CHAPTER 12

New Products

As investors resist direct allocations to hedge funds, and fund of funds look for new ways to invest in hedge funds, several new investment products have been launched during the past several years to entice investors into a low-risk methodology of hedge fund investing. These products include the following:

- 130/30 funds
- Leveraged products
- Principal-protected notes
- Best-idea fund of funds
- Hedge fund replication
- Multi-strategy hedge funds

130/30 FUNDS

First are 130/30 funds, which are expected to have $1 trillion in assets over the next few years and are attracting large, sophisticated investors such as the California Public Employees' Retirement System, the Illinois State Teachers Retirement System, and many other pension funds. The first inducement is a lower level of fees that average around a 1 percent management fee and a small incentive-based fee, substantially lower than the 2 and 20 percent commonly found in single-manager hedge funds. The similarity to hedge funds lies in the use of leverage and shorting. The manager is long 130 percent and short 30 percent for a gross market exposure of 160 percent and a net market exposure of 100 percent. 130/30 is a structure, like 2&20, but not necessarily a strategy. The performance is based on the beta to the relevant index. One of the key ingredients of success in hedge funds is the ability of managers to short as well as to come up with good long ideas. Shorting in 130/30 is merely a by-product of the structure and not necessarily part of the strategy. While proponents claim that this strategy can generate alpha, the fund objective is still 100 percent net market exposure.

Why Mutual Funds Can't Short

In search of additional asset-based fee income, many traditional long-only managers are hearing investors clamor for new investment options with a hedge fund–like product. The quest for alpha has led many investors to seek new ways to allocate capital. The biggest risk is the untested ability of a traditional long-only manager to short stocks. As most hedge fund managers will readily state, shorting stocks is one of the most difficult strategies to execute successfully. After all, there are only a few short-only managers that have been able to survive during the past 20 years, while new long/short managers have prospered. If a manager is really good at picking shorts, why restrict the amount to 30 percent? This lack of experience by the long-only managers is a negative and can lead to underperforming risk-adjusted returns in many market environments.

Often referred to as "hedge fund lite," the small percentage of typical shorting that 130/30 managers use can be, in our opinion, quite risky. If a manager is good at managing long money and has the unique ability to pick shorts and prosper, why do it with a lower fee structure? More skill and resources are required in shorting stocks. Judging by the huge interest in this new product earned in a short period of time and the desire to seek hedge fund–like returns with un-hedge fund–like fees, investors and their consultants may be overlooking many steps in the due diligence process for the 130/30 manager versus investing with a hedge fund manager.

The rise in 130/30 has been a consequence of several academic papers that suggest that investors can achieve greater returns by altering the prohibition on shorting stocks. The assumption is that the manager will be able to demonstrate his skill set and transfer the long selection process to shorting stocks. 130/30 mandates have strict investment disciplines that may not always be present in hedge fund investing. The research papers indicate that 130/30 offers investors higher alpha, and while the product is still in its infancy, the jury is still out to determine if this approach will really deliver the returns, correlation, and volatility characteristics that have been suggested.

This product may fill a gap for pensions, but the road is littered with the carcasses of bright analysts and traders who could not transition to hedge funds. Will this product prove to be the next creation of Wall Street that does not work? At this point, 130/30 looks like a mutual fund with a limited ability to short stocks.

HEDGE FUND REPLICATION

Hedge fund replication represents another alternative to both direct hedge fund investing and fund of funds investing. As direct investors looked for the next methodology to reduce fees, investment banks' alternative investment creativity gave rise to the newest alternative investment product.

The objective of hedge fund replication is, as the name implies, to replicate the risk/adjusted returns of hedge funds. Replication can be limited to specific sectors or can encompass a broad range of hedge fund strategies. Using a model-based strategy, the investor can select the allocation based on standard regression analysis using variables to account for the difference in historic hedge fund returns. Factors that may be considered might include returns of long/short equity of small cap versus large cap, long value versus growth, returns of bond indexes, commodity market indexes, or foreign exchange returns. An investor who has a long lockup in a hedge fund strategy may want to have a short exposure to a hedge fund and thereby reduce overall exposure. Because this is an imperfect hedge, investors should evaluate the risk associated with this trade.

The goal of the structuring should include the determination of the historical period to review to estimated betas of the various indexes. The final phase of the analysis is to put the hedge fund returns through regression models against the selected factors over the selected time period.

Investors select hedge fund replication as a strategy for asset allocation that provides a dynamic tool for consultants and allocators to assist investors in achieving overall portfolio objectives. And, of course, to save fees! The goal of replication is to attempt to follow hedge funds in their ability to anticipate and participate in market trends.

The real positive to replication lies in transparency and liquidity. Since investors will have position-level transparency, active portfolio management results in a better understanding of sources of alpha and correlation to market indexes. Replication will allow investors to reduce portfolio redundancy and allocate to sectors that were previously underweighted. With the increase in transparency, investors will quickly be able to react to style drift, one of the dreaded concerns of all investors. The major positive for investors is transparency, and fraud risk is eliminated by the daily liquidity and high transparency.

Hedge fund replication has several limitations. Since the allocation is based on the self-selection process of specific strategies, it may be broadly defined as a market-timing strategy that needs to have additional research information besides the investment timing. Another shortcoming is exposed when short-term allocation changes are required. When hedge fund managers are quick to adapt to changing markets, the replicator may be few steps behind the hedge fund. The timeliness of performance also presents a challenge. As part of the modeling and regression analysis, the replication strategy should analyze returns over a longer time with more frequent results. Unfortunately, hedge funds report monthly results, resulting in fewer reporting periods and less reliable data.

The Cost of Replication

In determining the actual costs associated with replication, the due diligence costs of hedge funds are substantially higher. However, the limitations of replication are manifest in the larger amounts of capital required for investment. Because of the monitoring and constant review and adjustment of returns and strategies as well as the larger number of strategies in which to invest, replication is restricted to larger investors. In the end, there is one question that investors must ask: Is replication cheaper than investing in fund of funds, and is it worth it?

The answer most likely is that the strategies of fund of funds and replication products can go hand in hand. Even though the cost of fund of funds may be higher, these funds provide professional management and portfolio diversification, although they are a bit slower to make changes. Replication strategies provide higher transparency and a closer process for asset allocation. On the other hand, direct hedge fund investing will continue to provide the best source of alpha for investors who have the resources and staff to identify managers who meet the investor's investment objectives.

OPPORTUNITIES IN EMERGING MANAGERS

One of the newest buzzwords in the hedge fund industry is *emerging manager*. In the same breath in many cases, the terms *seeder* or *incubator* usually follows. The hedge fund industry is one in which it is often challenging to define terms or strategies. Difficult-to-define terms include *hedge fund*, just for starters. While most know what a hedge fund is with its ability to short, to use leverage, and to implement redemption requirements that are different from long-only investing, many skeptics define hedge funds as a compensation scheme, given its imposition of an incentive fee.

Definitions for an emerging manager are equally difficult to define. Technically, all new hedge fund managers without a track record are emerging managers. However, a manager with a pedigree from a well-respected Wall Street firm or a large investment management firm is not included in this category. If a Wall Street executive who has managed a trading desk for the preceding 10 years and has been actively involved in the day-to-day trading or research launches a fund with $1 billion, he should be considered an emerging manager. This team of professionals from the former firm may not have worked together as a team but did work at the same firm, and may have added several professionals from other firms to launch the new firm. Allocators do not consider this group "emerging," since they had a large asset pool at launch, but should really be considered emerging since they, too, have no verifiable track record.

On other hand, if a group of two lawyers, a distressed trader, and an analyst who worked together on the prop trading desk of a buy-side firm launch their new fund with $7 million of their own funds, they are also considered to be an emerging manager. This group can also point to the results that were achieved at the firm they used to work for, but they do not have an identifiable, audited track record. The difference in defining emerging appears to lie in the size of the asset pools at launch. For our discussion, we will refer to emerging managers as those that are newly launched funds that do not have a prior audited track and fall below a specific level of assets, such as $100 million. The hedge fund community usually refers to emerging managers as younger, smaller managers who are early in their life cycle rather than to the billion-dollar launch of a team that also has no track record.

An emerging manager has one additional distinction: the ability to raise capital is limited due to several challenges. First, the new manager may not be able to raise meaningfully significant capital levels at first because of a lack of a track record as well as not being able to identify the initial round of investors. Second, many hedge funds are unsuccessful in capital raising because of poorly prepared marketing material, inability to properly explain the strategy, or the manager's unwillingness to leave the trading desk to meet prospective investors. To raise capital, the new hedge fund must use other approaches.

Emerging Manager Due Diligence

As fund of funds look for new managers to add to their funds, emerging managers are always on the horizon. However, some fund of funds have minimum asset size requirements or length of track record required before a new fund is even considered for review. As a result, many emerging managers fail to make the cut. For those fund of funds looking at emerging managers, the major question remains, will it be a career-threatening decision to invest in the new manager?

For fund of funds that will review emerging managers for portfolio evaluation, hedge funds that have seed or incubating relationships have a new set of criteria that must be understood and explained during the due diligence phase. As a result, the due diligence process must be refined to understand who the seeder is; the objectives; the economics; revenue/equity ownership; and the additional services that may be provided. A meeting with the seeder is imperative to understand what the seeder's overall investment objectives may be.

At the same time, recent developments in the fund of funds industry have included several firms focusing on emerging managers and investing exclusively with emerging managers. Several of these fund of funds invest with managers who are new, niche, and emerging without any financial linkage. In other cases, the fund of funds invest with managers with whom it has a strategic alliance. While there may be advantages to both methodologies, the key issue for the investor is how quickly the manager can sever the relationship. As a fund of funds investor, I may not want to be involved in private equity–like transactions and want the fund of funds manager to have the ability to act decisively and independently in the event of a change in strategy or in market volatility. Linking the economics of the investment manager of the fund of funds and the investment objective of the fund of funds investor may not be compatible and may lead to an unwinding of the relationship.

All of this leads us to the question of why anyone should invest in an emerging manager? There is a belief in the hedge fund industry that younger, smaller funds have better performance results earlier in the developmental stages of their track record. The pro-small community argues that smaller funds are more nimble, more flexible, and more liquid because of their ability to move capital and make better decisions more quickly. Smaller funds take smaller-sized positions, which result in fewer liquidity issues. It is believed that smaller, emerging managers can concentrate capital in fewer, more focused positions. The anti–emerging managers' side of the investment community argues that small funds underperform because of the higher cost of their infrastructures, and many emerging managers may cut corners, having reduced levels of support and research staff to execute the strategy. This camp believes that there are fewer controls and investment policies in place, and the new manager may in fact have a higher risk profile to achieve higher returns.

Smaller managers may have a concentrated client base that could present liquidity issues in the event of a sudden change in market sentiment. The lack of an audit by a major hedge fund accounting firm can prove to be detrimental to the ability of the manager to attract capital and may also reveal internal reporting weaknesses within the organization.

The pro–big hedge fund manager camp believes that larger funds have better results. With a larger research budget, better access to company management teams, and access to the investment banking and brokerage community, big funds are more efficient. Larger funds may be less susceptible to unforeseen capital flows than smaller funds, and the larger capital base will enable them to deploy capital into different sectors to capitalize on changing markets or investment strategies.

RISKS ASSOCIATED WITH NEW HEDGE FUNDS

As all hedge fund legal documents and marketing material indicate, there are risks associated with investing in hedge funds. With newly launched strategies, the risk is the greatest. Although investors may claim that size reduces risk, in the case of the newly launched fund with $1 billion in assets under management, size may hide risk. Comfort may be afforded by the larger size of assets and infrastructure, but the facts remain; this new team has not worked together in the same organization as a team, and the new firm does not have a track record or any operating history. In most cases, the new team has not previously managed an independent, stand-alone business with its own profit and loss statement. Despite the size, the risk is great.

However, with startups, size does matter, and the risk is great for a small manager even though this group may have worked together for many years.

The perception by hedge fund allocators is that the small managers have the greatest business risk, resulting in increased challenges for capital raising and future growth. As a result, many new small managers will look for alternative methods to raise capital to get to critical mass and then reap the benefits of a successful strategy.

Many turn to seeders and incubators. Who are they, what are they, and what do they do? As the hedge fund industry went through its growth spurt during the late 1990s and into the early 2000s, new hedge fund managers were able to raise new capital from existing relationships, both large and small. Many took advantage of working with the capital introduction teams at the prime brokers. Others chose to use third-party marketing firms to find capital. With the institutionalization of the hedge fund industry and the demand for greater pools of assets and organizational infrastructure, managers needed to attract more capital to prove their worth to investors. Seeders and incubators were two groups that provided many funds with the ability to prove their worth.

Seed Capital Providers

Seeding operations take many forms. For many years, high net worth investors and family offices would provide “seed” capital to launch funds. The investor may have been the first outside investor to commit a substantial amount of capital relative to the size of the fund's assets under management, and the hedge fund manager could use the name of the investor to attract assets from other investors. For their capital, many seeders demand better terms than those offered in the private placement memorandum, resulting in lower management fees, incentive fees, or redemption terms than those offered to the masses.

As the need for larger pools of capital grew, one of the early entrants into the world of seeding was Capital Z Asset Management. Capital Z's staff say that they are presented with and review hundreds of strategies each year and have funded less than two dozen since its inception in 1998. While there are more than 30 firms in this space that represent themselves as seeders, competition is stiff, and each model differs. Some of the seeding firms provide capital only, while others may provide infrastructure and marketing capability. Some hedge funds want to build out all parts of their business and look for the seeder to help. Other managers look to be part of a platform and have only the administrative responsibility managed by the seeder.

The economics of each seeding deal differ as well. All seeders want the hedge fund to manage the business on a day-to-day basis and want the firm to be successful. The participation by today's seeder varies, with some providing a fixed amount of capital period (e.g., two to three years) in exchange for a share of the manager's revenue.

In other models, the seeder takes an equity ownership stake in the management company. The additional economic advantage to the seeder is the ability to reserve capacity for a fixed period of time and to profit in the success of the total business, not just their assets placed with the firm. Other seeders may share in the equity for a determined period of time. In this case, the seeder likes to play the role of partner and a minority investor in the fund while providing strategic support. The equity ownership stake may be for a fixed period or in perpetuity, with the manager having the ability to buy out the seeder after a set period of time based on various factors or assumptions.

Data Helps the Decision Process

Several academic studies have been conducted to analyze returns, standard deviation, Sharpe ratio, and alpha of small versus large. The results are mixed, with several stating that smaller funds do better, several stating that larger funds do better, and several stating that the results are inconclusive.

A recent study by Infovest21 reviewed past studies of data that compared big funds with small funds. According to George Martin, associate director of the Center for International Studies and Derivatives Markets at the University of Massachusetts, “Research on the performance characteristics of emerging managers suffers from several weaknesses: survivorship or other reporting bias, lack of consensus on the definition of what constitutes ‘emerging.’ ” In other words,

- Are fund assets the definition?
- Is fund age the definition?
- Is manager experience the definition?
- Is it a combination of all three?

Martin said that assets under management, by themselves, do not make a meaningful statistical difference in performance when one controls for survivorship bias and strategy classification. He believes that there is no statistically significant return to investing in fund of funds that invest in emerging managers.

Young Funds Make Sense

A second study by Greg Gregoriou and Fabrice Rouah in the Winter 2002 *Journal of Alternative Investments* found that asset size has no impact on a fund’s performance, whether adjusted (Sharpe and Treynor ratios) or unadjusted measures are used to evaluate one fund versus another.[1]

The Infovest21 report includes eight studies by industry professionals and academics. While the other results are varied, the Infovest21 study concludes:

> ***The five studies examined conclude that younger funds have higher performance. One study said within the three years while another study found outperformance in the first year. Yet younger funds are also more vulnerable in the early stages and have higher mortality rates due to their limited infrastructure, and often they operate below breakeven levels. One study found the failure rate peaked at 28 months. Further studies on fund age and performance need to be updated to recent history and concluded over longer time horizons. Different methodologies need to be used to see if the conclusions are consistent. And, as previously stated, many factors contribute to the performance of hedge funds and it can’t be determined solely by age.***[2]

Despite contributing to an overwhelming case for emerging managers, the data seems to indicate that newer, younger managers have an advantage in achieving better results over their older, seasoned brethren. However, the risks are greater in investing early on with a new manager. A decade ago, a trader could leave a larger firm, be joined by a teammate, launch a fund in the garage of one of their homes, and then grow and achieve good results before taking formal office space to begin the capital-raising process. Today, this is virtually impossible. With institutionalization of the market, some undefined level of critical mass and infrastructure is required.

The due diligence process of more established fund of funds managers is more complex, with great risk for the newest managers. Although some investors may "drop off some money," as one fund of funds manager stated, to reserve a place at the table, what happens if dinner is not served. Emerging manager investors must be prepared for poor performance and higher rate of disclosure in searching for the next best undiscovered manager. In addition, the emerging manager investor must adhere to a strict schedule of monitoring results and portfolio positions to anticipate any warning signs that may appear. While no manager regardless of size or track record is exempt from disclosure, greater scrutiny is required for emerging managers.

Given the tighter controls and surveillance imposed by the SEC and the UK's Financial Services Industry along with the accounting industry, hedge fund investors, and the U.S. Congress, hedge funds and fund of funds will be monitored more closely in the weeks, months, and years to come.

Most emerging managers will avoid the regulatory expense and scrutiny until critical mass is reached, providing little extra level of inquiry by outside examiners.

The overall size of the fund of funds may prove to be the key determinant to investing in emerging managers. Larger fund of funds may eliminate allocation into emerging managers unless a specific mandate calls for it, while many small- to midsized fund of funds—say with assets under \$500 million—stress their unique ability to identify, research, and select emerging managers for inclusion into their funds. Smaller fund of funds, family offices, and high net worth investors are able to allocate smaller amounts of capital while enduring an extra level of due diligence and post-investment monitoring. In spite of everything, many large fund of funds, foundations, and endowments spend over 300 man-hours in the due diligence and review process before making the final decision to invest. In the end, the fund of funds or other investors must decide whether it has the skill or desire to add emerging managers to the overall portfolio along with its commitment to the tedious process required for investment approval.