CHAPTER 14

How Fund of Funds Source Managers

Finding hedge fund managers for inclusion in a search for a potential investment by the fund of funds manager is a labor-intensive process, one that is underestimated by many. One of the first paths is for the research team to sift through the various databases and look for manager profiles that meet the investment parameters of the fund. Size, length of track record, performance results, and strategy are key ingredients for a ‘‘first cut’’ to determine whether a telephone call with the hedge fund is warranted and whether it is worthwhile to take the time to gain further understanding of the strategy.

WHERE MANAGERS COME FROM

Depending on the outcome, an on-site visit may occur next in the research process, if the manager believes that the hedge fund strategy is consistent with his or her fund’s objectives.

Another starting point is the prime brokerage community. This is because hedge funds depend on the services of the prime broker. The prime broker offers a wide range of services for the hedge fund, including executing transactions, providing daily and monthly portfolio analytics, providing financing of securities positions through margin, and in some cases, actually providing office services and office space, including telecom, Internet, and Bloomberg access. One of the hallmarks of the prime brokers is to introduce hedge fund managers to a wide range of institutional, family office, and high net worth investors globally.

Montgomery Securities’ prime brokerage division was a pioneer in creating the capital introduction capability in the mid-1990s by hosting a two-day event for hedge fund investors and Montgomery hedge fund clients.

Over 500 investors would sit in the ballroom of the Ritz Carlton in San Francisco for two days and listen to brief, rapid-fire manager presentations. The event was well coordinated by Montgomery, and each manager would discuss his strategy and team—but not performance results—in the allotted span of 12 to 15 minutes. Montgomery distributed a one-page summary of each manager's strategy and biography, and the brief talk and printed material provided prospective investors with an opportunity to decide whether a one-on-one meeting at the conference to gain additional insight was justified and, if so, to schedule a follow-up phone call or arrange for an on-site meeting.

Today, prime brokers provide various levels of capital introduction services created by the Montgomery model. The description of the prime brokers' services may range from capital introduction to capital solutions, but the objective is the same: to gain additional assets for the hedge fund managers. However, the prime brokers realize that all attendees (or all investors) who receive regular e-mails from them must indeed be accredited investors. Since fund of funds are the largest targeted investors for hedge fund managers, it is rare not to see one at these presentations.

Talk Is Good

One of the best methods of sourcing managers is good old-fashioned, unscientific word of mouth. Although the databases are useful tools, in most cases, the data is not complete. The databases do not include newly launched funds, which have no track records. They also do not report the many managers who choose not to provide performance results to a database. According to the PerTrac 2007 annual database study, "a significant number of hedge funds and fund of funds, about 12,000 in the eleven-database sample, appeared only in a single database."[1]

Given the limitations of databases, knowing the "right people" or having the "right" industry friends can be advantageous to finding not just new managers but good managers. One of the best sources of new managers is hedge fund managers themselves. Most managers will not admit to speaking to other managers, but they often meet at company presentations, known as road shows, with other investors. Hedge fund managers are always aware of who is trafficking in the stocks that they own or seek to own. They also know who the new managers are, especially if a new manager has a good pedigree. If the investor has a good relationship with some hedge fund managers, they can be a good source of information for new manager introductions.

The Inside Track

Fund of funds that have senior management teams with extensive relationships at both buy-side and sell-side firms have an edge. An alum of a Wall Street investment bank or a traditional long-only manager is able to gain an inside track in sourcing into both new and established managers that may be below the radar screen or unnamed road on the GPS. These organizations and professionals have an added advantage in being able to gain greater insight and references for due diligence to short-circuit the review and background process. The behemoth fund of funds may prefer not to openly discuss ideas and managers with other fund of funds—or with their own fund of funds investors—for fear of creating greater competition in the search for new managers. Smaller fund of funds, however, enjoy the cooperative spirit of collaboration and don't have the same ‘‘paranoia’’ about revealing a manager who may be up and coming.

Another source of identifying managers is simply to ask the managers in which the hedge fund investor is invested, ‘‘Do you know any new managers or have any buddies from your old shop that may look interesting for my firm to review.’’ Many hedge fund managers are usually willing to provide insight. At the same time, the hedge fund manager who is not always receptive to giving free information may reply ‘‘Are there any new funds that you have seen that you like?’’ Or, ‘‘Have you met with the guys at such and such who just launched their fund?’’

Third-party marketing firms have grown in popularity as a means for raising assets for hedge funds. If the marketing firm has an extensive database of hedge funds along with a referral network of financial industry professionals, the marketing firm should be able to provide a source of ‘‘below the radar screen’’ managers to market and introduce to fund of funds.

BLENDING METHODOLOGIES

At the end of the day, the most successful investors use a blend of all of these methods to identify new hedge fund managers for consideration and investment in their portfolios. The capital introduction sources are most effective for junior personnel within the fund of funds organization, whereas senior professionals with extensive and long-standing rolodexes are effective in reaching out to new managers from an established network of industry professionals and buddies. It takes time, it takes work, and it is something that needs to be taken seriously. Due diligence is not to be taken lightly. It is important to meet managers and do business with them, but it is also important to make sure they do what they say they are going to do, that their past records are not blemished, and that your money is safe. This, in the end, is the value proposition that fund of funds provide their investors and potential investors.

The question is, can these investment vehicles live up to investors' expectations and deliver? One of the scariest things to come out of the Madoff revelation is that many of the world's most respected fund of funds had invested so much if not all of their assets with one manager after telling investors that they were diversified. It remains to be determined what if anything these managers did wrong, and we are sure the courts will take some time to decide. Still, it is clear to us as outsiders looking in that these fund managers did not deliver on their value proposition.