# Navigating the hedge fund maze

## An institutional investor's guide to hedge fund investing

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special report

# What to look out for when making your selection

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Phil Irvine, director of advisory services at Liability Solutions, looks at how to sift through more than 2,500 funds from some 500 providers to find the right one for you

The term 'hedge fund' is used to describe a very wide range of investment vehicles that share certain similar characteristics. Commonly, hedge funds are domiciled offshore, have broad mandates (from very cautious to extremely aggressive), close to new investments once they reach a certain size, have higher fees (typically with a performance element to them) and tend to have worse liquidity terms than most bond or equity funds.

Generally, most managers have a significant personal stake in the funds they manage and aim to achieve positive returns in differing market conditions.

With over 8,000 hedge funds in existence and assets exceeding $2 trillion, there is plenty of evidence of the return profile of such funds and the de-correlation benefits that they can bring to a typical institutional investor's portfolio.

However, as the 2001 *Myners Review* noted when discussing Hedge Funds [Page 157 (Section 12.21)]: "the selection of funds is crucial, and must take place on the basis of careful research...."

Given the different types of risks that exist in hedge funds, as advisers, we would always argue that a well-diversified portfolio of hedge funds should be selected to achieve the investment objectives. This article explores the four stages that should be undertaken in selecting an external manager in order to construct an optimal hedge fund portfolio or fund of hedge funds.

## Stage 1 – Defining the investment mandate

There are a number of issues that need to be addressed in this stage, which include:

- Determining the fund of funds position in the portfolio (e.g. separate asset class or designed for a particular investment purpose) and the size and number of mandate(s).
- Setting the investment risk objectives (in terms of volatility, maximum drawdown and downside deviation) and agreeing on a realistic Libor-related return associated with this target.
- Deciding upon the degree of correlation (or de-correlation from other assets in the portfolio) that is to be targeted.
- Choosing between an investment in an existing product or selecting a manager to create a bespoke portfolio.

A common objective is for the hedge fund portfolio to target a Libor plus 3% to 4% return with a volatility of 5% or lower, typically with a worst month of less than 3%. For portfolios in excess of £50 million, a bespoke account should be considered that can be tailored to specific client objectives.

## Stage 2 – Identifying managers

With close to 3,000 fund of funds products on the market, identifying appropriate managers is typically achieved with the aid of a consultant, although there are a variety of databases and



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specialist media that can shed light on this area.

There are two common approaches where care needs to be taken. Firstly, focusing only on the best-known brands may not necessarily lead to the best choice. The nature of hedge fund investing is that it is subject to restricted capacity.

Funds that focus on particular niches to exploit value can lose their competitive advantage and nimbleness as they grow larger. Similarly, asset gatherers at the fund of funds level can find it difficult to put the very large inflows of cash to work in an effective manner.

While there may be comfort with the brand, it is worth considering how important the fund of funds activity is within the group, how quickly the fund of funds assets have grown, and whether or not the investment and client services resources have matched the rate of growth.

Secondly, while past performance numbers are clearly an important element, it is strongly advised that this is not the main driver for selection. A number of hedge fund strategies have a return profile similar to selling insurance (i.e. mostly steady, profitable returns with occasional sharp losses). Hence, a very steady return profile may disguise some very high risks within the strategy.

Another issue to be aware of is the use of leverage at the fund of funds level. Clearly, a leveraged fund of funds will produce far higher returns in benign periods than an un-leveraged one. Therefore, straight comparisons between the leveraged and un-leveraged over short time periods are likely to be flawed.

### Stage 3 – Selecting manager(s)

The process of selecting an appropriate fund of funds manager should be approached with a similar ideology and expectations to that of investing in traditional long-only managers. So, as in the selection of a traditional manager, the trustees need to be satisfied with the fund of funds manager in at least the following areas:

#### *1) Organisation*

The fund of hedge fund management group must be able to demonstrate that they are of a pedigree that meets the standards of the institutional client. To make sure of this, areas that should be addressed include:

- Who owns the group – is it solely owned by the staff or is it owned wholly or partly by a larger organisation?
- How financially secure is the organisation?
- Over what period have the assets under management grown and has this growth occurred in a controlled manner?
- What business functions are outsourced and what is the quality of these external service providers?

#### *2) People*

It is essential to judge the capability of the specific team that will be managing your assets. Questions relating to this area include:

- What experience do the key personnel have and does this experience match the areas/strategies where the fund invests?
- How long have they been with the group and can

they justifiably take credit for past successes?
- What is the total number of staff and how many are investment professionals?
- What is the longevity of the current investment team and to what degree has there been staff turnover?

### *3) Investment process*

The process can be split into two areas: strategy selection and manager selection.

#### 3a) Strategy selection

- What is the strategic asset allocation policy and how has it been formulated?
- Are there set ranges per strategy and how often are they reviewed?
- How successful has the manager been in anticipating or reacting to changing market conditions?
- What examples can be provided of past allocation decisions and how have they added value to performance?

#### 3b) Manager selection

- What is the process for sourcing new managers and how does the approval process work?
- What degree of transparency is required before investing in that manager?
- How does the operational due diligence process work and does the due diligence team have a power of veto?
- What ongoing monitoring is undertaken on approved hedge funds?

#### 4) Portfolio construction

The portfolio construction phase is where the approved manager list, coupled with top-down strategic views, are combined to achieve client objectives. Issues to be addressed include:

- How many single-manager hedge funds are in the portfolio and why this number?
- How big is the largest hedge fund position in the portfolio and what percentage of the fund's assets are in the top five and 10 managers?
- How well diversified is strategy allocation within the portfolio?
- Is leverage or hedging applied at a fund of hedge funds level?

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Phil Irvine

### *5) Performance*

Past performance numbers should be primarily examined to gain an insight into the risks that were being undertaken in the portfolio, rather than to infer the future likely returns. Questions may include:

- From what date does the performance start and is this a sufficient period to judge the risks that emanate from the type of investments the fund of funds is making?
- How does their performance compare with their peer group or investment objective?
- What were the worst and best months or periods and why?
- What is the correlation of the returns of the fund of funds to equities and bonds and has it been within expectations?

## Stage 4 – Negotiation of terms and conditions

Our advice is to select your managers first and then negotiate fees and other terms, rather than the other way around. The fees, liquidity and the quality of investment reports are essential parts of the selection process and questions could include:

- At what size will the manager offer a managed account?
- Can the structure of fees be altered i.e. a single flat fee or a performance fee only structure?
- What are the redemption requirements of the product?
- Are there 'lock-up' periods or exit penalties?
- What degree of transparency and risk reporting will be provided?

## Conclusion

In summary, the addition of hedge funds into a portfolio of long-only assets can improve the overall risk/return profile of the portfolio. However, there are different types of risks that are associated with such investments and they need to be understood and managed.

We believe that selecting managers primarily on the basis of a quantitative screen, based on past performance numbers, could lead not only to an inappropriate selection, but could expose clients to possibly large, unexpected risks.

Our one golden rule and, if there were only one piece of advice that we could offer, it would be that there is no substitute for visiting a range of fund of funds managers in their offices to acquire a good understanding of how they select managers, construct portfolios and manage risk.

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Liability Solutions is a FSA and NASD regulated, institutional investment consultant specialising in funds of hedge funds and an independent placement agent of hedge funds.

Our consultancy service offers independent, specialist investment advice to institutional clients who are considering absolute return, liability-driven and fund of hedge funds solutions. We assist financial institutions in their understanding of the absolute return and fund of hedge funds market place and work closely with them in developing their investment strategy in this area. Our placement activity brings us into contact with the majority of the world's funds of hedge funds and gives us first-hand experience of both their resources and investment capabilities.

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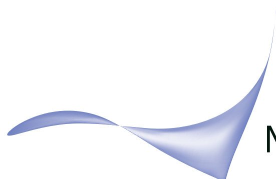


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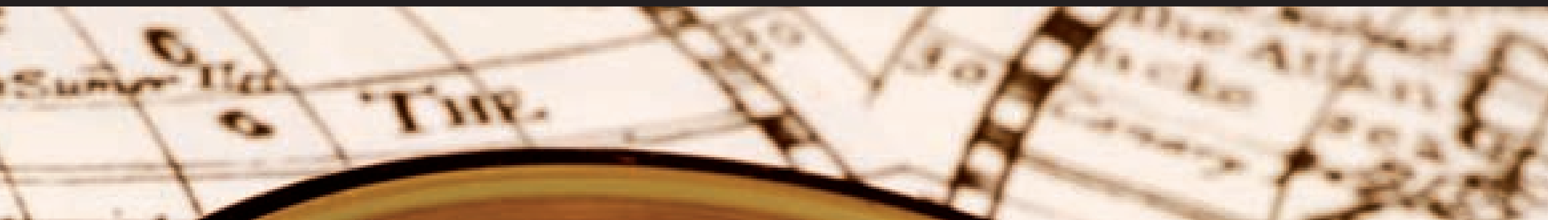

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