CHAPTER 6

Why Fund of Funds Work

The primary investors in fund of funds are high net worth investors, family offices, foundations and endowments, and institutional investors. This is essentially the same investor base as hedge funds have, with the newest large entrants being public and corporate retirement pension funds globally. Hedge fund investors are typically looking for an investment vehicle that meets one of the following requirements:

- No or low correlation to the public debt and equity markets
- Outperformance (i.e., no losses) in down markets, while capturing a significant portion of upside returns when the market rallies
- Investment in sectors that are not user friendly to investors that lack specialized skill sets (fixed income or credit) or may not have a team of investment professionals analyzing individual hedge fund strategies
- Intention to invest in hedge funds to lower overall portfolio volatility and market exposure

THE EARLY ADOPTERS

Early institutional adopters of hedge funds in the 1990s were foundations and endowments. Historically, this group has been more visible in hedge fund investing than most other institutional investors, given that there is a requirement to make distributions of a fixed percentage of assets annually—and higher—consistent returns were required to meet this stated mandate.

Family offices with substantial assets were also early to invest in hedge funds and fund of funds. While the global macrostrategy employed by famed hedge fund managers George Soros, Julian Robertson, and Michael Steinhardt was the dominant strategy pursued during the 1990s, many family offices recognized the need to diversify into other asset classes and less frequently adopted investment strategies. As a result, this group of investors needed help in identifying hedge fund managers. Our research tells us that all but a few family offices had the capability of identifying new and established managers in the fragmented and unfamiliar hedge fund universe. Most of this was done through word of mouth or through connections through the country club and other social settings. (Sound familiar?)

During the early 1990s, several fund of funds were being launched and were struggling to raise capital and to form infrastructures for the early phase of building out their businesses. This resulted in an unlikely partnership between fund of funds building new firms and looking for capital and family offices with capital to invest, and searching for hedge fund managers. It was the beginning of the relationship for several different family offices that have since dominated the fund of funds of industry and have consequently built very strong investment companies that invest in hedge funds. This enterprise of cooperation was a good fit, because the larger family offices resembled larger institutional investors in the early developmental stage. This was probably the beginning of the convergence of private wealth management with institutional assets; everybody everywhere, regardless of asset size, was looking to hedge funds for alpha.

Manager Selection

The coupling of family offices and fund of funds managers was the result of investors' wanting to learn the art of manager selection and due diligence. These investors were happy to invest with a fund of funds to learn the skills and to determine who the new managers were and what they were doing to extract profits from the market. A second benefit that this partnership offered was the ability of the investors to acquire the tools necessary to find new managers and gain access to a community they otherwise did not know. Since many family offices were started by successful entrepreneurs, these investors were and still are willing to invest with new managers that lack a long and seasoned track record if the family could thereby gain an additional advantage in the marketplace.

One of the first family offices to use this approach was Trip Samson of Landmark Management, Inc., a multifamily office located in New York.

Trip's firm manages the assets of several family offices and has allocated to hedge funds since the mid-1990s. The investment objective for his portfolios was to diversify away from the risk of the public markets and several large concentrated equity positions that were held by several members of his families. As Trip started to look at hedge funds, he met two financial services veterans who were both starting their own new fund of funds. Both needed capital, and both also wanted to expand the relationships that they had. Trip had capital, and he wanted to get his feet wet in hedge funds and thought that this relationship would be beneficial to both parties. The results turned out to be worth it. At the time, fund of funds returns, like those of hedge funds, were quite strong during the early years of his organization. The gamble paid off.

Capitalizing on the benefit of the relationship with the start-up managers, Trip has since expanded into direct hedge fund investing. The results have achieved the investment objective of each client, and they also preserved wealth during the technology meltdown of 2000–2002. He found that the fund of funds became overdiversified during this same period, and he now does all hedge fund investing direct with managers. In short, his enterprise has become a specialized fund of funds.

As a result of interaction with many family offices, fund of funds have come to the forefront with many first-time investors like Trip Samson or those looking to gain a toehold in hedge funds without hiring a team of seasoned professionals. Since family offices are often very knowledgeable and not hesitant about paying for outstanding investment talent, many have also moved into direct investing while still maintaining relationships with fund of funds as an extended research resource. In general, family offices are concerned more with customization of the portfolio rather than the low volatility that other, more traditional institutional investors seek through hedge fund investments. Many families like ‘‘high-octane’’ returns and seek to capitalize on this aspect of hedge fund investing. They also like the greater tax efficiency of long-term holdings that may be realized through the customized portfolio rather than the greater diversification of an investment into a fund of funds directly. When investing in fund of funds, many family offices prefer niche strategies such as emerging markets, distressed investing, or specialized areas (e.g., financial services or technology).

WHO INVESTS

While each family office has different—some might even say unique—investment criteria, one fact is clear: High net worth and family office assets are growing globally; regardless of market turmoil and fraud, assets from this group of investors will continue to flow into hedge funds and fund of funds (see Figures 6.1A and 6.1B).

One of the unique aspects of family office investment mandates is that they are not as institutionalized as other institutional investors; they usually report directly to the senior family members, who are quicker to complete the due diligence process and make investment decisions. This is good for both the investors and the investment managers who receive the allocation. Many other institutional investor groups move at a slower, more

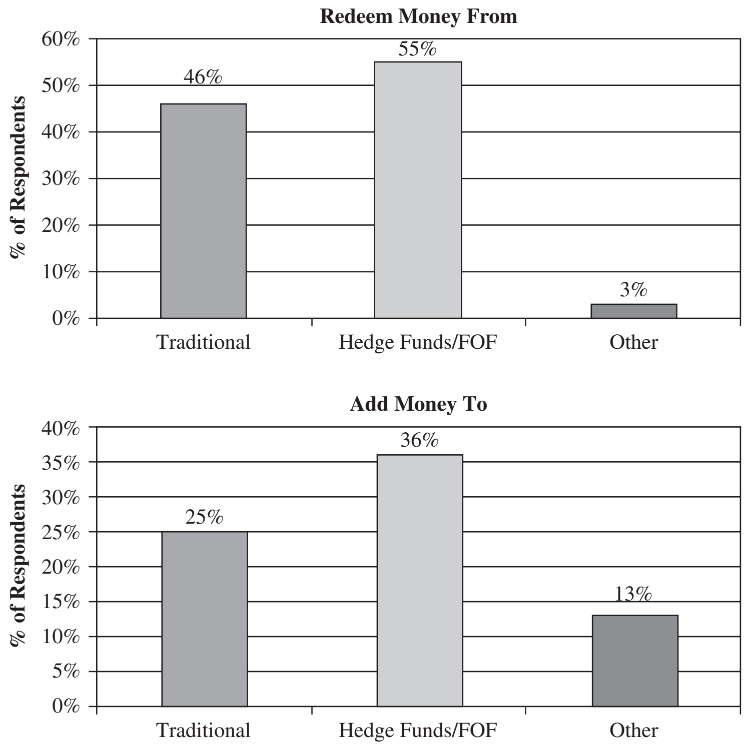

FIGURE 6.1A Percentage of Investors Who Expect to Redeem Assets from Managers
Source: IPI Family Performance Tracking® Survey 2008.

methodical pace and work within guidelines set by boards of directors that know as much about investment strategy and portfolio management as most of us do about brain surgery and changing a carburetor. That being said, one group of investors that has been pushing industry growth forward in the past few years has been large-state pension plans.

Large-state pension plans are massive pools of capital; clearly the biggest boys on the street. They know it, they use their size, and people respect them. Several of the names include Alaska Permanent Fund, Massachusetts Pensions Reserves Investment, and Pennsylvania State Employees Retirements System—all large-state employee pension funds.

Hedge funds are similar to private equity funds in that both are considered lightly regulated as compared with mutual funds and have limited periods of liquidity; most importantly, both structures permit investors to invest alongside of those who are actually managing the money. In the hedge fund

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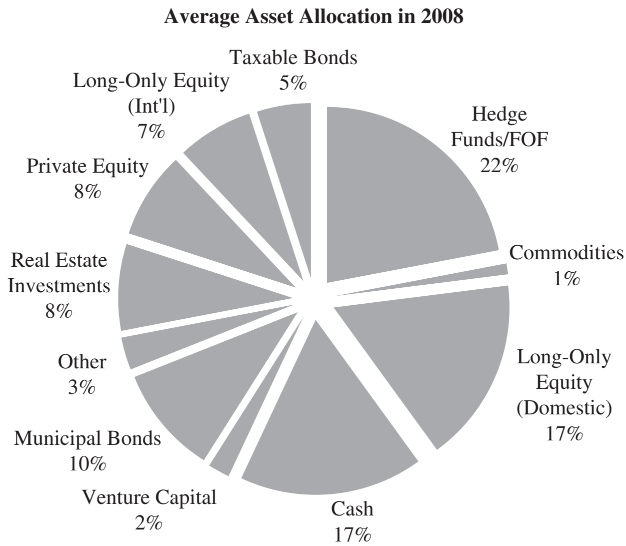

FIGURE 6.1B Percentage of Investors Who Expect to Add Assets to Managers
Source: IPI Family Performance Tracking® Survey 2008.

industry, as in other areas of the investment universe, this concept is known as ''eating one's own cooking.'' As prospective fund of funds investors or their advisors review strategies and meet with the managers, question number one for the hedge fund should be, how much do you have invested? Similarly, investors should ask this question of the fund of funds managers if they are looking to allocate to their fund.

As hedge funds and particularly fund of funds have grown, many of the largest funds are now starting to resemble mutual fund organizations, and the question arises, is this just a marketing organization, or is it an investment management organization? Most mutual fund managers are in the asset-gathering business, not the asset management business. They get paid for assets under management, not performance. Therefore, it is to their advantage to manage to the mean or the index that they benchmark their fund against. They are not rewarded for outperforming. Their survival, since many are public companies with shareholders, depends on their ability to gather money, not on what they do with it.

GROWING ASSETS

For an investor, the objective is *returns*, not distribution of assets or the ability of the firm to grow its assets. A well-defined organizational infrastructure is required to protect partner assets while meeting the portfolio investment objective. Investors must be aware of exceeding large capital inflows and of any organizational changes that will impact the strategy to determine whether investors' interests are still aligned.

Foundations and endowments have also been early adopters of hedge funds and fund of funds. Two major direct investors in hedge funds are Harvard and Yale, who have been investing directly in hedge funds for many years. However, most smaller foundations and endowments have not made the financial commitment to build out investment organizations that can tackle hedge fund allocation and therefore use fund of funds to gain access to these managers (see Figure 6.2).

In reviewing the results of the study, it is interesting to note the higher percentage of alternatives with larger institutions, but the shift has been for smaller participants to increase allocations over the past several years as they cite the need for portfolio diversification, downside risk protection, and improved portfolio returns.

How Hedge Funds Work

''Fund of funds investing has been the first step to understand how hedge funds really work,'' states Bob Boldt of Perella Weinberg Partners LP, a New York–based financial services firm. Most investors, including foundations, endowments, and pension funds, are looking to achieve alpha in more innovative ways. The role of the fund of funds manager is to separate alpha from beta—to buy beta cheaply, and to achieve alpha using different strategies. While the large-state pension plans are looking to stick their toes in the water with allocations of 3 to 5 percent of plan assets, foundations and endowments are more aggressive in seeking higher returns. Fund of funds represent a good first step, but as the alternative industry matures, these groups will migrate to directly investing into hedge funds.

The big behemoth waiting in the wings and moving ever so slowly is the combined assets of the individual state retirement plans. As baby boomers get ready to enjoy their golden years, these investors are looking to protect assets through investments that go long and short the market. However, it might be a little too late now for some plans.

As of January 2009, the top 1,000 plans saw their assets under management drop by nearly \$1 trillion as a result of the volatility in the equity markets. The top 200 defined-benefit plans lost nearly 16.5 percent of their assets, while the top 200 defined-contribution plans lost nearly 13.7 percent,. It was the worst decline in 30 years, according to *Pensions and Investments* magazine, which tracks the industry.[1]

2008 NACUBO Endowment Study © 2008 National Association of College and University Business Officers									
Average Asset Class Allocation of Total Assets*									
Investment Pool Assets	Equity %	Fixed Income %	Real Estate %	Cash %	Hedge Funds %	Private Equity %	Venture Capital %	Natural Resources %	Other %
Greater Than $1 Billion	39.4	10.8	6.4	1.4	22.6	10.0	3.6	5.3	0.5
>$500 Million to ≤ $1 Billion	42.5	14.6	6.1	1.9	19.2	7.7	2.8	3.5	1.7
>$100 Million to ≤ $500 Million	50.4	16.5	4.1	2.5	16.4	4.3	1.2	3.0	1.7
>$50 Million to ≤ $100 Million	54.1	20.3	4.2	4.4	11.5	1.8	0.5	1.9	1.4
>$25 Million to ≤ $50 Million	57.6	20.8	4.1	3.4	10.4	1.0	0.3	1.2	1.1
Less Than or Equal to $25 Million	55.9	27.1	2.2	8.1	3.3	0.6	0.3	0.4	2.1
Public	51.7	21.4	3.5	4.8	11.0	2.9	0.8	2.4	1.6
Independent	52.0	18.1	4.4	3.4	13.8	3.5	1.2	2.2	1.5
Equal-Weighted Average	51.9	19.2	4.1	3.9	12.9	3.3	1.0	2.2	1.5
Dollar-Weighted Average	40.0	13.1	6.5	0.5	21.0	8.4	3.2	6.5	0.9

*774 institutions provided investment pool asset class data.

FIGURE 6.2 Average Asset Class Allocation of Total Assets

(continued)

2003 NACUBO Endowment Study © 2005 National Association of College and University Business Officers									
	Average Asset Class Allocation of Total Assets*								
Investment Pool Assets	Equity %	Fixed Income %	Real Estate %	Cash %	Hedge Funds %	Private Equity %	Venture Capital %	Natural Resources %	Other %
Greater Than $1 Billion	44.8	18.6	4.2	1.8	19.9	5.2	3.0	1.9	0.7
>$500 Million to ≤ $1 Billion	54.4	18.2	4.2	1.4	13.4	4.2	2.7	1.1	0.4
>$100 Million to ≤ $500 Million	56.5	23.5	2.9	2.7	8.3	2.2	1.3	0.8	1.8
>$50 Million to ≤ $100 Million	58.7	27.2	2.8	4.9	4.3	0.6	0.3	0.1	1.1
>$25 Million to ≤ $50 Million	60.2	27.7	2.6	3.5	4.2	0.2	0.2	0.1	1.4
Less Than or Equal to $25 Million	57.0	29.8	2.2	6.6	1.6	0.2	0.1	0.0	2.5
Public	58.1	27.9	2.1	4.0	4.3	0.9	0.5	0.4	1.6
Independent	56.7	24.9	3.1	4.0	6.9	1.5	0.9	0.4	1.6
Equal-Weighted Average	57.1	25.9	2.8	4.0	6.1	1.3	0.8	0.4	1.6
Dollar-Weighted Average	49.4	21.4	4.5	1.5	13.5	3.8	2.7	2.4	0.8

*705 institutions provided investment pool asset class data.

Source: 2008 NACUBO Endowment Study; 2008 National Association of College and University Business Officers.

FIGURE 6.2 (*Continued*)

In short, their investments did not work. A change is needed, and it is believed that many will continue to look to alternative investments to right a sinking ship and get the plans to the promised land—a place where the return can achieve the returns of the actuarial tables.

Pension Plans and Hedge Funds

Hedge fund assets of the top defined-benefit plans increased 51 percent to \$76.3 billion, including direct hedge fund investments of \$38.6 billion and fund of funds investments of \$37.7 billion, as compared with \$3.2 billion as of September 2001. This indicates that large plans favor fund of funds but are starting to diversify into single-strategy funds as well to seek more customized solutions to achieve their investment mandate.

Bob Boldt said, "Pension allocations should be larger than 3 to 5 percent, but many don't clearly understand the role of hedge funds and will remain highly dependent upon their consultants. The challenge is for the consultants to provide a high level of education to their clients."

Boldt's comments are even more important in light of the Madoff scandal. Investors need to be educated and need to understand what is happening to their assets. Unfortunately, many do not have the time or specialized background to do the work. As a result, these plans in particular seem to rely heavily on consultants and others to make decisions and put money to work.

Internal Concerns

For those pension plans that have made the infrastructure investment with staff, direct investing is the logical next step. Boldt believes that foundations and endowments have made the investment in staff, and their increased allocations to hedge funds demonstrates the need for higher returns for foundations and endowments. Foundations and endowments need to earn a higher return and are willing to assume a different risk profile than other investors who use fund of funds to meet their hedge fund allocation needs. Boldt is aware of some institutions that hold hedge funds in their traditional allocation buckets as an alternative to long-only managers.

Each investor views hedge funds differently. While most investors view hedge funds as an asset class, some view hedge funds as a structure. This approach is a way of gaining exposure to a range of asset classes, and it provides the flexibility to shift market exposures to "where the action is." Hedge fund managers have broad mandates and the flexibility to seek new opportunities. Of course, this is not without risk.

There is no single model that distinguishes the risk level for a hedge fund investment program; this will be determined by the investor's risk profile and asset/liability requirements. However, investors should try to get up to speed in order to understand this asset class in greater detail along with the concomitant benefit and risk.

Foundations and endowments have spent the last decade educating their investment committees (or being educated by the investment professionals of the colleges and universities) and are in a position to assume a different risk profile than some more traditional hedge fund investors. Pension funds seek the security blanket of a consultant to blame if something goes awry such as a blowup or a fraud. While the likelihood of that is small, the plan administrator can always tell the trustees that the overall allocation to fund of funds was small and the consultant is responsible.

"Consultants fit the psychological need for having someone to blame," said Leslie Rahl, president and founder of New York–based Capital Market Risk Advisors. "With direct investing, the stakes may be higher, but the investors are able to customize the portfolio, make independent decisions, and understand why they have created the portfolio, and what the cost is."

EVERYONE IS INVESTED IN THE SAME THING

Why do consultants consistently recommend the same large fund of funds in most searches? While a few consulting firms have built dedicated hedge fund and alternative practices, most have not. Putting resources into building the infrastructure with senior investment professionals who have hands-on hedge fund experience has not been the objective of most of the gatekeepers. Many simply don't have the expertise and consequently rely on the herd concept. If the fund of funds or hedge fund is big, has a long track record, and is used by many other respected investors, it must be good! However, a new generation of consultants has grown up in the alternative arena who have the skill set required to delve deeper into hedge funds, transitioning from fund of funds into direct hedge fund allocation. That being said, in light of the losses of 2008, it is safe to assume that investors will increase due diligence and will no longer take consultant reports or information for granted. This means the industry will be viewed under a microscope for some time.

Hedge funds and fund of funds are still classified as alternative, because they go both long and short the market as compared with traditional investments that take only long positions. This belief has led many first-time institutional investors to be unhappy with the results of their allocation to fund of funds. Given that many of the institutional allocations have been made at the suggestion of a consultant, the first weakness may be due to the lack of complete understanding of the hedge fund industry or to incomplete education on the part of the consultant. The skill set to review, monitor, and select hedge fund investments differs from that required for traditional long-only investing, and both the consultant and investor may not have been up to speed as needed to understand the strategy of timeliness of reporting. A second weakness may also be attributable to the fund of funds manager, who may not have been fully aware of the unique reporting requirements for the new class of institutional investors and the need to explain the strategy, liquidity, investment process, and reporting expectations in greater detail.

Managers and investors alike who understand each other's approach are usually more satisfied with results, reporting, and fee arrangements.

Consultant Issues

Consultants must meet three challenges, right now and for the near and distant future. The first is to demystify the risks of hedge fund investing. At the same time, consultants must educate clients about the risks and benefits of hedge fund investing. The second is to acquire the talent needed to provide high-level research and dig into the opaque strategies that hedge funds employ. As a result, fund of funds remains the path for many consultants as they search out large managers with large research staffs that they think they can rely on.

Bruce Graham of Clearbook Investment Consulting, who works with pension plans, endowments and foundations, said that client education is what allows new investors to embrace the use of hedge funds. "Getting up to speed for foundations and endowments is quicker, usually a one-year process, but can be two to three years for large pension plans," he said. "However, both need the education before they can do anything, and that is our job."

Unfortunately, Graham's experience with many institutional investors may be limited to a series of phone calls and a three-hour semiannual meeting that covers a wide range of subjects; often, the discussion of hedge fund investing is reduced to a short time slot. Despite the time challenges, lack of experience, need for education and risks, Graham is often an advocate for clients adding hedge funds and fund of funds as alpha generators for their overall portfolio.

The third challenge that all investors face is the ongoing monitoring of both the funds selected and the prospective funds for future inclusion in the portfolio. Part of the postinvestment monitoring is to continue to update the client on changes with the manager, periodic performance reporting, and attribution of returns. Why was a fund up (or down) when the rest of the market did so well (or poorly) is a frequent question asked by investors.

Investors must speak with their hedge fund and fund of funds managers on a regular basis to ensure that managers deliver as promised. Put differently, if a manager will not talk to you, will not provide you with information, or is unwilling to respond to requests for a meeting, then redeem immediately. Managers who say that they cannot discuss their strategy with you because doing so is a risk to the portfolio are not managers to invest your money with. The follow-up risk management and monitoring is as important as the selection process. Read that again; it is important and we don't want you to miss it.

Consultants must be proactive; they must anticipate the questions that you pose and make sure that they are properly equipped to answer them, More importantly, they must be prepared, and required, to act should the information you receive not meet with your expectations. Simply put, it is your money.

EDUCATION

Clearly, the education process is critical. Many different moving parts are included in today's diversified portfolio investment products. These include derivatives, credit default swaps, and maybe some Term Asset-Backed Securities Loan Facility (TALF) money, rather than traditional stocks and bonds. You need to know what is going on with your money, and there is a lot to learn. The markets are global. We all live in a 24-hour investment cycle with nonstop media coverage, and you need to be prepared when the wheels come off the cart. One lesson we can say we learned in 2007 and 2008 is that the unthinkable is possible and we need to pay attention at all times. Consultants who got their clients up to speed with the ongoing developments of the past 24 months and continued to provide assistance as market gyrations occurred certainly earned their keep. As for the others—oh well, time to find a new consultant.

During the past year, institutional interest has pushed investment management consulting firms to increase their capabilities in hedge funds. Although many consultants have provided investment recommendations in real estate and private equity through the years, the increasing demand for education and follow-up exploration in hedge funds has been a drain on consultant talent during the past 24 months. The need for understanding hedge funds has pushed consultants to reassign staff from traditional long-only investing or to hire new staff to fill this gap.

Increasing institutional acceptance of these products, along with creation of new products, has also contributed to the evolution of hedge funds from alternatives to mainstream investing. Because of the unique nature of hedge fund strategies and the lack of standardized reporting requirements, the research has become more challenging than that required for traditional long-only investing.

One of the major components in recommending and evaluating hedge funds and fund of funds investing is investor education. Included in this is the demystification of what a hedge fund is in today's marketplace. This is very difficult, and something that many people struggle with on a daily basis. It does not help that the there have been blowups and that the press, for the most part, blames all that ails the financial world on hedge funds.

Many pension trustees are reluctant to make the leap into hedge funds and do so with some trepidation because of headline risk. Few are willing to make the time commitment required to understand the strategies, structures, and managers involved and believe that the headline risk is not worth the potential returns. It also does not help that the consultants, for the most part, drop the ball when it comes to investor education vis-à-vis hedge funds. In many cases, the consultant's representative is a young, ambitious, and up-and-coming analyst or marketing person looking to move up the ladder to the next job rung. This is a nightmare for both the investors and the managers. Trustees cannot put any faith in these people and often do not. Consistency in marketing and education may be challenged, and it serves to lengthen the education cycle of the prospective investment board.

"Investing directly in hedge funds requires knowledge, timing, and rolling up your sleeves to understand how the money is being managed," said Leslie Rahl. "If the investor is not willing to do the work, they better stick to fund of funds."

Education in hedge funds is much like understanding bond math. For many, understanding the relationship between interest rates, yield, and prices is as challenging as learning to speak Chinese. Do you ever wonder why most financial publications always include a sentence that says something like "when the price goes up, the yield goes down" in every bond story they publish. If the investor has trouble with that concept, the path to strong trustee stewardship will be a challenge when it comes to hedge fund investing. This role in theory should be filled by the consultant and others from the consultant's firm. It is their job to educate, explain, and make sure people understand what is happening with their assets.

Since the technology blowup of 2000 and the destruction that occurred in 2008, trustees and consultants alike have become aware of the benefit of hedge funds as an investment management tool to manage risk. Hedge funds that actually hedge provide a better tool to manage volatility and to produce alpha than traditional investment products. At the same time, the accounting industry has finally convinced trustees that the pension plan is a liability and is becoming more so. While hedge funds and fund of funds provide tools to lessen volatility, the plan sponsor should be willing to pay for hedge fund vehicles that dampen volatility as well.

Many of the early hedge fund adopters who were exposed to these strategies through fund of funds are now moving to the next generation of hedge fund investing. This is by way of direct investing with the managers through coinvesting in as many of the past successful arbitrage hedge fund strategies that have themselves become ‘‘arbed’’ away. While some institutional investors may choose to invest on their own, several are working with fund of funds on customized mandates in illiquid funds or strategies to coinvest with the manager in areas in which the investor will rely on the expertise or background of the fund of funds managers to vet the strategies. In addition, a few specialized fund of funds managers are creating managed accounts as investment vehicles with hedge fund managers to provide greater oversight, transparency, and ownership of the securities.

A Pension Investor

Specialized mandates are increasing as investors seek to capitalize on nonmainstream global investment opportunities and to take advantage of niche strategies in far-off lands.

One of the largest investors in hedge funds is ABP, the fund for 2.7 million Dutch retirees with assets over €208.9 billion or $277 billion in 2007. APB was an early adopter of hedge fund investing. Its management team has been actively investing in alternative strategies for the past seven years. It has an impressive track record for pension assets and currently allocates over 20 percent of assets to hedge funds.[2]

According to a PricewaterhouseCoopers report issued in March of 2008, ABP expects to raise its alternative exposure to 26 percent by 2009. This would put its allocation to these strategies at nearly the same level as the endowments of Harvard and Yale. It is unclear as of this writing whether the management of ABP was still planning to increase its exposure to alternatives in the wake of the turmoil in 2008.[3]

University Endowments

Kathryn Crecelius came to Johns Hopkins University in the newly created position as chief investment officer for the university’s endowment in October of 2005. She had previously built the alternatives portfolio at MIT. At Johns Hopkins, she ‘‘untethered the university’s assets from fund of funds and reallocated to single-strategy managers.’’ Her team works hard to monitor, source, and allocate assets to alternatives.

Crecelius does not see the value in fund of funds. Her belief is that the reason she was hired by the university and in turn built an internal investment team was to manage money. "It comes down to who is running the foundation or endowment," she said. "If the team is in place and can do the job, then they should do the job."

Johns Hopkins has created a staff to manage its assets internally, but many other institutions continue to do it by committee, and that is a nightmare. Many colleges, universities, and secondary schools have investment committees, endowment business staff, and external advisors including trustees who are active in the financial services industry. Of course, in almost all cases, the foundation or endowment relies on consultants to provide unbiased information and investment advice as well as someone to blame should things go awry.

Drivers of Growth

Eric Weber, who is not in asset allocation and is not a consultant but a mergers and acquisitions professional, believes that hedge fund asset growth is demand driven.

"New allocations into hedge funds and fund of funds are coming from investors who want out of bonds or traditional investments," he said. "The consultants tell them that hedge fund allocations should be increased and the allocations are increased."

In our experience, the learning curve for hedge fund investing for pension funds appears to be five years. As soon as the pension fund staff can absorb the knowledge imparted by the fund of funds, the training wheels start to come off and they start to make selective, independent, direct investments into managers.

Leslie Rahl says that prior to making direct investments, the consultants' role fits the psychological needs of the trustees or powers that be at a specific organization. As well, it provides a person or entity to blame when performance falls short. "After all, the new hedge fund investor may not have the skills or knowledge to do the work to allocate directly," she said. "At some point, they wake up and say that they are ready, and sure enough they go direct."

GOING DIRECT

As investors move away from fund of funds and into direct investing, institutional investors want to invest only with firms that have good reputations and that are large enough in size to accommodate large flows of capital.

While most investors gravitate toward the large firms, there are thousands of good, smaller firms that fly below the radar screen.

Unfortunately, many investors miss these opportunities, and investments continue to flow to the biggest funds. The bigger will continue to get bigger, and brand names will gain greater acceptance. Since hedge funds are not permitted to advertise, finding managers is a word-of-mouth business, and in this industry branding is important.

To be ''accepted'' and to appear on an unofficial ''approved'' list, branding comes from investors telling other investors that the manager is ''good.'' The problem is that market perception or brand acceptance is usually not worth all that much in the end. Nothing can replace good solid ongoing due diligence. Brand or no brand, due diligence is what matters most.