The Yin and Yang of Change: The Compelling Case for Changing Hedge Fund Due Diligence

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Impermanence is eternal. Buddha

Why is it that we will wait in line for hours to lay out hundreds of dollars on the latest gadget, yet we won't spend a minute to improve investment decisions entailing many $thousands? The difference is emotional versus rational. We want to have fun and to show off our latest toys. By contrast, investing is cerebral and can make our hair hurt. Never mind that investing helps us afford the fun stuff.

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Behavioral scientists tell us that we are all hard-wired to resist rational change because we suffer from the following biases, the "yin":

- **Attachment Bias**: Holding onto an approach for emotional reasons, such as "we've always done it this way"
- **Cognitive Dissonance**: The challenge of reconciling two opposing beliefs
- **Confirmation Bias**: The natural tendency to accept any information that confirms our preconceived position and to disregard any information that doesn't support this position
- **Overconfidence**: Works with confirmation bias to place too much emphasis on one's own abilities.
- **Status Quo Bias**: The tendency to do nothing even when action is in order.

On the other hand, the benefits of improvement are expressed in the following "yang":

- **Disruptive Innovation:** Our lives are made better by gradual replacement of everyday products with even better products. This idea was introduced by Clayton Christensen, who calls it the "technology mudslide hypothesis." Examples include post-it notes and staplers.

- **Planned Abandonment:** Management guru Peter Drucker taught his clients that "*Planned, purposeful abandonment of the old and of the unrewarding is a prerequisite to successful pursuit of the new and highly promising*." Drucker's clients agreed to think as much about what they should be doing as to what they should stop doing. In other words, abandon the old adage "*If it ain't broke, don't fix it*."

Changing Hedge Fund Due Diligence

Advancement in hedge fund due diligence is an example of an important change that is still waiting to happen. It's no secret that hedge fund due diligence remains in the dark ages. See for example [Surz, 2005].

Advocates of change preach "change talk", the language of overcoming the "yin" of change. We need to hear and understand the disadvantages of the ***status quo***, and to appreciate the benefits of a new improved future. Most importantly, people need to listen, so the message should be entertaining. That's why we produced a short video on the Future of Hedge Fund Due Diligence and Fees to reframe our thinking.

In the future we won't pay much for hedge fund exotic betas (risk profiles). We'll pay for superior human intellect instead. We'll know the difference because we'll abandon simpleminded performance benchmarks like peer groups and indexes, and replace them with smart science. Disruptive innovation will elevate our comprehension and contentment. Everybody will win.

Hedge funds are unique. That's their main attraction. The definition of unique is "without peers," so we cannot group unique. "Unique" and "peer" do not play well together. Hedge fund managers win or lose against peer groups because they are different rather than because they are better or worse.

It's this uniqueness (heterogeneity) that will lead us in the future to the science of evaluating hedge funds. Hypothesis testing and cyberclones will revolutionize due diligence. No one wants or needs to pay for exotic betas because they can be reverse engineered (replicated), but everyone is willing to pay for that critical factor they can't synthesize, namely superior human intelligence and wisdom that engender profitable decisions. We'll pay for brainwork, and we'll pay a fair price. Who says "2 and 20" is the right price?

Reference

Surz, Ronald J. "Testing the Hypothesis "Hedge Fund Performance is Good"." ***The Journal of Wealth Management***, Spring 2005, pages 78-83.