

# Hedge funds: Are the huge profits real or an illusion?

Whether you own a hedge fund or are contemplating investing in one, we would advise that you fully understand the benefits as well as the pitfalls of this type of investing.

Hedge funds became popular when their returns shined during the market collapse at the beginning of the millennium. Unlike stock and bond investments, which will typically follow the direction of their respective markets, hedge funds attempt to provide an absolute return. This means that hedge funds attempt to make a profit in up or down stock and bond markets.

## Take-aways

- Hedge fund K-1s may be misleading.
- Taxes, management and incentive fees can erode 60 percent of your hedge fund income.
- Accredited and affluent investors must know the solutions to the pitfalls of hedge funds.

be very beneficial to reducing volatility. But, just as you wouldn't cash out \$1 million from your \$3 million portfolio to bet on a race horse that has won 20 races straight, we would argue that even if a hedge fund has a tremendous track record, it doesn't mean that we put all of our eggs in one or even two or three baskets of hedge funds.

Although the portfolio diversification benefits of adding hedge funds to a traditional investment portfolio can be significant, perhaps the most serious challenge facing investors who invest in hedge funds either directly or through a hedge fund of funds approach is the inherent tax inefficiency.

For instance, many hedge funds utilize short selling. In a short sale, the interest the investor earns on the short sale proceeds is treated as interest income. Any gain on a short position, no matter how long the short position is held open, is treated as short-term capital

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gain and therefore taxed at your highest ordinary income tax bracket.

Unlike mutual funds, which make cash distributions of their gains, hedge funds send no money. Instead, they deliver a K-1 statement detailing the taxable income on which an investor must pay taxes. Even worse, many investors in funds of funds (as well as some hedge funds) often wind up paying taxes on more profit than their investment actually earned. How does that happen?

Before flowing through on a K-1, hedge fund expenses are not netted against income. Rather, the gross return is taxable to the investor with the management and performance fees shown separately as miscellaneous deductions to the investor. Many accredited/affluent taxpayers cannot deduct miscellaneous itemized deductions because that type of deduction must exceed two percent of adjusted gross income to indeed be a deduction. Investors subject to the alternative minimum tax also can be disadvantaged by this outcome.

As an example, an investor who owns a hedge fund with a \$110,000 gross return and \$20,000 in total management fees is left with a K-1 showing a \$110,000 taxable income flowing through on their 1040 when all the

investor realized was \$90,000.

There is a good reason hedge funds are typically offered to accredited investors (typically those with a net worth exceeding \$1 million). As an accredited investor you are expected to understand the full extent of the risks being taken as well as the consequences of taxes, management and incentive fees to your pocketed returns.

It is ultimately up to each of us to fully understand our financial picture before we can discern if an investment is a good one or not. The responsibility of ensuring that the IRS and your hedge fund don't end up with the lion's share of the profits is up to you, the investor.

Management fees are another potential pitfall. Let us assume a distressed debt fund charges a 2 percent management fee and then charges another 20 percent performance fee on the remaining profits. If this fund had a gross return of 15 percent, the net return to the investor would be 10.4 percent. Many hedge funds take the position that they are traders and that these management and performance fees are incurred in their business and deductible under Section 162. Thus the entity's form K-1 reflects only taxable income of 10.4 percent.

But, if the IRS took the position that the fund was an "investor" and not a "trader," then the K-1 would reflect an investment income of 15 percent and 4.6 percent in miscellaneous itemized deductions. If investors were not able to use those deductions, they would pay tax on 15 percent even though they only earned 10.4 percent. So what was thought to be a 10.4 percent pre-tax return, and thus a 6.76 percent after-tax return, is actually only 5.15 percent after-taxes. These calculations use a 35 percent federal tax rate and don't include state taxes.

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