CHAPTER 5

Understanding Alternative Investing Is Both Math and Science

To evaluate the performance results of individual hedge fund managers and the consequent aggregation of results of a portfolio of hedge funds, it is necessary to look at and understand the major influences on or drivers of hedge fund returns. Investors learned in the wake of the technology bubble's burst during 2000–2001 that the returns of many hedge fund managers, whose performance results in previous years had been skewed by participation in the high volume of initial public offerings, were mediocre at best. These investors believed prior to the market collapse that they had invested in a new breed of outstanding money managers.

Unfortunately, as technology stock prices fell, so did the value of many of their investments. As Warren Buffet once said, ''you only find out who is swimming naked when the tides goes out.'' Investors learned who did and did not have the right stuff. The reason investors use or invest with a fund of funds is because they believe that the manager knows how to evaluate and decide who is and who is not swimming naked.

HEDGE FUND RETURNS

Hedge fund returns are driven by many factors, including

- Performance of the stock market
- Shape of the yield curve
- Credit spreads
- Direction of interest rates
- Volatility

Stock Prices

Global stock prices clearly drive performance. As many say, "A rising tide lifts all boats." In a bull market, all managers look brilliant. But what happens when the market heads south? Which manager really has the skill set to profit from short positions? Or which manager has the exceptional talents and the conviction to identify trends, such as subprime, before the herd comes thundering through and early on establishes short positions in anticipation of a meltdown while the conventional wisdom is to be long?

Yield Curve

Hedge fund returns are also driven by the shape of the yield curve. An upward sloping curve is good for the economy and stock prices, but it is especially advantageous for arbitrage strategies including convertible arbitrage, fixed-income arbitrage, and capital-structure arbitrage. There are many ways to attack these markets when things are on the rise. A flat or inverted yield curve creates a nightmare for arbitrage investors; it creates few opportunities for investors, because the markets are not moving or are moving in the wrong direction. While declining interest rates benefit corporate balance sheets and earnings, rising interest rate environments present a challenge. A flat-rate environment with an upward sloping curve is beneficial to many types of fixed-income arbitrage.

Credit Spreads

Credit spreads also play an important role in hedge fund returns. As credit spreads widen, bond prices come under pressure, as we witnessed in the corporate scandals of 2002 and with the subprime meltdown of 2007–2008. While managers can profit from being on the "right" side of the trade, which can take many different forms, they may also benefit from spread tightening. No directionality in credit spreads is a challenge for returns; when markets don't move, it is harder to make money.

Interest Rates

With the globalization of the capital markets, most markets are linked, and as we learned in 2007–2008, most markets are positively correlated. Simply put, a problem in the United States is a problem in Europe, and so on and so on. It is has been an unwritten rule of Wall Street and the world that when the United States sniffles, the rest of the world catches the flu. As we write this book, the world markets seem to be using a lot of Vicks NyQuil.

During the 1950s and the 1960s investor sentiment said, ''What's good for GM is good for the country.'' Unfortunately, we learned a mere forty-odd years later that this is no longer true.

Volatility

Market volatility is another factor that comes into play with hedge fund returns. The most popular measure of volatility is the Chicago Board Options Exchange Volatility Index, often referred to as the VIX or the Fear Index.

This index reflects an estimate of future market volatility. In a market environment of low volatility, conventional wisdom would suggest that profit opportunities are strong. However, a spike in the VIX can lead to wide swings in return. Hedge fund results have been best in years when the equity markets were calm (see Figures 5.1 and 5.2).

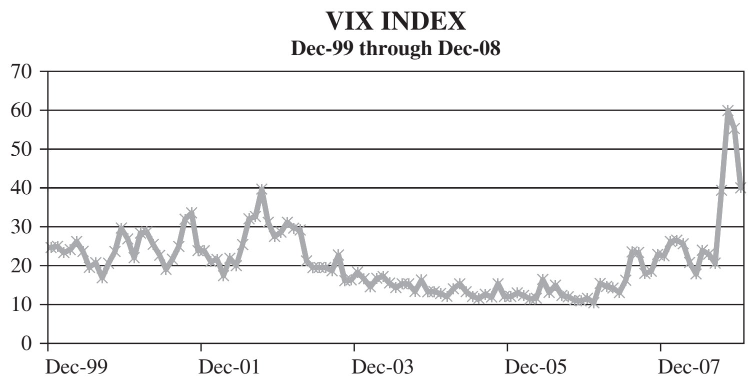

FIGURE 5.1 Annual Equity Market Volatility as Tracked by the VIX Index

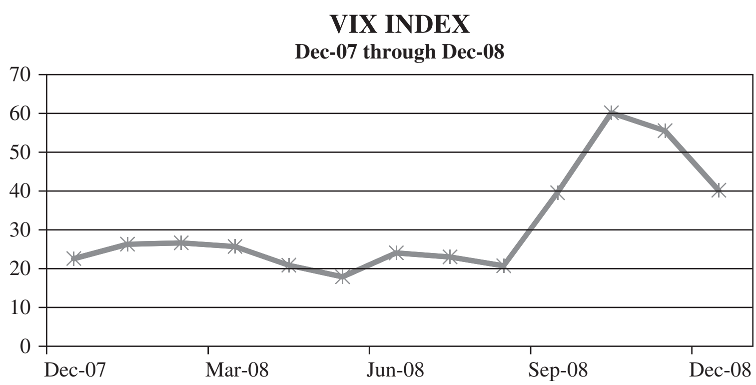

FIGURE 5.2 One-Year Measure of the VIX Index Movement from December 2007 to December 2008

The best performing managers in volatile markets are dedicated short sellers and managed futures. The short sellers are making investments that profit from the market moving downward. Managed futures managers profit from the spike in commodities prices that occurs when equity markets go down and investors look to gold, silver, oil, and other commodities as a source of returns. Unfortunately, our data concludes that these two strategies represent just 5 percent of all assets invested in hedge funds at the close of 2008.

DELIVERING ALPHA

While each of these factors contributes to returns and delivers alpha to investors, a change in one factor alone does not ensure overall profitable results of a portfolio or an investment. As an example, a price increase of 2 percent on a 5 times levered portfolio results in 10 percent gain on that portfolio. However, on the flip side, a 3 percent price decline on a 5 times levered portfolio results in a loss of 15 percent and possibly more if the manager is forced to sell positions to meet a margin call from the prime broker or Wall Street investment bank. However, a combination of capitalizing in the change in several of these factors along with the acumen of the manager should result in profit for the investor.

The bottom line is due diligence. When performing due diligence, investors must weigh the results of the manager in light of the factors previously listed. Asking a credit manager how he made money while credit spreads tightened is a good idea. Or how did the fixed-income manager make money while the curve was inverted or flat? Or with a flat and declining VIX, how did a convertible arbitrage manager have extraordinary results? Were there factors to drive the returns other than those listed in the marketing material or offering documents? One lesson that everyone has learned in light of the events of 2008 is that if something is too good to be true, it probably is; therefore, investors must ask questions and demand answers. If the answers don't add up, don't invest. Period. End of story!

A Short but Sweet Case Study

During a recent due diligence exercise, we met a convertible arbitrage manager with high teens performance results in a year when the convertible arbitrage index was slightly positive. After extensive questioning, he revealed that he had several positions in PIPEs (private investments in public equities). Generally, these are illiquid private placements, difficult to price, and initially priced at a substantial discount to the public market. Upon continuing our discussion, it became apparent that in reality, this manager was not really a convertible arbitrage manager, but a PIPE fund who still advertised as a convertible arbitrage manager. We took a pass.

To reiterate, look at the results of each manager and compare the results to what has happened in the real world to gain a greater understanding of the source and repeatability of returns. There is no excuse for not doing the work—after all, it is your money.

INVESTING IN A FUND OF FUNDS

In our experience, fund of funds are marketed using several main channels of distribution. For the record, marketing and distribution are synonymous with raising money. However, because many in the investment industry look down on the phrase ''raising money,'' it has negative implications for some people; the industry has adapted the alternative terms *distribution* or *marketing*.

In the beginning, most investment managers, fund of funds, or single strategy managers, go after the ''low-hanging fruit.'' This money is from friends or family or former colleagues; there is some direct personal connection, and the money manager, regardless of track record, style, strategy, or infrastructure, believes that he or she will be able to get assets into the fund. The reason it is called low-hanging fruit is because this sort of fruit is the most ripe. It is ready to fall to the ground. The manager's first pitch for assets is to those who are the most ripe.

Once this list has been gone through, the manager will market the fund to a wide range of high net worth investors and institutional investors who the manager knows has some interest in what he or she is doing. Most managers try to build relationship upon relationship on relationship to reach out to and access as many potential investors as possible. Distribution, or one's ability to raise assets, is the one and only means to growth and success of the business. Unless the fund of funds manager has a large marketing staff with strong global relations—or a niche fund with a specialized strategy such as emerging markets, emerging managers, or sector-specific strategy—raising capital is usually done internally and is often the biggest challenge to success.

Asset Gathering

Many managers rely on the ''if you build it, they will come'' theory of raising assets. They sit around and tell themselves and their colleagues that as long as performance is good and risk is kept in check, investors will seek them out. They believe that word of mouth from other friends and colleagues or other investors in the fund will magically cause investors to line up at their doorstep. It is, without a doubt, the most ineffective way to raise assets—one that reaches the smallest audience of potential investors.

Included in the methodology is the belief that data mining by prospective investors, those who hunt through databases looking for fund of funds that meet a specific investment criterion, will find a fund and invest. However, our experience is that data mining usually is helpful only to those with long track records and significant assets, say in excess of $1 billion under management.

THIRD-PARTY MARKETERS

Fund of funds managers may utilize the services of a third-party marketing firm to present the strategies to investors. Third-party marketers are companies or individuals who act as hired guns to raise money for a fund or fund complex. For the most part, their success is very limited given that many of these "marketing professionals" are usually not fully versed in the inner workings of the fund's investment strategy, have limited knowledge of the details of the strategy, and are unable to communicate the benefit of investing.

Besides not being well-versed in strategy details, many third-party marketers do not like the lower fees associated with working with fund of funds. They find the compensation schedule unacceptable and therefore put little effort into a capital-raising assignment. Fund of funds fees are typically a 1 percent management fee and a 10 percent incentive fee based on a hurdle rate. This fee structure is much lower than those employed by single-manager funds, and it reduces the amount of money a third-party marketer can earn working with a fund of funds.

It is our experience that the fees, along with the fact that one needs to know the direct investor (e.g., pensions, foundations, endowments, or consultants), cause many third-party marketing firms to shy away from trying to establish a marketing relationship with a fund of funds. Remember that third-party marketers are only as good as their relationships or ability to create relationships. If they are marketing a single-manager fund, they can target individuals, institutions, and fund of funds. However, if they are marketing a fund of funds, they lose one-third of their potential investors.

WHERE THE MONEY COMES FROM

Hedge funds, fund of funds, and alternative investments are the new capital-raising, income-generating model. It's the most recent trend for Wall Street, and it's here to stay.

Looking at the contraction of municipal bond dealers, which has shrunk from over 35 major firms when the space was profitable in the 1980s to a handful of investment banks today with narrow underwriting spreads, trade recaps of bond pricing made the market more efficient. The list of primary dealers reporting to the Federal Reserve has shrunk from 46 in the 1990s to 19 today.[1]

From the 1970s to the 1990s, most investment banks and commercial banks wanted to have large municipal bond departments or large government bond departments. What does that do to the outlook for hedge funds when Wall Street senior management teams decide that hedge funds present too much risk or too little profit? Has Wall Street learned from past mistakes? In 2009, the landscape is changing.

The success of each of the Street firms when raising capital for hedge funds shows how valuable the strategic partnership with hedge funds and fund of funds can be. The math of the joint venture makes sense for both parties, but is it in the best interest of the investors? Sharing (or recapturing) 2 and 20 percent from a hedge fund is a lot better than the 50 or 75 basis points these firms earn managing long-only money.

Given the proliferation of new investors looking for new ideas and trying to identify outstanding managers, investors must rely on intermediaries to identify investments and to perform sophisticated analysis and due diligence. At the same time, global financial institutions and private banks are getting increasingly more involved because they, too, see the writing on the wall, regardless of recent meltdowns. Investors understand the need for investments that can go both long and short the market and allow their portfolios to grow regardless of which way the market is moving.

Raising Capital

Since raising capital is the key to success for both manager and banks, the questions are, how far does the ''Street'' firm go to market the product? Is there a higher payout for the internal product? Or is it better to go to the ''open architecture platform'' that is more independent? These questions are ones that baffle many who work on the Street as well as those who are constantly trying to raise money. The second question asks whether the solicitor is a sales agent, an advisor, or just a marketing person tasked with raising money.

While many changes have been made in the post-Madoff period, sales conflicts are still prevalent in the current Wall Street model. The model is currently still somewhat broken. It is clear that sales agents and their client's interest are not always aligned. Our concern is that investors believe that because a product is being marketed or sold by individuals employed by some of the most powerful and respected investment firms in the world, they have a false sense of security. We hope that if Madoff taught us anything, it is to question everything. We believe that firms need to be more up front and transparent about their financial arrangements with the funds that they market. Investors need to ask the questions and get the answers.

In the wake of the market meltdown of 2008, we believe that investors need to have a greater level of transparency regarding their holdings. The problem, however, is not getting the information or data, but knowing what to do with it. It is all fine and good that Congress believes that the Hedge Fund Transparency Act will bring a new level of transparency to the industry. But what are investors supposed to do with this data, how are they to use it, and what is the value of having it? Many people believe that hedge funds will not provide transparency and are afraid of giving out data. To that, we say hogwash. The managers will provide the information; the question is, what does the investor gain by having it? Also, in light of Madoff, we now have to question the accuracy of the information. However, this last point will be covered later in the book. For now, assume the data is accurate and that one knows what to do with it.

These are tough questions to get answers to, and many have a hard time asking the questions and demanding the answers before they invest. This is the reason people invest in fund of funds. Fund of funds on the outside are supposed to do all this when they invest investors' money. Their job is to do the due diligence, pick the managers, and deliver returns. It is what you pay for, and it is their job.

And while that is all well and good, another interesting trend that has developed in the last few years in the funds of funds industry on the part of institutional investors is the use of fund of funds as a tool to find new, exciting, and emerging managers.

THE NEW NEW MANAGERS

There are a number of fund of funds that invest in ''undiscovered names.'' When discovered, the fund of funds redeems and moves onto to new undiscovered names. The investment premium of the fund of funds is lessened as the investor starts to allocate away from the fund of funds. While immediate access to a fund of funds may be a marketing strength to some, to many others the idea of finding a manager when that manager is small, undiscovered, and not on everybody's radar screen is the edge that that manager offers to investors.

Selecting a fund of funds that is right for your assets is a process that takes place over a period of months—and in many cases, years. It begins with a series of phone calls, continues to a series of on-site meetings at the manager's office and meeting all of the senior people along with the support staff and research analysts. It includes checking references; checking service providers; and hiring independent firms to perform background checks on the people who run the company, pick managers, and handle the money. It is not easy, it is not fun; it is work, and it is worth it because it is your money!

Due Diligence?

Many believed prior to the Madoff revelation that institutional investors and their consultants applied a more rigid process of scrutiny and due diligence to asset allocation because of the nature of the source of funds. However, in light of the losses that pension plans, endowments, family offices, insurance companies, and their advisors experienced with their allocation to Madoff, it appears that due diligence has been lackadaisical and a smoke screen of sorts to a small percentage of hedge fund investors. This cannot, should not, and hopefully will not continue.

Managers, both single-strategy and fund of funds, must understand the decision-making process and the need for independent evaluation of the firm during the marketing process. While most fund of funds and hedge funds meet the expectations, many investors report negative experiences in dealing with the marketing individuals and teams at the firms. Attitudes, arrogance, and annoyance are often quite prevalent. Don't put up with it—it is your money. If they don't want to answer, are annoyed, are arrogant, or have an attitude, don't hire them; then e-mail us at dsrb@hedgeanswers.com.

Marketing is nothing more or less than a sales job. Some people get it, others don't. It is not a good or bad thing, it is just a thing. There is little, if any, glory in sales, and many fund companies seem to have a revolving door when it comes to their marketing staffs. There is clearly a shortage of experienced institutional marketing professionals relative to the size of the market. Don't be surprised if one day you talk to one person only to find out a few days later you are dealing with someone else.

The marketing phase takes place over a long period of time, and personnel changes are common at both the investor and the consultant level. Therefore, fund of funds marketing professionals must be able to provide an intense level of detail regarding the fund's strategy and organizational structure. Equally important is the fact that investment strategy education is critical, because many investors may be first-time investors, and constituents of the investment process may be time constrained.

Asking Questions

As basic as it may sound, the most effective marketing question that should be asked by a fund of funds professional to potential investors is: What are their investment needs and their expectations of the investment? On the flip side, an investor should ask what the stimulus for firing or redeeming a manager is and when was it last triggered.

Meeting with key investment and risk managers of the fund of funds organization should provide a high level of comfort in the decision-making process regarding the portfolio. However, you need to go deeper than a couple of meetings. Interaction between the fund of funds and its investor provides many with a high level of satisfaction, but satisfaction is not enough. You need to get documents, meet the accountants, and perform background checks. There are many people who say that Madoff would never have passed their investment test; however, there are even more who are considered serious hedge fund and fund of funds people who got caught in the fraud. Although the jury on the level of their involvement is still out, maybe they knew, maybe they didn't. One thing is for sure: had they looked into the accounting firm that allegedly performed the audit and net asset value calculations, some alarm bells should have gone off signaling that something was not quite right.

Getting Answers

Fund of funds must be able to plainly explain the difference between their strategy and that of other firms and to demonstrate where they can and do add value. It is more than a matter of a few basis points here or there. Many fund of funds are accustomed to bringing armies of analysts to hedge funds during the due diligence process. This can be a smoke screen. It is nothing more than an appearance that work is going to be done. We believe that the manager should bring only senior representatives, including a decision maker, to the meetings—that is, the people who have a role in the funds management process and understand the investment process. Too many cooks spoil the soup.

In keeping with Wall Street customs, most investment managers think that he who has the biggest "pitch book" has the best fund. While size may be contested, it's really all about content and the synthesis of the information. Since the decision makers' time is limited and the manager may get only 30 minutes of the busy schedule of the investor, the fund of funds should simplify the presentation, review several of the pages—certainly not the whole book—and encourage an open dialogue of questions and answers.

Investors want to know about risk management, the research process, the background of the investment team and senior professionals, access to managers, and how the funds of fund will fit within the overall portfolio. Investors also want to understand the current investment climate and how the fund of funds is positioned; they want to receive a bird's-eye view of the economy and to be told how the fund of funds plans to adapt to changes in the economy and markets that may lie ahead.

After screening various databases for fund of funds according to predetermined quantitative requirements, the investor or consultant will follow up with on-site due diligence to meet prospective managers. In addition to meeting key investment personnel, operational staff, and legal and compliance personnel, the prospective investor should feel comfortable that the investment philosophy and strategy had been well articulated by all the people involved. When reviewing the investment portfolio of hedge fund managers and strategies, the investor should understand the flow of information and how the best ideas make their way into the fund of funds portfolio. Ask about postinvestment monitoring by the fund of funds manager; this is important to ensure that the "advertised" risk management system is real and that they are paying attention.

The Due Diligence Process

One of the most effective tools used (as well as abused) as part of the research and due diligence process in identifying managers is the Request for Proposal—RFP in the vernacular. In the world of asset management, the RFP was originally intended to be an invitation for an asset manager to submit a proposal to a prospective investor who was conducting a search for a specific investment mandate. Investors, through their investment consultants, would advertise that a search was being conducted for managers that met the specific criteria and would invite managers to complete an RFP and possibly make a formal proposal stating why each firm's strategy was better than that of its peers. They would then patiently await a favorable response from the prospective investor.

Many financial publications such as *Pensions and Investments* advertise classified notices of current investment requests for proposals. Each RFP has a unique set of questions in which the manager lists performance history, the background and experience of the firm and its principals, legal structure, fee structures, investment process, and risk management systems. RFP questionnaires can range from 15 or 20 pages to 50 to 60 pages.

Many of the large hedge funds and fund of funds have staffs charged with the sole purpose of completing RFPs. As the hedge fund industry has matured, the RFP has taken on a life of its own. It is now used as a primary marketing tool by hedge fund managers. It is a textual presentation of the "pitch book," the PowerPoint version of the marketing book. In short, it consists of words instead of pictures.

While managers are proud of the hours spent by a staff of designers and analysts who insert the graphs, performance charts with peer group comparative results (always showing the manager in the top deciles or quartile), org charts, and all biographies, the RFP is nothing more than a long-winded document that looks about as interesting as any printed page.

The consulting industry, along with other direct investors, now ask or request an RFP to obtain all of the information relating to the manager and strategy as the first step in the due diligence process. It provides concise data in a format that will provide investors with the opportunity to fill in the blanks with a standardized format. Whether the information is actually directly used to evaluate managers as part of the due diligence process for the current RFP or is used simply to aggregate data that can be used for creating internal databases, in many cases consultants and fund of funds will boast that they have "x" thousands of managers in their database, but only allocate to a smaller percentage of "y" dozen managers. Size, it seems, matters here as well.

One of the issues that concerns managers is that the RFP is considered to be a marketing piece and must be reviewed and approved by legal counsel prior to dissemination to potential or existing investors. Since hedge funds are prohibited from advertising, each manager and the legal staff must be prudent about the content of these documents and safeguard the information being provided to both qualified and unqualified investors. The lawyers are really sticky about this point. Some managers require the completion of a nondisclosure agreement (NDA) to prevent distribution of the information to those outside of the direct investment process at a potential investor's firm or organization.

Ongoing Monitoring

Once the decision to invest has been made, it is important to follow up. Ongoing monitoring should include spending time with the key investment professionals and being provided with interim reports that describe the prior reporting period. Updated RFPs should be received and reviewed to determine what changes have been made since the last written report. The information should also detail any changes that occurred to the portfolio during the prior period as well information on expected changes to the portfolio. In addition, the fund of funds manager should notify investors of any personnel changes, including key hires or departures and commentary on performance results.

Remember the following three rules and you are assured to be safe:

1. If it appears too good to be true, it probably is.
2. Anyone who does not use well-known, well-respected, and industry-experienced service providers is someone you don't want to invest your money with.
3. If you ask for information and don't get it in a timely manner, don't invest.

These rules apply not only to investing in hedge funds, fund of funds, or private equity funds but to all investments. It is your money, you worked hard for it, and you deserve to have it managed properly, ethically, and as described. Ask questions and demand answers; if you do not like what you hear or receive, go someplace else. There are plenty of smart, sophisticated people who will do the right thing; you must do your work and find them.