Arnerich Massena
Building Better Portfolios

What is the Future of Funds of Hedge Funds?

Arnerich Massena, Inc.

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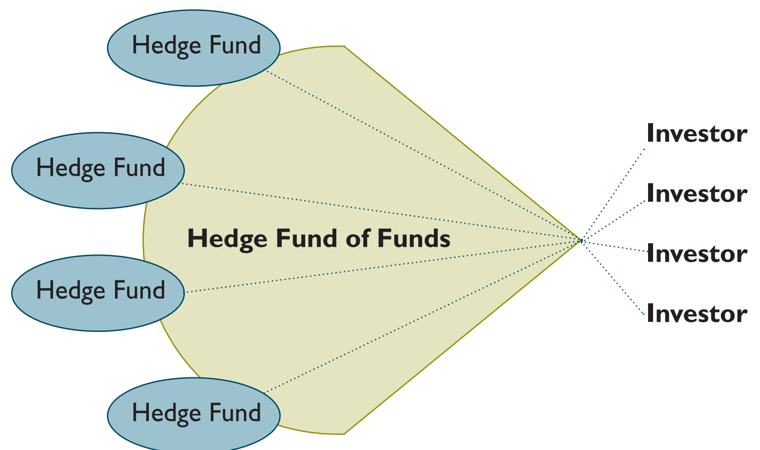
What is the Future of Funds of Hedge Funds?

> "'Thinking back to the conversations we were having with clients ten years ago,' recalls Gideon Berger, senior managing director and head of risk management for Blackstone's hedge funds group, 'investors would come to us and say, 'Our consultant has recommended that we put our money in hedge funds; can you give us something really conservative, and while you're at it, what is a hedge fund?'"
>
> *- Rose-Smith, 2012*

The days of hedge funds lurking under a shroud of mystery and giving investors heart palpitations by their mere mention have passed. As the value of alternative investing has become widely understood and appreciated, investors have grown in their experience and sophistication in this once-obscure universe. The appeal of funds-of-funds vehicles has recently begun to show an inverse relationship with this learning curve, falling somewhat out of favor as investors have begun more frequently to bypass funds of funds and invest in hedge funds directly. With investor needs shifting as sophistication increases and the industry working to better accommodate those needs, what is the future of funds of funds?

What is a fund of funds?

A fund of hedge funds is a single fund that invests in multiple hedge funds. Fund-of-fund managers seek to select the best single-fund managers and develop a diversified portfolio of hedge funds. By offering investors a portfolio of hedge funds in a single instrument, funds of funds can often make hedge fund investing simpler and more accessible for many investors. Fund-of-fund managers typically charge a fee for their services, which is in addition to possible fund-related expenses and the management and performance fees charged by the individual hedge funds included in their fund, as well as other fund-related expenses.



"FoF [funds of funds] stand out within the broadly defined investment industry as one of the greater successes (growing by 974% in just seven years) and one of the greatest failures (shrinking by 52% in just two years). These two opposing extremes speak to the outsized investment opportunities available to FoF and the similarly outsized perils that they must successfully mitigate in order to succeed."

– Brown, 2010

The rise (and fall) of funds of funds

Alfred Winslow Jones, the "father of hedge funds," originated the first hedge fund in 1949. His fund employed short selling and leverage combined for the first time in a single strategy. He also instituted a different fee structure, using a 20% incentive fee rather than a fixed percentage of assets. Jones' first hedge fund enjoyed extraordinary success and other money managers began to follow his example. As hedge funds have developed, the term has come to encompass a wide variety of financial products. Their common characteristics typically include the ability to short sell, the ability to use leverage, the addition of an incentive fee on top of a fixed management fee, a partnership structure, and a broader range of assets available for use within the fund.

By 1968, more than 140 hedge funds had appeared on the scene. But in the bear market of the early 70s, these funds (which used leverage to a greater degree than short selling, thus exposing them to more market risk) saw huge losses, and the industry all but disappeared. Hedge funds made their reappearance in the early 80s, driven largely by now-famous investors George Soros, Michael Steinhart, and Julian Robertson. Their success resulted in a renewed interest in hedge funds, and by 1990, there were more than 500 hedge funds in existence worldwide. That was only the beginning: "The industry grew (in terms of unleveraged managed assets) from $38.9 billion in 1990 to $536.9 billion in 2001." *(Rappeport, 2007)* As of June 30, 2012, the total industry has grown to more than $2 trillion. *(Hedge Fund Research, 2012)*

The first fund of hedge funds was started in 1969 in Geneva; the first U.S. fund of funds was launched in 1971 by Grosvenor Partners. Funds of funds took off during the 80s and 90s. With the expansion of hedge funds during that time, and thus hundreds of hedge funds from which to choose, funds of funds offered a valuable proposition with their aim of selecting the best of the best.

From 2000 to 2007, the fund-of-funds industry's assets under management grew by 974%, reaching a high in 2007 of almost $1.2 trillion. But by 2009, the industry had rapidly declined, shrinking by 52% to only $560 billion. The financial crisis of 2008 hit the fund-of-funds industry hard; the combination of fear driven by scandals like the Bernie Madoff fraud and a scramble for liquidity sent investors pulling out of hedge funds and funds of funds alike.

"Starting in the third quarter of 2008, the hedge fund industry suffered from net redemptions for the first time since the collapse of Long Term Capital Management. This was the result of deteriorating investment returns, a need for liquidity, and overall investor de-risking in the face of a systemic financial crisis. "

– Casey, Quirk & Associates, The Bank of New York Mellon, 2009

Figure 1: Fund of Hedge Funds AUM (m)

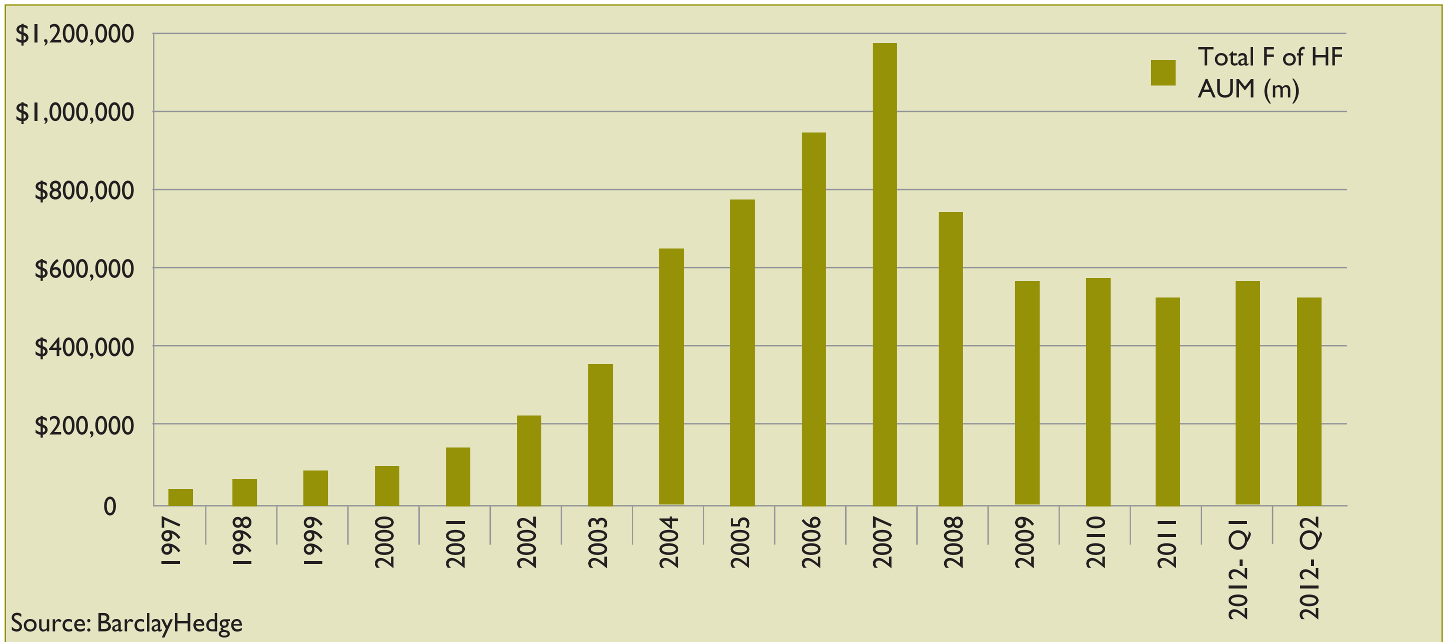


Figure 2: HFRI Fund of Fund Composite Index Annualized Performance

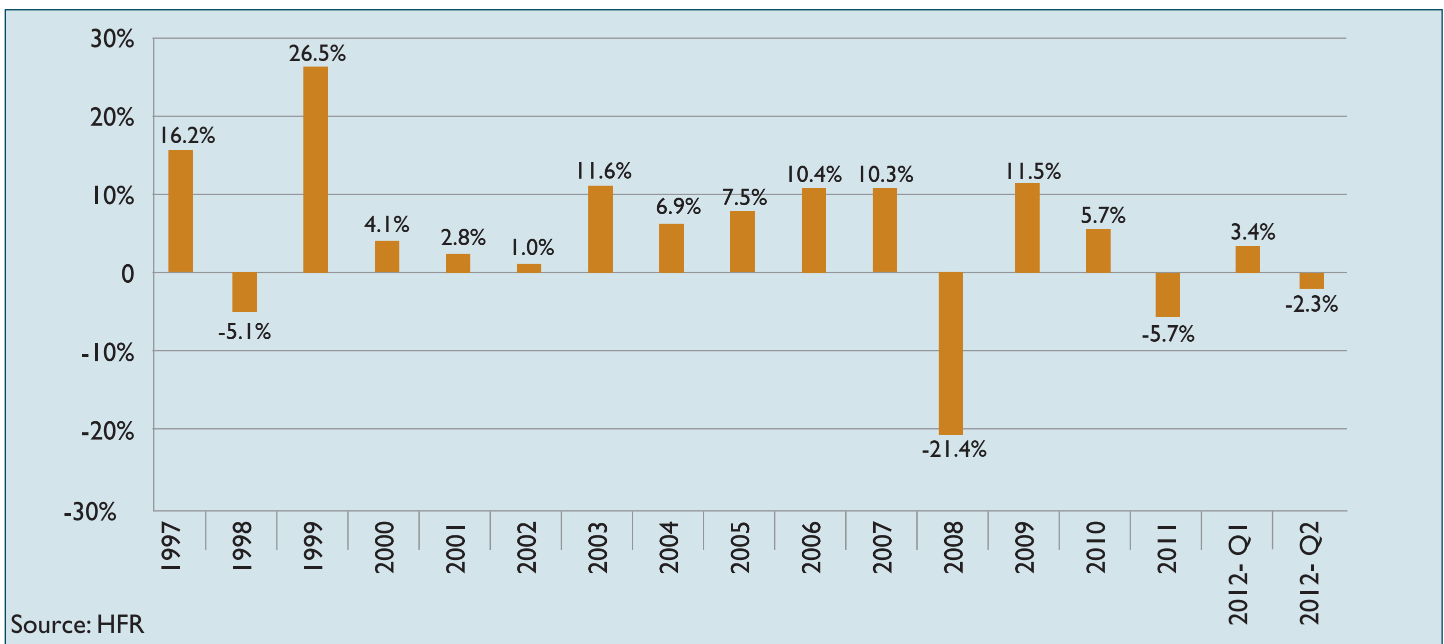
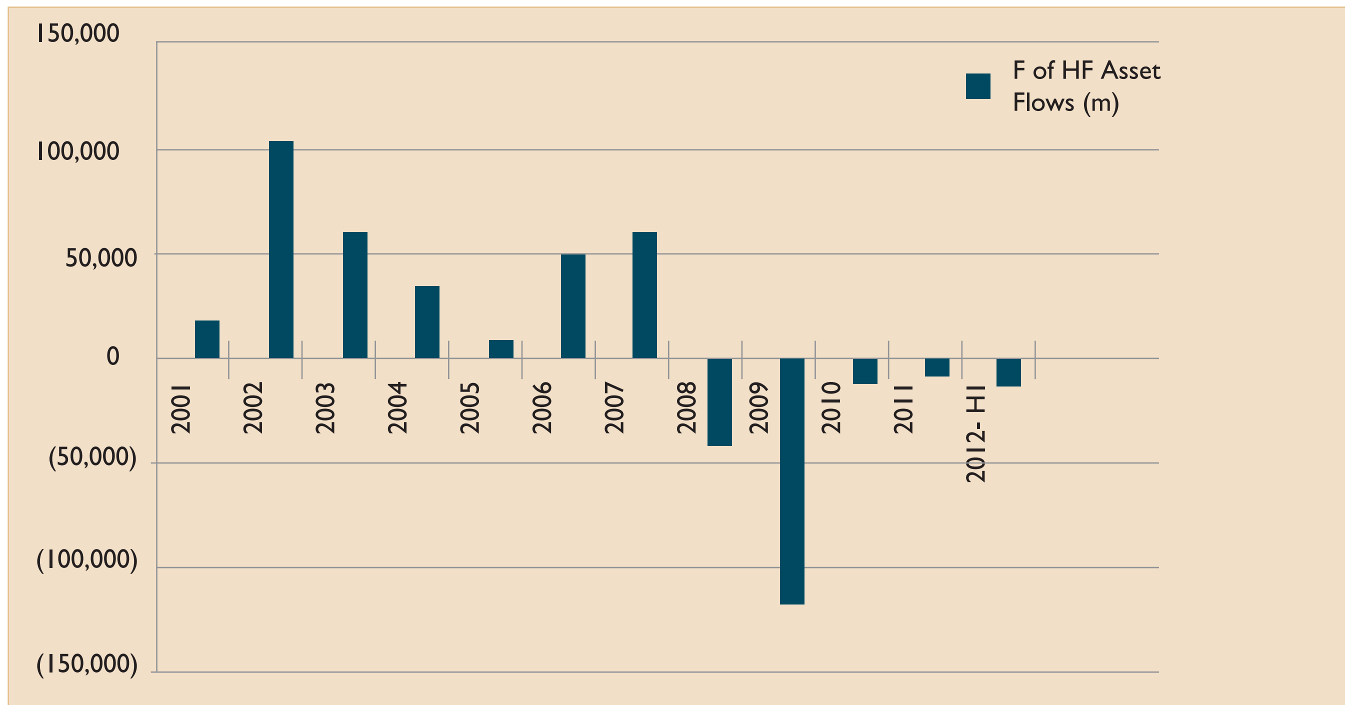


Figure 3: Fund of Hedge Funds Asset Flows (m)



Source: HFR Global Industry Report

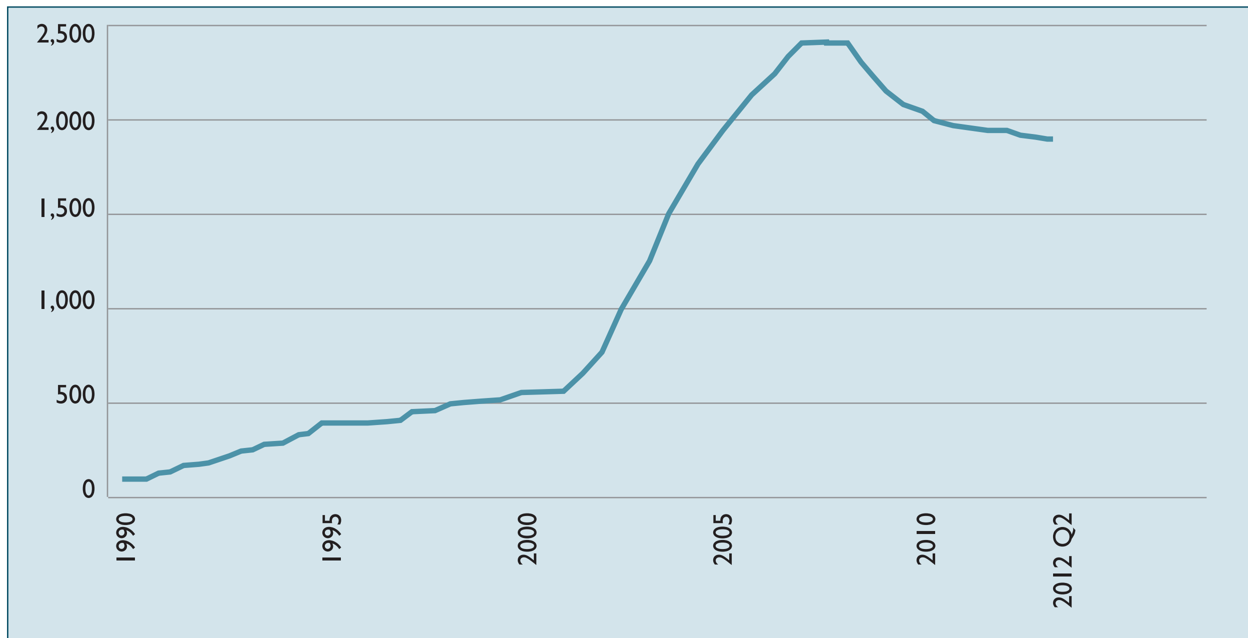
While hedge funds have begun to climb back after the 2008 crisis, funds of funds have continued to struggle. A recent *Pensions & Investments* survey found that almost 65 percent of the fund-of-funds managers surveyed saw assets decline during the 12-month period ending June 30, 2012. *(Williamson, 2012)* Overall, assets managed by fund-of-funds managers worldwide have decreased 42% from June 2008 to June 2012. *(Williamson, 2012)* You can see in Figure 3 that while outflows have slowed over the last couple of years, assets continue to flow out of funds of funds rather than into them. This phenomenon has prompted a need for evolution in the industry.

Poor performance plus high fees equals trouble

In the post-crisis environment of uncertainty, many hedge funds did not continue to produce the results that they generated pre-crisis, and this had a direct and negative impact on the funds of funds that were investing in them. This anemic performance in the long/short space has persisted for several reasons, all of them endemic to the

> "Once a fast-growing source of capital for hedge funds, funds of funds...have been hurt by criticism about their high fees and poor returns."
>
> *–Wilkes, 2012*

Figure 4: Number of Funds of Hedge Funds



Source: HFR Global Industry Report

investment environment that has evolved out of the 2008 crisis. Fundamental investing has struggled as macroeconomic factors dominate, lesser-rated companies are able to access vast depths of credit, and passive strategy ETFs draw investors away from active management. Additionally, short selling, a primary tool for equity-based hedge funds, has become costly: borrowing shares now often carries significant fees that cut into the potential return from a short sale and the zero interest rate environment negates any possible crediting rate. Additionally compounding this pressure on funds of funds were investor focus on fraudulent schemes in hedge funds (like Madoff) and insider trading, as well as concerns over fund-of-funds liquidity. Funds of funds began to see outflows as it became more difficult for long/short instruments to prosper, and this liquidation of the asset class amplified performance issues.

> "The added layer of fees charged by FoHFs has eroded returns while adding to the pressures of meeting risk and return expectations and the non-correlation, diversification benefits FoHFs work to deliver to justify their fees."
>
> *– SEI, 2012*

When performance suffers, investors take note, and fund-of-funds investors started to pay attention to their fees, putting further pressure on the asset class. Funds of funds charge their own fees in addition to the individual hedge funds' fees, and this additional layer of costs becomes increasingly evident when returns are low or lower than their benchmark

indexes. High net worth individuals and institutional investors alike are turning to direct hedge fund investing as an alternative, building up back-office structures to accomplish the necessary due diligence, or relying more on advisory services to help select and diversify among hedge funds.

> "Performance of many hedge funds of funds has not met expectations, observers said, eroded to a great extent by the extra layer of management and performance fees charged by hedge funds-of-funds managers on top of those levied by the underlying hedge funds in the portfolio. The impact of fees on returns convinced many institutions to look to direct hedge fund investment."
>
> *–Williamson, 2012*

Demand for change

The response of the fund-of-funds industry has been to look at ways to adapt. Fee structures have been slow to change, but fund-of-funds managers have found other avenues to add value. "To survive, firms have been selling themselves as more than just purveyors of one-size-fits-all, co-mingled funds." *(Rose-Smith, 2012)* Fund-of-funds managers have introduced new strategies to add value, including:

- Negotiating the fees paid to individual hedge fund managers: "Blackstone only rarely pays the customary full 2 percent management fee and 20 percent performance fee to any of its underlying hedge fund managers. 'The 2 and 20 percent structure is no longer the 'default option' fee structure,' says Brian Gavin, COO of Blackstone's hedge fund group. Managers, he says, have to really prove they are worth it." *(Rose-Smith, 2012)* Fund-of-funds managers may also negotiate the fund expenses charged to investors.
- Providing a higher degree of client education
- Providing more customized portfolios for clients or working with hedge fund managers to create custom investment strategies
- Becoming more nimble and opportunistic, often with a greater degree of specialization
- Negotiating appropriate liquidity terms
- Providing greater transparency
- Accessing emerging managers and niche strategies: "With an eye to increasing the value they add, more than a few FoHF managers are shifting away from well-known, name-brand hedge fund managers and toward emerging managers and strategies." *(SEI, 2012)*

> "If you want to succeed as a manager of managers in this environment, 'you have got to be different,' says Robert Kaplan, CIO of Permal Group. 'The days of being a passive hedge fund allocator are long gone. You have to offer insight, and you have to offer judgment.'"
>
> *– Rose-Smith, 2012*

"'It is interesting that the declines in the funds-of-funds space are not universal and that some large firms have received large, new allocations in the last 12 months. This is evidence that despite the broad shift in investor preference, funds of funds provide a valuable service and there is still demand, albeit diminished,' [Peter Laurelli, vice president of research for eVestment Alliance LLC] said."

–Williamson, 2012

Despite efforts from funds-of-funds managers to refresh their image and revive their reputation, experts predict that the industry will experience continuing consolidation. From a high of more than 2,400 funds of hedge funds in 2008, the number of funds of funds has decreased to just over 1,900 in the second quarter of 2012. The move toward more direct investment in hedge funds appears to be a growing trend.

What is the future of funds of funds?

Despite outflows and consolidation, funds of funds are not going away. Gil Ottensoser, head of capital introduction for the Americas of Deutsche Bank, believes that fund-of-funds outflows have stabilized, "in part because firms have changed their business models to keep up with the times." *(Rose-Smith, 2012)* Fund-of-funds managers still offer a valuable service, but it may be to a narrower clientele than previously.

For some high net worth and smaller institutional investors, the extra layer of fees charged by funds of funds may be worth it:

- As a one-stop solution, the diversified strategy of a fund of hedge funds can provide better diversification than a smaller investor may be able to achieve by investing directly in hedge funds. Given the broad range of potential outcomes for hedge strategies, this value should not be underestimated.
- Fund-of-funds managers offer dedicated research and due diligence, relieving the investor of the complex research and analysis involved in hedge fund investing.
- Fund-of-funds investors have less oversight, making fund-of-funds investing more efficient and simpler on an ongoing basis.

Fund-of-funds investing is often the simplest, most efficient way for investors to access the value and potential of hedge funds. Additionally, thanks to the shift in the industry, investors may find that funds of funds offer an improved value proposition, providing more customized approaches and negotiating lower fees. A recent survey conducted by SEI suggests that fund of hedge funds managers are "substantially whittling down management and performance fees, in some cases settling for minuscule management fees or waiving them altogether for larger clients." (*SEI, 2012*)

"…at SEI we believe that the fund of hedge funds model may have more resilience and adaptability than some observers seem to think."

– SEI, 2012

We would recommend that investors look for fund-of-funds managers who:

- Offer customized service and solutions
- Aggressively negotiate the fees paid to individual hedge fund managers, ensuring a fair level commensurate with the strategy, and also scrutinize the fund expenses charged to an investor to ensure they are reasonable and competitive (and low)
- Have the skills to take advantage of opportunities as they arise, and flexibility with their process and mandate
- Hold the fund of funds to a manageable number of hedge funds (on average, we would consider that a fund of funds with more than 20-25 hedge funds with 85-90% of assets is likely over-diversified)
- Diversify by style, providing one-stop shopping for long/short, credit, global macro, arbitrage strategies, and CTA (commodity trading advisor) strategies
- Perform

But those investors for whom direct hedge fund investing is an option may find it worthwhile to make the transition away from funds of funds and into a number of hedge funds directly. The main question investors need to ask is whether the value added by a fund of funds is equal to or greater than the extra layer of fees imposed by funds-of-funds managers. For larger investors, the answer is often no. Larger investors should consider:

- The broad diversification of a fund of funds may be more diversification than necessary for the hedge fund portion of a portfolio.
- The one-size-fits-all approach of a fund of funds may not adequately target the investor's objectives.
- The broadly diversified approach of a fund of funds can "water down" performance, rather than focusing on the skill of a select few hedge fund managers.

For many investors, provided you have an advisor with the skill and experience to assist, a focused approach to investing directly in hedge funds can access the return potential of the asset class, without extra fees cutting into those returns.

Conclusion

At Arnerich Massena, we are of the view that for large investors who are able to commit the necessary resources and time, direct hedge fund investing can be more efficient and provide for increased customization and better alignment with return goals. It allows for a more holistic approach to portfolio construction,

keeping fees manageable and making improved risk management and oversight of the aggregate portfolio possible. In order to go this route, investors must be prepared for increased due diligence and more intensive portfolio management, as well as possible heightened volatility at the indivdual fund level. Also essential is an advisor to guide investors in the due diligence, selection, and monitoring processes. An exception to this would be in the non-U.S. hedge universe, in which funds of funds are often the most viable way to access this asset class.

For smaller investors, we find that some funds of funds continue to offer a valuable proposition and provide greater accessibility to the asset category, and we utilize fund-of-funds managers. For those investors who fall somewhere between large and small, direct hedge fund investing versus fund-of-funds investing depends upon the investor's particular situation and objectives.

We anticipate that the fund-of-funds industry will continue to change and adapt to the environment, and we will continue to monitor and evaluate the ways in which funds of funds add value. For clients of Arnerich Massena, whether to use funds of funds or invest directly in hedge funds is a decision that depends on clients' objectives, preferences, and portfolio size. The information in this report is designed to provide some context regarding the industry and environment, helping clients to understand the factors involved in the decision.

"At this point, it is crucial that FoHF managers and, indeed the FoHF industry at large, look beyond their short-term survival and profitability and think seriously about their long-term future."

– SEI, 2012

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