The Courtship Between Hedge Funds and Institutional Investors

Research Highlights from Charnley & Røstvold
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Preface

- ***Hedge funds and alternatives are the most rapidly growing asset classes in the institutional investment arena despite obstacles to working together.***
- ***Three factors are compelling the institutional investor to embrace hedge funds: alpha potential, attractive risk attributes and low correlations to existing investments***
- ***Transparency is improving, while databases, benchmarks and indices are evolving to levels of greater relevance.***
- ***Hedge fund investors are becoming familiar with institutional needs and demands, and many are accommodating their distinct needs.***
- ***Regulatory boards are setting standards for disclosure and communication.***
- ***Despite compressing returns, assets from institutional investors are continuing their positive march into hedge funds.***
- ***What could go wrong? Plenty. What could go right? Plenty.***

Twenty-five interviews, 8 white papers, numerous industry reports and articles, and nine months later – here's what we've learned about what people know and want to know about hedge funds. The number of resources, contacts, interviews, and intellectual curiosity notwithstanding, we have gathered just enough information to be dangerous. But that has never stopped us from sharing insights and thoughts before. So with the disclaimer that current observations are not indicative of future results, let us share what we learned about the appeal, viability and challenges between hedge funds and institutional investors.

When Opposites Attract

Institutional investors and hedge fund managers – two seemingly disparate worlds. The hedge fund world historically has been governed by: service to a relatively few wealthy individuals, endowments and foundations; esoteric strategies and instruments; secrecy deemed necessary to take advantage of investment anomalies; leverage; and frequent dependency on limited assets in a strategy to succeed.

The Prudent Man Rule, however, governs the institutional investor. How does the Prudent Man reconcile fiduciary obligations to seek attractive returns at reasonable risk levels with investment opportunities, where the asset pools are frequently small, the number of allowable investors is limited, the strategies are complicated, knowledge of the holdings and/or trading strategies is restricted, performance records are short or non-

existent, indices and benchmarks are of questionable relevance, lock-up and withdrawal provisions exist, and the fees are high by any standard? Where there's a will and an alpha, there's a way. Institutional investors and hedge fund managers are clearly forging a united path to investment partnership.

What Does the Institutional Investor Seek?

First, it's important to understand what is driving institutional investors to consider hedge funds at all. Institutional investors have very specific obligations, whether for retirement funding or payout levels. With outlooks for stock and bond returns in the single digits, looming problems concerning unfunded liabilities, and difficulty meeting endowment or foundation spending obligations, naturally the institutional investor is seeking a knight in shining armor.

Alternatives and hedge funds, with glorious and very public accomplishments on behalf of some of the nation's most prestigious endowments and illustrative families of great wealth, have an almost irresistible appeal. Hedge funds, offering prospects of more reliable and consistent alpha, less downside risk and low correlations to traditional stocks, bonds and other assets, present nearly heroic solutions. The result? A swoon by the institutional investor. At the same time, the immense pool of institutional assets and the high fees commandeered by hedge fund strategies create an equally powerful appeal to the hedge fund manager world.

Enormous Expansion – in Assets, Providers, Strategies, Databases, Benchmarks

In the late eighties, the global hedge fund industry represented $40 billion, and less than 500 hedge funds. KPMG's March 1998 "The Coming Evolution of the Hedge Fund Industry" projected an annual growth rate of about 26% to over $500 billion of assets by 2001, and a tenfold increase to over $1.7 trillion in ten years. That number has already been exceeded in 2004. According to a recent study by Financial Solutions LLC, in Memphis, Tennessee, the current global hedge fund industry represents in excess of $2 trillion. London-based Platinum Capital estimates hedge funds will be managing $4 trillion by the end of this decade.

A recent Casey, Quirk & Acito study, "Institutional Demand for Hedge Funds: New Opportunities & New Standards," projects that institutional capital will soon account for more than 50% of annual net flows into the hedge fund industry. Furthermore, the study foresees half of this institutional capital directed by Funds of Hedge Funds (FoHF).

The mighty march of assets into hedge funds is matched by a panoply of providers. Over 8,100 hedge fund providers are now listed in the Hedge Fund Research database. Even though the vast majority manages less than $25 million, there are 175 single hedge

managers with more than $1 billion under management. *Pensions & Investments* reports there are 2,600 FoHF managing about $415 billion as of November 2004. Enriching and complicating the opportunity set even further, the global hedge fund world is widely divergent in terms of types of strategies – Hedge Fund Research includes 37 different strategy categories, numbers that are both a boon and a curse to institutional investors.

Comparison Shopping

Institutional investors are notorious comparison shoppers and purported trend followers. They do everything possible to maximize probabilities and gain comfort that they are making reasonably astute decisions for their investment objectives. As noted above, hedge funds initially were the investment choice for the affluent, cloaked in secrecy with respect to strategies, instruments, leverage and trades. Hedge managers maintained that secrecy was essential to deliver exceptional returns with minimal risk. This was one of the first challenges between the two different worlds.

As a result, databases, benchmarks and indices for hedge funds began emerging in the mid-nineties; however, issues quickly surfaced. Hedge fund managers, who closed to new assets or often closed funds with disappointing returns, simply declined to report returns or assets, or were selective in terms of which strategies they would continue to report. Some of the records are audited; others are not. How meaningful could the data be?

Analysts, academicians and vendors began tackling the resulting issues of survivorship bias, selection bias and different weightings. Regardless of the integrity of the current data, the databases, benchmarks and indices continue to grow and are in high use, creating the first step to systematizing the search and selection of hedge fund managers. In addition, recent regulations require all hedge fund managers with $25 million or more in assets to register with the SEC.

The Unveiling

Transparency accompanies most traditional stock and bond strategies; thus, institutional investors comfortably assumed transparency of investments was a right, not a privilege. Again, the hedge fund cloak of secrecy held the institutional investor at bay. With the Prudent Man Rule as a guide, few were willing to hand over assets to completely shrouded strategies.

Multiple solutions evolved almost immediately to fulfill the institutional investor "need to know." Some hedge fund managers directly went to transparency, making it a competitive advantage. Third-party vendors developed services to provide "pseudo-transparency," with individual instruments and trading strategies released only after any value of knowing is zero. Institutional investors, in many cases, willingly compromised

on the need for complete transparency. After all, what would the institutional investor gain from knowing specific holdings and particular trading strategies? Today, transparency is offered via these various methods, but the real questions are what transparency is truly provided, how does it help the institutional investor and what does the institutional investor do with the information once it is available? The answers remain unclear.

Matchmaker, Matchmaker, Make Me a Match!

For the most part, institutional investors and hedge fund managers speak different languages. So with such strong mutual attraction, both sought translators who were knowledgeable on the other's world. The interested parties turned to three qualitative sources for help:

- Independent third-party sales reps who specialize in the alternatives world
- Search consultants
- Funds of funds

"I Know the Major Players"

First on the scene were the third-party independent marketing reps already experienced in working with alternatives, hedge funds and sophisticated institutional investors. The endowment and foundation world, along with some of the nation's largest, most sophisticated institutional plans, have been hedge fund investors for many years. As one independent rep shared with us, the majority knows one another, and they know who the hedge fund players are and what their strategies are. This relatively exclusive group has been conferring together for years, with one of their main objectives to be "early in the game." Independent third-party reps familiar with both the high-tier investor and quality hedge fund strategies serve a valuable role in providing introductions, helping investors be "early in the game" and servicing sophisticated investors. Extraordinary growth, however, created a need beyond these independent reps.

"I Can Help"

In the consultant arena, small specialty consultants were the first to benefit from the emerging demand for hedge fund managers. Many were already relatively knowledgeable on hedge funds from working with high net worth families. A majority of search consultants with institutional practices, however, were slow to come to the hedge fund table, primarily because research on hedge funds is more difficult than traditional manager research. Not only is the universe of hedge managers massive, but it is extremely dynamic, and many of the strategies are difficult to understand and measure. The flows and growing interest by institutional investors, however, could not be ignored. Consultants took on the research and resource challenge despite the fact that little of the traditional investment manager research could be leveraged. Consultant firms, large and small, are still expanding necessary resources, which include hard-to-develop information

technology (off-the-shelf is virtually useless), databases with relevant data and experienced analysts who are in high demand, but few in number.

"Yenta Services"

Funds of Hedge Funds (FoHF) appeal equally to many institutional investors and hedge fund managers. The key to success is to understand both the needs of the institutional investor and the hedge fund manager, and to have experienced professionals overseeing all the roles involved – from manager research to asset allocation to service.

A good FoHF relieves the institutional investor of the due diligence research required, both in hiring and monitoring hedge fund managers. Simultaneously, the FoHF allow the hedge fund managers to focus on investment management, with the FoHF assuming the responsibility for marketing, sales, communications and reporting for clients, operations and compliance.

FoHF are popular for several other reasons. The majority report audited performance, and potential investors can see both successes and failures, eliminating survivorship bias. These funds offer excellent diversification of strategies and managers, and often access to managers otherwise closed or unavailable to new individual investors. The successful funds have clear expertise and understanding of different hedge fund strategies, and have devoted the necessary talent and resources to staying expert. For newer or smaller hedge fund investors, the FoHF structure makes perfect sense.

So why aren't FoHF used in every case? The added layer of management fees is a deterrent for some investors. In some cases, the funds use less experienced analysts to evaluate and select the managers, or they have unclear processes by which they integrate different hedge fund strategies. Some have held the infamous blow-ups, such as Askin Capital and Long Term Capital Management. Others have a reputation of playing "hot potato," bringing in a manager and firing them just as swiftly. In those cases, word generally gets around quickly, and hedge fund talent refuses to play, keeping their capacity for investors willing to make a serious, long-term commitment.

A Party for Everyone

Conferences were cited by many as useful to attend, some primarily for education and others for the opportunity to connect with institutional investors. NMS Conferences receive rave reviews for connecting serious institutional investors with hedge fund vendors, and covering topics that are relevant and enlightening to the industry overall. Industry experts also cited the GAIM USA conferences as valuable. The need for education is enormous, and presents a communication opportunity for all.

Beauty Is in the Eye of the Beholder

The universe of institutional investors varies significantly in knowledge and comfort level with hedge fund investments; therefore, what is important to one investor may not be for others. The very sophisticated, experienced investors are more likely to invest directly in single hedge funds, and sometimes allocate assets to FoHF as well. Newer, smaller or less knowledgeable investors are more likely to embrace a FoHF and avoid investing with single hedge managers. The criteria for selecting single hedge funds most cited during interviews are outlined below.

Organizational

Of the single hedge funds that have come and gone, a majority have failed due not to returns, but to flawed business models. As a result, one of the most important criteria for consultants and investors alike is the business model and who manages the business. Organization criteria include:

- ***Background, experience, reputation and credibility of key professionals***
- ***Strong business platform and infrastructure***
  - Organizational stability
  - Sound business model and effective management
  - Back office, marketing, support services, compliance, operations
  - Compensation and incentives
- ***Retention and continuity of key professionals***
- ***Effective capacity management***
  - Does the strategy(ies) lend itself to growth ("show, not tell" when possible)?
  - Does the manager manage their growth to maintain their performance edge?
- ***Key man provisions***
- ***How much of the manager's money is invested?***
- ***Regulatory compliance***
  - Is the manager registered with the SEC?
  - Any investor complaints on file with state or federal authorities?

Investment Process

- ***Clarity of process*** **–** Purchase criteria, sell decisions, overview of trading strategies and team decision-making process
- ***Adherence to process and strategies*** – Must be demonstrated
- ***Transparency*** – Investors vary dramatically in expectations around transparency
  - Process transparency and overall portfolio characteristics can substitute for individual holdings transparency when necessary
- ***Leverage*** **–** The tolerance for leverage is strategy-specific and more than 3-4X is generally unacceptable
  - The key is to be forthright in how leverage is used
- ***Quantitative analysis*** – "Everyone has it"
- ***Qualitative analysis*** – Absolutely key; can be an important distinction if prowess is evident here
- ***Risk management*** – Need to be able to define and demonstrate effective risk management
- ***Focus*** – Is the manager committed to their proven area of expertise or adding new products (e.g., long-only strategies) to grow their firm?

Performance

- ***Record of achieving return targets***
- ***Drawdowns*** – Low tolerance unless driven by strategy; be prepared to show and explain history
- ***Net returns – Annual, quarterly, monthly (in some cases)***
  - How consistent are the returns; what is the length of track record?
  - Disclose whether the numbers are audited
  - Show rolling five-year and rolling three-year alpha if possible
- ***Risk measurements*** – Results within volatility targets; beta, Sharpe ratio, information ratio
- ***Peer performance*** – Which is hard to measure…what is the make-up of the index, what is the size of the assets under management, what is the survivorship effect and are there any biases as to the funds reporting the results?

Institutional Client Service

- ***ERISA clients*** – What is the manager's experience with similar clients?
- ***Fit of strategy in total plan*** – What does it accomplish for the client?
- ***Low correlations to traditional equity and bond strategies; low correlations to clients' other investments***
- ***Lock-up periods*** – Negotiable
- ***Liquidity*** – Typically not a critical factor to long-term institutional investors
- ***Monthly and quarterly reports*** – Are sufficient
- ***Customization*** – Unimportant

What Are the Questions to Ask when Considering a Fund of Hedge Funds?

When investing with a Fund of Hedge Funds, investors want to know:

- Clarity of process – particularly for asset allocation and manager research
- Do you have a limit on the maximum level of assets you will take? If so, what is it?
- Describe your due diligence procedures in depth.
- Who is doing the manager research and what is their experience level?
- How do you accommodate the constant need to identify superior new managers?
- How do you select the underlying strategies? The underlying managers?
- How do you avoid managers who "flame out"?
- How do you weight the different managers?
- Do you or the underlying managers use leverage, and if so, please explain how?
- How do you monitor the underlying managers?
  - What's the biggest mistake you've made; what did you do about it; what did you learn from it?
- Why is your fee worth it?

Are the "Real" Opportunities" in the Hedge Fund Universe, the Ones that are Unknown?

One plan sponsor noted that if hedge fund managers are in a public database, then it is too late to invest with them. Jeffrey Tarrant, in his paper, "The Life Cycle of Hedge Fund Managers," defines "the period between the first year and the fifth year to be the best years to invest with hedge fund managers." He also cites a study by Cross Border Capital that showed the youngest decile hedge fund managers beating the oldest decile hedge fund managers by 960 basis points per annum.

Initial small cap equity forays were to achieve higher returns than the S&P 500, and then the rare decade where large companies outperformed small unfolded. What did institutional investors do? Change the benchmark from the S&P 500 to the Russell 2000. Ultimately, the objective shifted to selecting the superior small company managers who could deliver the highest small cap returns.

International equities were originally sought to add diversification and returns to the U.S. market. Again, as time marched forward, correlations to the U.S. market increased and relative performance failed to measure up for a period. Many institutional investors moved out of international investing or reduced their exposures. More, however, kept their position for diversification, and more recent markets have rewarded that long-term decision.

The Double-Edged Sword of High Fees

Both parties are interested in whether there is fee pressure, for obviously divergent reasons. Hedge fund fees are typically 1% to 2% of assets under management plus 10% to 20% of profits, although some managers charge a 1.5% to 2.0% base fee plus as much as 50% performance fees. Fund of Hedge Funds add another 1% (or more) for management fees, but are receiving some downward pressure. One consultant recommends that FoHF fees should be less than 1.25% in management fees and less than 10% annual incentive fee, if any. The tragedy would be if the FoHF failed to provide the underlying value to the clients to warrant the additional layer of fees.

Fees, which at first glance seemed shockingly high to plan sponsors, are palpable when the alpha/beta/diversification promise is met. Institutional investors are standing in line where talent is proven, and gladly paying high fees. No wonder these hypnotically high fees are luring many of the strongest investment talents away from traditional long-only shops. Only the largest of the large plan sponsors, who insist on no dowry payments in excess of 1%, are receiving fee discounts.

The golden glitter of the high fees, however, comes with a steep price. If hedge funds can maintain 12% to 15% and higher returns, the fees are easily justifiable. In 2003, single hedge funds returned an average of 19.55%, and Funds of Hedge Funds yielded an 11.61% average return, according to Hedge Fund Research. Year-to-date 2004, however, single hedge funds have returned 4.46% and Funds of Hedge Funds only 2.72%.

It would be wise to anticipate that if hedge fund returns continue to compress, pressure to reduce fees will mount. If the hedge fund investor fails to fulfill the investment promise, the sword falls swiftly and surely. Investors will flee faster than Julia Roberts in Runaway Bride.

Are Hedge Funds a "Bubble" or an Asset Class?

The answer is "Yes" and "Yes". If a bubble means a sudden dazzling rise, alternatives have definitely enjoyed a swift ascent. Will it burst? Perhaps. Who among us truly knows what the underlying strategies are, how much leverage is at play and whether they are truly hedged? The size of assets flooding the number of investment strategies – even though numerous in number and low in correlations to one another – could easily swamp opportunities for meaningful returns and destroy liquidity. In addition, the institutional investors' own demand for transparency may undermine the hedge managers' ability to deliver the alpha investors seek. At minimum, the asset flows, the virtual number of hedge funds, along with the continually evolving databases, benchmarks and indices, and the "yentas" will create change.

Second, we concur with KPMG's assessment in "The Coming Evolution of the Hedge Fund Industry" – *"It is our view that the structure of the industry will also evolve to accommodate this sustained growth and maturation of the industry. We believe that the entire hedge fund industry will move from a relatively local and private business to a more mature, globally operating and institutionalized industry."*

We see the progress toward this maturation unfolding before our very eyes. History shows us some important lessons. Even when the NASDAQ rose to its illustrious peak of 5132.52 in March 2000, and "burst" dropping to 1108.49 in October 2002, investors maintained their exposure to NASDAQ stocks. In the 1990s when U.S. large cap equities dominated both international and small cap stocks for nearly a decade, investors still held their positions in both assets. When value equities lost their shine in the late 1990s, investors still held value exposures.

Why? Because institutional investors have long-term time horizons and invest, not just for returns, but also for the diversification and risk reduction benefits. Yes, they may pay attention to the reasons why an asset class is disappointing and modify their exposures, or move from poor-performing managers, but they typically keep their commitment to an asset class. Also, analytical tools and research are continually evolving to help reconcile the differences between the institutional investor and the hedge fund world. The opportunities also motivate both parties to make it work.

Conclusion

As one very astute observer of the institutional industry said, "Hedge funds will be here for a long time – because there are enough people who are dumb and rich."

The other side of the coin is that there are enough people managing the hedge funds who are smart and want to stay rich. Certainly, we have seen and will continue to see bubbles within the hedge market burst as new and old funds fail and close for a variety of reasons. Like the small cap, international and value managers of the '90s, however, let's not underestimate the hedge managers' abilities to build lasting partnerships with the institutional investor.