CHAPTER 13

Multi-Strategy Funds versus Hedge Fund of Funds

If you ask seasoned hedge fund investors what keeps them awake at night, with very few exceptions you will get the same answer: the possibility of a massive drawdown. Such a drawdown can be classed into two broad categories: those related to poor portfolio management and trading decisions, and those caused by some exogenous factor outside the portfolio management process. To successfully navigate the universe of hedge fund investing, sophisticated investors have developed procedures to determine whether a drawdown could take place at a given hedge fund at any given time based on any given situation.

Despite the passage of time and the occurrence of other well-known blowups, hedge fund investors are still feeling the aftermath of the collapse of Amaranth in 2006 and the subsequent market meltdown in which some of the industry's greatest names went down 10, 20, or even 30 percent in 2008. As a result of these losses, many hedge fund investors are once again asking questions about the optimal investment vehicle to provide portfolio diversification. Many answers come down to two choices—fund of funds or multi-strategy funds.

DRAWDOWN ISSUES

Given the large pools of capital coming into the hedge fund industry, hedge fund investors proudly flaunt their unique due diligence processes and their ability to detect signs that a drawdown may occur. Sophisticated investors view the massive drawdown as an uncommon occurrence that their detection systems can sniff out with relative ease. Certainly, valuable lessons can be learned from what happened in 2008, but those events were essentially affirmations of their review processes. From time to time, a massive drawdown takes place within the hedge fund universe that goes beyond just questioning the investor's manager selection process and actually raises issues as to how investors view the industry generally. For such an event to take place, the drawdown would have to come from an established fund that may have avoided many investors' due diligence red flags.

As discussed previously, the demise of Long-Term Capital Management (LTCM) was the first such episode to raise fundamental questions about the hedge fund universe. Before the summer of 1998, hedge funds had come and gone, some more notable than others, but any major losses were seen as involving only a particular fund or manager. However, the events of the fall of 1998 forever changed the public's perceptions and investors' perceptions of the hedge fund industry; it was the sheer enormity of the situation as well as the number of players involved that had such an impact. Staffed with leading Wall Street executives and academics, LTCM was a vast institution that investors flocked to in droves; in fact, investors could not give the firm enough money. When the Russian government defaulted on its debt and fixed-income trades went awry (spreads diverging when they were supposed to converge), the dreaded massive drawdown that all hedge fund investors feared came about. A thorough postmortem ensued, and many important lessons that we take for granted today were first learned, albeit the hard way.

For the first time, questions began to be asked whether investing in individual hedge funds was the most efficient way to access the hedge fund management talent. While fund of funds had grown in number along with the growth of hedge fund assets during the 1990s, the aftermath of the LTCM debacle provided rationale for portfolio diversification through investments in fund of funds.

This review of history brings us to one of the past members of this infamous "Blowup" club—Amaranth. Like LTCM, Amaranth was a large and well-established multi-strategy fund organization. Unlike LTCM's, Amaranth's plunge was barely felt outside the circle of its own investors and employees, despite the loss of $6.5 billion. At the same time, many hedge funds and banks prospered at Amaranth's expense.

HOW BLOWUPS AFFECT THE INDUSTRY

Even though its overall effect on the hedge fund industry may have been muted, Amaranth's failure once again raised the age-old question: should I seek out a fund of hedge funds or a multi-strategy hedge fund manager? Institutional investment commitments are growing larger, and investors representing hundreds of billions of dollars are now deciding whether to invest with fund of funds or multi-strategy funds. After the LTCM blowup, much of the institutional capital that entered the hedge fund space did so through fund of funds, but over time, many of these same investors started investing directly with single managers. There are several reasons why this happened, but the Amaranth event has come to symbolize one prominent answer to this very question.

Arguably, the most common replacement for a fund of funds was the multi-strategy fund (multi-strat), which has attracted large inflows of institutional capital. As we review the multi-strat fund, we recognize once again that clearly defining this type of fund is difficult in spite of its simplicity. (Webster could probably publish a dictionary with hedge fund terms alone, but who would write the text?) A complicating factor is that until several years ago, multi-strats did not exist. Most managers did not start as multi-strategy funds but rather as single-strategy funds.

Robert Schulman, formerly of Tremont, states, "The best managers are always reinventing themselves, always looking for the new market opportunity or dislocation."[1] Historically, many of today's well-known multi-strat funds started out as either convertible bond arbitrage (as Amaranth did), risk arbitrage, or distressed managers; over time, they adapted to market conditions and morphed into multi-strategy complexes. Amaranth had become the poster child for multi-strat and had reignited the debate between fund of funds and direct hedge fund investing by the time it collapsed.

Funds of Hedge Funds

The first step in contrasting both structures is to compare the advantages, disadvantages, and distinctions of both classes of investment. Although both strategies seek to provide portfolio diversification, each strategy has many distinct defining characteristics. To begin with, the following two levels of fees apply:

- The underlying hedge funds management and performance fees (on average a 1.5 percent management fee and a 20 percent performance fee).
- Fund of funds managers' management fee, typically averaging 1 percent and sometimes including a performance fee of 10 percent.

Fund of funds invest in various hedge fund strategies through separate underlying hedge fund managers; the fund is responsible for the hiring and firing of each underlying manager. Because the underlying hedge fund managers restrict redemption frequency, fund of funds have reduced ability for frequent changes to the overall fund's portfolio allocation.

Security-level position transparency is limited because of the number of underlying hedge fund managers, which can exceed 40 to 50, each with hundreds (if not thousands) of positions. Many fund of funds, however, do provide individual hedge fund manager positions, which detail the strategy that the underlying hedge fund manager employs.

Due diligence and monitoring of each underlying hedge fund investment are performed by the fund of funds manager; the process includes understanding each underlying hedge fund manager's risk profile and relevant expertise. These funds are typically multiple strategies in orientation (although some are single-strategy focused), so their goal is to limit the fund's overall exposure to any one manager or strategy.

In some instances, fund of funds have access to closed funds by virtue of their length of investment. The breadth of possible investment is limited only by a fund of funds manager's ability to find appropriate underlying hedge fund managers. Since each investment is a separate legal entity, a massive drawdown in one underlying fund should have a small impact on other funds in the fund of hedge funds' portfolio. In the end, investors must ask: who is able to come up with the best trading ideas?

Will the fund of fund or the multi-strat argue that it is best equipped because it can go externally to source the best managers and ideas? Fund of funds will terminate strategies when the strategy goes awry, such as use of merger arbitrage when no deals are being done.

Multi-Strategy Hedge Funds

Multi-strategy hedge funds have only one level of management, and performance fees average at a 1.5 percent management fee and a 20 percent performance fee. It is also important to note that the performance fee is charged at the portfolio level. Other key attributes include the following:

- Multi-strats invest directly in strategies selected by the investment committee (or portfolio manager) responsible for the portfolio.
- Capital can be adjusted frequently, based on changing market opportunities, and is constrained only by the liquidity of the underlying position.
- Since many multi-strats manage large capital bases (in excess of $1 billion), they have the ability to attract highly talented trading and research teams dedicated to specific investment strategies.
- Multi-strat managers rotate capital allocations to strategies where opportunities exist and reduce capital allocations away from strategies with narrower profit potential.

- Multi-strat funds typically allocate more capital to arbitrage and process-driven strategies that use leverage to augment returns.
- To add additional strategies to the current multi-strat fund, new investment teams must be hired.
- Transparency varies from fund to fund, but multi-strats have the ability to offer clients better position-level information than fund of funds by virtue of managing every position.

Why Multi-Strats

Because the multi-strat is one fund with several underlying strategies, a drawdown in one strategy may affect other strategies. For example, investor redemptions may force the sale of illiquid securities to meet margin calls, resulting in a decline of overall portfolio value over a relatively short time. Furthermore, it may lead to the imposition of a gate to prevent the exodus of capital. In addition, one trader could cause a massive drawdown across the entire portfolio if not properly supervised.

One of the biggest challenges for multi-strat managers is to hire superior portfolio managers who are willing to work within the framework of an organization and sit on the bench waiting for market opportunities to arise that will enable the portfolio manager to come to bat. As Robert Schulman said, ‘‘If you're an expert in a field, do you want to hit every day? Or do you want to be a pinch hitter?’’

Baseball may have batting specialists; some players hit lefties, others hit righties. The best managers want their players on the field every day. A good distressed manager or merger arbitrage manager has to be in the game each day, not waiting for market fundamentals to change to present opportunities for his strategy. After all, A-Rod plays every day, even when he is in a slump.

Without question, the choice to allocate to a multi-strat fund as opposed to allocating to a fund of funds seems to be driven by the quest for higher absolute returns. The data shown in Figure 13.1 confirms this statement. From January 2001 through December 2007, average multi-strat returns were 3.24 percent higher then those of fund of funds.[2] (We should point out that the data does have its limitations; please read note 2 in the Notes for this chapter.)

One difficulty is that all hedge fund managers can choose to classify themselves as they see fit. As a result, multi-strat managers are particularly difficult to distinguish from others in the hedge fund universe. For example, a hedge fund manager that runs a distressed merger arbitrage and capital structure arbitrage book could choose to classify the strategy as a multi-strategy manager or as a single-strategy event-driven manager. By the same

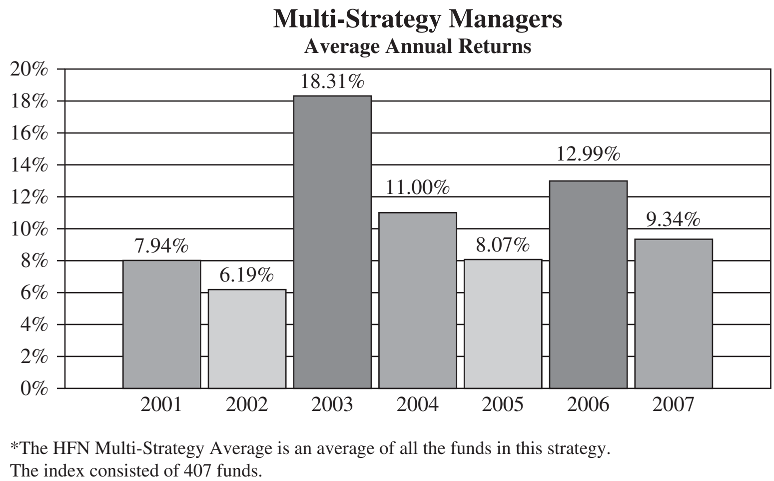

FIGURE 13.1 Multi-Strategy Managers Average Annual Returns
Source: HedgeFund.net.

token, a manager that primarily invests in convertible bond arbitrage and statistical arbitrage—very different strategies from those previously mentioned—could also choose to self-classify as a multi-strategy manager, but might choose relative value arbitrage instead. Needless to say, it is not an easy task to define the multi-strat vis-à-vis the long/short equity hedge fund manager space.

When evaluating the investment results, it appears that the return differential between fund of funds and multi-strats has several causes, some of which we have touched on.

- Fund of funds overall fees average from 1 to 1.50 percent higher, thereby reducing the net return to the end investor.
- Multi-strats typically use higher levels of leverage, both at the individual strategy level and at the overall portfolio level; this augments return but also increases volatility. By contrast, most funds of funds are not leveraged at the fund level; leverage is not applied to the portfolio unless the investor specifically requests it or the manager believes that it may enhance returns without dramatically raising volatility.
- Multi-strats have the ability to shift capital rapidly to react to changing market conditions; they can quickly take advantage of opportunities or reduce strategies when the strategies fall out of favor.

CONVERGENCE IN THE HEDGE FUND INDUSTRY

We have witnessed a convergence between hedge funds and private equity funds' investments into areas that previously had been the domain of private equity firms only. For many years, the largest component of hedge fund private equity investing had been private investments in public equity (PIPEs), but that component has grown recently to include real estate, traditional private equity, and levered loans. With the inflow of capital into hedge funds and private equity, this is one of the strategies whereby many hedge fund managers have expanded their traditional menu of investment options by adding hybrid securities and private finance capabilities to realize higher levels of return.

For many of these managers, these side pockets do not account for a large portion of their overall portfolios. However, the return targets necessary, given the illiquidity of these positions, can have a meaningful impact on the overall multi-strat. The manager can also enable certain investors, who so choose, access to their side pocket fund, which is a dedicated vehicle for illiquid investing. Fund of funds generally do not invest directly into the side pockets, given the nature of the redemption requirements of the overall fund.

Credit Crisis in Multi-Strat Funds

In the wake of the 2007–2008 mortgage meltdown, many multi-strats with specialized research and mortgage trading capabilities have added positions in highly illiquid asset-backed securities (ABS) and mortgage-backed securities (MBS). While the multi-strat looks for tremendous upside price movement for these bonds, their liquidity is reduced and longer holding periods for the funds are required.

In reviewing the volatility and correlation of both strategies, fund of funds have a beta of 0.1 to the S&P 500 and 0.03 to the Lehman Bond Aggregate Index, whereas multi-strats have 0.18 and –0.02, respectively. Standard deviation of the fund of funds index is 3.29 percent and for multi-strats is 3.94 percent. Thus, investors must evaluate the factors that drive the additional returns of multi-strats and determine whether the additional return is justified by the added leverage and exposure to sectors with reduced liquidity.

The search for alpha in the current market environment with moderate returns and the search for strategy diversification with larger hedge fund organizations may be the main forces driving investors toward multi-strats. On the other hand, the single manager blowup risk is the most compelling reason to invest in a fund of funds, where the risk is dramatically reduced for investors. In a fund of funds, each underlying hedge fund investment is viewed on its own terms; the liquidation of one underlying hedge fund investment does not affect the value of other investments held in the portfolio. Furthermore, the portfolio diversification employed by the fund of funds reduces the single entity risk by allocating to a broad range of strategies.

The Amaranth failure demonstrates precisely the additional risk level an investor in a multi-strat would have assumed. Let's suppose that a hypothetical fund of funds allocated to 20 underlying hedge fund managers, Amaranth included, each with equal weighting. Based on the reported Amaranth drawdown, the implied one-month drawdown at the portfolio level would have been approximately 3.25 percent if every other underlying hedge fund investment had been flat during that month. On the other hand, the Amaranth investor was shocked with an approximately 65 percent decline, offsetting several previously profitable years. The collapse of Amaranth has demonstrated that the diversification provided by a well-structured fund of funds can provide downside protection even with Amaranth exposure.

Allocations and Due Diligence

At the end of the day, the allocation decision is highly dependent on the due diligence process. Because of the varied risks inherent in fund of funds and multi-strats, the ensuing due diligence process for evaluating each investment vehicle is different. For example, additions to distressed or private placements, strategies that are relatively illiquid, or increases in arbitrage strategies, which typically use higher levels of leverage and may increase the risk of cross collateralization, will swiftly change the composition of the underlying multi-strat. As a result, the due diligence process requires a finely tuned understanding of each strategy and sufficient drilling down to the individual strategy level to evaluate each strategy independently and assess its impact on the overall portfolio. Sophisticated investors derive much comfort from their ability to spot the frauds, which are responsible for the majority of hedge fund failures.

Included in the assessment would be a review of the portfolio management, risk management, and investment teams. Strict attention must be paid to the infrastructure. Ultimately, success or failure depends on the management team, the risk/return objective, and the internal control systems. Thus, a strong back office that handles complex strategies and a legal staff that oversees investment activities are critical for the multi-strat, and to provide ample significant transparency to investors. While the largest and most sophisticated hedge fund operations are relatively lean organizations, even though they may boast hundreds or more of employees, the vast majority of funds are much smaller. Let's not forget that hedge funds are small businesses at their core and are generally run by the founding partners. There is no standard business model, and each fund has an enormous variation in structure, organization, and operational capability.

Review, Review, Review

In light of the latest chapters in the history of hedge funds, investors must review the due diligence process of the fund of funds and multi-strat that much closer to ensure that the following questions have been asked and satisfactorily answered:

- Is there sufficient diversification within the multi-strat?
- Is the risk management system central to the strategy or merely an afterthought to satisfy institutional investors' desires? Is the manager looking to improve the current system?
- Are all of the portfolio management, risk management, and trading personnel based in one location? If not, how is oversight conducted?
- Who has the responsibility for risk management within the organization, and is that authority independent? Can the risk manager take steps to correct deviations by portfolio managers from the stated policies?
- How are portfolio managers compensated? Is it based on the performance of each strategy or on the overall performance of the fund?
- Do investors pay additional fees for bonuses, rent, and other operating expenses?
- What type of risk reporting is provided to investors? How frequently is it reported, and from what date is it reported?

In our view, there are several lessons to be drawn from the Amaranth experience and other multi-strat meltdowns that should hopefully contribute to a more robust due diligence process. Large allocations to a big single-sector bet are always a reason of concern. Outsized returns from a single strategy should cause alarms to go off, given that most of the capital in the Amaranth strategy was dedicated to the natural gas bet at the time of the blowup. In this recent meltdown, as reported in the press, most of the assets that were advertised as "multi-strategy" were in fact primarily single-strategy dedicated to rising natural gas futures; the bet went out of kilter as gas prices dropped during September 2006. Many of the investors were large, blue-chip hedge fund investors, who presumably had done extensive due diligence and should have been able to understand the portfolio investments.

Realizing Risk

Misunderstanding or misrepresenting risk is an investor's nightmare. Rising volatility and returns at Amaranth should have been sufficient red flags to signal appropriate action. This case study provides a first-rate example of strategy drift. Investors must scrutinize the path that the manager took to arrive at the current strategy: was it organic growth or reaction to reduced opportunities within the original core strategy? In this failure, circumstances had changed a few years earlier, but many investors applauded as they were rewarded with higher absolute returns.

Outside the realm of due diligence, some other points are worth noting:

- The capital markets yawned at the Amaranth news, while investors sought to point fingers.
- Investors increased the call for greater transparency.
- Investors did not question outsized upside returns.
- While losses were incurred by some fund of funds, most fund of funds performed as expected with relatively minimal drawdowns.

Investors and consultants have always raised questions about the use and cost of fund of funds investing. With the trend toward investing in multi-strats, many investors are now raising new questions about the risk/reward profile and complexity of these programs. One path is apparent: investors must exercise superior judgment in the selection process for alternative managers, especially funds of funds and multi-strats. Even though risk is a fact of life in hedge fund investing, risk reduction should not be construed as the sole source of the generation of return. Risk must be identified and then controlled and monitored. On the other hand, if risk is eliminated, returns will disappear. While it would be anticipated that multi-strats will be subject to new and higher levels of due diligence and questioning, fund of funds will not be exempt from new inquiries either, especially those that have more opaque strategies.

If future trends follow those of the recent past, assets will continue to flow to both strategies. Investors must evaluate the higher returns, leverage, and volatility along with the reduced liquidity of most multi-strats compared with the lower return of fund of funds, but taking into account the independence of funds of funds to make changes to the portfolios, albeit at a slower pace. Despite the concerns about different fee structures, there is overwhelming justification for multi-strats in certain process-driven strategies such as fixed-income, derivatives, or event-driven. At the same time, fund of funds provide an approach for investors to gain exposure to a wide range of strategies managed by a team of professionals. As investors and gatekeepers look for investment opportunities in diversified hedge fund strategies, it is not a question of one or the other; both have a place in a diversified portfolio.

Ultimately, the real issue that comes out of this discussion is whether investors who moved or are contemplating a move from fund of funds to multi-strats or single hedge fund investments are capable of performing the necessary due diligence. By their very name, multi-strats evoke complexity—complexity of strategy, technology, and operations. Truly understanding the inner workings of a multi-strat is a much more difficult task than attaining a similar level of knowledge about a long/short equity hedge fund or a fund of funds. Investors need to think hard about multi-strat investing before embarking on it. Until investors can adequately evaluate the complexities of the multi-strat, they should stick with fund of funds. The marginal benefit in terms of increased return does not outweigh the cost of choosing the "wrong" multi-strat.