

DON'T BE NAÏVE

With institutional investors, more specifically pension funds, entering the hedge fund arena, they find themselves faced with a myriad of choices, foremost being the many fund of hedge fund offerings. There are more than 1,000 fund of hedge funds products reporting into well-known industry databases. There are estimated to be a further 700-plus which are not reporting to databases, but are open for investment and are actively soliciting third-party monies. This excludes the multitude of multi-strategy hedge funds, which are highly akin to fund of funds.

So where does this leave the poor pension fund trustees who have full-time jobs other than investments? Given that these trustees have accepted the argument that hedge funds are important to enhance and improve risk-adjusted returns, especially as they are lowly-correlated to other asset classes, it still begs the question as to how one goes about selecting the right ones from this ever-expanding universe.

We should take a few steps back and assess this situation relative to stocks – a daunting task. The MSCI World Equity index is made up of 1,500 stocks – the London exchange has approximately 200 stocks at best – that one can look at due to liquidity constraints that come into play once a reasonably-sized pension portfolio is put on the table. The next step is to select an appropriate manager to come up with the best mix of stocks in a relatively small universe.

However, when looking at fund of hedge funds the pension trustee has to choose one or two fund of funds out of a universe of a thousand such funds. To think these funds are the same is simply naïve. They differ dramatically in terms of strategy allocation, manager selection, and liquidity at the basic level.

That said, trustees often use investment consultants when looking at their investments. The consulting industry is still finding its footing in the hedge fund industry, as institutional demand has only recently gained momentum, specifically after the severe absolute losses the equity markets sustained in 2000.

It's interesting to note the Dax, the CAC, the Nikkei and the Nasdaq are still down around 45% since their highs, with the Nasdaq being closer to 55%. This means these equity portions invested in the markets by pension funds need to almost double for them to be in the position they were in four years ago.

The most clued-up fund of hedge fund investors are undoubtedly the family offices and endowments that have been investing in hedge funds for many years, and which often allocate directly to hedge funds themselves.

The approach to evaluating fund of hedge

funds versus traditional managers is very different. The complexity and need for sustained onsite due-diligence reviews when assessing fund of hedge funds requires a huge commitment in resources and buckets of experience.

It therefore appears simpler to choose the large or safe bets as the fund of hedge fund advisers. These often have a good brand behind them and if something goes wrong, then it's 'who could have known?' This is simply a cop-out by all parties concerned, as the most experienced talent and those who were the pioneers in the brand organisations often set up their own fund of funds. Given that, one finds a higher staff turnover in most the big brand houses.

A fund of funds that is too small can also be problematic, but big is not necessarily beautiful, especially in the hedge fund industry. The real jewels rest with the focused fund of hedge fund boutiques.

Having said all this, what should pension fund trustees do? Simply, they should put the need to do their homework carefully on two fronts. First, they need to assess whether their adviser is appropriate and has the necessary skill and resources for conducting a fund of hedge fund search. The fluency and resource set required

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for the traditional set does not cross over to hedge fund of funds.

Second, they need to carefully determine what they want from a fund of hedge fund manager in terms of risk budgeting, reporting, administration, and service providers. Only once this has been done should the brief go out.

I recently worked with a large pension fund that wanted to invest in a fund of hedge funds. The chairman of the board was 74 and he took a focused approach to educating himself with regards to the industry. He went to hedge fund conferences and obtained educational materials about the hedge fund industry. This made a great difference when it came to the pension fund's whole approach in terms of tackling its hedge fund allocation.

There are no safe bets in picking a fund of hedge funds adviser, warns Robbie Alexander



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