The Case for Funds of Hedge Funds

The performance of funds of hedge funds has apparently underperformed that of direct investments in hedge funds even after correcting for fees. Why is this?

Performance Table April 2003 to July 2010. A comparison of FOF, HF and a sample FOF

*HFRXGL is an investable hedge fund index, HFRIFWI is the HFRI hedge fund index, HFRI FOF is the HFRI fund of hedge funds index and Fund X is an actual FOF.

- Data issues are a big source of the measured underperformance of FOF to their underlying hedge funds. Many hedge fund databases suffer from survivorship and self reporting biases. This means that hedge fund indices like HFRI will show inflated returns compared with funds of funds indices like HFRI FOF even after correcting for the additional fees charged by FOF. HFRI FOF is a more representative benchmark for what is achievable in reality since they show the performance of actual portfolios of hedge funds.
- HFRX GL is an investable hedge fund index. It is difficult to be truly representative of hedge fund performance since hedge funds value proposition lies in the individual unique edge of each manager.
- Investors have become disenchanted with funds of funds due to their underperformance relative to direct hedge fund exposure, especially when measured by indices.
- As in all things, not all funds are the same. Some funds of funds are better than others and consistently outperform their peers.
- Size is an issue for funds of funds. It is difficult to manage funds of funds beyond 2 to 3 billion USD in assets under management. There are many reasons for this; being forced to invest in larger, less nimble hedge funds one of the more serious problems.
- Expertise in hedge fund manager selection and portfolio construction is also highly varied. The divergence of performance between funds of hedge funds is high. It is important to select the right funds of funds manager.

Performance Table April 2003 to July 2010. A Selection of

Actual Funds of Funds, compared with MSCI World Index

- Funds of funds remain an efficient means of investing in hedge funds. Selecting the right funds of funds manager can result in consistent absolute returns which are important for long term compound returns.
- Hedge funds remain a superior investment compared to passive long only equity investments. Even superior long only investment managers have to contend with volatility which imposes the issue of timing the

investment correctly. Hedge fund investments exhibit low volatility and so timing of entry and exit is less important.

- Despite losing some 22% on average in the financial crisis of 2008, the value of hedge funds is clear in the context of the drawdowns of long only indices like the MSCI World which fell 56% in the crisis.
- Take a look at the Sharpe Ratios