IN THE PRESS

Since setting up an advisory team in 2002, Liability Solutions has conducted 14 assignments covering in excess of $5 billion of assets up to end July 2006.

HEDGE FUNDS

PHIL IRVINE of Liability Solutions discusses the steps to consider in the quest to select an appropriate fund of hedge funds manager

DO YOUR RESEARCH

THE Myners Review was published with a recommendation that trustees consider the full range of investment alternatives and concludes that greater diversity of asset allocation policies would be desirable. Hedge funds, once the preserve of very wealthy private clients, have increasingly begun to attract assets from pension funds and other institutional investors. It is estimated that $1000bn is now invested in over 8000 hedge funds and that there are in excess of 1000 fund of hedge fund products. Given the enormous number of funds, the huge variety of strategies, and the very different risks associated with managers, careful research, as the Myners Review recommends, is crucial.

STEP 1 – TRUSTEE EDUCATION

The term hedge fund is used to describe a wide range of investment vehicles that share certain characteristics. Commonly they are domiciled offshore (which typically have loose regulatory and disclosure requirements), have broad mandates (from very cautious to extremely aggressive), close to new investments once they reach a certain size, and have high fees (normally with a performance element to them). Generally, most managers have a significant personal stake in the funds they manage and they aim to achieve positive returns in all market conditions.

A number of factors should hopefully emerge from this education process. Firstly, a portfolio approach to investing in hedge funds is the best route given the variety of risks associated from investing in any one fund. Secondly, the belief that "hedge funds tend to target significantly higher returns than funds managed in a more conventional manner" (Myners Review, page 157) is widely held, but not the case. The vast majority of hedge funds aim to give superior risk-adjusted returns than traditional asset classes, but are not aiming to be "turbo-charged" equities. Thirdly, while care needs to be taken with some of the wilder claims for the past performance of hedge funds, an investment in this area deserves serious consideration.

STEP 2 – DECIDING STRATEGY

Assuming that a decision to invest has been taken, there are a number of issues that need to be addressed:

- Deciding hedge funds' place in the portfolio. At present, the majority of UK pension funds allocate to hedge funds as a separate asset class, which means that they tend to favour very diverse portfolios that broadly represent the industry. However, larger pension funds, which have been investing for a period, generally select specialist portfolios of hedge funds to suit a particular purpose in their portfolio.
- In-house selection or external fund of hedge funds manager? The majority of pension funds use an external manager for their investments in hedge funds given the level of complexity involved. Other alternatives include performing the role entirely in-house or having an advisory relationship with a fund of hedge funds manager.

The steps below apply should the decision be made to outsource the construction and management of the hedge fund portfolios to specialist managers.

STEP 3 – DEFINING MANDATE

It is extremely useful when deciding on the mandate to not only define the "hard characteristics" (e.g. mandate size, product or managed account, desired risk return characteristics etc), but also to consider other preferences as well. These may include location of manager, character of organisation (boutique or institutional), asset growth of the manager (i.e. whether they are an asset gatherer or asset manager), transparency of portfolio and risk processes etc.

STEP 4 – IDENTIFYING MANAGERS

Identifying appropriate managers is typically achieved with the aid of a consultant, although there are a variety of databases and specialist media that can assist in this area. While performance numbers are clearly an important element, it is strongly advised that this is not the main driver for selection. Given that a number of hedge fund strategies have a return profile similar to selling insurance (i.e. mostly steady, profitable returns and occasional sharp losses) and that fund of hedge funds themselves can leverage up their portfolios, care clearly needs to be taken.

STEP 5 – SELECTING MANAGER(S)

The final selection phase is normally conducted after a detailed questionnaire. Clearly trustees need to comfort themselves with the organisation, people, process, risk, performance and product specifications. A number of questions that could be asked include:

- Describe your manager research process for the different types of hedge fund strategies you invest in.
- Are there any strategies you avoid and why?
- What is the ratio of in-house analysts to the managers on your watch list and why do you feel this appropriate?
- What degree of transparency do you get from your managers and what do you do with this information?

STEP 6 – NEGOTIATING TERMS & CONDITIONS

There are two essential areas in the negotiation phase: transparency and fees. With regard to transparency, at a minimum there should be disclosure of the managers within the portfolio. Too much disclosure is not only impractical, but rarely illuminates the risks that exist within the portfolio. Firstly, the majority of hedge funds believe that too much transparency undermines their competitive edge (hence they tend not to give real-time full disclosure) and secondly these positions can change very quickly.

With regard to fees, our advice is to select the managers first then negotiate the fees, rather than the other way around. Fees are certainly open to negotiation and fund of hedge funds managers rarely insist on settling at their headline fee level. An element to bear in mind is on the ratio of performance fees to management fees. This ratio should be appropriate to the targeted return profile and align the interests of the manager and the trustee.

STEP 7 – MONITORING

Probably the most contentious area with regards to monitoring is the adoption of an appropriate benchmark. This is subject to much debate within the hedge fund industry, with many claiming that benchmarking will lead to similar problems that exist with the management of traditional asset classes (i.e. closet benchmarking). However, trustees need to ensure that the management of their assets is of a high standard and there exists a range of hedge fund indices provided by reputable organisations. Possibly the best solution is to enquire of each manager during the final selection phase what is the best way to measure their success.

CONCLUSION

Whether you believe that hedge funds are simply a short-term fad or a legitimate area for investment, this area of active management deserves further scrutiny. If there is one piece of advice that we offer, it is that there is no substitute for visiting a wide range of fund of hedge funds managers in their offices to get an understanding of how they select managers, construct portfolios and manage risk. Screening for managers simply on the basis of past performance could lead to an inappropriate selection.

Phil Irvine is director of advisory services at Liability Solutions

LIABILITY SOLUTIONS ADVISORY & RESEARCH TEAM

Phil Irvine	Des Hogan	Taco Sieburgh Sjoerdsma CFA	Jodi Bisson
+44 (0) 20 7659 6964	+44 (0) 20 7659 6953	+44 (0) 20 7647 2172	+44 (0) 20 7659 6951
philirvine@liabsol.com	des@liabsol.com	taco@liabsol.com	jodi@liabsol.com

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