S7-25-06 Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles

The riskier fund products are those that fail to manage or hedge their market exposures. Regulators should permit retail investors access to a wider range of strategies whose performance is less dependent on the stock market or general economic conditions. The "accredited investor" amount does indeed require modernization:- from $1 million to $1. The SEC needs to factor in how the world has evolved since 1982, not simply adjusting for inflation in isolation. All investors are wealthier today, in knowledge and resources terms, thanks to better information, product innovation and technological progress in financial markets and investment strategies. Every individual investor needs complementary return sources, lower total risk and true portfolio diversification. Cannot those who choose, have the right to access new and alternative methods of performance generation?

- The stock and bond markets can go through extended periods of low or negative returns making hedge fund availability for all investors essential
- Global asset and strategy innovation has expanded the range of investment returns beyond long only stocks and bonds
- It is inconsistent to deem hedge funds suitable for defined-benefit pensions but not defined-contribution pensions and other self-directed retirement plans
- Risk managed and financially engineered funds permits reduction of exposure to and dependence on underlying market factors, thus benefiting investors
- Hedge funds fill the portfolio gap between bonds and stocks for individuals with lower risk tolerances and seeking strategy diversification
- Personal financial freedom is about having access to a wide range of investment products in a competing market of hedged and unhedged fund products
- The historical track record of hedge funds in lower volatility and risk-adjusted terms proves their mandatory place in all investors' portfolios
- There is little threat to the mutual fund industry but retail investors who desire to invest in hedge funds should be allowed to, if the manager agrees
- Most investors are aware that selection of fund managers is a complex field requiring either extensive analysis themselves or hiring specialist expertise
- There are effective solutions to the very rare problems of fraudulent fund administration and self valuation that can better protect investors

Abolishing the outdated "smart enough for hedge funds" wealth-test

1. Empowerment

Financial and technological innovation has greatly empowered individuals of all wealth levels to make better investment decisions on a more level playing field. The level of investment knowledge of the mass affluent is higher than it was in 1982. Investors have access to information that is vastly more comprehensive than 25 years ago. The ability to check out potential funds and managers is far superior. Back then, there was no financial TV and no investment websites. No media coverage or scrutiny of hedge funds. Almost no third party evaluation and research on fund managers. Blogs are the latest empowerer. Adjusting for information and innovation there is now little need to "protect" the non-accredited investor from hedge funds able to provide extra portfolio diversification and risk reduction.

2. Global financial advances

In 1982 it was basically US stocks and US bonds for most US investors - large or small - but products and markets have evolved and almost the entire world is now investible. A much wider variety of assets and strategies are now available but many require expertise to navigate. During the past 25 years, electronic trading and deregulation have made execution much cheaper making shorter term, higher frequency strategies feasible. Arbitrages that were not possible in 1982, due to illiquidity, high transaction costs or non-existent securities (at that time), are now tradeable. The relationships between different asset classes in different countries over different holding periods creates new money making opportunities. In 1982 interest rates were high, but now they are low meaning leverage is cheap enough to be effectively employed in a skilled and advantageous manner. Why can't anyone who wants to benefit from financial and technological advances and innovative, superior, safer and sophisticated investment strategies be allowed to do so?

3. Investing for retirement

It is inconsistent that hedge funds are deemed suitable for retail beneficiaries of defined benefit plans but NOT defined contribution plans. Many DB pension funds either have or are in the process of including hedge funds in their portfolios, because they recognize the return enhancing and risk reducing benefits. But today the move is to DC and self-directed pensions. DC pensions infamously perform worse than DB pensions since they are not managed by a dedicated investment team, have higher fees, less diversification and enjoy no economies of scale. With DC pensions, individuals are out in the cold and their employers' bottom line is not affected. Why can't individuals, saving for their retirement, get added portfolio diversification away from long only and towards safer, more consistently performing products. Every 401(k) menu should have, at the minimum, some good fund of hedge funds offerings. Make a portfolio of 50% bonds and 50% fund of hedge funds the default DC menu option. If an individual then wants long only, so be it.

4. Risk management by fund managers

Nowadays financial engineers have the product tools to reduce many market exposures. In 1982 the ability to hedge out risks was very limited. Equity and interest rate derivatives markets were embryonic while weather and credit derivatives were over a decade away. The opportunity to reduce some risks and keep exposures a manager is skilled enough to take is the KEY financial development in the last 25 years. Why should retail investors only have available unhedged equities and bonds? Why must the retail investment product industry stay stuck in the time warp of long only? Yes, managers with the skills to manage risk charge higher fees but should not people have the freedom to choose those funds if they want? Another word for hedge could be insurance, so why not allow retail investors to invest with managers who make an effort to insure their portfolios? Yes, all investors CAN now diversify away systemic market risk.

5. Risk tolerance of investors

The risk continuum is high grade bonds -> hedge funds -> long only equity. Good hedge funds are LESS risky than long only funds. However how you measure it, their value at risk is less and the volatility of returns is smoother. The drawdown risk is much lower and of course the Sharpe and Sortino ratios are better. The performance in bear markets, in particular, is vastly superior. For the past fifty years, hedge funds have outperformed long only products on a risk-adjusted basis. At least let risk-averse investors get a higher return than bonds without enduring the devastating losses and volatility of public stock indices, if they so choose. Just as many investors will prefer to remain in unhedged funds, should not others have the freedom to invest in risk-managed alternative investment products?

6. Personal freedom and risk

Why should rich people be allowed to invest in hedge funds and not the less welloff? There is little connection between financial sophistication and wealth. Should all investors have to pass the CFA and CAIA before they can invest in anything other than a money-market fund? People are free to drink, smoke, gamble and consume junk food, yet Mom and Pop are “protected” from the healthiest financial products. Real estate brokers are allowed to sell houses to overleveraged buyers, some of whom will default on their mortgages and suffer foreclosure. People of negative net worth are allowed to take on excessive credit card debt at high interest rates. Individual investors can trade stock index futures at over 60x leverage, currencies at 200x leverage or put their entire life-savings in a pink sheet stock but can't access the best money managers and fund of hedge fund allocators. Why?

7. Track records of good hedge funds are conclusively superior

Back in 1982 stocks AND bonds had been poor investments for many years. Yet hedge fund managers like George Soros, Warren Buffett and others knocked the cover off the ball throughout the 1970s. The original investor protection laws came in 1933, yet the stock market then was lower than 30 years previously, while hedge fund managers like Jesse Livermore, Bernard Baruch and others performed outstandingly during that era. More recently better hedge funds made money in 2000, 2001 and 2002. Isn't it about time the proven ability of good hedge funds to make money in a bear market was made more generally available? Isn't it logical that the mass affluent have access to funds that can partially immunize their portfolios against 50-80% drops in the stock, bond or real estate markets?

8. Hedge funds are NOT a major threat to mutual funds

No good hedge fund has the intent or inclination to build the massive sales, marketing、hand-holding and record-keeping infrastructure necessary to be truly retail. And proper hedge funds focus on performance generation not asset gathering. But why should a financially informed, self-directed investor be precluded from putting some of their money, no matter how small, with their chosen hedge fund? Assuming the manager agrees, which is a big assumption given the desire for big tickets these days, what rationale does the SEC have for preventing consenting adults from doing this? Some retail investors would indeed prefer to put their money with hunter gatherers rather than asset gatherers. Hunters are incentivized to perform, otherwise they starve. So-called “hedged” mutual funds have also been shown to be poor imitations of true hedge funds.

9. Financial advice

Hedge funds are sophisticated and the instruments many trade require specialist expertise. Cannot all investors be permitted to access these skills? Retail investors should be allowed to properly diversify their portfolios with new, lower risk sources of return. The current law implies a low net worth person who wins the lottery suddenly becomes an investment expert. Finance is complicated but so is surgery or flying a plane. Why do people have the freedom to find a good doctor or good pilot but not a good money manager? Retail investors in many other countries can choose between long only funds and hedge funds, that compete with each other in a free market. The SEC could learn a lot from some overseas regulators.

10. Administration and valuation

Hedge fund scandals have primarily been confined to the USA. The SEC could require ALL onshore US-domiciled funds to have INDEPENDENT administration and valuation. Almost all frauds can either be traced to fudging the valuation of securities or managers having total control of fund cashflows. In the offshore world, wire transfers from investors go to a NEUTRAL fund administrator and I don't see why this could not happen with ALL onshore funds. It is a safer check and balance for institutional, high net worth AND retail investors. There are many better and modern ways to monitor and police the marketing of investment products than depression era, outdated and no longer necessary protective solutions.

Fund manager selection does indeed require sophistication, but that applies to ALL strategies including traditional products. Unless an individual, of any wealth level, has the time and expertise to evaluate hedged and unhedged funds themselves, they need QUALITY, INFORMED advice from those with the skills to conduct thorough analytical due diligence on managers and construct a TRULY diversified portfolio. The accredited investor rule has never justified the division of individual investors into "sophisticated" and "non-sophisticated", based on such a blunt measure as net worth. It is time to get rid of a rule that prevents so many from accessing superior risk-adjusted returns and more consistent absolute performance.

Veryan Allen

Email: hedgefundblog@gmail.com