

Hedge Fund Investing: Direct, Fund-of-Funds, or Both?

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Introduction

Fund sponsors have traditionally ignored fund-of-funds, viewing them as high fee, retail-oriented offerings that are not appropriate for larger and more sophisticated institutions. This includes alternative investments. There are virtually no real estate fund-of-funds. Private equity fund-of-funds have fared somewhat better but most investors have been smaller endowments and foundations who later become investors in direct partnerships when their assets grow large enough to meet investment minimums.

These same preferences for direct investing were characteristic of early hedge fund investors. Endowments, foundations, and a few corporate pension funds that were early investors in hedge funds relied primarily upon direct hedge fund investing, though a few used fund-of-funds as a way to initially gain expertise (i.e. GM used Grovesner for this purpose) and portfolio diversification during a gradual ramp up to a target allocation. With several years of hedge fund experience, these same investors have generally reduced or eliminated their fund-of-funds allocations.

However, in recent years fund-of-funds have surprisingly gained new traction as a way to invest in hedge funds. At December 31, 2005, hedge fund-of-funds held 36% of the \$1.1 trillion in hedge fund assets, more than doubling from 17% at the end of 2000.¹ Much of the hedge fund-of-funds growth has been sparked by institutional investors, many of whom are large public retirement plans both in the U.S. and Europe that are just beginning to make allocations to hedge funds. Massachusetts PRIM and Pennsylvania ERS have each allocated over \$1 billion to hedge fund-of-fund managers.

At the same time, other public pension plans have gone in a different direction by investing directly in hedge funds. For example, Calpers and Texas Teachers have each allocated over \$1 billion to hedge funds directly.

This paper discusses the relative strengths and weaknesses of direct hedge fund investing and fund-of-funds. Cost considerations tend to be fairly straightforward but there are other more subjective considerations that can weigh heavily in the decision process. Our conclusion is that there is no clear answer. Institutional investors that are comfortable with their access to hedge expertise, whether through staff or consultants, will likely invest directly in hedge funds, particularly larger “institutional quality” firms, to avoid large intermediary fees. For this group, the use of fund-of-funds will be limited to a non-core role to gain access to new managers, far geographies, or unique strategies. On the other hand, many institutions in the public sector will

choose to pay much higher fees for the perceived fiduciary protection and administrative ease that fund-of-funds provide.

Hedge Fund Implementation Options

There are four approaches institutional investors have used for implementing a hedge fund allocation:

- a) The *staff-driven* approach where trustees approve final hedge fund selections but rely upon an experienced staff to source, recommend, and monitor a portfolio of direct hedge funds;
- b) The non-discretionary *consultant-driven* approach where an outside consultant, often working with staff, provides direct hedge fund selection and monitoring services to trustees, who in turn make final investment decisions;
- c) The *fund-of-funds (commingled)* approach where an investment is made in a existing commingled pool of hedge fund managers – called a fund-of-funds – and where the fund-of-funds manager exercises discretion over assets with full authority to invest in hedge funds;
- d) The *fund-of-funds (separate account)* approach where a fund-of-funds advisor is hired to manage a separate (segregated) portfolio with full authority to invest in hedge funds.

There are at least five factors that can influence which of the four implementation choices might be optimal for any particular institution:

- i. Fiduciary
- ii. Performance
- iii. Diversification
- iv. Resources & Costs
- v. Liquidity & Flexibility

i. Fiduciary

Trustees overseeing public retirement plans are frequently attracted to the unique alpha opportunities hedge funds offer. At the same time, they express concern that should their portfolio be invested in a hedge fund that blows up, such as the recent Bayou example, a backlash of critical public scrutiny might threaten confidence in the existing governance structure of the retirement plan. They see the fund-of-funds as potentially providing a shield should an “event” occur with anyone of the hedge fund managers.

It is hard to measure the substance of this argument. If the intent is to avoid having one’s name associated with a fallen hedge fund, the fund-of-funds (commingled) is the investor of record and the fund sponsor may avoid direct attention. But, as in the Bayou case, the press is now savvy about fund-of-funds as conduits and will publicize the fund-of-funds’ participation which ultimately might make its way back to the institutional investor. It is probably naïve today to think that fund-of-funds create any break in information flow for those seeking to link investors to hedge funds.

If the intent is to delegate fiduciary responsibility over selection and monitoring, then the consultant, fund-of-funds, and separate account approaches are equivalent alternatives. In all

three approaches an experienced third-party, acting as an independent fiduciary, renders analysis and judgments that trustees can rely upon in making their own decisions (consultant-driven approach) or in delegating decisions to a commingled or separate account fund-of-funds.

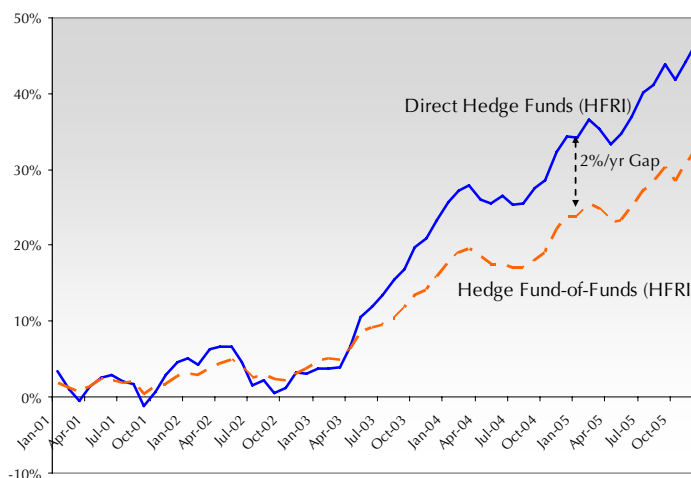
ii. Performance

Evidence is developing that commingled fund-of-funds do not have a performance advantage and, in fact, fund-of-funds investors are more likely to underperform direct hedge fund portfolios. For example, in 2005 the HFRI Fund Weighted Composite Index (an average of direct hedge fund returns) returned 9.28% while the HFRI Fund-of-Funds Composite Index returned 7.50%. The difference, 1.78% is well in excess of the 1%+ in extra fees charged by the average fund-of-funds.

The fund-of-funds “performance deficit” is illustrated graphically in Exhibit 2, which shows cumulative performance for direct hedge funds and fund-of-funds (source: HFRI) over the five year period from 2001 through 2005. For this entire period, the average direct hedge fund outperformed the average hedge fund-of-funds by over 2% per year. The performance gap seems most pronounced over the past three years, a period when the equity markets performed well. This observation is consistent with the general notion that fund-of-funds lean toward conservative market neutral managers, giving less weight to equity long-short managers and other higher risk directional strategies.

Some suggest that this conservative bias is a byproduct of asset-based fee structures offered by fund-of-funds which encourage them to keep volatility low – and return low as a result – for fear that a large performance shortfall could cause asset outflow. This is similar to “index hugging” by traditional long-only managers with asset-based fees. If correct, this may explain at least part of the fund-of-funds performance lag.

Exhibit 2: Direct versus Fund-of-Fund Performance: 2001-2005



The performance deficit for fund-of-funds also exists if we narrow the comparisons to institutional quality offerings. The five year average return for 18 of the largest fund-of-funds, and presumably among the top performing for otherwise they would not have attracted the most assets, was 7.02% per year. This is higher than the 5.88% five year HFRI fund of funds return but still almost one full percentage point below the 8.01% HFRI average for direct hedge funds.

For the same period, the average return for a group of approximately 150 of the largest direct hedge funds, also identified by Cliffwater, was 10.86%, almost four percentage points per year higher than the group of large fund-of-funds. It seems reasonable to conclude that fund-of-funds investors should expect performance to fall below a portfolio of directs by the level of extra fees, currently around 1% per year. They should also expect that shortfall to be even greater during periods of strong capital market returns.

This finding of a persistent performance deficit for fund-of-funds runs very much contrary to the frequently heard claim that fund-of-funds gain a performance edge partly from access to top-performing hedge funds that investors acting on their own could not identify or gain access to. Rather, the performance deficit is consistent with a recent trend among top tier hedge funds to shut out or force redemptions from fund-of-funds. Direct investments from institutional investors are viewed as more desirable because hedge funds believe they can control their own destiny. In some cases hedge funds are receiving withdrawal requests due to the fund-of-funds performance, not their own.

The performance shortfall by fund-of-funds applies to the average return. Despite this, an investor may wish to use a highly regarded fund-of-funds manager that has the expertise, track record, and hedge fund access that is superior to the average and thereby can be expected to overcome the cost disadvantages associated with the fund-of-funds approach.

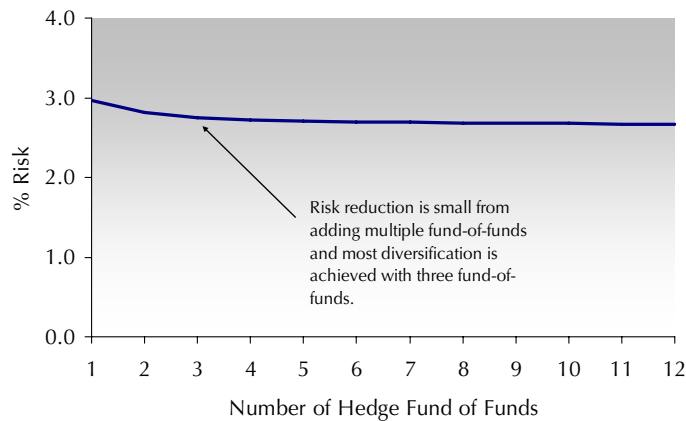
iii. Diversification

Fund-of-funds are thought to offer good initial diversification to first-time hedge fund investors. However, some who have invested in several fund-of-funds have become concerned with the resulting large pool of underlying hedge funds from combining just a few fund-of-funds. Larger fund-of-funds hold 30-40 underlying hedge funds and our experience is that the overlap among constituent hedge funds is a low 10-15%. The result can be a portfolio of over one hundred hedge funds from combining just three fund-of-funds. For investors who are already skeptical about accessing alpha from hedge funds, finding so many hedge fund managers within a portfolio raises the same “closet indexing” concern that arose from having too many traditional long-only managers, but with much higher fees. Large hedge fund portfolios constructed by using even just a few fund-of-funds are vulnerable to diminished alpha because the sheer number of hedge fund names forces an average result where a top quartile result is desired and because average hedge fund performance may no longer produce a LIBOR plus 4-5% result as it has in the past.

Furthermore, there is little diversification benefit from adding multiple fund-of-funds. Exhibit 3 shows that portfolio risk (vertical axis) declines very little as the number of fund-of-funds is increased (horizontal axis) and that most of the diversification benefit is achieved with three fund-of-funds. This somewhat surprising result is because the average correlation between institutional quality fund-of-funds is a very high 0.79. The risk numbers in the exhibit are based upon 15 of the largest fund-of-funds covering the five year period ending February 2006. The average risk among the fund-of-funds was 2.97%, and that declines to 2.75% after three fund-of-funds. It takes another 21 fund-of-funds to get risk down to 2.65%.

In contrast, the average correlation among direct hedge funds is a much lower 0.30. As a result, the diversification benefits from including at least 12-15 individual hedge funds in a portfolio are significant where they are not for fund-of-funds.

Exhibit 3: Risk and the Number of Fund-of-Funds



iv. Resources & Costs

The one percentage point in fees (plus a 5-10% incentive fee, in some cases) paid to fund-of-funds is high compared to other asset classes and with little flexibility even for very large investors. This quickly makes going direct an attractive option if a mix of staff and consultant resources is available. Independent consultants that have good direct hedge fund services are available but not as prevalent as those that select only fund-of-funds. Hiring and retaining experienced investment staff can be difficult for many institutions but the high fees paid to fund-of-funds should at least give those willing institutions the financial room to offer competitive salaries.

v. Liquidity & Flexibility

The fund-of-funds commingled vehicle gives the investor unique opportunities and risks that are not present with the other approaches.

In normal market circumstances, fund-of-fund investors can gain quick exposure to hedge funds or liquidate sooner than investing directly in hedge funds. Upon entry to a fund-of-funds, new investors' assets gain immediate pro rata participation in an existing group of hedge funds, thereby avoiding time delays in implementing a direct portfolio that can extend six months or more. Upon exit, a single investor's withdrawal request can sometimes be accommodated by new investor capital. More likely, entering and exiting investors will be taking advantage of long-term investors in fund-of-funds who could be suffering dilution from entering investors and providing liquidity to exiting investors.

The advantages to fund-of-funds can quickly become disadvantages. If the fund-of-funds manager does not control asset growth, investors may find that their portfolio's exposure to hard-to-access hedge funds becomes diluted as the number of funds climbs, creating possible over-diversification. Also, liquidity will likely be suspended if large numbers of investors want to exit at the same.

The truth is that liquidity is available only if other investors want to provide it. Increasingly, fund-of-funds managers are being pressured to close successful fund-of-funds to prevent dilution, leaving new investors to place assets in new fund-of-funds without exposure to the hedge funds

that created past success. And we have not yet witnessed a period of poor hedge fund returns when exit demands will likely trigger suspension in the easy exit liquidity that is now generally available.

While liquidity may be an advantage to fund-of-funds, the other approaches allow greater flexibility to customize the risk-return profile. Fund-of-funds may exhibit lower returns because they provide liquidity to investors. Hedge funds that have longer lock-up periods or make use of sidepockets² may not qualify for fund-of-funds. Hedge fund managers argue that these less liquid hedge fund strategies offer a higher return potential that could be included in staff/consultant advised portfolios and separate accounts.

Exhibit 4 summarizes the four hedge fund implementation approaches and their relative strengths

Exhibit 4: A Decision Guide for Implementing Hedge Fund Allocations

		Decision Factors in Selecting a Hedge Fund Implementation Approach				
		Fiduciary	Performance	Diversification	Resources & Costs	Liquidity & Flexibility
Hedge Fund Implementation Approaches	Staff-driven	Absence of outside advisor offers least level of protection.	Lower intermediary fees enhance returns by 1% or more.	Smaller asset size allows for a more concentrated portfolio with a better risk-return profile.	Requires experienced investment staff that can be retained.	Can customize the portfolio as desired. Liquidity is limited by fund terms but can participate in illiquid assets.
	Consultant-driven	Outside advisor provides protections but trustee involvement required.	Consultant fees are lower than fund-of-fund fees, thereby significantly enhancing returns.	Smaller asset size allows for a more concentrated portfolio with a better risk-return profile.	Consultant fees and hedge fund services vary but are much lower than fund-of-funds.	Can customize the portfolio as desired. Liquidity is limited by fund terms but can participate in illiquid assets.
	Fund-of-funds (commingled account)	Trustee separate from investment decisions and there may be some protection from "event risk."	Performance gap of over 2% per year due to fees, low risk portfolio design, and liquidity needs.	Allocations to several fund-of-funds can result in excessive diversification and lower returns	Fees average 1% plus a 5-10% incentive for many fund-of-funds.	Offer greater liquidity under normal circumstances but vulnerable to dilution.
	Fund-of-funds (Separate account)	Trustee separate from investment decisions and there may be some protection from "event risk."	High fees reduce performance potential but portfolio design can be customized to desired risk.	Allocations to several separate accounts can result in excess diversification and lower returns	Fees average 1% plus a 5-10% incentive for many fund-of-funds.	Can customize the portfolio as desired. Liquidity is limited by fund terms but can participate in illiquid assets.

Combining Direct Hedge Fund Investments with Fund-of-Funds

Some fund sponsors invest in hedge funds both directly and through fund-of-funds. Below are two examples of implementation strategies that use a combined approach:

- a) A fund sponsor may combine fund-of-funds with a few direct multistrategy³ hedge fund managers. This approach keeps down the number of fund investments and takes partial

advantage of the lower cost structure of direct hedge fund investing. The potential disadvantage is that good single strategy hedge funds will be under-represented in the overall portfolio.

- b) A second approach will have the fund sponsor invest directly in hedge funds (staff and/or consultant driven) to benefit from the lower cost structure and also to better gain hedge fund expertise. Once a direct hedge portfolio is in place, the sponsor complements the direct hedge fund portfolio with specialized fund-of-funds, whose role is to access smaller firms, newer strategies, and distant geographies that may be beyond the sponsor's immediate resources. Specialized fund-of-funds will have higher return potential and lower correlation with the direct hedge fund portfolio. The allocation split between the direct portfolio and specialized fund-of-funds will generally weigh heavily (70-90%) toward direct hedge funds.

Conclusion

Fund sponsors are using a variety of approaches in implementing hedge fund programs. Unlike investments in the traditional public markets, there is no one generally accepted approach at this time and decisions in many cases are based upon unique fund sponsor circumstances such as public disclosure, trustee comfort with the asset class, staff experience, and access to resources.

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¹ Source: HFR Industry Reports.

² A "sidepocket" is a designated investment within a hedge fund portfolio, generally because it is illiquid and difficult to value, that is owned only by those investors existing at the time the investment was purchased. Sidepocket assets are often valued at cost. Subsequent investors in the hedge fund do not have an ownership stake in prior sidepocket investments. Likewise, investors having an ownership interest in a particular sidepocket asset can't exit until it has been sold. As a result, an investor that exits a hedge fund that makes use of sidepockets won't get 100% of the proceeds until sidepocket assets are sold.

³ "Multistrategy" hedge funds combine several investment strategies in one investment vehicle, in contrast to single strategy hedge funds that use one investment strategy. Some investors loosely view multistrategy hedge funds as a kind of fund-of-funds except that all the strategies are managed by a single firm.