



# Back to the Drawing Board: Redefining Hedge Fund Investing

By



Benjamin Poor  
Manager of Markets Intelligence  
Securities & Fund Services, Citi



Peter Hill  
Global FOF Product Manager  
Securities & Fund Services, Citi



Improving transparency and liquidity have become just as important as investment performance for investors in hedge funds. To better understand how the dynamics of the industry are changing, Peter Hill, Citi Securities & Fund Services, Global FOF Product Manager, recently sat down with four industry professionals

**Dan Federmann, CPA, CFA**

Chief Operating Officer  
Senior Managing Director  
Protégé Partners, LLC

**Jacqueline D. Jenkins**

Managing Director  
Asset Management, AIG

**Eric S. Lazear**

Head of Operational Due  
Diligence, FQS Capital Partners

**Karl Ehram**

Principal, Deloitte & Touche LLP

diligence, many FOF were heavily exposed, and in a few extreme cases, almost fully invested with these hedge funds. Taken together, these shortcomings led many investors to question the value of FOF.

Post-Madoff, mere fee concessions will not win over new clients. Investors are questioning the very FOF model, and seeking better ways to construct portfolios. FOF are responding by stepping up their game, delivering the following improvements:

- FOF are specializing in terms of strategy (e.g., CTAs) or approach (e.g., seeding managers) to stand out from the crowd
- FOF are delivering increased transparency through managed accounts, fund-of-one, and hedge fund advisory arrangements
- FOF are redoubling their due diligence efforts, emphasizing compliance, so as to minimize fraud and other operational risk

To further illustrate this transformation, Citi conducted a round table with four industry experts. Each of these three themes is developed in the sections that follow.

**Specialization, Not Size, Matters**

During much of the past two years, FOF found themselves at the center of a maelstrom: Performance had not met expectations, investors demanded fee concessions, liquidity demands drove allocation decisions, and a series of investment scandals called into question the ability of FOF to add value and justify fees. Not only had several FOF failed to identify high-profile cases of fraud, such as those committed by Madoff and Westridge, but a few had actually invested quite heavily in these troubled managers. For much of 2009, both high net worth (HNW) and institutional investors either withdrew funds, or put future allocations to alternative investments on hold.

**Executive Summary**

In the aftermath of the Madoff fraud, investors have become increasingly frustrated with the level of transparency, liquidity, and due diligence provided by funds of hedge funds (FOF). Rather than protecting investors through diversification, risk management, and proper due

In 2010, while investors did not return to hedge fund investing in droves, a clear pattern emerged among the flows of new investments. During the first half of 2010, nearly all of the \$23 billion of new investor capital went to hedge funds that already had more than \$5 billion in assets under management. The same was true with FOF investments: Institutions increasingly came to view investing with the largest FOF as a safe move, since these players could both afford significant investments in talent and technology, while managing enough money that they wouldn't take undue risk with questionable strategies or undeserving managers.

While data from HFR shows that hedge funds managing less than \$50 million outperformed billion-dollar funds by nearly 1.5% annualized for the 15 years ended December 2010, trustees and other institutional investors consciously developed a preference for blue-chip managers, preferring to avoid headline risk and invest in the same managers as their peers. Taken together, these developments led some to conclude that mid-sized FOF would

struggle, and smaller players would merge or fade out of existence.

### New paradigm

Recently, industry participants have noticed a more nuanced split in the industry, as FOF bifurcate more along lines of specialization than size per se. "Smaller players can survive if they have a niche focus," observes Dan Federmann, Chief Operating Officer of Protégé Partners, while "large firms can have the value proposition of having a huge balance sheet and the necessary infrastructure that institutional investors want to see."

Specialization can be somewhat subjective, but Federmann claims that a key component of his firm's value proposition is its ability to identify managers for specialized smaller and niche strategies and managers, and then, when appropriate, to provide seed capital to a certain number of these small funds. Such actions are really twofold: First, the firm identifies the investment opportunity, and then as the seed investor, having an opportunity to share in the growth and performance of the manager through

its revenue sharing arrangement with the seeded funds. Having a fund that combines "arm's-length" investing alongside "seed" investing helps to achieve a better alignment of interests for their investors, offering their own clients and the underlying managers a chance to grow together. Roughly 90% of hedge funds manage less than \$1 billion in assets, forcing FOF to turn over many stones to find successful managers. Since smaller, younger funds tend to generate more alpha, and that the average fund has a lifespan of five to seven years, providing seed capital to select managers can be a very successful long-term strategy.

Another example of specialization includes the ability to focus on certain investment strategies. "It's tougher to succeed with a [plain] multistrategy vehicle; you need to have a niche," explains Eric Lazear, Head of Operational Due Diligence for FQS Capital Partners. His firm is increasingly being asked by investors, whether endowments or pension funds, to provide specialized solutions. After the crisis, interest in Commodity Trading Advisors (CTAs)

and distressed debt rose sharply, as the former proved uncorrelated with other strategies, while a flight-to-quality created pockets of value for savvy credit investors. But not every FOF can be flexible enough to seize upon these trends. "Many FOF have no CTA expertise," Lazear elaborates, referring to a lack of experience working with managers structured as commodity traders, which are structured differently and regulated by the CFTC, rather than the SEC.

Specialization has become so valued that Lazear and Federmann have even been approached by multistrategy FOF looking to augment their own skill set. Such interest rarely comes from mega players, who either have the internal capability, or would lose face were they to outsource such expertise. Although there are clearly some advantages of scale, FOF will need to specialize to continue to grow their business. Such differentiation becomes all the more important as institutions take a fresh look at portfolio construction—an approach that could impact FOF's business model.

## Critical mass

Defining what level of FOF size is truly sustainable can be somewhat problematic. For single-manager hedge funds charging two-and-twenty, a hypothetical fund of \$200 million returning 20% could yield the general partner some \$8 million per year—not enough to get filthy rich, or support a team of 100, but enough to survive for a year or two until such results cause assets and attention to increase. Many FOF, on the other hand, have only limited performance fees and lower (if any) management fees; moreover, as diversified vehicles, it will be difficult to survive on capital gains alone. A comparably sized (i.e., \$200 mil.) FOF charging a 0.5% management fee and 10% of performance might generate only \$3 million of revenue—possibly a marginal business, given a FOF's need to conduct both investment and operational due diligence on dozens (if not hundreds) of managers per year. As Lazear sums it up, "Sure, [smaller] players can potentially survive, but not thrive," and therefore need to provide some sort of specialized service, such as expertise researching quantitative managers.

There is some general consensus that hedge funds and FOF can run a healthy business around \$2 billion - \$3 billion in AUM. But current size alone may be less important than the path taken to get to that level. "There are more \$150 million - \$500 million FOF popping up," notes Lazear, and if they are following an upward arc, those businesses may be sustainable. "But some of these players fell from a peak of \$2 billion," he continues, "and that's tough to climb back up," especially since firms of the multibillion-dollar size may have grown overhead significantly when assets were much larger.

For hedge funds and FOF, striving for the "right" size might be chasing rainbows, especially since institutional investors have competing goals. "Institutions have been somewhat schizophrenic," asserts Jacqueline D. Jenkins, Managing Director, at AIG Asset Management. "Institutional investors want a large, well-recognized firm that is highly institutionalized, has a deep bench, all the necessary systems and a proven track record." But if managers become too large and try to be all things to all people,

how much cancellation of alpha do they have in their products? “So, many institutional investors prefer mid-sized firms,” Jenkins explains, “but then the question is, do they have the platform?”

### Customization: Solutions for Improving Hedge Fund Transparency

Equally strong as the pressure for FOF to specialize has been the pressure to customize. Post-Madoff, institutional and HNW investors began to demand greater transparency. Gone were the days of hedge fund “black magic”: Investors demanded more visibility around investment exposures, including individual positions, as well as leverage. For some investors, increased willingness on the part of hedge funds and FOF to share information was sufficient, while other investors began to demand a new framework for investing. Three solutions gaining traction in the marketplace include managed accounts, the “fund of one” and hedge fund advisory. Each of these is discussed further below.

### Hedge fund managed account

Rather than accepting their status as a limited partner in a hedge fund commingled with other clients, some institutions (and a few family offices) have pushed for so-called “managed account” arrangements. Under this arrangement, the manager creates a separate portfolio for the institutional investor, with custody and administration conducted by providers of the client's choosing, rather than the hedge fund firm. When the hedge fund manager wishes to place a trade for the managed account, those instructions are routed to the custodian.

This approach offers clients a number of sizeable advantages: First, the investor owns the investment directly vs. an investment in a partnership interest; second, the custodian can provide full transparency of the portfolio at any time, possibly even in real time. Either through predetermined rules or ad hoc alerts, the client can also direct the custodian to reject individual trades that might violate the investment policy guidelines. While “side

letters” do allow some special rights for designated limited partners, separate accounts allow fuller portfolio customization (sector, position and leverage limits). A major selling point of hedge fund managed accounts for institutions is that the risk of Ponzi schemes is greatly reduced by the designation of an independent administrator and custodian. Finally, because the account is a bespoke solution, the institution's investment is not commingled with other clients. This avoids the imposition of gates or the need for forced selling which might depress asset prices in the portfolio and lead to poor performance.

Yet for all of the benefits of separate accounts, investing in this type of bespoke hedge fund portfolio does come with some drawbacks. Chief among these is the fact that if bespoke investments are a privilege, they also come with additional responsibilities. Whereas limited partners delegate decisions regarding custodians, administrators, prime brokers and other third parties to the fund manager, users of managed accounts need to engage these

providers themselves. Only the most sophisticated investors will be able to effectively negotiate their own terms.

### “Fund-of-one”

Even for those savvy enough to navigate such discussions, managed accounts have an additional cost. Arguably, limited partners are already enjoying economies of scale by sharing the costs of custody, administration and prime brokerage with their commingled partners. If investors considering moving to a managed account are hoping to incur similar costs, then the mandate has to be of sufficient size. And if the mandate is indeed quite large, a second option to consider is the so-called “fund-of-one.”

As the name suggests, the fund-of-one is structured like a typical hedge fund, but with only one limited partner. For the investor, this structure may offer many of the advantages of a managed account solution, including increased transparency and lower fees, as the terms are mutually agreed upon between the client and the manager. Moreover, the burden of identifying and engaging service providers,

which is required under the managed account structure, falls upon the hedge fund manager, just as it would in a “fund-of-many” (i.e., off-the-rack fund allowing multiple investors).

### Hedge fund advisory

Hedge fund advisory arrangements offer another form of customized investing usually only available for institutional investors. As an alternative to investing in FOF, for example, an institution can hire a consultant to advise on asset allocation and manager selection. Many institutions looking at hedge fund advisory arrangements are pursuing this arrangement to reduce costs and improve control. “To the extent we were previously invested in FOF,” Jenkins explains, “we had way too much diversification, and we were paying fees on top of fees.” AIG’s arrangement with its two hedge fund advisors also helps address the transparency issue. “We need the underlying managers to provide transparency to our two managers-of-managers, but not directly to us. Otherwise,” she continues, “I’m replicating what these advisors are supposed to do for us.”

Experts believe that there is a certain inflection point at which bespoke portfolios not only become possible, but also make more sense. “When I was at my previous firm,” Jenkins recalls, “we were already moving from FOF to [a custom portfolio] with \$1 billion in assets.” At that level, she explains, a client can justify the added costs of the necessary infrastructure. Karl Ehrsam, Principal at Deloitte & Touche LLP’s Enterprise Risk Service Group, notes that he sees advisory relationships often in the endowment and foundation channels. “For example, they might place \$80 million direct with several hedge funds,” he explains, “but often they don’t fully understand the risks, and might not be able to afford to build out a platform. So they seek out firms that have the experience and resources to assess the risks and help them make informed decisions.” While industry observers in the past have argued that institutions typically “graduate” from FOF into direct hedge fund investing, hedge fund advisory arrangements suggest that there is no singular path in the evolution of hedge fund investing.

## Can customization truly improve liquidity and transparency?

Clients may also need to consider whether or not custom portfolios can truly deliver on their promises of greater transparency and liquidity. While “full transparency” can be provided, it is fair to question whether it can be acted upon in a meaningful way. “Transparency is useless for a high-frequency strategy,” Federmann observes, as such funds may place hundreds of trades a day, rendering position details immediately stale. Similarly, getting a handle on transparency can be complicated for investors in multiple separate accounts, as they could be receiving portfolio information from five or six different administrators. “They may have different valuation policies, so their books look different, making it harder for investors to reconcile their overall exposures.”

Federmann points out, “You can have a liquidity mismatch and get burned,” which Federmann refers to as “Portfolio liquidity vs. Structural liquidity,” if the strategy takes longer to unwind than the terms specified

in the contracts. Lazear agrees: “Even if it’s in the documents, it is not necessarily controlled.” He does not believe investors’ liquidity has changed that significantly post-crisis. “Even if you are able to sell, at what cost will you?”

Some institutions are taking a more practical approach and realizing that the liquidity premium exists for a reason. Certainly institutions want to negotiate the best terms possible, but they should expect low levels of liquidity during times of crisis. Having improved liquidity “sounds good in theory,” Jenkins argues, but “the way I think of it, institutional investors shouldn’t be looking to their hedge fund portfolio for liquidity. That’s what their Treasury and bond portfolios are for.”

FOF and their underlying managers are taking a similar approach, recognizing that having a cash position is the ultimate way to get in or out of markets quickly. “For us, as a FOF, for all underlying managers, we are analyzing their cash position,” Lazear notes. “Some may post dry powder,” so as to take advantage of fleeting opportunities without first

having to close out other positions. FOF are also keen to better manage their own clients’ liquidity. “FOF have a certain cash percentage on hand to meet redemptions,” he continues. As the firm wants to avoid lockups, FQS may view their portfolio in “liquidity buckets,” including marketable securities, cash, underlying manager’s liquidity and access to a credit facility.

From a manager perspective, separate accounts can also create unwanted headaches that may not be worth the additional assets. Federmann warns, “You have to worry about managed accounts cannibalizing your FOF investors.” If alpha is constrained by capacity, then hedge fund and FOF managers who agree to run separate accounts are effectively taking on lower-fee business at the expense of more scalable arrangements. Some have even argued that this creates a conflict of interest, with bespoke investors unwittingly putting themselves at a disadvantage to off-the-rack fund clients, while at the same time harming off-the-rack clients by reducing the AUM of the funds they are invested in, and possibly applying selloff pressure on the investments.

## Other solutions

Given these challenges, a number of hybrid arrangements are proliferating. “A few endowments like our multistrategy vehicle, may prefer a bespoke solution,” Lazear notes, with certain risk metrics controlled. “One has to consider the cost of development,” he cautions.

Yet adjusting the business model to appeal to different clients has its limits. Our panel was not very optimistic regarding hedge fund managed account solutions being piloted in mass-market retail channels. “This is a knee-jerk reaction,” Federmann remarks. “I’m generally against going after mass market clients.” While such managed accounts could provide increased transparency, he doubts retail clients could properly digest such detailed information. Lazear has a similar take: “After the collapse of Lehman Brothers and the Madoff fraud, there was a lot of buzz for this, but what do you do with the information?”

## Due Diligence: the Search for Operational Alpha

For FOF and institutional investors, due diligence has always been about

identifying quality managers who are likely to perform well in the future. While capturing alpha remains a key objective, post-Madoff, industry professionals have increased their emphasis on operational due diligence.

## Deeper benches

While most were never keen to invest with the proverbial “three guys and a spreadsheet,” professional investors increasingly insist on hedge fund firms fielding larger staffs. Even firms such as Federmann’s, which focuses on emerging managers, want to see some depth to the organization. “But we require more headcount today compared to five years ago: Having a COO and potentially another compliance person is key. So if three people were sufficient before, you want to see at least five to seven people, plus third-party support.” He notes that his own firm parallels that shift: Protégé grew from 25 to 40 people expressly to become “institutional ready.”

Lazear agrees: “Post-2008, we definitely have a higher threshold,” though there are a series of other factors to consider. As FQS provides managers with seed capital, firms

launching with \$300 million – \$500 million would be expected to add additional employees. But the answers also depend on the manager’s strategy, as well as its use of third-party service providers. “If they are running 100% long/short strategies, investing in level 1 securities,” Lazear cautions, “while relying on an administrator for back-office and middle-office services and a compliance partner, then we’re comfortable with that.” But a manager trading volatility swaps or more esoteric strategies, without internal staff scrutinizing ISDAs, would make him uncomfortable. “There’s nothing wrong with considering a small team if they are leveraging administrative and compliance providers,” he states.

Jenkins also believes that it is a mistake to eliminate certain managers that only field a handful of employees. “Post-Dodd-Frank,” she notes, citing the Volcker Rule, “you have entire teams, intact, spinning out of prop desks—and they have the backing, resources, money and track record of the prior firm.”

## Creating a culture of compliance

Beyond headcount in general, all four panelists stressed the importance of compliance. “A COO and potentially another compliance person are key,” stresses Federmann. Lazear echoes the sentiment: “At minimum, you need a COO, CFO—even if it wasn’t expected in the past.” The recent insider trading scandal involving Galleon and a prominent industry consultant serves as a painful reminder that fraud and breach of duty did not cease to exist when Madoff was put behind bars. Managers need to demonstrate that they are dead serious about compliance.

Opinions differ on whether the SEC oversight is essential at the firm level. Not surprising, Jenkins finds it quite important. “Many institutional investors would prefer not to have headline risk, even at the expense of top performance,” Jenkins asserts. Federmann notes that, “We don’t necessarily rely on SEC registration, as we don’t want any sense of false confidence there,” and further added that operational due diligence needs to continue in both preregistration and post-registration environments.

While talented and experienced compliance professionals are de rigeur, a successful compliance program is not necessarily judged by having done a stint at the SEC or holding degrees from the best schools. What’s most critical is having or implementing a strong compliance culture. “The one good thing that has come out of this crisis and the reforms is that even the reluctant manager has been forced to take a look at policies and improving them,” asserts Federmann. A key piece of the puzzle is the need for the CFO and COO to be segregated from the portfolio management function. “Do you need an SEC vet? No—a former auditor is fine.” It is essential that the COO has a good relationship with counsel or any compliance consultant and can stand up to the portfolio manager on certain issues. Ehram states, “My view is that you don’t necessarily need a law degree, but need to understand how the business operates. Actually, a person with CFO experience could prove as, or more valuable than someone with strictly legal knowledge.”

Lazear takes a similar stance: “Compliance culture has to start at

the top. As long as the compliance culture is taken seriously, and drilled down from the top, OS partners can add the minutiae/finer points. We look at what the culture is and how that is incorporated.” Inculcating a compliance culture can go a long way to running an upright business, but there are still no guarantees. “Insider trading is a really hot topic right now,” Lazear concedes, “but unless you run wiretaps on your managers, there’s no real way to detect it.” That being said, firms that fail to develop a compliance culture might be more prone to inappropriate activities.

## Looking Forward: Specialization to Continue

If hedge fund transparency and liquidity left something to be desired during the financial crisis, the fact that hedge fund assets have hit an all-time high seems to suggest that the industry is addressing these issues. A renewed emphasis on compliance has helped hedge fund investors identify managers who can deliver operational alpha, while new vehicles and investing structures have led to improved transparency.

While there is ample room for funds of funds, direct hedge fund investments, and tailored manager-of-managers advisory programs, there is little room for mediocrity. Although the past few years have proven challenging, Citi believes that FOF and consultants who can provide investors with solutions in the form of unique strategies, improved transparency or the ability to create bespoke portfolios will enjoy ample growth in the future.

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FQS Capital Management is a dynamic multiasset management firm employing sophisticated proprietary quantitative modeling and integrated risk analysis to maximize investment return. Dr. Robert J. Frey is the firm's Founder, Executive Chairman and largest shareholder. Dr. Frey was formerly a Managing Director of one of the world's most successful hedge funds, Renaissance Technology Corp.

FQS has its head office located in the Cayman Islands, with its operational hub based in the penthouse of the former London Stock Exchange and a satellite office in New York.

### **About Protégé Partners, LLC**

Protégé Partners was founded in early 2002 by Jeffrey Tarrant and Ted Seides, and the Protégé Partners Funds were launched later that year. Protégé currently manages three different investment strategies: the Protégé Partners Funds (launched July 2002), the Protégé Opportunistic Funds (launched July 2007) and the Protégé Tactical Funds (launched May 2011). The firm's flagship funds, the Protégé Partners Funds, invest their assets with a diversified group of directional, relative value and event-driven investment managers supplemented by those in tactical niche strategies. The Funds invest both "arms-length" with hedge fund managers and seek to enter into strategic "Seed Investment" relationships with hedge fund managers such that they receive cash flows in addition to the market-related return on their investment.

