 2015

Well, today,[1] *The New York Times* has gotten in on *Institutional Investor*'s annual listing of the top hedge fund earners. The article is mentioned on the front page of the print edition and is a top article on the paper's website. The reasons for this include standard gawking at the rich that has probably been going on since one person had a bigger mud hut than her neighbor, but also, as this is *The New York Times*, the scoring of certain political points ("these guys made all this money despite mediocre years!").

Unfortunately, this list, published for many years now, makes little sense. Full disclosure — I was on this list once, in 2001, back when the numbers were merely eye-popping rather than eye-popping-squared. You are free to infer that I'm biased in either direction from this information — bitter that I'm not on the list anymore or a defender of overpaid managers.

What's wrong with this list? Well, it purports to report what the managers earned last year. In a narrow sense (like what income you report for your taxes) it indeed might come close (though from experience I can tell you there's a ton of guesswork involved). However, in a larger sense it fails at what most people would assume is its purpose (like comparing your salary to theirs). Worse, you have to read pretty carefully, and pause to think hard about it, to discover this failure.

Here's the crux of the issue. The income they report, probably just to make the numbers larger (all journalists regardless of political bent would prefer to report larger numbers), is the sum of what the managers made from their hedge fund businesses (what their clients paid them), and what they made on their own investments in their funds (where many keep much of their own money). Casual observation suggests that the second part has come to dominate. So, why is this a problem?

Well it's not if you're trying to give away a lifetime achievement award — that is, tell us who started the year very wealthy. For example, if you start with a $5 billion dollar fortune and make 10% on your money, well you just earned $500,000,000 according to this list (and that's not including anything you earned from your business of running money for clients). If this is relevant, I'd imagine Bill Gates's investment returns (not to mention Warren Buffett's) would qualify every year (at least every positive year) if we decided to label them "hedge fund managers.'[2] So, what we really have here is a list of people who started out the year very very rich, that we also categorize as "hedge fund managers." We learned very little more than that during 2014, yet 2014 is what the list is supposed to be about!

Who among all of the world's hedge fund managers started out really really rich may be interesting to people. Moreover, if you're making political arguments — say, about inequality — pointing at them may or may not be fair, but it's almost a completely separate point from their income in 2014, the purported point of the list.

Put simply, it's mostly a lifetime achievement award given every year where the achievement (at least in *The New York Times*) is viewed in a somewhat negative light.

Now, criticizing hedge funds is fair game if done even‑handedly. We ourselves have written extensively over 15 years and critically about the overall level of hedge fund fees and a few other aspects of what they do (like not hedging enough, and pursuing well‑known strategies at fees only justifiable for unique strategies). This criticism doesn't always make us popular among the tonier parts of Greenwich, Connecticut, nor is it enough to please, or even get noticed by, the inequality crowd. But such is life….

Another problem with the list is it's all about the positives. Yes, in years of positive returns (even if disappointing positive returns — though we also think people get too disappointed with partially hedged investments in bull markets) fund managers make a lot on just their starting wealth. But for this list only the big positive outcomes count. While I can already hear the world's smallest violin playing, in 2008 you didn't make the list if this sum went negative. No, the compilers just move on to the largest positives that year. That's ok. It's a "top" list, not an all-inclusive or bottom list. But it illustrates how the return on personal wealth, wealth we knew about at the beginning of the year, drives so much of what's going on here.

Of course, when these lists appear in places like *The New York Times*, or many web commentaries, they engender a lot of catty comments. Like *The Times* focusing on how only half the managers at the top beat the S&P 500 (again that criticism is overdone). But when you see it's mostly just a list of "who started out really wealthy and had decent returns and who we can also label a "hedge fund manager" you see the list is rarely a surprise and rarely new news. It is voyeurism and mostly just an excuse to act as if this wealth is news, recycle many of the same comments (at least for critics of hedge funds and the wealthy in general), and make tired snarky comments as if this were fresh and new stuff. It's not. It can certainly be fair to criticize the wealthy. But, it's not fair to report their wealth daily (or annually) as if it's brand new news.

News flash! One way to make a lot of money is to start out with a very large fortune and make any non-trivial positive return on it. Lest I sound too Piketty-ish (not normally one of my many problems) this doesn't prove r > g, or that these fortunes won't be dissipated over time by heirs, taxes and the actual negative years that never get accounted for in the list. But this obvious occurrence just provides an excuse for some to write about the wealthy and pretend something new and important happened last year.

If you're interested in whether investment managers are worth their money, you should look at a list of top total compensation paid by investors to managers — not total income and not just hedge fund managers — relative to fund performance after fees. You should do so conscious of the massive statistical challenges in gathering the data, dealing with biases in the data, and the fact that separating skill from randomness/luck is extremely difficult. But those are for serious attempts to address serious questions and that is not the goal of this list or most writing about it.

Bottom line, if people are interested in a list that's (mostly) about "who among the people we label 'hedge fund manager' started out last year wealthiest," then go for it. That's the list you're getting here. Heck, I'm interested in that list. It's fun. But if this list is misinterpreted as being significant information beyond that, as I believe it commonly is, well that's a triumph of sensationalism and bad math over sobriety.

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* OK, it's not quite about "nothing," but I'm trying to keep up my theme of using *Seinfeld* episodes for many of my titles, and sometimes I have to kind of make it fit…

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[1] I wrote this before reading Matt Levine's better version on Bloomberg View, though I probably read his discussion of the same issue last year. I promise it's been independently driving me crazy for about 15 years. The common Buffett and Piketty mentions are downright disturbing!

[2] Indeed, the authors of the *Institutional Investor* article tacitly acknowledge the absurdity of counting one's personal investing income as "hedge fund earnings" when they explicitly dropped last year's No. 2 hedge-fund manager from this year's list because he now invests only his own capital.

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