

Octane Oracle

Offshore fund of hedge fund selection in an ever-growing universe

Executive summary

- Historically, South African investors have used a “simple” screening tool and methodology i.e. brand, track record and some form of local presence, to select offshore fund of hedge fund (FoHF) managers;
- Offshore FoHF managers with strong brand names, and some form of local presence, are typically larger funds with their main focus on growing their assets under management (i.e. asset gatherers);
- A trade-off exists between size and performance. Size is the enemy of alpha and is expected to dilute the performance numbers of the larger, and still growing, FoHF managers;
- With all the challenges facing the offshore hedge fund industry and growth remaining robust, the size of the FoHF manager is expected to become an even more important “filtering tool” in the manager selection process.

Introduction

One of the key issues for investors to contemplate in terms of their offshore hedge fund investment is to find the most optimal investment managers. This is not a simple task.

The universe of single strategy hedge fund managers is in excess of 10,000 funds and the FoHF's universe is larger than 2,300, and these numbers are still growing at quite a pace. Furthermore, the offshore hedge fund industry has grown from \$25 billion¹ in 1990 to pass the \$1.4 trillion mark in 2006. Strong growth is still forecasted, with a number of investors expected to make an allocation for the first time and investors with existing exposure, expected



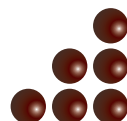
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to increase their portfolio allocations to a more meaningful weighting.

South African investors have selected FoHF's rather than trying to combine a portfolio of single hedge fund managers to meet their fund objectives. How does a South African investor go about selecting one or more offshore FoHF managers in this ever-growing and quite distant universe?

In this issue of Oracle we discuss the following:

- We reflect on how South African investors went about selecting offshore FoHF managers when these funds were first introduced into the local market;
- We elaborate on the “pitfalls” South African investors have experienced using “simple” screening tools and methodologies to select offshore FoHF managers;
- We demonstrate why finding the optimal size FoHF managers is such an important criterion in the manager selection process and provide reasons why the smaller FoHF's have and are expected to continue to produce superior returns; and
- We briefly discuss how Octane selects FoHF managers.



How South African investors have gone about the selection process

Investors that have allocated a portion of their international investments to offshore hedge funds, have typically selected the option to utilize one or more FoHF managers to manage their assets. A FoHF manager selects a range of single strategy hedge fund managers and then combines them into a well-diversified portfolio to achieve the investors' objectives. FoHF managers now account for approximately half of all hedge fund assets and continue to attract the large majority of new inflows.

To make the selection decision, South African investors have historically utilized "simple" screening criteria and methodologies to dilute the more than 2,300 FoHF managers into a more manageable universe from which to select. The criterion has typically been to shortlist only those offshore FoHF managers that have a quality brand, well-established track record and at least some form of local presence. The rationale for considering FoHF's with a local presence stems from investors believing that they do not have control over their offshore assets if no local presence exists.

Can this be regarded as an optimal way of screening FoHF managers as part of the manager selection process?

"Pitfalls" South African investors have experienced when screening offshore FoHF managers

A publication by InvestHedge, the "Billion Dollar Club"² shows that the 20 largest FoHF managers are responsible for approximately 50% of assets in the "Billion Dollar Club". The publication also refers to the "super league" with 21 of the FoHF managers having more than \$10 billion each under management.

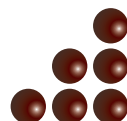
The large FoHF managers all have strong brand names with significant distribution channels and large sales forces. The prime focus

of these FoHF managers is generally asset growth (i.e. asset gatherers).

These large FoHF managers typically form part of international investment banks and are just one of many product lines to diversify the bank's income stream. They are also not staff owned (i.e. the team is made up of employees and not partners), which means that the FoHF manager's interests are not necessarily aligned with that of the investor and the focus not solely on hedge fund management.

The size of the FoHF managers' assets under management also reveals how important the investor is to that manager. For example, if you were a R10 billion South African retirement fund (the size of some of SA's largest retirement funds) and you invested 5% of your offshore assets in any one of the "super league" FoHF managers (i.e. more than \$10 billion managers), your investment would be less than 1% of their business. If one considers that investors typically diversify their offshore hedge fund assets across more than one FoHF manager, one could assume that the average large South African investor would be less than 0.5% of any such large manager's asset base. This demonstrates that not even the largest South African investor can be expected to be significant in these large FoHF managers' lives. No wonder they don't have any actual presence / office in South Africa and if they do, it's typically one marketing person servicing a large client base. Furthermore, investors are generally limited to "off the shelf" products that may not necessarily be suitable for the investors' specific and sometimes very unique requirements.

Lastly, many of the FoHF managers with some form of local presence, have historically produced very similar performance, risk, correlation and strategy allocations resulting in a peer group mentality i.e. "herding". Investors selecting more than one of these FoHF managers may therefore be adding duplication to their portfolio rather than diversification.





“Growth pains” encountered utilizing simple screening tools:

- FoHF managers with some form of local presence are typically larger FoHF managers i.e. with assets under management in excess of \$1 billion;
- These strong brand names are generally more focused on asset gathering than on providing niche and boutique solutions;
- Combining larger FoHF managers, which have some form of local presence, may add duplication rather than diversification.

Sourcing smaller boutique FoHF managers is an important criterion for manager selection

Research suggests that size impacts FoHF managers’ performance numbers. New research recently conducted by PerTrac Financial Solutions³ confirms the widely held belief that emerging hedge funds perform better than the older and larger hedge funds.

Octane has also conducted extensive research that shows smaller boutique FoHF managers produces superior returns. No such information or research is publicly available on FoHF managers, but based on our unique business model (we research FoHF managers whereas our competitors research single strategy hedge funds), we were positioned to perform such ground-breaking research.

Our research shows that FoHF managers smaller than \$1.5 billion produced better annualized returns with returns diminishing as the fund size increases above the \$1.5 billion mark. Furthermore we have found that the FoHF managers that have some form of local presence (i.e. an after-sales service team) are mostly larger than the \$1.5 billion mark. **It is therefore important for South African investors to consider widening their selection criteria by including smaller boutique FoHF managers.** These smaller FoHF managers are more niche and boutique players who do not have a brand to ride on and often don’t have or frankly are not interested in marketing their business in South Africa to attract new assets. Their focus is solely on producing perfor-

mance with a large portion of their own money invested alongside their investors’ money.

With the industry still growing in size and new FoHF managers setting up shop, the belief is that the smaller boutique FoHF managers will continue to produce superior returns. Some of the main reasons are:

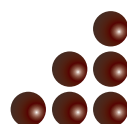
Smaller FoHF managers are perceived to be “more hungry”

Smaller FoHF managers appear to be “more hungry” for success - by that we mean achieving superior absolute return numbers. The only way smaller boutique FoHF businesses will attract new flows is when the FoHF manager has built a solid performance track record. These FoHF managers have the ability and flexibility to identify opportunities that may not have been fully exploited in the market.

Smaller boutique FoHF managers are more flexible and have the ability to fully exploit anomalies in the market which impacts positively on performance.

Quality of capacity available – larger FoHF managers’ at a disadvantage

Research conducted shows that the majority of hedge funds are not operating at full capacity. Only approximately 15%⁴ of single hedge funds or FoHF managers are operating at their full capacity with about 37% operating at less than 25% of capacity. However, the dilemma





the industry is faced with is that the capacity available is not all prime capacity – “are too many dollars chasing too little capacity?” - why is prime capacity limited in the hedge fund space?

The problem is twofold – declining arbitrage opportunities in certain strategies and the lack of skilled individuals who are capable of invent-

ing new strategies as the financial markets evolve. Some strategies are more scale-able than others e.g. long/short and global macro, but overcrowding in some of the less scale-able strategies exposes the risk of low returns. Therefore, although capacity is available, the current prime capacity cannot readily accommodate all new demands without diluting fund returns.

Capacity available in the hedge fund space is not all quality capacity, and with new money invested, the larger FoHF managers are at a disadvantage for the reason that they may find it more difficult to obtain the required exposure to prime capacity and be forced to exchange quality for quantity, resulting in lower performance.

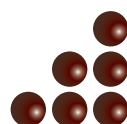
Octane selects “smaller and boutique” FoHF’s

Octane’s business model is unique in the offshore FoHF industry. Where our competitors only screen the universe of single strategy managers to construct a diversified portfolio, Octane screens the universe of FoHF managers and combines FoHF managers to construct solutions. More importantly however is that Octane only includes and combines FoHF managers that have assets under management of less than \$1.5 billion. This is based on our proprietary research that shows smaller and boutique funds generally outperform the

larger players, as pointed out in this paper. Our unique and already successful business model therefore allows Octane to add more underlying “smaller” FoHF managers, as the business grows, without compromising our flexibility and composite solution performance numbers.

Furthermore, Octane focuses on tailor-made solutions for clients rather than selling “off the shelf” products. We do not believe that a “one size fits all” type offering suits the needs of our clients. Each investor has their own particular requirements e.g. performance objectives, risk budget, liquidity, transparency, reporting requirements and more.

Octane has proven to be uniquely positioned to facilitate the selection process of small and boutique FoHF managers.





ACKNOWLEDGMENTS

¹ *Hedge Fund Research Inc.*

² *InvestHedge publication. February 2007. "Billion Dollar Club Survey"*

³ *Investment Journal Derivatives Use, Trading & Regulation. 2007. "Examining of Fund Age and Size and its impact on hedge fund performance" (February)*

⁴ *KPMG Survey 2005. "Hedge Funds: a catalyst reshaping global investment" – Annual Research Report)*

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