

# Not all that meets the eye

The use of guaranteed products remains a popular vehicle through which hedge fund exposure can be obtained, specifically by hedge fund newcomers. I have met several pension fund trustees who have realised hedge funds can play an important role in terms of helping meet their liability objectives. However, some are new to understanding this asset class, so a guarantee at the end of a defined period appeals to some trustees as this is a conservative allocation decision to an asset class that scares them. Some hedge funds have found it easier to sell their funds through a guaranteed product to pension fund trustees.

Let's look at the implications for investing in a note issued by a guarantor. This note invests into a diverse number of underlying hedge funds. This article intends to highlight important considerations that should be taken into account when assessing guaranteed hedge fund investments.

Guarantors are willing to issue several notes, such as constant proportion portfolio insurance (CPPI), second-generation CPPI products and different option-based products. Some products are path-dependent and some aren't. However, the following considerations are generic and apply to guaranteed hedge fund products.

■ **Consideration 1:** The underlying hedge funds themselves. The guarantor will usually ask for around 75% of the managers to have monthly liquidity, so they can realise cash at short notice if things start to go wrong. The bulk of the hedge industry's managers have a 90-day notice period, excluding them from consideration.

Most guarantors give a basic matrix which indicates the level of participation the note will have to the underlying hedge fund basket. This is determined by factors such as interest rates, duration, liquidity and volatility. It is important not to confuse this with the amount invested in the underlying hedge fund basket. I have seen cases where the term sheet states the participation in the hedge basket may be 100%, and the salesman is quick to explain if US\$10m were invested, then with a 100% participation the full US\$10m will be invested in the underlying hedge fund basket. The rub is in all option-based products there is a delta at play. A delta of 0.8 would imply with 100% participation, the actual investment in the underlying basket is 80% of the amount invested.

■ **Consideration 3:** Leverage. Several

notes allow for leverage, usually up to a 150% of capital. The leverage costs range from Libor flat to Libor plus 2%. It's important to realise there is a cost associated with leverage. And if you have a participation rate of a 120% and the delta is 0.8, then your actual investment into the hedge basket amounts to only 96%.

## Keep an eye on costs

■ **Consideration 4:** Costs. Guarantee fees can range between 1% and 2% pa. Some guarantors like to use their own platforms to house the underlying hedge funds. One needs to fully understand the costs of being on that platform as well as switching in and out of funds. Second, you may find the term sheet stating the manager of the underlying hedge basket has the right to charge their hedge fund management fee on the greater of the amount actually invested or initial book value. So assume US\$10m was invested in the note, but only 50% of the actual amount, in this case US\$5m, would be invested in the underlying hedge fund basket. In this case the manager has the right to charge a fee on the full US\$10m, although only US\$5m was invested. Investors need to be careful!

Third, these products allow for a sizeable up-front commission to be taken. In some cases if the product has a long duration, commission charges can amount to 4%. This is a key factor as to why a number of intermediaries love selling these kind of products. Although the commission charges are disclosed in the term sheets, I have seen cases where it's not that easy to pick up. Most products are structured in a way the up-front commission is spread over the life of the product, so a salesman can give good initial participation rates. However, this gives rise to hefty early termination costs. Last, additional management charges on a per-annum basis, can find their way into the term sheet.

■ **Consideration 5:** Negotiate. You'd be surprised how much room you have for negotiating! But you need to ensure you understand what product is being offered to you. You do not want to land up paying the insurance rates for an Aston Martin if you own a VW Golf.

Hedge funds sold in guaranteed form have a place. Investors considering these products need to do their homework, allowing them to understand the product mechanics.

**Guaranteed products are becoming popular as they can help pension funds meet their liability objectives, says Robbie Alexander**



Robbie Alexander is chief executive of Octane Holding Ltd, based in Switzerland.