

Part I

An Introduction to Hedge Funds
and Hedge Funds of Funds

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1.1 ABOUT THIS BOOK

This book is about *hedge fund of funds* – funds which invest across a range of underlying hedge funds. The aim of the book is to describe what hedge funds of funds do and how they do it, and to give help and advice on assessing and investing with them. As such, it should be of use to anyone who needs to gain a deeper understanding of hedge funds of funds such as the following:

- Existing and potential hedge fund investors
- Existing and potential hedge fund of funds investors
- Hedge fund of funds personnel
- Trainee hedge fund of funds managers and analysts
- Hedge funds and their marketers
- Investment consultants
- Academics and students of the area
- Those seeking to work in the area
- Hedge fund of funds administrators
- Prime broker capital introduction personnel
- Hedge fund of funds lawyers
- Hedge fund of funds leverage providers and structurers

Given that this book describes how a hedge fund of funds assesses underlying hedge funds, those that invest directly into hedge funds themselves may also find this book of use. Also, many hedge fund managers and their marketers, especially those just setting up, tend to find the hedge fund of funds investment process somewhat opaque, and so I would hope that this book may also allow them to get a better understanding of this approach.

The book is split into four parts:

- Part I takes an introductory look at both hedge funds and hedge fund of funds.

- Part II is dedicated to understanding what a hedge fund of fund does and offers tips and advice on how to do it.
- Part III offers advice and help on selecting a suitable hedge fund of funds with which to invest.
- Part IV takes things up a notch by talking about some of the more complex ways to access hedge funds such as through structured products, portable alpha and hybrid products.

In this book, I have tried my hardest to be clear, honest, objective and concise. However, it should be noted that I work as the Chief Investment Officer of Key Asset Management – a 17 year old hedge fund of funds with USD 2bn under management – and so I obviously believe in the benefits of investing this way. In the spirit of fairness, I have indicated in the text when I believe my opinion has been a viewpoint rather than fact. Furthermore, the more rampantly opinionated of my comments have been quarantined in a section that appears throughout the book entitled ‘Off The Record’, which should be assumed to be subjective.

I have aimed for this book to be as pragmatic as possible, and to this end I have included two sizeable practical examples of investment reports on both a hedge fund and a hedge fund of funds at the end of Parts II and III, respectively.

As I mentioned above, the world of hedge funds is very much ridden with jargon and, given the complexity in this area, sometimes specific terminology is unavoidable, so I have included a glossary of all jargon used at the end of each chapter in Part I, with a glossary for the entire book in an Appendix.

1.2 OVERVIEW

Part I of this book is an introductory section. Here, I aim to introduce and define the concepts of hedge funds and hedge funds of funds and discuss what they do and what investment strategies they use. We will take a look at who invests in this space and why and the reasons why assets have been growing so much of late.

In Chapter 1, below, I define and describe both hedge funds and hedge funds of funds and we will take a look at the causes for recent growth. In Chapter 2 we will take a closer look at the hedge fund space by looking at the different types of strategies hedge funds practice. In Chapter 3 we will take a look at the rationale for investing in this area and take a look at the nature of returns one can expect and the reasons

why different investor types chose to invest. In the final chapter of this section, I lay out the pros and cons of investing with hedge funds of funds over investing directly into hedge funds.

1.3 WHAT ARE HEDGE FUNDS?

Hedge funds are becoming hard to ignore. From the first hedge fund in 1949 until very recently, these investment vehicles have been the secret of those who are 'in the know'. But lately, hedge funds have received more and more coverage from the international press, and more and more investment from both private investors and institutions. Over the past 10 years, assets managed by hedge funds have grown exponentially, with estimates indicating that there is now over one trillion US dollars invested in this area. But what are hedge funds and why are they becoming so popular with investors?

Hedge fund is a pretty useless descriptor as it is an umbrella term that covers many different strategies which vary radically in terms of market exposure and risk. Given this breadth, I would define a hedge fund as *a fund that is incentivised and flexible enough to generate returns irrespective of the direction of core underlying markets*, although I have never seen a truly satisfying definition of the term hedge fund, including the one above. There are, however, certain characteristics that are common to most hedge funds.

True hedge funds are 'absolute return' funds, which means they do not aim to track or beat a certain benchmark or index, but instead are focused on pure return generation – they aim to make money whatever the underlying markets are doing. For example, if a traditional equity fund manager benchmarked to the FTSE 100 lost 10% in a year when the FTSE 100 lost 15%, he would be understood to have outperformed as he beat his benchmark by 5%, even though he lost 1/10 of your savings. However, a hedge fund manager investing in the same universe would consider himself to have performed badly in any other situation than making money, irrespective to the FTSE 100's loss. Anything below 0% performance (after fees) is a loss for a hedge fund manager, whatever the underlying market is doing. Of course there is a converse here: the traditional manager would be considered to have underperformed if making 20% in a year when the FTSE 100 rose by 25% whereas the hedge fund generating 20% would be compensated for this gain. Remember, hedge funds do not present a free lunch – they just have a different approach, which we will describe later in this chapter.

Characteristic of many hedge funds is their deliberate lack of institutionalisation. They are often run by small skilful teams, either within large institutions or as breakaway groups. Even the biggest hedge funds avoid too much peripheral support away from the investment side; for example, I know of few hedge funds with a dedicated HR officer.

Often, hedge fund managers have previously been at the very top of their profession in traditional investment management or trading, and it is this expertise that has attracted them to the hedge fund world and their investors to them. Many hedge fund managers that have migrated from the long-only investment side have said that their skill has been constrained by the tight mandates found in traditional funds, i.e. long only, has to be fully invested, has to follow a benchmark. Typically such migrants say that their skills have been wasted in traditional investment management as they have not been able to apply them to the full – many say it had been like working with one hand tied behind their back – and that having the ability to take long and short positions has allowed them to exercise their skill to the full. Naturally, if they believe they can add more value through lessening the constraints on their skill then this can lead to more money being made for them also.

Hedge funds usually charge a fixed percentage ‘management fee’ of somewhere between 1% and 2% per annum. Additionally, fees based on positive investment performance (on new gains rather than on regained loss) are usually charged at around 20% of all positive gain per annum. This ‘performance fee’ alongside the fact that hedge funds also often contain a large proportion of the personal assets of the fund manager incentivise the hedge fund manager to generate good positive performance. As a result, the hedge funds’ managers impose capacity constraints on assets managed to avoid performance being ‘diluted’ by managing too much money, i.e. the manager stops taking in new money to preserve the best opportunities for the funds existing investors since this maximises the return on his own assets and the performance fee he receives. This leads to some of the best funds being ‘closed’ to new investors. This is fantastic news if you are already invested in the fund as you don’t have to share the ‘best bits’ with too many others, but bad news if you want to invest with the fund or increase your investment, as often you can’t.

Another distinguishing feature of hedge funds is the breadth of their mandate – the manner in which they are sanctioned to manage their

funds. They are often allowed to use leverage (can borrow to invest more), invest in a multitude of financial instruments, and do many other things that a traditional fund cannot. Below, we take a look at what hedge fund managers do and how it allows them to generate absolute returns.

1.4 HOW DO HEDGE FUNDS GENERATE ABSOLUTE RETURNS?

Hedge funds aim to profit in all market conditions, even when underlying markets are falling. There are four main reasons why they can do this: by investing in areas that are obscure enough to be unaffected by falls in mainstream markets, by taking market exposure through derivative instruments such as options rather than through direct market positions, by holding cash or defensive instruments in falling markets and by taking what is known as ‘short’ market positions as well as traditional ‘long’ positions (i.e. holding stocks and bonds).

To address the last first, a short position in a stock is essentially achieved by a hedge fund borrowing stock from its owner (usually a long term investor such as a pension plan or long-only equity fund) and selling that stock into the market, leaving the hedge fund negatively exposed to the equity (since it isn’t owned – just borrowed). The equity is then bought back and the debt repaid at later date. This is generally done as a single mechanism through a broker and is the most direct way of making money when the market falls. By taking short positions as well as traditional long positions hedge funds can actually profit from falling markets as well as rising ones.

This negative exposure can also be gained by buying put options and other derivative instruments. The hedge fund also has the ability to avoid loss from falling markets through moving the portfolio to cash and thus avoiding much downside, although it is notoriously difficult to ‘call’ markets in this way.

Many hedge funds avoid loss through the way they invest, be it by keeping neutral to the underlying markets through hedging (being short as well as long and negating the exposure) or by investing in areas that are obscure and driven by esoteric factors far removed from traditional markets. Remember, given that hedge funds are mainly rewarded by performance fees on new gains (not remade gains), they are heavily incentivised to avoid loss.

As well as the flexibility that hedge fund managers enjoy and the preponderance for skilled traditional managers to move into this area, returns exist also due to the niche nature of many of the strategies. Many such strategies are designed to exploit inefficiencies that exist in markets as a result of the rigid nature of traditional investment management. In the traditional world, the stringent mandates that govern funds and the lack of cross-disciplinary skillsets within the management of such funds means that many inefficiencies go unexploited, e.g. between equities and bonds, when complex situations occur in traditional markets such as mergers and bankruptcies, and in complex instruments such as derivatives. Some hedge funds specialise in these complexities and build cross disciplinary teams of various specialists to exploit such inefficiencies to turn them into returns.

1.5 WHO INVESTS IN HEDGE FUNDS?

In the past, hedge funds have been the preserve of wealthy individuals and endowments who were quick to recognise the benefits of the returns that hedge funds can offer. Now, more and more institutions and individual investors have money with hedge funds. This can be attributed to a number of reasons. Firstly, risk adjusted performance has been very good over the last 10 years or so and, given their lack of correlation to traditional investments, quantitative studies have shown hedge funds to be a beneficial investment class for portfolios, in terms of portfolio efficiency. Secondly, the boom/bust nature of equities over the late 1990s and early 2000s have caused many institutional investors to be wary of equity markets, instead appreciating more steady returns. Thirdly, the migration of renowned skilful fund managers to the hedge fund world has made this area difficult to ignore. Probably as a result of all three factors, the area is now viewed as a significant and established class of investment (although not an asset class since hedge funds practice strategies rather than represent a class of assets) and has been recommended by investment consultants to pension plans as a legitimate strategic investment. Similarly, more and more retail style hedge fund investment vehicles have been made available to individuals through banks and financial advisors. Interestingly, large amounts of the investment in this area have been made through hedge fund of funds, the reasons for which I address briefly below, and will discuss later in more depth in Chapters 3 and 4.

1.6 WHERE'S THE CATCH?

There isn't a catch but there are things to be wary about. Different strategies range widely in terms of risk and return. Some strategies are solid and consistent – producing positive returns almost every month. However, other strategies aim much higher in terms of returns with accordingly higher risk. There are also strategies that look consistent and involatile, but can be particularly volatile under certain conditions.

The important thing is to understand these strategies and cut through the complexity to fully assess the risks, as well as to perform rigorous analysis and monitoring on the hedge funds themselves before investing. This is one of the reasons why many investors, be they private or institutional, prefer to access hedge funds through *hedge funds of funds*.

1.7 WHAT ARE HEDGE FUNDS OF FUNDS?

A hedge fund of funds is a fund that invests in a number of hedge funds in order to give diversified investment in this area; such vehicles are also known as funds of hedge funds. Such funds of funds have been popular investments for a number of reasons. First of all, hedge funds are sometimes complex and require in-depth analysis and expertise before investing and a high frequency of monitoring once invested. Furthermore, different hedge fund strategies work better at different times and so having diversified access across the range of hedge fund strategies is desirable. Such diversification would be difficult to achieve for all but the biggest investors given that many hedge funds have minimum investments that stretch to millions of dollars. As a result, collective investment vehicles such as hedge funds of funds are particularly appealing to investors that wish to achieve informed and diversified access to a broad range of hedge funds. The main reason for the prominence of hedge funds of funds, however, has been the growth of the underlying hedge funds themselves, which has been moving at a quite dramatic pace of late.

1.8 THE GROWTH OF HEDGE FUNDS

Assets in hedge funds and hedge fund-of-funds have grown explosively over the past 10 or so years. Back in the early to mid 1990s when I started investing in the area, it was very easy to meet with practically every hedge fund manager in existence at the same conference, because

there were only around 300 of them worldwide. Today there are an estimated 20 to 30 times this amount of hedge funds, with this growth being matched by inflows of assets.

Despite this recent growth, hedge funds are not a new concept. The first hedge fund was started over 50 years ago, but even by the 1980s, very few people had learned to use the term ‘hedge’ beyond its horticultural context. At this time, there were just a few hundred hedge funds in existence, with most of them quietly managing money for market savvy, wealthy individuals and endowments, almost exclusively in the US. Assets certainly weren’t flooding in yet, and in these antediluvian days there was estimated to be less than USD 50bn in assets managed in this area, making it more of an exclusive club than an investment class all of its own. Since then, assets in this area have been estimated to have grown beyond USD 1 trillion, with some saying that this could be over USD 3 trillion when leverage is considered.

So what made this exclusive club throw open its doors to form a significant and well publicised asset class? Well, as I mentioned above, hedge fund investors in the early days were typically rich, market savvy investors. Such investors typically move in well-connected circles and sit on the boards of endowments and charities. Hedge fund investors were generally well rewarded from their investments since their hedge funds had performed well for them in the good times but also avoided loss in tough times such as the 1987 stock market crash. As a result hedge funds were seen as a highly appropriate investment for those who were rich and wanted to stay that way – an investment objective shared by wealthy individuals and the charities and endowments with which they were associated. Because of this attractive and defensive performance and word of mouth from their board members, many endowment boards and charitable trusts soon became sizeable hedge fund investors also.

This increase in assets soon rendered the hedge fund investment class big enough to catch the attention of larger institutional investors such as US pension plans, which started to notice the benefits of a steady reliable return stream that was uncorrelated with their existing equity and bond investments. Since then growth has been relentless. Now, in the US, endowments such as Harvard and Yale, and one of the world’s largest pension plans, CALPERS, all invest in hedge funds. As a result, when equity markets collapsed in 2000, those that had already invested in hedge funds sighed with relief, and those that had not became very interested.

The increase in institutional investment in hedge funds has also spread to Europe. Over the past few years, European pension fund interest and actual investment in the hedge fund space has increased significantly and this is a trend that is set to continue. Mercers, the investment consultancy, report that 20% of UK pension plans have already invested in hedge funds or hedge funds of funds and, looking forward, a recent KPMG survey (Rajan *et al.*, 2006) has found that 50% of all pension plans questioned intend to invest in hedge funds of funds in the next three years.

This trend can be seen as a broader move away from equities into bonds and alternatives: the Financial Times (FTfm 6/11/06) reports that a recent Greenwich Associates survey of UK corporate pension plans estimates that the vast majority of plans intend to decrease significantly their equity exposure in favour of bonds and alternatives (roughly equally split by private equity, property and hedge funds). Such moves are certainly in line with the proposed softer stance emanating from the Alternative Investment Expert Group within the EC, that recommends an end to all arbitrary restrictions on pension plans investing in hedge funds although this is nothing new given that many major European countries allow or are about to sanction investment in this area by pension plans.

To match this growth in demand, there has been an impressive increase in supply of new funds – from 300 to over 8000 in little over a decade. Nowadays, successful traditional bond and equity managers see moving to manage a hedge fund as a natural career progression; they are well rewarded and they find their skill is less constrained. Now these managers have the power to avoid losing money when the market falls as they are no longer tied to a benchmark, and instead have the added capability to make money in such situations.

Growth in the number of new funds has been stimulated by the development of new strategies, which in turn has been stimulated by the development of new markets. For example, a recent British Bankers Association report finds that the global credit derivatives market has grown from USD 5 trillion in 2004 to USD 20 trillion in 2006 and is estimated to grow to USD 33 trillion in 2008. They also find that hedge funds were already the third biggest participants in this market in 2004 but since then their share of market volume has doubled. Not only has the emergence of the credit derivatives market allowed hedge funds to develop new strategies that profit from inefficiencies in this area, but also buy high levels of protection to further insulate their portfolios.

1.9 CONCLUSION

From obscure origins the growth of hedge funds and hedge funds of funds has been tremendous. This has been driven by the need for investments that are steady, downside controlled and uncorrelated to major asset classes – traits desirable to both institutional and individual investors. Today, hedge funds form a well-established investment class that operates in areas from liquid to illiquid, exchange traded to private and basic to complex. In the next chapter, I will explain a little about the range of hedge fund strategies in existence.

1.10 GLOSSARY FOR CHAPTER 1

Absolute Return

A fund manager seeks to generate absolute returns if he aims to generate positive returns irrespective of the movements of underlying markets or benchmarks.

Closed

A fund that is closed will not take in any new investors or investments.

Credit Derivatives

Options, swaps and other derivatives based on the credit rating of an underlying company or index.

Exchange Traded

Traded on a financial exchange such as a stock exchange as opposed to traded privately.

Fund of Hedge Funds

Another name for a hedge fund of funds.

Hedge Fund

Funds that are flexible and incentivised enough to generate absolute returns.

Hedge Fund Manager

An individual or company that manages a hedge fund.

Hedge Fund of Funds

A fund that invests solely in a number of hedge funds.

Hedge Fund Strategy

A given methodology applied to given markets that describes the approach of a hedge fund, e.g. an equity long/short hedge fund seeks to invest in equity markets with both long and short positions.

Long-Only Fund

A fund that only holds long positions (as opposed to long and short).

Long

A position in a portfolio that has been bought and is being held, e.g. long 1 equity in ABC means the portfolio holds an equity in company ABC.

Management Fee

A fixed percentage of assets that is paid to a fund for management of assets.

Mandate

A set of rules governing or restricting the management of assets issued to a fund and its manager by investors.

Negative Exposure

Having a position in a market that moves in the opposite direction to that market.

Neutral

Having no exposure to a given market (usually whilst holding positions in that market that are hedged or offset).

Performance Fee

A fixed percentage of positive returns that is paid to a fund for management of assets.

Portfolio Efficiency

The amount of return generated given the risk that is taken, e.g. portfolio efficiency is improved if more return is generated for the risk taken or, conversely, if risk is lowered whilst maintaining return.

Positive Exposure

Having a position in a market that moves in line with that market.

Risk Adjusted Returns

Returns generated scaled (divided) by the risk taken to generate them.

Short Position

Holding a position in a security that moves in the opposite direction to that security, i.e. a position that has been borrowed and sold in the market so that when the security falls, the short position gains and vice versa.

Traditional Fund

Another name for a long-only fund.

1.11 SUMMARY OF IDEAS FOR CHAPTER 1

- Hedge funds seek to generate absolute returns.
- Hedge funds are invested with for absolute returns, because they are uncorrelated with traditional asset classes and because they have shown to have good risk adjusted returns.
- For these reasons, hedge funds are popular with institutional investors and growing fast.
- Hedge funds of funds invest only in hedge funds and give diversified exposure to this area.