The Future of Funds of Funds

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We begin in the past:

In the financial market collapse of 2008, one area of particular decline has been the fund of funds industry. Many fund of funds run to a greater or lesser degree, an asset liability mismatch. That is, they provide better liquidity terms than they receive from the hedge funds they invest in. The reasons for the existence of funds of funds include:

1. Aggregation of capital to provide access to hedge funds. Most hedge funds accept minimum subscriptions of 1 million USD. For the smaller sized investor, this is too much to construct a diversified portfolio.

2. Aggregation of investors for hedge fund managers. Funds of funds also serve an intermediary function for hedge funds who would otherwise incur investor acquisition costs of their own. Fund of funds incur costs of acquisition of investor capital.

3. Risk management. Investing in hedge funds involves analyzing complex risk profiles and aggregating them into a portfolio in such a way as to optimize the return to risk characteristics.

4. Manager sourcing and due diligence. As hedge fund investing is all about identifying skill and talent, as it is widely held in the investor community that the majority of hedge funds are of poor quality, there are high search costs. These search costs involve analysis of complex strategies, identifying talent and skill, assessing the non-investment risks such as operational integrity, corporate governance and resource adequacy of a manager.

What has been achieved:

Using data from January 1990 to February 2009, we have a look at hedge fund returns and fund of funds returns. We use the HFRI Index to represent hedge fund performance, and the HFRI FOF Index to represent fund of hedge fund performance.

First of all, an interesting chart showing the correlation between hedge funds' and fund of funds' returns. Starting at around 0.75 in 1994, it has climbed steadily to 0.97 in 2009. You would expect to see high correlation since one is contained in the other. The explanation for lack of correlation is that funds of funds are somehow not tracking the performance of the underlying funds as closely. This can be good and bad. If one argues for the value added by a funds of funds, one would expect the correlation to be less than 1. The closer to 1, the less the value added since funds of funds then become a mere conduit. That the correlation has grown over time is an indication that the value added has fallen over time.

*reconstructed from data compiled by HFR

In the period, HFRI has returned an average of 11.8% per annum with a volatility of 7.10%. HFRI FOF has achieved an average 8.1% per annum with a volatility of 6.1%. It is possible to explain some of the differences by the fees that funds of funds charge for their services. Let us apply those funds of funds fees to the HFRI and see where we get. Lets assume that on average, a fund of funds charges 1% management fees and 10% performance fees. Funds of funds have a variety of fee structures but this one is quite representative. If a fund of funds simply invested in the HFRI and charged those fees, they would return 9.7% per annum with a volatility of 6.4%.

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One is tempted to argue that funds of funds have been a failure. It is more interesting to analyze than to criticize, however, and funds of funds are a rich area for research. Let us make a simplistic start. Of the 4 main arguments for funds of funds, lets see which ones of them have failed, and what other problems have not been covered.

The first two purposes, I think, are easily fulfilled. Funds of funds have fulfilled their roles as intermediaries with benefits for both investors and fund managers. There are more tricky issues here which we will revisit.

Portfolio and risk management are functions where by and large funds of funds have been successful at. A few funds of funds run concentrated portfolios and may be underdiversified, if anything too many funds of funds run portfolios with overdiversification where the marginal diversification is tiny. Strategy specific funds of funds exist but their mandate is precisely to be concentrate by strategy. There are issues of correlation introduced laterally through the equity base which we will deal with when we revisit the intermediary functions.

It is in due diligence where many funds of funds have fallen down. There are two types of failures in due diligence. The first is where the fund of funds was unaware of a problem and the problem was thus unavoidable, and the second is where the problem is apparent but the fund of funds took a view. Madoff falls into the latter category. (See my earlier post on **Madoff** on 16 December 2008).

Problems faced by funds of funds:

Its not easy running a fund of funds. Some fund of funds managers have been careless, some have had poor judgment, some have are not all that bright, but for the most part, funds of funds are run by well trained professionals working within tough constraints in turbulent markets.

Size. This is one of the biggest problem with funds of funds. They are victims of their own success. Let’s be clear about this, not even the smallest fund of funds can always be nimble and shift allocations from one strategy to another, or from one manager to another. That just makes life difficult for everyone. As a matter of risk management, funds of funds rightly have concentration limits. Their capital often cannot represent more than 10% of the capital of a hedge fund they invest in. Thus a fund of funds can allocate no more than 10m to a hedge fund with 100m assets under management. In order for the allocation to be meaningful, a fund of funds does not want to invest with 1000 hedge funds, providing each one with 0.1% of their capital. So, funds of funds will have at the back of their minds, a target allocation of say between 3% to 6% of their capital per manager on average. This means that on average, a 1 billion USD fund of funds needs to deploy say 50m USD per manager, requiring that the average size of the manager themselves must be at least about 500m. For a 10 billion USD fund of funds, just multiply by 10. There are about 10 funds of funds managing between 15 billion to 30 billion USD last year. Not surprising, in a nod to our symbiosis hypothesis, there are about 10 hedge fund management groups managing between 20 billion to 40 billion USD. Both numbers are smaller now. Still, there are not so many hedge funds out there with 5 billion USD under management. And so the larger funds of funds are forced into a smaller and smaller set of hedge funds to choose from.

Asset liability mismatches. This problem really came under the spotlight last year. Funds of funds usually give monthly or quarterly liquidity to their investors. They do this to attract investors, to make their products more palatable to their target investors. This, however, limits the type of funds that a fund of funds can invest in since they should match the duration of their assets to their liabilities. Some strategies are liquid, like equities, fixed income, macro. But others like credit, distressed, event driven and small caps and derivative strategies are not liquid. Some funds of funds take a view, limit their allocation to such strategies but invest all the same. It is hard to say what is the right limit, 10%? 20%? 30%? In a crisis, 10% is too much. In normal times, 50% is too little.

The industry is a cliquish and fashion driven one. The main centres of fund of funds management are Geneva, New York, London, with some up and coming centres like Hong Kong and Singapore. Everyone knows everyone, everyone is exchanging notes, seeing the same hedge fund managers and developing an industry wide Groupthink. In any industry, not just the fund of funds one, trends are often driven by the loudest voices. I can see no intuitive reason why decibels and IQ should correlate well.

Lets us return to the points about aggregation of capital by funds of funds on behalf of investors, and on the other side, on behalf of hedge fund managers. There are lots of interesting things going on here. The size issue overflows into the concept of funds of funds being aggregators. By construction, the larger funds of funds must invest in the larger hedge funds. This implies a high level of overlap in their portfolios. Large funds of funds have higher numbers of hedge fund managers in common. (It makes little sense therefore to diversify between large funds of funds.) Conversely, large hedge funds must have higher numbers of exposure to funds of funds in common. This dual overlap can and has been a toxic combination as investors seek to exit from their exposure to hedge funds as a whole.

The Future of Funds of Funds:

We have heard anecdotal evidence that funds of funds had redemptions of 30% of their assets in 2008 and that redemptions have continued in 2009 albeit at a much reduced rate. We hear about funds of funds redeeming from their underlying hedge fund investments in expectation of further redemptions. All the news is bad.

But funds of funds serve a very important role. The 4 functions they serve, risk management, diversification, aggregation of managers, aggregation of investors, continue to be valid. What has gone wrong is a problem of implementation. The devil has been in the details.

The asset liability mismatch has to go. This means that funds of funds will have to pass on the liquidity terms they receive to their investors. Some strategies such as distressed credit will be off limits to the existing funds of funds by reason of the monthly or quarterly liquidity that the funds of funds offer to their investors. More longer lock up funds of funds will emerge to service both the funds offering these less liquid strategies and the investors who want to invest in them.

Liability management will become as important as asset management. This means a bigger role for marketing, investor relations, for structuring of fund offerings and vehicles, for a greater variety of structures, for better analysis and management of investors. In asset management, liability management means the analysis of hedge funds' investor bases, funding terms and requirements and stability of counterparties and counterparty arrangements.

The size issue is uncertain. Smaller funds of funds don't suffer from the problems highlighted. Investors who cotton on to the size issues will adjust their allocations accordingly and help to smooth out the size distribution of funds of funds. On the other hand, some investors will demand size and scale as proxies for adequacy of resources. It is really not clear which side is right or will dominate.

Standards of due diligence will be raised, whether or not this makes sense. For the most part it makes sense, but there will also be new optical embellishments. The hedge fund industry is not immune to image. With the new chassis, engine and suspension will come a new coat of paint. Too long has the industry been dominated by jargon, by assumption, by the signaling of a brand name. Investors will likely return to the roots of good due diligence – no question is too stupid to ask. And they will ask this of their funds of funds intermediaries as well.

Much faith has been lost in the funds of funds industry. Much money has been lost. The average fund of funds lost 20% in 2008. But many of the better ones, smaller ones, lost between 9% to 12%. Those have done well against any other alternative save cash and treasuries. But how will the industry organize itself going forward? What investor class will it target? I argue that retail investors need hedge funds in their portfolios but don't have the means and resources to do so. What improvements will funds of funds bring to their processes and products?

These questions I invite you to answer on my Forum. **What is the Future for Funds of Hedge Funds?**