The hard work of funds of funds

Four Asia-based executives at funds of hedge funds discuss their industry's fallout from the financial crisis, the new competitive landscape and how to avoid future Bernie Madoffs.

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In mid-February, AsianInvestor hosted a gathering of executives at our office in Hong Kong to discuss the fund-of-hedge-funds industry in the aftermath of the global financial crisis. We had a variety of experienced industry players, from investment bank-affiliates to large independents to Asian boutiques.

Where do you work and what is your firm's fund-of-hedge-funds business?
Deng Xiaoli: I'm with Morgan Stanley Alternative Investment Partners and we manage $19 billion globally across hedge funds, private equity and real estate. I do fund research and due diligence focusing on Asia-Pacific managers.

Brenda Tse: I look after the Greater China business for Permal. We're in the top-five funds of funds managers in the world and currently our assets under management is $21 billion. We focus on deep and liquid hedge-fund strategies. We have regionally focused and themed funds, but most of our money is in absolute-return funds, notably our Fixed Income Holding fund and Macro Holding Fund which are at about $5 billion each.

Denise Hu: I am the chief investment director for Rockhampton's fund of funds group, known as Archer Asia, so as to avoid confusion with their separate hedge-fund operation. I joined the firm in April 2009 to help them put together a fund-of-hedge-fund business focusing on Asia Pacific and Japan. We target an annualized return of 12-15% with low volatility. We invest across all strategies. We don't disclose the fund size at present because it is mostly private capital.

Harold Yoon: I'm the CIO of Sail Advisors and I joined them in July 2009. Prior to that I worked at ING's fund of hedge funds. Sail had previously been an Asia-focused investment firm, but as part of my move to Sail, the latter purchased ING's fund-of-funds business, including Onyx and Topaz, a pair of global multi-strategy funds. That also included opening a New York office where we took over ING's analytical team. We manage about $2.3 billion of assets.

What has been your performance in 2008 and 2009?
Brenda Tse: We had a good 2009 with our multi-manager funds up on average 16%, while the fund-of-funds sector returned around 9%, with particularly good numbers in fixed income and macro.

Harold Yoon: Our Topaz fund was down about 13% in 2008 and up 18.% in 2009. Onyx was down 9% in 2008 and up 13% in 2009. The Flagship fund was down 23% in 2008 and was up about 12% in 2009. The Asia Pacific Fund was down about 7% in 2008 and up 5% in 2009. We have a core/satellite approach, with the satellite managers being a bit more aggressive, so as markets rallied in 2009, they did well in the second half, and the core manager's best performance came in the first half of 2009.

Deng Xiaoli: We performed above the industry average in 2008, with our global macro fund generating strong absolute performance. In 2009, all the funds on our platform had a strong year. Our asset-weighted return across all portfolios was about 18%, led by our distressed and emerging-markets funds, which both returned over 25%. Our global macro fund

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Harold Yoon: A shakeout is underway

Denise Hu: Managers need a niche

was up nearly 14%, driven by discretionary strategies. Multi-strategy, macro, and opportunistic long/short equity strategies drove performance in our diversified fund of funds vehicles.

What is the future of the fund of hedge funds business? What is going to change? How about fees?
Harold Yoon: I think there may be a phase of consolidation and a shakeout. There were [institutional investors] that simply chased name brands and multi-strats, and in so doing added little value at all in return for fees. Some smaller funds of funds, with assets of $100 million to $2 billion, are deciding that their business model doesn't work anymore. Some of this is due to redemptions, but also as the industry starts to demand so much more in terms of risk management, operational and analytical research capabilities. To have all that in one shop demands a certain level of revenue.

If you look at attempts to standardize hedge-funds products, such as the Ucits code in Europe, hedge-fund replication products and index products, all these as they develop will give investors an alternative source of alpha and beta.

Brenda Tse: We operate four funds on which we do not charge performance fees. One is our largest flagship fund, the $5.4 billion macro fund. On the others we do charge a performance fee, but only about 5%. We think funds of funds will focus on either liquid or illiquid strategies. For many years we have been in the former camp. It might be difficult for those who try to have a foot in both camps. Investors are focusing on due diligence processes and how to avoid Madoff-like situations.

Size and experience matter in this industry. Economies of scale will make a difference for funds of hedge funds, in matters such as the cost burdens of compliance and due diligence, given that over 53% of hedge-fund companies manage less than $100 million. Fewer than 5% are over $5 billion and they control over 60% of industry assets.

Denise Hu: The industry has over-expanded globally in the last couple of years. Going forward funds of funds need to find an edge to distinguish themselves. We are Asian specialists, and there is only a handful who have our experience, skill set and on-the-ground presence. In terms of the benefits of scale, we can leverage the Rockhampton infrastructure for institutional quality resources such as IT, legal and compliance, given they want to build a strategic allocation in Asia.

Are funds of funds at risk from multi-strategy hedge funds?
Deng Xioali: I don't think that funds of hedge funds are going to be replaced by multi-strategy funds, whose difficulties in 2008 demonstrated that adequate diversification may be difficult to achieve within these vehicles. A number of the big brand hedge funds were down 40-50% in 2008, but there aren't any big funds of hedge funds down that much. It is difficult for new, smaller funds of funds to find a way in. We will see the big get bigger.

Harold Yoon: In general, the 2009 performance for funds of funds was poor. Hedge fund indices were up about 20% and fund of funds indices were up roughly 11%. There's never been such a big gap between the two. I think that's because a number of funds of funds were damaged coming into 2009 and in dealing with illiquidity, to the extent that they were unable to run their portfolios normally. That's been a black eye against those funds of funds.

Denise Hu: Part of that gap can be explained by the fact that a number of funds of funds were stuck with their legacy positions, particularly among those who were left in possession of large illiquid holdings. They had to gate or suspend. So when opportunities returned, in say equity or event-driven strategies in 2009, they found they didn't have cash left to deploy.

Harold Yoon: It seems easy to say now about 2009 'You just had to take beta,' but let's remember that in the first three months of that year it looked like the whole financial system might melt down. That explains the cautiousness of investors and I think that explains some of the under-performance.

Funds of funds are often perceived as being less 'sticky' investors. What do you hear from your investors about their liquidity needs?
Brenda Tse: Historically Permal has been perceived as a long-term 'sticky' investor. Our investors appreciate our monthly liquidity with 20 days notice. We can offer those terms because of our increased use of separate managed accounts with managers and the terms embedded in them. That accounts for a third of our relationships. Not only does it provide us with greater flexibility and control, but it also allows us to bargain our managed-account terms with the manager and often we don't invest in their flagship product but a variant.

Harold Yoon: I am not a big fan of managed accounts. Funds that offer them typically need the assets more, so there is something of a negative selection bias about them. If I knew that a fund offered better liquidity terms to other investors

Brenda Tse: Due diligence needs scale

through a managed account, I would be hesitant to invest.

Denise Hu: In 2008, everyone redeemed and wanted to get out of the door, not just funds of funds. We saw managers experiencing redemptions from traditionally sticky investors such as pensions and endowments too. For those investors that were stuck in 'locked up' hedge funds, it was a very frustrating experience. Going forward, investors are much less tolerant towards long lock-ups, and managers must align the liquidity they offer to the individual strategy.

Deng Xiaoli: We consider ourselves to be 'sticky' investors, which is feasible given the generally longer-term orientation of the majority of our investor base. Liquidity terms should be consistent with the liquidity of the underlying strategy. If, for example you had a distressed manager offering no lockup with monthly liquidity, that won't work. On the other hand, a long/short manager focused on large caps should not have a multiple year lock up.

What advice would you give to someone starting a new fund of hedge funds?

Denise Hu: Whether a fund of funds or a hedge fund, you have to offer an edge, and investors expect so much more these days, especially extending to operational functions in addition to supporting the investment process. The quality of start-ups in hedge funds right now in Asia is mixed. The opportunity cost to set up is quite low though; for example, rents are still reasonable.

Harold Yoon: The best thing to have before you start business is $5 billion in assets under management! Apart from that you need to have the resources to run it well. Asia does offer opportunities if you are good at understanding regional markets and finding new markets. Investors who go into funds of funds are looking for diversification, risk management, operational due diligence and strong research. Unless the resources to provide all these are present, then they won't invest.

Deng Xiaoli: A hedge fund can charge 2% management fee and 20% performance fee. A fund of funds can charge perhaps half that. The evaluation of complicated hedge-fund strategies requires specialists who understand the drivers of risk and return, and who can differentiate between many funds. Also, a disciplined portfolio-construction framework is needed to achieve a targeted risk reward. You can't

Deng Xiaoli: Liquidity must be justified

just put 20 to 30 managers together in your book and call it a fund-of-hedge-fund portfolio. And you still have to pay everyone, plus data costs, travel and operational expenses. So you have to have significant assets to start with.

Denise Hu: It helps that nearly all hedge funds are open, and have capacity. But yes, you do need to start your business with a meaningful size and have at minimum twenty plus managers in the portfolio and an infrastructure quality infrastructure. In 2006/2007, you could have started a fund of funds without substantial backing because it was easier to source capital.

Funds of hedge funds that did not invest in Bernard Madoff point to their operational due diligence processes. Have any of you ever met and turned down a dodgy dealer?

Harold Yoon: I got pitched Madoff a lot, but didn't invest. I didn't meet with him. Doing operational due diligence in a checklist-style is not sufficient, and the hedge-fund guys are smart enough to learn about what kinds of questions will be asked. The value added is for the operational due diligence people to work as a team with the risk-management and portfolio-management people when research into a fund is taking place.

Brenda Tse: We met Madoff in 1993, and we rejected him at that time. We'd never heard of the audit firm, his brother ran compliance, he didn't use a custodian and he couldn't really explain his strategy. We got requests from our clients in 2003 and sent our portfolio managers to see them, and said 'no' again.

Denise Hu: I did meet Wood River in San Francisco, which we never invested with and which turned out to be a fraud. There were some issues that caught our attention. The numbers were too good to be true. They'd also changed their prime broker. An act like changing a service provider is a red flag. High personnel turnover can also be a red flag, as is bitterness expressed by staff. You don't need a sixth sense, but when you have the experience of having met that many managers, you can learn to tell when something is not right.

Are there still funds of funds making those mistakes?

Denise Hu: In Asia, it has been an industry standard to have independent fund administrator, whereas in the US it hasn't always been the case. Most new launches will have a top-four auditing firm and well-known prime brokers and legal advisors.

Deng Xiaoli: We had received pitches for Madoff's strategy, but did not purse the investment given several clear red flags, including the unusual fund and fee structures, the affiliated broker/dealer, self-administration, and a lesser known auditor. For us, operational due diligence is as important as investment due diligence. Our operation due diligence team has rejected approximately 35 managers over the past six years.

Having a forensic accountancy background is all well and good, but what if a fraudster is forging convincing-looking documents. How do you spot a charming crook who is setting out to deceive you?

Brenda Tse: We run a dedicated operational due diligence team, which includes heavy quantitative and qualitative analysis. This includes interviews, reference checks with third parties and current investors, systems and documentation analysis, potential conflicts of interests, business continuation plans, how they go about calculating NAVs. It is hard to deceive consistently across every area of a business. If the manager fails this, or even raises any flag, their case doesn't go before our investment committee. ■