June 2025

Two from WSJ:

These Funds Are Yield Magicians. How Do They Do It?

New funds offer huge payouts, but harbor even bigger risks

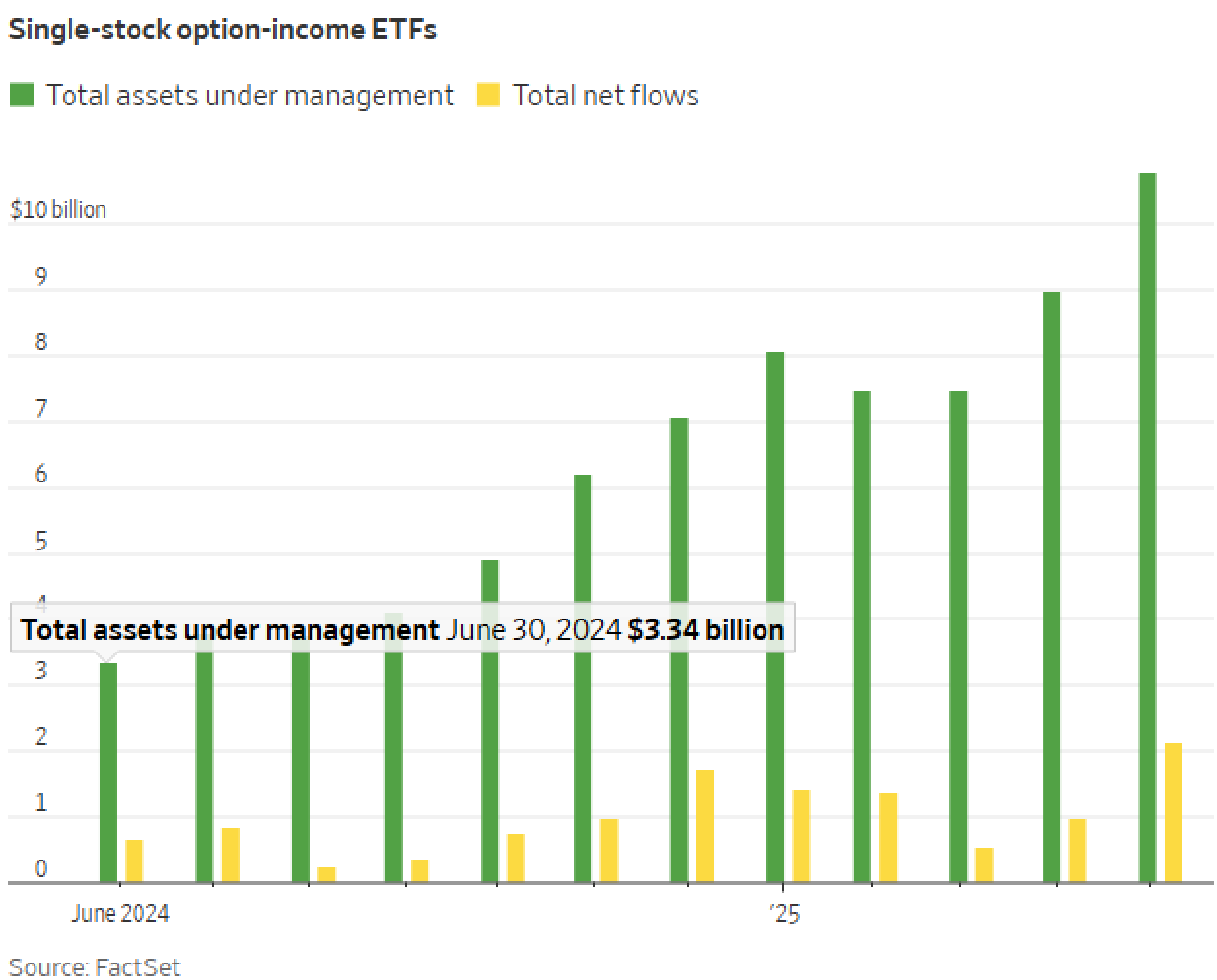
By Jason Zweig
June 27, 2025

The dividend yield on the S&P 500 is 1.3%. As if by magic, nearly a dozen exchange-traded funds were offering payouts of at least 100% this week.

This implies that for every $100 you invest, you might expect to earn more than $100 in yearly income. Several of these ETFs boasted yields of 130% to 230%.

These funds generate high weekly or monthly income by trading options contracts on a single stock. Such option-income funds have been wildly popular this year, attracting more than $6.4 billion in new money, according to FactSet.

Is such high income also highly risky? You might as well ask if the pope is Catholic.



Many of these ETFs are tied to such volatile stocks as Coinbase, MicroStrategy, Nvidia or Tesla. Often, much of the "yield" is just your own money handed back to you, and the principal value of your investment could shrivel.

"It's risky enough to go into a single volatile stock," says Elisabeth Kashner, director of global fund analytics at FactSet, "but then you're gearing it up with additional layers of risk."

I suspect many buyers don't fully understand what they're getting themselves into. Regulatory filings indicate that at least 95% of some of these ETFs are held by individual investors or small financial advisers.

By selling options, most of these funds trade away some of a stock's future upside to earn higher income now. Often, they keep much of the downside. In most cases, when the stock goes up, these ETFs won't do nearly as well; when it goes down, the funds will do a little less badly.

Neena Mishra, director of ETF research at Zacks Investment Research, points out that the total returns of eight of these funds have trailed the underlying stock by at least 50 percentage points cumulatively since inception, with four of them behind by more than 100 percentage points.

Nor can the ultrahigh income protect you from loss. The YieldMax option-income ETF tied to Moderna fell more than 80% from May 2024 to May 2025; the YieldMax fund linked to Super Micro Computer lost nearly 58% in less than three weeks last fall. To be fair, each lost slightly less than the underlying stock.

What's more, you can't assume the huge reported yields will last. They're based on taking the ETF's payout in the most recent month, multiplying it by 12 and dividing by the fund's net asset value. That distribution rate can vary enormously as the underlying asset shoots up and down.

At a few of these ETFs, the options trading isn't tied directly to a given stock, but rather to another ETF that amplifies the returns of that stock.

One firm, GraniteShares, uses such leveraged funds, which seek to double the daily return of stocks like Nvidia and Tesla, as the raw material for some of its own option-income ETFs.

Some funds seek to limit potential losses using their options trades. At others, the share price has already fallen sharply, even though none yet have a three-year track record.

A YieldMax prospectus warns: "The repeated payment of distributions…may significantly erode the fund's [value] and trading price over time. As a result, an investor may suffer significant losses to their investment."

Take the YieldMax TSLA Option Income Strategy ETF, which sells options on Tesla stock. Its distribution rate, or implied yield, was 62.8% this week.

The fund launched in November 2022 at a split-adjusted $40 per share. It traded this week under $8.50—roughly an 80% decline even though Tesla's stock is up nearly 70% over the same period.

After all those huge payouts, the fund's total return has averaged only a bit above 7% annually—a small reward for its giant swings in price along the way.

Where did the rest of the ETF's value go? It was shaved down in monthly installments, handing shareholders their own money back as a return of capital.

Jay Pestrichelli, portfolio manager for YieldMax, wasn't available to comment, but he told me last year, "people should realize that something at a 70% yield should be riskier than something at 5%."

Income is normally associated with safety, but that isn't the case here.

"The higher the yield you're generating, the higher the risk you're taking with the principal," says Will Rhind, chief executive of GraniteShares, which offers several option-income funds. "Can you get a 150% annualized yield with no downside? There's no free lunch in this world."

When a fund sells options on, say, a double-leveraged Tesla ETF, you get roughly twice the income you'd get from selling options on Tesla's own stock, says Rhind. But, he adds, "you're also taking more risk because those options are more volatile than the [Tesla] stock itself."

Piling risk in this many layers for individual investors is reminiscent of funds that rolled out right before the crash of 1929. Led by Goldman Sachs, firms built "pyramids" in which one fund bought another inside yet another, with leverage at each level.

One reader in Wisconsin recently emailed me that he has made a small investment in an option-income ETF with a recent distribution rate of about 60%. He asked: "So what am I missing here?"

The best answer is an old maxim: You should be more concerned about the return *of* your money than the return *on* your money.

Funds Promising Shelter From Wild Swings Are Booming. But Do They Deliver?

Investors have poured $56 billion into so-called equity hedged funds and ETFs

By Gunjan Banerji
June 1, 2025

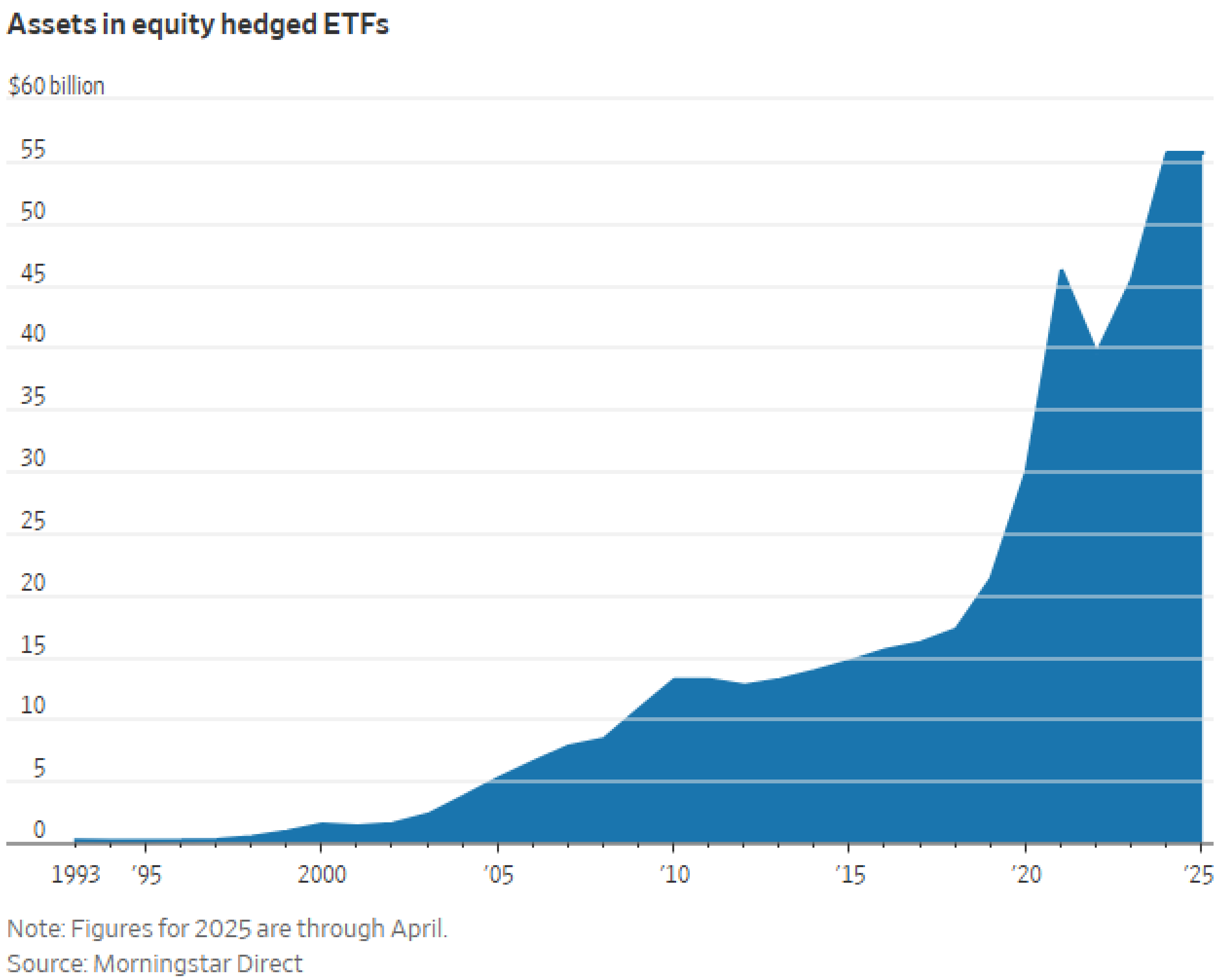
Americans have poured money into funds promising shelter from the stock market's wild swings. They don't always work as expected.

Assets under management for so-called equity hedged exchange-traded and mutual funds tracked by Morningstar have surged to $56 billion this year, roughly double the figure just five years ago. More than two dozen have launched since the start of 2024.

Wall Street advertises them as protection against scary times in markets, kind of like stock insurance. But between high fees and complicated strategies, some haven't delivered as well lately as just staying invested and compounding returns.

AQR Capital Management analyzed a slice of equity hedged funds with at least five years of performance and found the majority failed to deliver either better returns or less severe drawdowns than a portfolio of stocks and cash.

Here's what you should know before wading in:



How they work

The funds tap a variety of strategies to buffer against big market declines, and there are more than 100 funds in the Morningstar category tracking the investments. Many involve options, which are contracts giving investors the right to buy or sell stocks at a specific price, by a stated date.

For example, an investor might buy a "put option" that gives the right to sell shares of Tesla at the price of $330, a roughly 5% drop. If the stock drops to $320, owning the put means that investors can still cash out at the higher level.

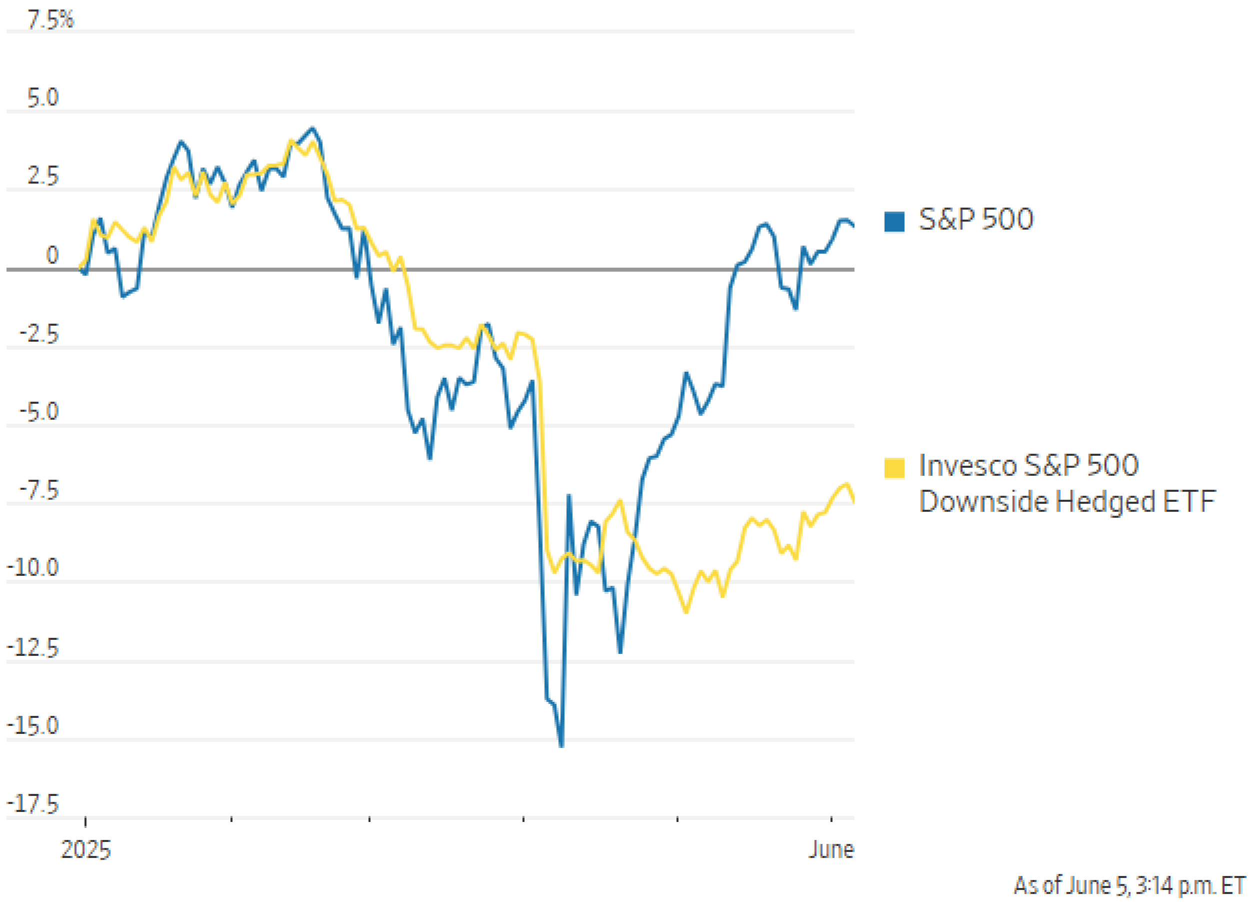
Some claim to provide protection from declines in the S&P 500 or Nasdaq-100 indexes, while others trade in the futures market. Some get even more complicated.

The cost

Many of the funds are pricier than plain vanilla index funds tracking stocks. Around half of hedged funds tracked by Morningstar have expense ratios of more than 1 percentage point—or $100 annually on a $10,000 investment. To compare, a popular exchange-traded fund tracking the tech-heavy Nasdaq has fees of around one-fifth of a percentage point, about $20 on a $10,000 investment.

Ups and downs

ETF and index performance



Source: FactSet

Some funds have struggled this year, underscoring how tricky it can be to profit from the market's wild gyrations.

The Invesco S&P 500 Downside Hedged ETF, for example, has around $100 million in assets and uses complex bets on market volatility to achieve "positive total returns in rising or falling markets," according to its prospectus. The fund is down almost 8% this year, far worse than the 0.5% rise for the S&P 500.

Others have done better. The JPMorgan Hedged Equity Fund, one of the category's behemoths, with more than $20 billion in assets, was down 11% at the S&P 500's low for the year, better than the index's 15% decline. Hamilton Reiner, the fund's portfolio manager, said that helped keep people invested during a haywire stretch.

The challenges

Hedges are costly, and options' regular expiration requires fund managers to pay up repeatedly, chipping away at returns, AQR found. Meanwhile, the protection is often weaker than simply reducing your stockholdings.

AQR's Cliff Asness and Daniel Villalon said that investors looking to take less risk in markets would be better off simply keeping more of their portfolios in cash.

For example, they said 78% of these funds tied to options fared worse during this year's steep market decline than a portfolio of stocks and cash, according to an analysis through April. ...

Follow-ups

Two from the WSJ's Jason Zweig. The first on June 11th:

2025, Meet 1968

Last year, my colleague Jon Weil wrote brilliantly about the habit some private-equity funds have of reporting returns of 1,000% or more in a single day. In my latest column, “The Future Ain’t What It Used to Be for These Funds," (see below) I looked at a recent fee change at one such portfolio, Hamilton Lane Private Assets Fund.

The fees are based on the fund’s net assets, of course—and the net asset value is based on whatever the fund’s managers say the holdings are worth.

Can the managers buy assets at a discount and immediately mark them up, enabling them to charge higher fees? You bet!

Fund managers have played this game before, and it didn’t work out well for investors.

Back in the late 1960s, a popular technique was the “investment letter” or “letter stock,” in which publicly traded companies sold unregistered, private stock to a mutual fund at a discount to the market price, accompanied by a letter stating that the fund wouldn't trade the shares anytime soon.

The fund would then mark the nontraded letter stock up to, or near, the market price of the company's publicly traded shares.

Here's part of what Jon wrote last year about what private-equity funds can do now:

In many cases, [the funds] quickly mark up the stakes they acquire to the official value, no matter how little they paid for them....The investment funds that mark up their acquisitions benefit from instant gains, which increase assets and boost fees. Strong performance numbers draw in new investors.

Now look at what The Wall Street Journal noted 56 years ago:

Letter stock essentially is unregistered or restricted stock. It can't be traded publicly, but can be sold in certain private transactions that are exempt from SEC registration requirements. The securities are called letter stock because a purchaser usually signs a letter saying that he is buying the stock for investment purposes, not for public resale in the foreseeable future.

The SEC has become increasingly concerned about the burgeoning market for letter stock, especially among fast-growing mutual funds. Its primary concern is a practice among some funds of buying the stock at discount prices and immediately revaluing it upward in their portfolio, a maneuver that increases a fund's asset value per share and, in turn, enhances its position in the important mutual fund performance ratings.

The Wall Street Journal, April 25, 1969, p. 9.

It’s deja vu all over again!

In his 1969 book “New Breed on Wall Street,” the journalist Martin Mayer wrote:

…a young [fund manager] who should have known better was talking recently about some letter stock from a company trading over-the-counter at $21 a share, which had sold [his fund] unregistered shares at $6 a share. “We want to be conservative,” the young man said, looking out of the corners of his eyes, “so we’re carrying it on our books at a 10% discount—i.e., at $18.90 a share.

The difference between the fund’s purchase price of $6 and $18.90 would have been treated as an instantaneous unrealized gain, boosting the fund’s reported return—and the asset base on which it could charge fees.

This valuation gimmick was so popular that one fund even named itself Fund of Letters. The SEC estimated that funds held $4.2 billion in letter stock as of the end of 1968, or something like $79 billion in today’s dollars.

This game ended when the Mates Investment Fund, run by the charismatic Fred Mates, paid a combined $3.6 million for nontraded letter stock issued by six companies and then marked them up to $7.2 million. Mates paid $3.25 a share for one private holding, Omega Equities; its publicly traded shares were then priced at about $24, so Mates discounted that by one-third for the lack of tradability, valuing its Omega shares at $16 per share.

“It will be noted that this was almost five times what [Mates] had just paid for them,” the business journalist John Brooks wrote. “With no change in the market price of Omega stock…the Mates fund had made…an investment yielding an instant profit.” By early December 1968, the fund was up an astonishing 168% for the year.

As the SEC later noted:

unrestricted shares. As of November 26, 1968, the six issues of restricted securities were carried in Fund's portfolio at a value of $13,459,000, more than $10,000,000 in excess of their cost. As of that date, more than $10,800,000 of the more than $13,600,000 of indicated unrealized appreciation on all securities in Fund's portfolio represented indicated appreciation in restricted securities on the basis of the valuation procedures used by Mates.

March 9, 1970.

At the end of 1968, the music stopped. Omega Equities collapsed amid allegations of fraud. Mates's investors asked for their money back, but Mates couldn't immediately give it to them because the SEC had suspended Omega's stock from trading. Mates marked his Omega shares back down to $3.25, and his fund fell from the pinnacle of performance to the bottom.

Suddenly, all letter stocks—and every fund that owned them—were suspect. Investors lost billions of dollars at a time when billions were real money. The SEC cracked down, stating:

…the practice of automatically amortizing the discount over an arbitrarily chosen period creates the appearance of an appreciation in the value of the securities which has not, in fact, occurred, and, accordingly, is improper.

After that, the practice disappeared for decades.

Will a similar fate befall today's funds whose valuation procedures aren't so different from those of a half-century ago?

As the letter-stock saga shows, fund managers are not magicians. When it seems as if they are, that's a signal that their claims might not hold water.

The Future Ain't What It Used to Be for These Funds

Wall Street wants to sell more 'alternative' assets to small investors. The glory days for these assets may already be ending.

By Jason Zweig
June 6, 2025

With their words, the managers of private assets are telling investors that the best is yet to come. With their actions, they're suggesting the glory days already may be ending.

Giant firms like Apollo, BlackRock, Blackstone, Capital Group, KKR, State Street and Vanguard Group are all rushing to get individual investors to buy "alternatives," including hedge funds, venture capital, and nontraded debt, equity and real estate.

What you'll hear from them is that private assets are less risky than publicly traded stocks and bonds. What's more, such firms claim that "democratizing" alternatives will bring these previously exclusive investments within the reach of almost any investor.

To see why you should weigh their actions as well as their words, look at what recently happened at Hamilton Lane Private Assets Fund.

With $3.6 billion in net assets at the end of March, this fund is a fast-growing player in the game of buying chunks of private-equity funds in the secondary market. In the first quarter, the Hamilton Lane fund took in an average of more than $4 million a day of new money from investors.

That's thanks largely to its remarkable performance. Counting a predecessor fund's returns, since September 2020 the fund has gained an average of 16% annually, outperforming the S&P 500 by an annualized average of nearly 4 percentage points.

Like other such funds that invest in secondaries, Hamilton Lane Private Assets can buy private-equity stakes from other holders, often at a deep discount to the official net asset value. It can promptly mark up its holdings to that official NAV. By doing so, it disregards the discounted price it just paid—even if that price was set in a competitive auction.

As my colleague Jonathan Weil exposed in a Wall Street Journal article last year, this technique has sometimes resulted in gains of 1,000% or more in a single day.

Such maneuvers are legal. But if you don't think they smell a little fishy, I suggest you make an urgent appointment with an ear, nose and throat doctor.

"We believe the assets are fairly valued today," says Brian Gildea, a managing director at Hamilton Lane, "and are marked accordingly with fair market value principles and standard industry accounting standards."

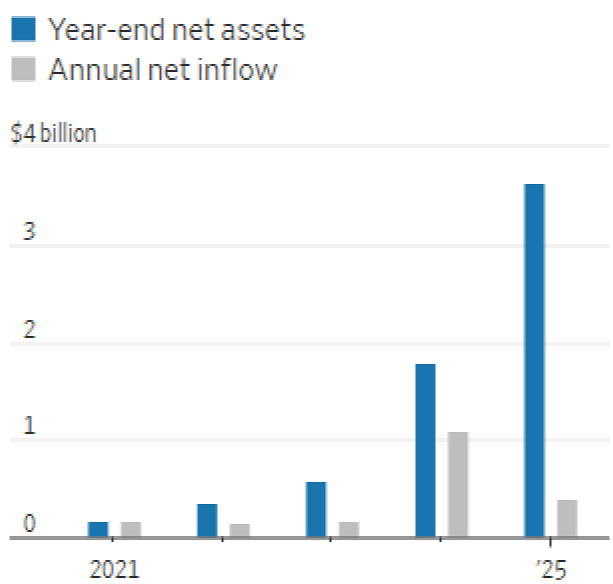
Last year, $162 billion in secondary deals changed hands, with an average discount of 11%, according to investment bank Jefferies. In theory, a secondary fund could have earned a little more than an 11% average return, before fees, by marking its purchases up to the official NAV and doing absolutely nothing else.
The fund managers call this "fair value."

Tim McGlinn, an investment veteran who blogs about private assets at TheAltView.net, calls it "NAV squeezing."

Is NAV squeezing sustainable in the long run? Maybe not, based on the way Hamilton Lane is changing how it collects its fees on its Private Assets fund.

In February, the fund asked its shareholders to approve a change in how Hamilton Lane charges fees. Under its original

Hamilton Lane Private Assets Fund



Note: For years ending March 31; 2021 is partial year, as fund began operations Jan. 4, 2021; 2025 net inflows are for January through March.
Source: the company

management contract, Hamilton Lane could earn a 12.5% incentive fee on the fund's profits above certain levels.

But the firm could collect the money only "deal-by-deal," when it sold a specific secondary investment at a profit. And only the portion of profit in excess of 8% was subject to the performance fee. (On other assets, the incentive fee kicked in on gains above 6%.)

Because it has sold almost none of the holdings, Hamilton Lane had collected a grand total of $1.6 million of performance fees. (It did take in $41 million of ordinary management fees last year at a 1.5% annual rate, which will drop to 1.4%.)

Under the old contract, Hamilton Lane couldn't collect more incentive fees because the gains on the fund's underlying assets were unrealized. In fact, if the assets turned out someday to be worth less than Hamilton Lane says they are, the manager might never have earned some of those fees.

Under the new arrangement, which was approved in March by 96% of voting shareholders, the performance fee falls to 10% from 12.5%.

From now on, the incentive fee will be payable across the entire fund, not on each deal measured independently.

Note carefully: The new fee is payable not just on realized gains, but on unrealized gains as well. That means Hamilton Lane no longer has to wait to sell each secondary holding at a gain of at least 8% to take its cut.

Even if the fund still holds the assets, any gains above zero will count. And those are easy for secondary-fund managers to generate when they can unilaterally mark up assets they bought at a discount.

Thanks to the new fee structure, Hamilton Lane took in $58 million of incentive fees from the Private Assets Fund after the shareholder vote. That was money the manager otherwise might not have received for years, if ever.

Hamilton Lane waived $22 million in performance fees it was due under the old arrangement, but the $58 million it received is net of that number.

The changes suggest that "Hamilton Lane sees the possibility of reaching in and grabbing that $58 million before it goes away," says McGlinn of TheAltView.net. "It takes cynicism to a new level."

Hamilton Lane says otherwise. The old structure was dependent on each asset's value relative to the minimum return at which the performance fee kicked in. "It was difficult for investors to calculate on their own," says Hamilton Lane's Gildea.

The new arrangement conforms with how comparable funds charge fees, says Gildea, and "responds to what the market is looking for: a simpler-to-understand fee structure with a lower performance-fee rate."

It sends another message, too. When fund managers want to be paid today instead of tomorrow, you should remember the words of the immortal Yogi Berra: The future ain't what it used to be.