



University of Toronto Faculty Association
720 Spadina Avenue, Suite 419
Toronto, Ontario M5S 2T9
Telephone: (416) 978-3351
Fax: (416) 978-7061
E-mail: faculty@utfa.org
Website: www.utfa.org

Date: April 28, 2008
To: Governing Council Business Board Members
From: George Luste, President, University of Toronto Faculty Association (UTFA)
Re: **Agenda item #3. - University of Toronto Asset Management (UTAM) and its Annual Report for 2007**

My 5-minute time limit requires I be selective and very brief in the few issues I can raise.

Background. UTFA members are the major stakeholder group in the UofT Registered and SRA pension plans. About 65%, or about \$2 billion, of the liabilities and assets pertain to faculty and librarians.

The 2007 UTAM Annual Report¹ has serious shortcomings on a number of important issues. Much is hidden from the reader. We can only touch on a few issues. Please do read this memo.

Issue #1. Investment Costs are not discussed. Why? Costs can be controlled by UTAM and Business Board – unlike markets or currencies or interest rates.

The alarming increase in pension plan costs is illustrated by the histograms on page 3. Annual costs are now about \$20 million more than in years prior to 2000 (pre UTAM). The cumulative excess cost, above a 20 basis point baseline, totals about \$68 million from 2000 to 2007. Since the plan is in deficit, this extra cost (of \$68 million) impacts the UofT operating budget. This point has been made before.

Issue #2. Performance Incentive problems are not discussed. Why? Can investment luck be distinguished from investment skill? How?

Basing management pay on various measures of performance incentivizes UTAM to avoid passive investment options – even if such options would be otherwise selected by prudent investors.

Pay based on fund performance may also lead to more aggressive risk-taking by managers and can lead to higher fees and potentially dangerous risks. Such issues are even more important when investing in complicated ‘alternate assets’.

(See the two attached articles on pages 9 and 12.)

Issue #3. A simple passive investment policy beats UTAM by about \$206 million, in total from 2000 to 2007, and with a lower volatility. Why is the passive option not discussed? Do the compensation incentives mitigate against it?

It is well known that in the active investment fund business, most of the time “ You pay for what you don’t get.”

See page 4 for the details of a Passive vs UTAM comparison from 2000 to 2007.

¹ See web link <http://www.governingcouncil.utoronto.ca/AssetFactory.aspx?did=5103>

Issue #4. There are intrinsic problems - with performance measurement - and with peer group comparisons. They are not discussed. Nor are benchmark issues.

In his 1991 publication, "The Arithmetic of Active Management"² Nobel Prize winner William F. Sharpe wrote (with my emphasis):

"An important corollary is the importance of appropriate *performance measurement*. **"Peer group" comparisons are dangerous.** Because the capitalization-weighted average performance of active managers will be inferior to that of a passive alternative, the former constitutes a poor measure for decision-making purposes. And because most peer-group averages are not capitalization-weighted, they are subject to additional biases. Moreover, investing equal amounts with many managers is not a practical alternative."

Issue #5. Alternative Assets and Hedge Funds. Numerous Issues. Very worrisome!

Cost issue? Very high fees. Total costs will increase as the % of Alternative Assets in the portfolio increases. Issue of: is there value added and at what risk?

Transparency issue? Hedge funds lack transparency.

- What are UTAM's indirect exposure to Asset Backed Commercial Papers?
- Do we know? -
- Is UTAM investing millions of pension dollars via fund-of-fund hedge funds without a clear and transparent knowledge of where these dollars will be allocated?

Risk issue? Recent blowup examples, like Bear Sterns, are sobering reminders that it is difficult to determine actual risk prior to the blowup.

Illiquidity and Market Value issues? Hedge fund lock-up issues?

Fund of Fund Issues?

Please see the attached two articles. They bear on the above issues.

- [Why today's hedge fund industry may not survive](#) (see page 9)
- [Hedge Funds Come Unstuck on Truth-Twisting, Lies](#) (see page 12)

Issue #6. Pension Plan Governance Issues (relates to UTAM).

Not a UTAM issue per se but it needs to be addressed. Pension plan members need to have a significant say and control of their pension plan assets. Faculty at the University of British Columbia do and so do Faculty at McGill. At the University of Toronto they do not.

Pension plans must represent the beneficiaries and no one else. Pension governance must be free from any suspicion of conflict of interest. That is not the case at the University of Toronto.

² See <http://www.stanford.edu/~wfsarpe/art/active/active.htm> and page 5 in this memo

The following 12 pages provide further details for statements on pages 1 and 2.

Issue #1. Costs matter! Fees and expenses increased by 48% (from \$15.6 to \$23.1 million) for the Pension Plan in 2007. Most of this increase is due to the more costly alternate asset (including hedge fund-of-fund) fees.

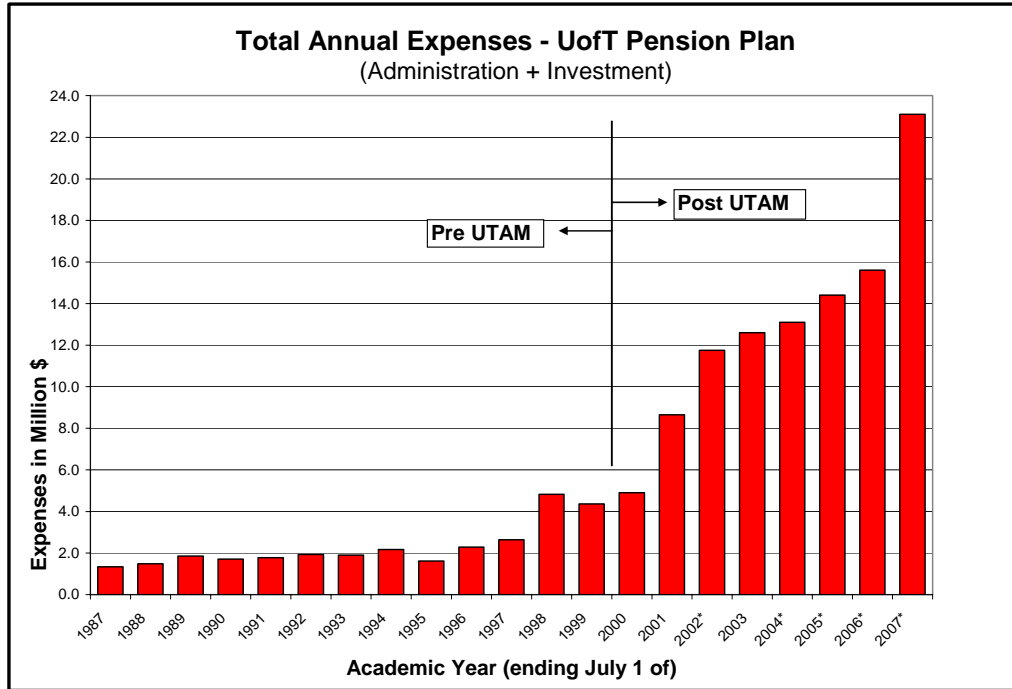


Chart – A

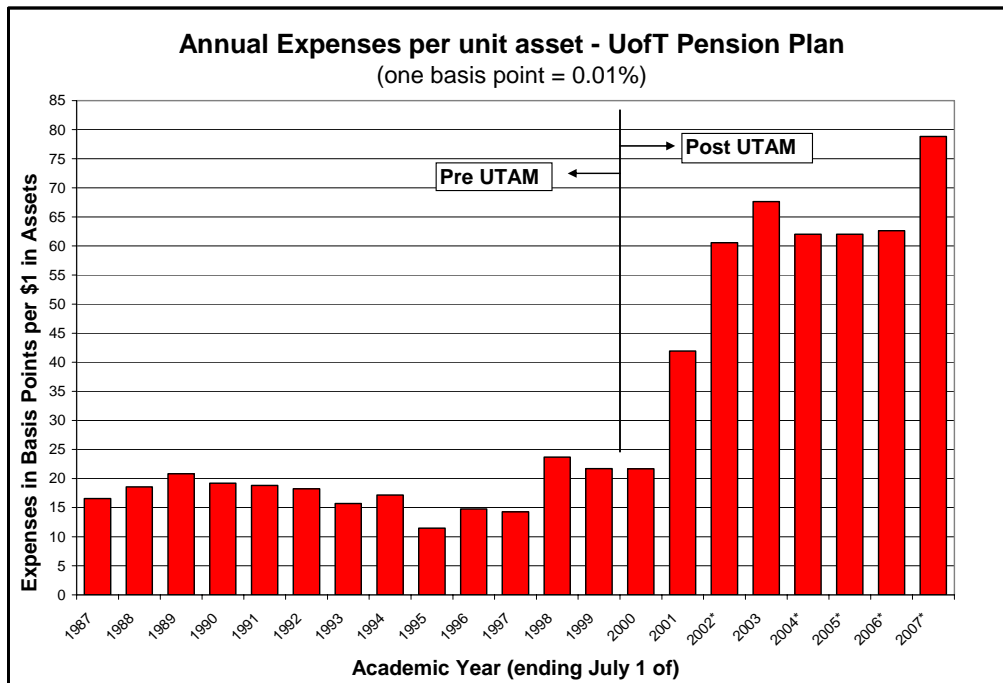


Chart – B

Issue #3. A simple passive investment policy example beats UTAM by about \$206 million, in total from 2000 to 2007, and with a lower volatility (standard deviation of returns). Why is the passive option not discussed?

Question: "How does a passive index return compare to UTAM's?"

Passive Index Performance

Year	Pension Assets on Dec 31 \$ in Bil	Passive All Canadian Bonds	Passive TSX Composite	Passive Mix 50% All-C-Bonds 50% TSX	Passive Pension Gain or Loss in \$ Mil
2000	\$ 2.27	10.2%	7.4%	8.8%	\$ 199.8
2001	\$ 2.15	8.1%	-12.6%	-2.3%	-\$ 48.4
2002	\$ 1.91	8.7%	-12.4%	-1.9%	-\$ 35.3
2003	\$ 2.11	6.7%	26.7%	16.7%	\$ 352.4
2004	\$ 2.31	7.1%	14.5%	10.8%	\$ 249.5
2005	\$ 2.58	6.5%	24.1%	15.3%	\$ 394.7
2006	\$ 2.87	4.1%	17.3%	10.7%	\$ 307.1
2007	\$ 2.99	3.7%	9.8%	6.8%	\$ 201.8
Average Compounded				8.1%	
St Dev				7.9%	
Sum				7.1%	\$ 1,621.6

UTAM's Performance

Year	Pension Assets on Dec 31 \$ in Bil	Active UTAM returns	UTAM Pension Gain or Loss in \$ Mil
2000	\$ 2.27	5.2%	\$ 117.8
2001	\$ 2.15	-1.5%	-\$ 31.8
2002	\$ 1.91	-7.0%	-\$ 132.9
2003	\$ 2.11	15.9%	\$ 335.5
2004	\$ 2.31	11.4%	\$ 263.3
2005	\$ 2.58	12.3%	\$ 317.3
2006	\$ 2.87	12.1%	\$ 347.3
2007	\$ 2.99	6.0%	\$ 178.8
Average Compounded		6.8%	
St Dev		6.6%	
Sum		7.8%	\$ 1,395.3

Difference

Year	Pension Assets on Dec 31 \$ in Bil	Passive less UTAM in \$ Mil
2000	\$ 2.27	\$ 81.9
2001	\$ 2.15	-\$ 16.6
2002	\$ 1.91	\$ 97.6
2003	\$ 2.11	\$ 16.9
2004	\$ 2.31	-\$ 13.9
2005	\$ 2.58	\$ 77.4
2006	\$ 2.87	-\$ 40.2
2007	\$ 2.99	\$ 23.0
Sum		\$ 226.3

Answer: "The passive portfolio is about \$207 Million better than UTAM, over the 8 UTAM years, from 2000 to 2007, assuming a 0.10% MER for the passive costs."

Issue #4. **Intrinsic problems - with performance measurement - and with peer group Comparisons. They are not discussed. Nor are benchmark issues.**

The Arithmetic of Active Management

William F. Sharpe

Reprinted with permission from The Financial Analysts' Journal Vol. 47, No. 1, January/February 1991. pp. 7-9
Copyright, 1991, [Association for Investment Management and Research](#) Charlottesville, VA

"Today's fad is index funds that track the Standard and Poor's 500. True, the average soundly beat most stock funds over the past decade. But is this an eternal truth or a transitory one?"

"In small stocks, especially, you're probably better off with an active manager than buying the market."

"The case for passive management rests only on complex and unrealistic theories of equilibrium in capital markets."

"Any graduate of the ___ Business School should be able to beat an index fund over the course of a market cycle."

Statements such as these are made with alarming frequency by investment professionals¹. In some cases, subtle and sophisticated reasoning may be involved. More often (alas), the conclusions can only be justified by assuming that the laws of arithmetic have been suspended for the convenience of those who choose to pursue careers as active managers.

If "active" and "passive" management styles are defined in sensible ways, it *must* be the case that

(1) before costs, the return on the average actively managed dollar will equal the return on the average passively managed dollar and

(2) after costs, the return on the average actively managed dollar will be less than the return on the average passively managed dollar

These assertions will hold for *any* time period. Moreover, they depend *only* on the laws of addition, subtraction, multiplication and division. Nothing else is required.

Of course, certain definitions of the key terms are necessary. First a *market* must be selected -- the stocks in the S&P 500, for example, or a set of "small" stocks. Then each

investor who holds securities from the market must be classified as either *active* or *passive*.

- A *passive investor* always holds every security from the market, with each represented in the same manner as in the market. Thus if security X represents 3 per cent of the value of the securities in the market, a passive investor's portfolio will have 3 per cent of its value invested in X. Equivalently, a passive manager will hold the same percentage of the total outstanding amount of each security in the market².
- An *active investor* is one who is not passive. His or her portfolio will differ from that of the passive managers at some or all times. Because active managers usually act on perceptions of mispricing, and because such misperceptions change relatively frequently, such managers tend to trade fairly frequently -- hence the term "active."

Over any specified time period, the *market return* will be a weighted average of the returns on the securities within the market, using beginning market values as weights³. Each passive manager will obtain precisely the market return, before costs⁴. From this, it follows (as the night from the day) that the return on the average actively managed dollar *must* equal the market return. Why? Because the market return must equal a weighted average of the returns on the passive and active segments of the market. If the first two returns are the same, the third must be also.

This proves assertion number 1. Note that only simple principles of arithmetic were used in the process. To be sure, we have seriously belabored the obvious, but the ubiquity of statements such as those quoted earlier suggests that such labor is not in vain.

To prove assertion number 2, we need only rely on the fact that the costs of actively managing a given number of dollars will exceed those of passive management. Active managers must pay for more research and must pay more for trading. Security analysis (e.g. the graduates of prestigious business schools) must eat, and so must brokers, traders, specialists and other market-makers.

Because active and passive returns are equal before cost, and because active managers bear greater costs, it follows that the after-cost return from active management *must* be lower than that from passive management.

This proves assertion number 2. Once again, the proof is embarrassingly simple and uses only the most rudimentary notions of simple arithmetic.

Enough (lower) mathematics. Let's turn to the practical issues.

Why do sensible investment professionals continue to make statements that seemingly fly in the face of the simple and obvious relations we have described? How can presented evidence show active managers beating "the market" or "the index" or "passive managers"? Three reasons stand out⁵.

- First, the passive managers in question may not be truly passive (i.e., conform to our definition of the term). Some index fund managers "sample" the market of choice, rather than hold all the securities in market proportions. Some may even charge high enough fees to bring their total costs to equal or exceed those of active managers.
- Second, active managers may not fully represent the "non-passive" component of the market in question. For example, the set of active managers may exclude some active holders of securities within the market (e.g., individual investors). Many empirical analyses consider only "professional" or "institutional" active managers. It is, of course, possible for the average professionally or institutionally actively managed dollar to outperform the average passively managed dollar, after cost. For this to take place, however, the non-institutional, individual investors must be foolish enough to pay the added costs of the institutions' active management via inferior performance. Another example arises when the active managers hold securities from outside the market in question. For example, returns on equity mutual funds with cash holdings are often compared with returns on an all-equity index or index fund. In such comparisons, the funds are generally beaten badly by the index in up markets, but sometimes exceed index performance in down markets. Yet another example arises when the set of active managers excludes those who have gone out of business during the period in question. Because such managers are likely to have experienced especially poor returns, the resulting "survivorship bias" will tend to produce results that are better than those obtained by the average actively managed dollar.
- Third, and possibly most important in practice, the summary statistics for active managers may not truly represent the performance of the average actively managed *dollar*. To compute the latter, each manager's return should be weighted by the dollars he or she has under management at the beginning of the period. Some comparisons use a simple average of the performance of all managers (large and small); others use the performance of the median active manager. While the results of this kind of comparison are, in principle, unpredictable, certain empirical regularities persist. Perhaps most important, equity fund managers with smaller amounts of money tend to favor stocks with smaller outstanding values. Thus, *de facto*, an equally weighted average of active manager returns has a bias toward smaller-capitalization stocks vis-a-vis the market as a whole. As a result, the "average active manager" tends to be beaten badly in periods when small-capitalization stocks underperform large-capitalization stocks, but may exceed the market's performance in periods when small-capitalization stocks do well. In both cases, of course, the average actively managed *dollar* will underperform the market, net of costs.

To repeat: Properly measured, the average actively managed dollar must underperform the average passively managed dollar, net of costs. Empirical analyses that appear to refute this principle are guilty of improper measurement.

This need not be taken as a counsel of despair. It is perfectly possible for *some* active managers to beat their passive brethren, even after costs. Such managers must, of course, manage a minority share of the actively managed dollars within the market in question. It is also possible for an investor (such as a pension fund) to choose a set of

active managers that, collectively, provides a total return better than that of a passive alternative, even after costs. Not all the managers in the set have to beat their passive counterparts, only those managing a majority of the investor's actively managed funds.

An important corollary is the importance of appropriate *performance measurement*. "Peer group" comparisons are dangerous. Because the capitalization-weighted average performance of active managers will be inferior to that of a passive alternative, the former constitutes a poor measure for decision-making purposes. And because most peer-group averages are not capitalization-weighted, they are subject to additional biases. Moreover, investing equal amounts with many managers is not a practical alternative. Nor, *a fortiori*, is investing with the "median" manager (whose identity is not even known in advance).

The best way to measure a manager's performance is to compare his or her return with that of a *comparable passive alternative*. The latter -- often termed a "benchmark" or "normal portfolio" -- should be a feasible alternative identified *in advance* of the period over which performance is measured. Only when this type of measurement is in place can an active manager (or one who hires active managers) know whether he or she is in the minority of those who have beaten viable passive alternatives.

Footnotes

1. The first two quotations can be found in the September 3, 1990 issue of *Forbes*.
2. When computing such amounts, "cross-holdings" within the market should be netted out.
3. Events such as mergers, new listings and reinvestment of dividends that take place during the period require more complex calculations but do not affect the basic principles stated here. To keep things simple, we ignore them.
4. We assume here that passive managers purchase their securities before the beginning of the period in question and do not sell them until after the period ends. When passive managers do buy or sell, they may have to trade with active managers, because of the active managers' willingness to provide desired liquidity (at a price).
5. There are others, such as differential treatment of dividend reinvestment, mergers and acquisitions, but they are typically of less importance.

Note added by George Luste (UTFA) about the author:

William F. Sharpe is Emeritus Professor of Economics at Stanford University. In 1990 He co-shared the Nobel Prize in Economics with Harry M. Markowitz and Merton H. Miller "for their pioneering work in the theory of financial economics."

See http://nobelprize.org/nobel_prizes/economics/laureates/1990/

His more recent articles on the topic of post-retirement economics can be found at <http://www.stanford.edu/~wfs Sharpe/retecon/index.html>

from <http://www.ft.com/cms/s/0/c8941ad4-f503-11dc-a21b-000077b07658.html>

Why today's hedge fund industry may not survive

By Martin Wolf,

Financial Times, published: March 18 2008



Hardly a week goes by without the implosion of a hedge fund. Last week [it was Carlyle Capital](#), with an astonishing \$31 of debt for each dollar of equity. But we should not be surprised. These collapses are inherent in the hedge-fund model. It is even conceivable that this model will join securitised subprime mortgages on the scrap heap.

Getting away with producing adulterated milk is hard; getting away with an investment strategy that adds no value is not. That was the point made by John Kay, in a [superb column last week](#) (this page, March 11). With the “right” fee structure mediocre investment managers may become rich as they ensure that their investors cease to remain so.

Two distinguished academics, Dean Foster at the Wharton School of the University of Pennsylvania and Peyton Young of Oxford university and the Brookings Institution, explain the point beautifully*. They start by asking us to consider a rare event – that the stock market will fall by 20 per cent over the next 12 months, for example. They assume, too, that the options market prices this risk correctly, say at one in 10. An option costs \$0.1 and pays out \$1.

Now imagine that we set up a hedge fund with \$100m from investors on the normal terms of 2 per cent management fees and 20 per cent of the return above a benchmark. We put our \$100m in Treasury bills yielding 4 per cent. We also sell 100m covered

options on the event, which nets us \$10m. We put this \$10m, too, in Treasury bills, which allows us to sell another 10m options. This nets another \$1m. Then we go on holiday.

There is a 90 per cent chance that this bet will pay off in the first year. The fund then grosses \$11m on the sale of the options, plus 4 per cent interest on the \$110m in Treasury bills, for a handsome 15.4 per cent return. Our investors are delighted. Assume our benchmark was 4 per cent. We then earn \$2m in management fees, plus 20 per cent of \$11.4m, which amounts to over \$4m gross. Whatever subsequently happens, we need never give this money back.

The chances are nearly 60 per cent that the bad event will not occur over five years. Since the fund is compounding at a rate of 11.4 per cent a year after fees, we will make well over \$20m even if no new money is attracted into this apparently stellar enterprise. In the long run, however, the bad event is highly likely to occur. Since we have made huge profits, our investors have paid us handsomely for the near certainty of losing them money.

The immediate response may be that so naked a scam is inconceivable. Well, imagine a fund that leverages investors' money by borrowing massively in short-term money markets in order to purchase higher-yielding paper. Assume, again, that the premium gives a correct estimate of the risk. With sufficient leverage, this fund, too, is likely to make profits for years. But it is also very likely to be wiped out, at some point. Does this strategy sound familiar? It certainly should by now.

We can identify two huge problems to be solved. First, many investment strategies have the characteristics of a "Taleb distribution", after Nicholas Taleb, author of *Fooled by Randomness*. At its simplest, a Taleb distribution has a high probability of a modest gain and a low probability of huge losses in any period.

Second, the systems of reward fail to align the interests of managers with those of investors. As a result, the former have an incentive to exploit such distributions for their own benefit.

Professors Foster and Young argue that it is extremely hard to resolve these difficulties. It is particularly difficult to know whether a manager is skilful rather than lucky. In their telling example, the chances are more than 10 per cent that the fund will run for 20 years without being exposed. In other words, even after 20 years the outside investor cannot be confident that the results were not being generated by luck or a scam.

It is also tricky to align the interests of managers with those of investors. Obvious possibilities include rewarding managers on the basis of final returns, forcing them to hold a sizeable equity stake or levying penalties for underperformance.

None of these solutions solves the problem of distinguishing luck from skill. The first also encourages managers to take sizeable risks when they are close to the return at which payouts begin. Managers can evade the effects of the second alternative by taking positions in derivatives, which may be hard to police. Finally, even under the apparently

attractive final alternative it appears that any clawback contract harsh enough to keep unskilled managers away will also discourage skilled ones.

It is obviously best not to pay the manager, as a manager, at all, but rather to invest alongside him, as at [Berkshire Hathaway](#), Warren Buffett's investment company. But we still have the challenge of knowing whether the manager is any good. We know this today of Mr Buffett. Fifty years ago, that would have been very hard to know.

What we have then is a huge "lemons" problem: in this business it is really hard to distinguish talented managers from untalented ones. For this reason, the business is bound to attract the unscrupulous and unskilled, just as such people are attracted to dealing in used cars (which was the original example of a market in lemons). The lemons theorem states that such markets are likely to disappear. The same may happen to today's hedge-fund industry.

Now consider the financial sector as a whole: it is, again, hard either to distinguish skill from luck or to align the interests of management, staff, shareholders and the public. It is in the interests of insiders to game the system by exploiting the returns from higher probability events. This means that businesses will suddenly blow up when the low probability disaster occurs, as happened spectacularly at Northern Rock and Bear Stearns.

Moreover, if these unfavourable events – stock market crashes, mortgage failures, liquidity freezes – come in stampeding herds (because so many managers copy one another), they will say: "Nobody could have expected this, but, now that it has happened to all of us the government must come to the rescue."

The more one believes this is how an unregulated financial system operates, the more worried one has to become. Rescue from this crisis may be on the way, but what about next time and the time after next?

*[Hedge Fund Wizards](#), and [The Hedge Fund Game](#), January 2008

martin.wolf@ft.com

More columns at www.ft.com/martinwolf

Note added by George Luste (UTFA) - about the author --

Martin Wolf is associate editor and chief economics commentator at the Financial Times. He was awarded the CBE (Commander of the British Empire) in 2000 for services to financial journalism. He was made a Doctor of Letters, *honoris causa*, by the University of Nottingham in July 2006 and a Doctor of Science (Economics) of London University, *honoris causa*, by the London School of Economics in December 2006.

Martin Wolf was joint winner of the Wincott Foundation senior prize for excellence in financial journalism in both 1989 and 1997, and won the RTZ David Watt memorial prize in 1994. He was the winner of the 2003 Business Journalist of the Year Decade of Excellence Award. He has been a forum fellow at the annual meeting of the World Economic Forum since 1999. He won the Newspaper Feature of the Year Award at the Workworld Media Awards in 2003. He is the author of *Why Globalization Works* (Yale University Press, 2004).

from http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aPM_46b_7s3k

Hedge Funds Come Unstuck on Truth-Twisting, Lies:

Commentary by Matthew Lynn, Bloomberg News columnist

April 9 (Bloomberg)

Has the hedge-fund industry been built on a series of lies?

For the past decade, its explosive growth has been based on a simple claim: that skilled money managers, motivated by high performance fees, could outperform the market when it was going up -- and sidestep the trouble when it was going down.

And yet the credit crunch has shown that to be a myth. Although a few hedge-fund managers have done brilliantly, far more have come unstuck.

Now it looks as if the industry might be based on a more systematic falsehood. Two recent academic studies suggest that hedge funds have been routinely dishonest, or at least economical with the truth.

If that's right, then it is worrying for alternative-asset managers. As the idea gets out that hedge funds can't deliver the kind of guaranteed returns they promised, a lot of money is heading for the door marked exit.

There is no questioning the gloom surrounding a once-booming industry. Almost every day brings news of another fund stumbling. More than a dozen big hedge funds have shut up shop, frozen redemptions or been forced to find outside capital this year as markets turned volatile.

Peloton Partners LLP liquidated its largest fund after making bets on mortgage securities that turned sour, while JWM Partners LLC, run by former Long-Term Capital Management LP chief [John Meriwether](#), was hurt by swings in Japanese government bonds. Overall, hedge funds turned in their worst quarterly performance in six years, according to Chicago-based Hedge Fund Research.

Distorted Returns

Everyone knows that the markets go down as well as up. There isn't any investment that makes money every year. The hedge funds were bound to go through a bad patch. But what if the funds have been distorting the truth?

[Veronika Krepely Pool](#), assistant professor of finance at Indiana University in Bloomington, Indiana, and [Nicolas Bollen](#), associate professor of finance at Vanderbilt University in Nashville, Tennessee, [examined](#) how hedge funds reported to their

investors over several years. Although the funds often scored a gain of 1 percent a month, they rarely reported a loss of the same amount.

“We estimate that approximately 10 percent of returns in the database we use are distorted,” they concluded. “This suggests that misreporting returns is a widespread phenomenon.”

Of course, you can understand why that might be happening. It's embarrassing to own up to losing money when you have promised investors you will make a profit. The difference between losing 0.1 percent and making 0.1 percent might not add up to much in money terms. Yet in terms of presentation it can be crucial. You might excuse that as a small lie. The trouble with small lies, however, is that they lead to bigger ones.

‘Outright Con Artists’

A [report](#) from Wharton School of the University of Pennsylvania suggests dishonesty on a greater scale. Statistics Professor [Dean Foster](#) and Brookings Institution Senior Fellow [H. Peyton Young](#) said it is easy for hedge funds to start up and make money without having any real investment skills.

“It is very hard to set up an incentive structure that rewards skilled hedge-fund managers without at the same time rewarding unskilled managers and outright con artists,” they said in a paper called “The Hedge Fund Game.”

So how is it done? They say you can just replicate an investment strategy devised elsewhere, take big positions, and collect enormous performance fees until the whole thing blows up. By then, you will already have pocketed plenty of money, and you won't have to pay any of it back if the fund goes bust.

“It is extremely difficult to detect, from a fund's track record, whether a manager is actually able to deliver excess returns, is merely lucky, or is an outright con artist,” they said.

Raw Deal

There is nothing about those conclusions that will surprise anyone who has followed the hedge-fund industry. The deal was that in return for high fees, which in effect gave the managers a stake in the fund, investors would get above-average returns.

Yet, it appears many funds have just been relying on a rising market and sitting back and collecting 20 percent -- the typical performance fee on a hedge fund -- of the profits.

The conclusion? The promise on which the industry was built looks to be largely a false one.

If investors start to question the hedge funds' ability to produce consistently superior returns, they will start to exit the industry in droves -- and rightly so.

The hedge funds need to start tightening up their reporting procedures. Massaging your results to make your performance look better isn't acceptable.

More important, they need to re-examine their strategies to see if they are genuinely beating the market -- because if they aren't, they should hand their money back to investors.

([Matthew Lynn](#) is a Bloomberg News columnist. The opinions expressed are his own.)

To contact the writer of this column: Matthew Lynn in London at matthewlynn@bloomberg.net.

Last Updated: April 8, 2008 19:02 EDT

Note added by George Luste (UTFA) about Bloomberg L.P. –

Bloomberg L.P. was the world's largest financial news and data company with 33% of international market share until the merger of its competitors Thomson Financial and Reuters into Thomson Reuters on 17 April 2008 (with 34% of the market). In addition to the Bloomberg Terminal service, it includes a global news service, including television, radio, the Internet and publications.