CHAPTER 4

Hedge Fund Investing

The crossover or convergence of hedge funds and private equity has provided new opportunities for investors and managers to work together and extract profits from the markets. However, as the convergence has occurred, investors have raised many questions and concerns about how their money is being managed. All marketing material for hedge funds, as well as for other investments, states "past performance is not indicative of future results." In the changing environment, investors are betting on better future results.

PRICING PROBLEMS

One of the challenges of hedge fund investing is subjective and periodic pricing of the portfolio. Pricing of the individual positions in portfolio or "marking to market" can be a complex issue for illiquid or less frequently traded securities (i.e., private equity holdings). Managers will generally use pricing obtained from publicly available sources as well as from proprietary sources from the prime brokers or administrators. The Wall Street dealer community also provides pricing data to the manager. In less liquid or illiquid positions, the challenge is different.

To standardize the pricing and reduce the need to manage pricing and monthly performance results, the Financial Accounting Standards Board (FASB) introduced FASB 157 for Fair Value Measurements to define fair value within the annual auditing process. The purpose is to reduce the risk of mark to market bias by managers by addressing three issues: definition of fair value, methods used to establish fair value, and providing additional disclosure and its results.

Accounting Rules

To define fair value, the FASB established a three-level system of classification for the portfolio and set a requirement for each level. Level one inputs are quoted prices or ''observable prices'' in active markets. This is easy for companies that are quoted on a stock exchange. Level two inputs are ''observable for the asset or liability, either directly or indirectly.'' Level two prices may not have an observable price, but the prices are based on input for financial instruments such as interest rate swaps. Level three includes ''unobservable prices,'' such as private equities, real estate loans, or complex derivatives. Level three may require using a model to price the position and to consider when selling the position. This would include taking the current market pricing and liquidity into account for the pricing, even though the position may have no market and no resulting liquidity. Most hedge fund managers would argue that the value is unchanged, given that there is no known market and the value has held up, because no deterioration of the credit has occurred despite the change in market liquidity.

Illiquid Securities

The greatest challenge for hedge fund investors traditionally had been the pricing of illiquid securities, but the introduction of FASB 157 in 2007 presented a new wave of issues for hedge fund managers and the U.S. commercial banking industry. While the auditors and bank examiners forced depository institutions to ''mark down'' the prices of hard-to-value securities and to take a hit to equity capital, the issue was not as clear for the hedge fund industry. Now being holders of private equity comparable to longer locked positions, investors who seek liquidity have found pricing to be a major issue. This was never more evident then in the waning days of 2008 and the early part of 2009, when investors who experienced massive losses from pretty much all investment strategies demanded redemptions for their underlying hedge funds and fund of funds. Many large hedge funds chose to limit or suspend redemptions, stating that the prices in the marketplace were simply not correct or that fund managers could not execute sales at prices that were acceptable or at reasonable price levels. Many fund managers put in place a little-known item in their private placement memorandum called a *gate*.

The gate provision allows a manager to limit or shut off redemptions for any investor, based on the idea that to allow one investor out, he or she could be wreaking havoc on the portfolio and causing other investors to suffer. The suspension of redemptions and the use of gates caused quite a stir in the popular press and, more significantly in the hedge fund investor community during the second half of 2008 and the beginning of 2009. Apparently, many investors believed that managers were not necessarily acting in the best interest of investors when they used their ability to gate the fund and suspend redemptions and were really only acting on behalf of themselves. It remains to be seen how investors will react to fund mangers who used gates or suspended redemptions. The reality is that some managers will suffer for their decisions and others will thrive. It comes down to their ability to communicate why it was necessary to take the action in the first place.

HEDGE FUNDS AND THE PRESS

Whenever hedge funds make front page news, finger-pointing is renewed about the ability of "secretive" hedge funds to move markets and alter the course of both financial and political history. Hedge funds have always been described as "secretive," but a quick search using Google shows results of over 11.3 million pages with the term hedge fund in it.[1] (By the way, Google found these 11.3 million pages in less then 0.21 seconds!) With the press continuing its vicious attack on hedge funds by publishing successive negative reports on these investment vehicles and the wizards who run them, many hedge fund investors seeking refuge from the onslaught from their own peers have started to separate the myth from the reality of hedge fund investing. Unfortunately, we have found that no discussion of these sought-after investment vehicles is complete without listing a few of the most important, influential, and interesting myths that prevail in the marketplace.

The Failure of Large Hedge Funds Will Have a Major Impact on the Markets

As we witnessed with the 2006 implosion of Amaranth, the impact was restricted to the direct investors in the strategy. While $6 billion of investor assets evaporated overnight and direct Amaranth hedge fund investors were impacted severely, one-month returns for fund of funds were only slightly impacted as a result of the overall portfolio diversification. With most fund of funds averaging more than 20 different manager positions, a wide range of exposure to different strategies, sectors, and managers provides a risk-reducing tool for fund of funds investors. When Amaranth imploded, the rest of the capital markets barely yawned because of the wide diversification of exposure. During the final three months of 2008, hedge funds globally were selling massive amounts of securities across all asset classes to meet year-end redemptions, but traditional long-only investors were dumping as well as investors who sought the safety of cash.

While hedge funds were one component of the sell-off, the cause was not the failure of a large fund but a crosscurrent resulting from the combined selling by all investors. The reality is that because each and every market is so intertwined, there is probably no single fund or group of funds that could cause the financial markets to collapse. In the aftermath of the announcement of the $60 billion Madoff fraud, the markets did not flinch. Even though the Madoff affair provoked considerable discussion and debate among investment professionals, the staggering losses it caused did not move the markets. However, it is fair to say that as the markets become more and more intertwined, large fund complexes can move markets—and that they do. Total and utter destruction is not something that is likely to be created by a fund manager; most managers simply have decided to leave that up to their respective governments.

Hedge Funds Are Dangerous Because They Use Derivatives

Because the use of derivatives is highly complex and depends on the underlying development, creation, and analysis of quantitative models, the use of derivatives is limited to sophisticated investors, including hedge funds that have specialized staff to analyze these positions. When used as hedging vehicles, derivatives generally lower portfolio volatility and also offer a cost-effective methodology to reduce risk. If used to make big bets, derivatives may raise portfolio volatility to higher levels. Simply put, nobody really knows how to define the impact of derivatives on a portfolio, because to do so one needs to know the extent to which these contracts are being used. In some instances, with levels of leverage, derivatives can cause massive problems for the fund and its investors. In other situations, the use of derivatives can add significant alpha. The reality is that not all uses of derivatives are bad; when used appropriately, derivatives are an important part of the capital markets.

The Use of Leverage Is Bad

Most hedge funds use no level or limited levels of leverage to extract opportunities from the marketplace. In the case of traditional Jones-style long/short equity, all managers are able to use the same leverage amounts as defined by Regulation T.[2] Reg T as it is known in the industry, is the Federal Reserve Board's regulation that governs how much credit or margin a brokerage firm can give to a customer to buy additional securities. Most individual investors regardless of size can borrow up to 50 percent of their holdings. This includes the amounts that individual investors can use in their brokerage accounts as well. While some funds such as traditional fixed-income or mortgage-backed securities arbitrage funds use higher levels of leverage, the use of leverage peaked in 2007 when managers were able to borrow as much as 12 to 15 times the value of their underlying securities. Now, in light of the current credit crisis and decrease in leverage mandated by banking examiners, the numbers have been dialed down considerably; in 2009, most fixed-income managers are able to get 3 to 10 times in leverage. Two things seem funny to us when the discussion turns to excessive leverage. First, leverage is nothing more then borrowing; most Americans use leverage every day when they buy a home or a car or use the plastic card in their wallets. Furthermore, it was the excessive use of leverage by the traditional banks and the investment banks—often more then 25 to 30 times their balance sheets—that many believe is to blame in part for the credit crisis and the economic havoc that taxpayers around the world were being forced to deal with in early 2009.

Hedge Fund Strategies Are Niche or Quirky

Hedge funds are often viewed as being the extension of the highly guarded proprietary trading desks of Wall Street firms of yesteryear. After all, some of the best hedge funds were born at Wall Street's biggest trading desks. That is where creative minds were able to exploit market inefficiencies and capitalize on the large capital base and distribution capability of the investment banks to earn massive profits for their shareholders. As hedge fund entrepreneurs develop their business models, the key is to be able to replicate the style and strategy of their former shops and then grow the new hedge fund business franchise. Hedge funds of today have replaced many of the proprietary trading desks of yesterday, because hedge funds answer only to their investors and the regulators. Today, most investment banks have either merged into traditional banks or are themselves in the process of becoming traditional banks. As such, each is no longer able to put capital at risk, and the risk takers have been replaced. Hedge funds now fill this crucial area of the capital markets. They pick up where Wall Street left off.

Hedge Funds Are All-Day Traders Using Nonpublic Information

As the hedge fund industry has become more globalized and trade less liquid positions in many strategies, the holding periods for securities have grown longer and longer. Financial information is available to all who ask for public information, and Regulation FD[3] (or Fair Disclosure) has leveled the playing field. As investment returns have moderated, hedge funds are looking for less-trafficked ideas, many of which are longer term. Because of the growth in the number of hedge funds since 2000, market liquidity has increased. New financial products such as weather derivatives or investments in private equity and real estate have provided financing for many projects that have unique funding requirements, with financing coming from hedge funds. Many of these trades are not covered by traditional rules regarding disclosure.

However, most funds discuss transactions as they relate to the overall performance of their fund. Furthermore, in light of some of the insider trading cases that have been prosecuted in New York and other jurisdictions over the past few years, it is clear in the minds of many that there is a clear distinction between what is and what is not public information, including the ramifications for disclosing nonpublic information to those who can profit from it. The Securities and Exchange Commission, regardless of the lapses manifested in the Madoff situation, takes quite an aggressive stance against trafficking in nonpublic information.

Hedge Fund Fees Are Too High

While hedge fund fees have moved up, returns have met investors' objectives, as demonstrated by the growth of industry assets to nearly $2 trillion by the end of 2007.[4] The hedge fund industry contracted during 2008 and the early part of 2009 as a result of significant levels of redemptions due specifically to poor performance, and fees are once again on the minds of many investors. Let us just say this: it seems that, for the most part, the only people really complaining about the fees are those who cannot charge them. When investors demand a decrease in fees, the fees will decrease. 2009 will probably usher in a new era of lower fees.

Hedge Funds Don't Tell Us What They Invest In

With the institutionalization of the hedge fund industry, this is no longer true; hedge funds managers understand the need for investors to be able to perform specific levels of due diligence and use risk models to analyze their portfolios. As such, hedge fund managers are providing a greater flow of information surrounding their investment strategies, with most providing position-level transparency. If a manager is not receptive to providing an acceptable level of transparency, investors should simply take a pass.

Fund of Funds Charge a Second Level of Fees, Which Reduces Returns

This statement is correct. However, the argument for the additional fees is that fund of funds managers provide a level of service and expertise that some investors cannot accomplish on their own. Direct investing through single-strategy managers requires a significant internal expertise and substantial investment in infrastructure. The fund of funds fee should more than offset the resources that the fund of funds provides, including research, due diligence, ongoing monitoring, appropriate portfolio diversification, and risk reduction for the investor. The problem is that some fund of funds don't do what they say they are going to do and provide little if any value for their services. Choosing a fund of funds is right for some and wrong for others. The key is making sure you are getting what you pay for.

Hedge Funds Dislike Fund of Funds

While hedge funds are receptive to receiving new assets and want to grow, if you ask most hedge fund managers what they think about fund of funds' assets, their answer is not always positive. Most hedge funds will respond that fund of funds are "information hogs," "always looking for fee concessions," or "constantly rebalancing managers" (or is that a case of heading for the exit after a few poor months?). This is problematic, because managers don't like investors that take up a lot of their time, demand lower fees, and move in and out of the fund based solely on performance. In reality, fund of funds spend considerable resources and time and are reluctant to make changes to their allocations unless the strategy currently being pursued is no longer viable or changes have taken place within the organization that merit redemption. Hedge funds prefer "sticky" assets, such as foundations, endowments, or pensions, which are interested in longer-term investing over a cycle rather than quarter to quarter. However, many fund of funds that have deliberate, comprehensive due diligence processes that are developed over a long period of time to identify strategies are welcomed by many hedge fund managers as sticky investors. Many investors, including a small number of fund of funds, are constantly searching to find the next hot strategy and will jump from manager to manager in search of perceived or untapped alpha. Frankly, these managers just don't succeed and usually burn out. Hedge funds want stable assets! Many hedge funds compare these sticky assets to core deposits in the banking industry, where depositors are looking for a full-service relationship rather than a rate and term for the cash.

THE FUND OF FUNDS VALUE PROPOSITION

Fund of funds managers provide a basic service that most investors are unable to provide: the ability to construct a portfolio of diversified hedge funds that offer attractive returns and liquidity terms in a cost-effective investment vehicle. Many investors will state that it is easy to start a fund of funds because the start up costs that constitute the main barrier to entry are relatively low. The reality is that to be successful, the fund manager needs significant assets to manage to make the business viable.

There are significant economies of scale that can be realized by the manager once assets cross the $500 million mark. However, before those levels have been reached, some fund of funds have difficulty competing in the marketplace. Size does matter. The manager must be able to fund the infrastructure and staff in order to source, review, allocate, and monitor the portfolio of hedge fund managers, not to mention handling the day-to-day tasks of running the business.

Fund of Funds Investors

In light of the poor hedge fund performance in 2007 and 2008, capped by the Madoff scandal, many investors have soured on fund of funds. That fund of funds managers were in the marketplace offering "diversified portfolios," when in reality all or most of the assets were with a single fund or strategy is, in our opinion, criminal. This has been an unfortunate wake-up call to remind many of us that we're just getting over the blowups at Amaranth and D.B. Zwirn, along with the fraud of Bayou. There is no level of due diligence or regulation that will totally wipe out fraud or blowups. These are natural occurrences. However, managers who cut corners by not completing background checks or operational evaluations make the situation even worse. The reason fund of funds make sense, are important, and are worth the fees is that investors are buying services that are too hard, too costly, and too time consuming to perform on their own.

FEES

As of year end 2008, by our unscientific albeit straight-to-the-point exercise, fund of funds averaged a 1 percent management fee and a 10 percent incentive fee. Fund of funds are often criticized for this so-called additional layer of fees, but unless the investor is prepared to build out an investment, due diligence, research, legal, accounting, and reporting team, the fees are actually low. Fund of funds managers provide a unique and specialized service as portfolio managers. Our research shows that most fund of funds managers' operating expenses exceed .50 percent, which means that the fund of funds business is a low-margin proposition. However, because the business is scalable, the business proposition continues to improve as assets under management continue to increase. As long as fund of funds are able to achieve higher than average returns with lower volatility, there is, in our opinion, sufficient justification for the level of fees that are charged by the manager.

Many fund of funds managers offer various arguments to justify their fees—arguments that we do not subscribe to. If you are provided with such arguments, in our opinion you should ask, "How?" Ask this question if the managers claim to be able to

- Access closed managers.
- Access managers generally below the radar screen.
- Achieve above-average performance results.
- Discover new and emerging managers as well as up and coming strategies.

The fund of funds manager is supposed to access closed managers, access undiscovered managers, and uncover new strategies. Nothing stated here would make a fund unique. But these statements must be met with skepticism.

ALLOCATION STRATEGIES

One of the ongoing challenges of individual hedge fund selection and allocation is the size of the underlying managers. Many investors like to claim that they have been the first to discover and allocate to the newest, greatest manager that no one else knows about. Still, the question is really one of capacity. The new, emerging manager may have a great pedigree, but no track record. He or she may have capacity constraints and may not be able to run a business. Fund of funds managers and other large institutional investors constantly ask, "How much capacity will you reserve for my fund?" This is usually one of the final questions of the due diligence process. Since fund of funds are quick to point out the ability to source new up-and-coming managers, size may be the biggest challenge to performance. Most strategies such as small-cap or sector-specific strategies may have size constraints; most large fund of funds have size constraints before allocating initial capital, or requirements placing a maximum amount of capital that may be committed to one manager.

The challenge of the fund of funds manager is the ability to commit capital to managers that will not restrict asset terms while at the same time not diluting returns. If this is an issue, fund of funds managers will look at larger managers that can accept unlimited amounts of capital. Unfortunately, in this scenario many fund of funds will start to look like other large fund of funds as they continue to invest in all of the same ''household names.'' The redundancy of the same positions in the large fund of funds portfolios may cause a problem in markets that do not function as modeled or when a blowup occurs. In the wake of the Amaranth blowup, many fund of funds investors quickly discovered that while they had invested with different fund of funds managers to achieve portfolio diversification, many of the fund of funds actually owned the same Amaranth position in each of their portfolios. Amaranth was a widely respected hedge fund with great pedigree, and it would have been smart to include it in a diversified strategy. Redundancy of positions by several fund of funds for large institutional allocators can actually prove to be counterproductive

One investment trend today is for allocators and their consultants to invest in ''bulge bracket,'' or multibillion-dollar fund of funds only. As a result, investors may not place a premium on the research ability of the fund of funds manager to find new undiscovered managers because the manager has a capacity issue and can allocate only to larger hedge funds that have the ability to accept larger inflows of capital. As an example, small-cap equity managers that are always looking for new companies with a unique edge in the market by researching companies that are not widely covered or followed are hedge funds that large fund of funds may not be able to utilize. The question then becomes, ''What is the value added to an equity manager who invests in large-cap companies such as Microsoft or IBM where most of the relevant research data is in the public domain?'' The answer is ''little or none.'' Therefore, we believe it's best to shy away from large fund of funds that cannot distinguish their strategies because their size limits their ability to perform.

Fund of funds managers that research and access small-cap managers or other specialized strategies are able to charge higher fees than the larger funds, given that the cost of discovering and allocating to new, emerging managers is more challenging. At the same time, many of the large multistrategy managers are starting to look like fund of funds, further clouding the waters.

When looking for hedge fund managers, fund of funds are looking for managers with a competitive advantage. According to Robert Schulman, former president of Tremont Advisors, a large fund of funds that got caught in the Madoff scandal, ''You are looking for managers to reach a decision and gather knowledge that nobody else is finding. That is not done with published material or shared by others.'' Schulman believes that most fund of funds should be paid to discover the next generation of hedge funds or strategies by knowing their industry.

BOUTIQUE INVESTING

As the institutionalization of the hedge fund industry continues, this former cottage community of small, secretive boutiques is now morphing into large asset management firms that perform investment banking transactions, engage in commercial lending, and finance real estate, all the while managing large portfolios of global securities. As a result, these large hedge funds are becoming some of the largest investment banking clients of Wall Street. These once small companies of a few have adopted many of the same attributes as the large, well-respected Wall Street investment banks, including

- Risk management systems to monitor and stress test portfolios
- Technology to support the firm's investment process and internal investment system
- Transparency to access a client base of highly regarded investors
- Enhanced distribution from strategic partnerships with well-respected financial institutions
- Shared ownership by a range of employee ownership to demonstrate an alliance of interests
- Forward-looking vision for the company

At the close of 2007, there were nearly 7,200 fund of funds in the marketplace, according to the most recent PerTrac Study.[5] The recipe for success for a fund of funds is different from that of a hedge fund, with distribution being a major ingredient.

Institutional Names

According to Eric Weber, chief operating officer and managing director of Freeman & Co., brand name is key. He notes that no independent fund of funds is among the top nine ranked by assets under management and only one in the top 16 is an independent firm. Each of the largest is a part of a large money management complex. The independents are not able to grow because the market doesn't want the perceived risk associated with a small firm. Remember, nobody ever got fired for buying IBM computers. The same can be said for fund of funds. Nobody ever got fired for investing in Goldman Sachs, Bank of New York, or JP Morgan Chase fund of funds.

Finding distribution channels is a significant challenge for smaller fund of funds.

Weber said that many large asset managers and private banks in the United States and outside the United States offer distribution relationships, and it's hard for smaller participants to compete. Consultants also provide a key role in the education of clients and consequently provide a different level of distribution of fund of funds for their clients.

As the hedge fund industry grows and well-publicized frauds and blowups escalate, the need for greater transparency increases. Larger, better-capitalized fund of funds are able to develop state-of-the-art risk management systems and greater in-depth research staffs to analyze and conduct due diligence for newly created strategies. These efforts require a higher level of financial, legal, and regulatory oversight and come at a cost. At the same time, many midsized fund of funds, firms with assets of less then $1 billion under management, are picking up assets because of their ability to achieve better results than some of their larger peers. While hedge fund and fund of funds investors are always looking for market correlations or low correlation to major strategies and indices, one fact is clear: There is a positive correlation between a fund of funds' size and growth rate. Critical mass is the major ingredient for growing assets, and many fund of funds are primarily concerned with growing with the masses.

With $750 billion in assets under management as of 2008, according to PerTrac, the fund of funds industry is really a story of the haves versus the have-nots.[6] Eric Weber believes, "many small funds are stuck at subscalable asset levels."

Weber's firm has been working hard in the mergers and acquisition marketplace to conduct transactions with fund of funds for quite some time. Weber and his colleagues have helped buyers enter markets, helped entrepreneurs sell their businesses, and helped parent companies divest their fund of funds holdings.

IVY AND BoNY

A catalyst for the industry was The Bank of New York's purchase of Ivy Asset Management in 2000. With $2.7 billion, the Ivy/The Bank of New York consolidation has demonstrated the benefit of having a strong distribution partner that is also a strong strategic partner with global recognition that has enabled assets to grow to over $15 billion by year end 2007.[7] However, recent developments, including poor performance and other issues, have caused the fund complexes' assets to drop significantly since 2007; at the time of this writing, many in the industry had put the firm's assets at less than $5 billion.

According to Freeman, there have been over 35 fund of funds transactions with funds over $1 billion in assets through 2007. The motivation for sellers has been the need for liquidity or succession planning; pressure from a parent company or outside shareholder; or, as is usually the case, the need for greater distribution, greater size, or increased branding. On the other hand, buyers of fund of funds have been motivated by a need to enter the marketplace quickly, rather than trying to build out an organization, track record, and brand. Buyers also want to gain product expertise and immediate presence in the industry. Most buyers want to capitalize on the brand and distribution capabilities of the acquirer as opposed to building it themselves from the ground up.

In The Financial Services' *Executive Forum First Quarter 2008* survey (released by the American Banker in connection with Greenwich Associates LLC), of 315 banking and financial services executives conducted in February 2008, the conclusion was that banks have an advantage over other financial institutions when it comes to trust and confidence.[8] The trust level shown here is slightly higher than that shown in a similar survey performed in the third quarter of 2004. With banks gaining an advantage over other financial services firms, it adds firepower for banking institutions to continue along the growth path of acquiring or building out alternative investment platforms.

Madoff

Some of the questions that arose in the wake of the Madoff scheme were: What happened to the fund of funds? How did the due diligence fail or become so fooled? Why did the fund of funds fail to uncover the fraud?

The answer to all of these questions is simple. According to data from the Madoff Receivers' office, less than 100 fund of funds actually invested with Madoff. In an industry that has a global head count of more than 7,000 fund of funds at year end 2008,[9] this means that slightly more than 1 percent of all fund of funds allocated to Madoff. It seems to us that the fees that Madoff paid to his investors were the major issue that caused allocators to avoid the strategy. The final reckoning on the Madoff situation is still to come, but one thing is for sure: there is clearly more to it then we all know at the time of this writing.

In the end, the question that investors must ask is whether the cost of returns is justified by the large fund operators, or can smaller, niche fund of funds provide greater alpha by not increasing risk to an uncomfortable level and offering different levels of portfolio diversification. It really comes down to what one believes and where one thinks benefits will come from with the allocation of assets.