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Taking a shot with hedge funds (and paying plenty for it)

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Hedge funds used to be reserved for the yacht club crowd -- those who could invest at least $1 million. But these investments are now opening up to the merely affluent, those with $25,000 to invest.

Whether these investors should take the bait is another question.

Hedge funds are investment pools that are lightly regulated and take more risks than mutual funds. Their managers often sell stocks short, use borrowed money and take large positions in stocks, all in hopes of beating the market.

Because they're fairly risky, they're traditionally open only to wealthy (and presumably sophisticated) individuals, as well as institutional investors such as pension funds and university endowment funds. But several brokerage companies are offering mutual funds that invest in a collection of hedge funds. These so-called ``funds of funds'' have lower minimum investments, often about $25,000.

The appeal to investors is the hope of getting better returns than the stock market as a whole over long periods. ``Some of the best and brightest people (manage) hedge funds,'' said Kurt Schacht, an executive with the CFA Institute, which credentials financial analysts.

As a result, the industry has grown to an estimated $1.1 trillion from about $120 billion a decade ago, according to the Managed Funds Association, which represents hedge funds.

The funds that invest in hedge funds say they offer investors a diverse mix and the

professional know-how to pick the best ones.

But there are plenty of uncertainties connected to investing in hedge funds. In fact, the Securities and Exchange Commission recently warned investors about the downside.

For one thing, they have significant annual fees -- 1 percent to 2 percent of assets, plus a manager's bonus of 20 percent of the fund's yearly profits. In addition, the hedge funds lock up an investor's money so that shareholders can only get their investment out at certain times of the year.

If you invest through a fund of funds, the SEC warned, ``you will pay two layers of fees'' -- one for the underlying hedge fund and one for the fund of funds.

And because of the risks they take, hedge funds can fail in dramatic flameouts. Remember Long-Term Capital Management, the hedge fund that needed a $3.6 billion bank bailout in 1998?

Advocates of hedge funds say these issues pale next to hedge funds' performance. According to the CSFB/Tremont Hedge Fund Index, hedge funds have tripled in value over the past decade. While the Dow has almost tripled in that period -- from 3,754 to about 10,900 -- hedge funds still come out ahead.

But Burton Malkiel, a renowned Princeton economist and investment expert, said recently that hedge funds may not be as lucrative as they look, because hedge fund indexes don't count the funds that collapse and shut their doors.

``If you want to get a feeling of how hedge funds have done, you also need to look at dead funds. From the standpoint of the performance of the industry, you have to look at the whole industry,'' Malkiel said in a recent speech, according to the Reuters news agency.

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