"Hedge Fund" has become a catch phrase for smart-money investing – the sort of unusual and sexy investing that only the very rich get to exploit.

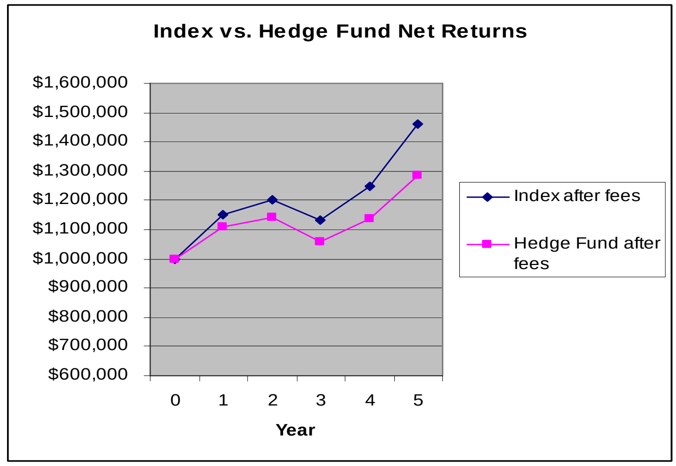
There's some truth in the aura of hedge funds, private investment pools that can use options and futures and buy and sell short securities. Only clients with $1 million or more (soon to be $2.5 million) can invest. Many of the smartest minds in finance work in the field.

As an investor, remember two things: 1) The smartest minds in finance typically make sure that they draw excellent pay; 2) As many less-than-unusual financial minds also have set up as hedge funds, your odds of finding a winner are low.

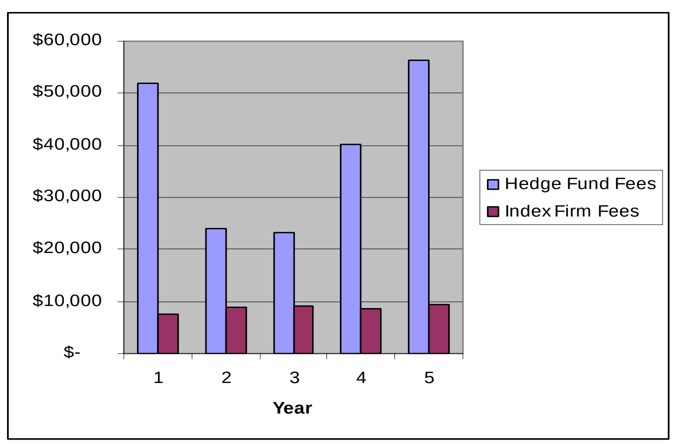
A typical hedge fund fee setup is known as 2 and 20. You pay two percent of your invested assets each year ($20,000 a year on a $1 million investment). The juice is in the 20: Hedge funds take 20% of fund profits each year.

Now that Hedge Funds as a group manage more than $1.4 trillion, it is hard for them to claim more than average performance as a group. After taking into account returns of hedge funds that have failed and a tendency for some funds to backfill favorable past performance, financial researcher Burton Malkiel concluded in a recent paper: "Investors in hedge funds take on a substantial risk of selecting a dismally performing fund or, worse, a failing one."[1]

Imagine a hedge fund that pulls in a gross return equal each year for five years to a basket of stock market indexes that return 16%, 5%, -5%, 11% and 18% over the five years. Compare the returns for an investor after fees charged by the index firm and fees charged by the hedge fund:



Why the disparity over a short period? The juice is in the performance fees – for the hedge fund manager. Even a fund that outperforms the index by four percentage points in many years comes out behind. Hedge Funds can make good money, but most of it goes to the fund manager rather than the investor.



[1] "Hedge Funds: Risk and Return," Burton G. Malkiel and Atanu Saha, *Financial Analysts Journal*, Volume 61, Number 6.