What investors want from hedge funds

January 2015

WILSON WILLIS

“Talent gravitates to hedge funds – and we want access to that talent

“The problem is: how to put together your team

“Its about the proximity the principals have to the risk

“If they haven’t delivered, they will be terminated

“I don’t need a regulator telling me what’s good for me

“We won’t invest in a fund that doesn’t have a dedicated COO

“If the underlying investments are liquid enough, then UCITS are fine

Investor roundtable sponsors

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[1] On an AUM basis – According to the HFMWeek 2014 Survey. [2] On an AUM basis – According to the Institutional Investors 2014 Fund of Hedge Funds Survey.

OLDMUTUAL GLOBAL INVESTORS

Old Mutual Global Investors (OMGI) is delighted to co-sponsor the Wilson Willis hedge fund investor roundtable.

The firm launched its first hedge fund in 2001 and now manages over $3 billion in hedge fund and alternative UCITS funds.

We believe that hedge / alternative UCITS funds can play a very important part in a portfolio by seeking to deliver diversifying returns with low correlation to traditional assets that should be expected to reduce drawdowns in difficult markets. Our view is that this investment approach, which seeks to deliver better risk-adjusted returns, will become even more important as demographic trends shift more people into the later life phases of their investment cycle.

We are extremely interested to hear directly from experienced hedge fund investors and investment consultants as to the role they see hedge/ alternative UCITS funds playing in client portfolios.

We hope readers of this discussion, chaired by Neil Wilson, will find the discussion to be useful and thought provoking.

Donald Pepper
Managing Director of Alternatives
Old Mutual Global Investors

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Introduction

Neil Wilson

John Willis

This report aims to address two main questions: Why should investors want to allocate to alternative investments like hedge funds? And how best should they go about it? The body of the report focuses on the thoughts and comments on these questions from a leading group of investors and their close advisers who we gathered together for an afternoon in late November at the Renaissance Hotel in St Pancras, London, to discuss and debate.

There is indeed a lot to debate on what investors are looking for from hedge funds – given not least the diversity of new products and regulations being introduced. We decided there were certain core issues such an event ought to address, including: Why bother with hedge funds at all? Where to go for advice on how best to invest? What sort of structures to invest through? How much to pay in the way of fees? And how best to conduct due diligence and select managers successfully?

To address the questions we were delighted to be able to assemble such a diverse group of participants, including people involved with end-investors like endowments and family offices; investment consultants – who have become such important gatekeepers for institutional allocators like pension funds – plus at least one person who advises pension fund trustees; and from groups who run funds of hedge funds (FoHFs), in previous times very much the dominant allocation route into hedge funds and still a very important source of capital for many managers.

To make an event work, we also needed input from the asset management side of the fence – from firms who wanted to engage with investors and hear from them on their issues, with no holds barred. We were delighted to find two such firms – in Old Mutual Global Investors and Amundi Asset Management – with the vision and far-sightedness to back such a project and make it possible, for which we give them both many thanks. We hope you find this resulting report illuminating and useful.

Neil Wilson John Willis

WILSON WILLIS

Wilson Willis Management Ltd provides specialised services including analysis, commentary, bespoke research and conferences to the asset management world, with a primary focus on hedge funds. For more information contact: Neil Wilson, neil@wilsonwillis.com or John Willis, john@wilsonwillis.com

Panellist biographies

Kevin Gundle Aurum Fund Management

Kevin Gundle is a founding member of Aurum Fund Management Ltd and is chief executive officer at Aurum Funds Ltd in London.

Kevin Gundle has been investing in the alternative investment markets for more than 25 years and oversees Aurum's investment and research framework and chairs the firms risk committee.

Aurum is an award winning manager of multi-manager hedge funds. For over 20 years Aurum has successfully demonstrated its ability to provide investors with stable absolute returns through various market cycles.

Kevin is a trustee of both Absolute Return for Kids (ARK) and the One to One Children's Fund.

Kevin holds a Bachelor of Engineering Honours degree in Computer and Control Engineering.

Robert Howie Mercer Investments

Robert Howie is a principal in the Alternatives Boutique, a unit within Mercer Investments. Located in London, he leads the manager research and generation of intellectual capital for alternative assets in Europe, focusing on hedge funds, insurance-linked securities, multi-asset and other liquid alternative strategies. Additionally, he advises institutional investors on the use of alternative assets, including manager selections and portfolio construction.

Robert serves on several of Mercer's Ratings Review committees and is chair of the Infrastructure and Natural Resources committee.

Robert has over 15 years of experience within the financial services industry, and has been with Mercer for over 12 years. Whilst at Mercer he has been involved in both research and has consulted to clients across Europe and the Middle East, including pension plans, sovereign wealth funds and wealth managers. Prior to joining Mercer, he worked for Barclays in London and African Life (now part of Sanlam) in South Africa.

Robert has a Master of Business Science from the University of Cape Town, and is a fellow of the Institute of Actuaries.

Chris Jones bfinance

Dr Chris Jones is a managing director at bfinance, where he is head of public markets and liquid alternatives and also heads up the London office. bfinance is an independent investment consultant whose clients' assets top $1 trillion.

Chris has 21 years' investment management experience with specialism in hedge funds. He previously spent seven years as CIO of Key Asset Management, a multi-billion fund of hedge funds, and has also authored numerous academic papers and a book on the area.

Chris has a degree in Mathematics from Oxford University and a PhD in Mathematical Finance from the Judge Business School at Cambridge University, where he is a fellow, teaching postgraduate courses on hedge funds and risk management.

Mattia Nocera Belgrave Capital Management

Mattia Nocera is CEO/CIO of Belgrave Capital Management, the London-based research/investment management company of Banca del Ceresio, a Swiss family-owned private bank. The Group is one of the historical investors in hedge funds having started to allocate to external managers the equity exposure of their clients in the early 1960s. The group is also partner in the two oldest funds of funds in the industry: Leveraged Capital Holdings NV and Haussmann Holdings NV.

Belgrave Capital Management undertakes fund research and analysis for the group and is the investment manager to Vitruvius SICAV, a Luxembourg multi-portfolio, multi-adviser UCITS established in 1999.

Mattia is a director of both Global Selection SGR SpA and Global Selection Advisors Ltd, the two funds of funds investment management companies of the group, and is a member of their respective investment committees.

Prior to establishing Belgrave Capital Management in 1995, he spent 10 years with Bankers Trust Company in various positions, both in New York and London. He holds a BA in Economics from Brown University (1982) and an MBA in Finance from The Stern School of Business of New York University (1987).

Donald Pepper Old Mutual Global Investors

Donald Pepper CFA is managing director of alternatives at Old Mutual Global Investors, which he joined in December 2012. He was previously investment director – hedge funds at TT International (2010-2012) and was head of hedge funds at New Star Asset Management/Henderson Global Investors (2008 – 2010), where his responsibilities included being co-portfolio manager of two hedge fund of funds, with AUM of over $200 million.

Prior to this Donald was managing director of prime brokerage at Merrill Lynch (2003-2008) and spent 16 years at Goldman Sachs (1987-2003) in prime brokerage and in fixed income, currencies & commodities, in London and New York.

Donald is a graduate of The Queen's College, Oxford, where he read Philosophy, Politics & Economics. He was appointed by Sir Alan Budd to be an inaugural member of the Provost's Council which provides advice to the College on matters including the management of its endowment. Donald is a CFA charterholder.

Ian Prideaux The Grosvenor Estate

Ian Prideaux manages the Grosvenor Estate's non-property investment portfolio. This includes long equity and bond portfolios, commodity, hedge fund and private equity investments.

Ian is responsible for asset allocation and manager selection, investments being managed externally. Ian has been with Grosvenor since 2006, and was previously at HSBC Private Bank, SG Warburg (now UBS) and Price Waterhouse (now PWC).

Benedicte Rabier Amundi Asset Management

Benedicte Rabier has over 12 years' experience within the hedge fund industry and more generally on alternative investments.

She has worked primarily on the equity derivatives desks of investments banks, such as Societe Generale Asset Management (Paris), Natixis (New York), Lehman Brothers (New York) and Barclays (New York and London). She ran fund derivatives trading books and held funds positions as collateral under the structured products she traded. Her clients were mainly funds of hedge funds and family offices.

During her career, Benedicte has covered hedge funds and mutual funds risk, strategy analysis, due diligence, manager selection, portfolio allocation and managed accounts. She also has 10 years' experience in complex structured investment products such as constant proportion portfolio insurance, UCITS wrapping, variable funding notes, usage of conduits and special purpose vehicles.

Prior to joining Amundi Asset Management, in September 2014, Benedicte was an alternative investment adviser for pensions and local authorities at AllenbridgeEpic. Benedicte is now a product specialist at Amundi, focusing on Alternative Investments.

Benedicte holds a Masters of Science in Economics and Asset Management from University of Paris-IX Dauphine, and a Bachelor in Economics and Finance, with Honours, from University of Orleans, France.

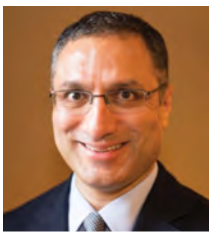
Karen Shackleton AllenbridgeEpic

Karen Shackleton is a senior adviser at AllenbridgeEpic. She is the independent investment adviser to three local authority pension funds, providing economic and market reviews as part of strategic input feeding into pensions committee investment strategy. Her role includes the monitoring of hedge fund portfolios for these clients.

Karen was chief executive/managing director of AllenbridgeEpic, between 2010 and 2013, turning the company around in that time by doubling assets advised to over £40 billion and growing the size of the team.

With a career spanning 30 years in the financial sector, Karen has developed an expert perspective on the fund management industry, an in-depth knowledge of the main players in the UK and an understanding of the performance characteristics of different investment approaches. She has a high appreciation of investor needs having undertaken over 650 interviews with institutional and retail investors, backed up by 10 years' experience as a fund manager. She also has an expertise in training and has run courses on hedge funds for pension fund committees and for Euromoney.

Sanjay Tikku KAUST Investment Management Company



Sanjay Tikku is senior adviser to KAUST Investment Management Company.

KAUST is an international graduate research university dedicated to advancing science and technology through interdisciplinary research, education, and innovation. Established in 2009 and located in Thuwal, Saudi Arabia, the university pursues breakthrough research to address challenges of global significance in the areas of water, food, energy, and the environment.

Sanjay was previously managing director of AIS within UBS Global Asset Management, where he served on the global investment committee in addition to heading the London, Hong Kong and Tokyo investment offices of the group.

A British national, Sanjay is a graduate of Princeton University, where he was awarded the Peter F. Crossman, Class of 1911, Scholarship, and the James H. McGraw Scholarship. He was later a doctoral candidate and teaching fellow at Harvard University and a visiting scholar at the University of Cambridge.

Chapter 1

Why invest in hedge funds?

SUMMARY POINTS

- Access to top talent
- Flexibility of mandate, exposure to risk
- De-correlation, diversification of sources of return
- Increased institutionalisation – good or bad?
- Increased regulation – good or bad?

Ian Prideaux

The primary driver of risk for most institutional investors tends to be equity risk. In order to achieve some stability in the return profile and also to meet liabilities, whether these are for pay-outs such as grants from an endowment or pension payments to pensioners, investors need to look beyond equities alone for some diversification.

Fixed income has traditionally played the main role in diversification, which led for many institutions to an overall portfolio that was a bet on equities and a bet on the correlation between equities and fixed income – or two big bets that everything was dependent upon.

Many investors have thus wanted to get away from that and therefore to seek additional or different sources of income that can be relied upon over a whole investment cycle – which has led them into 'alternative' investments such as private equity, real estate and hedge funds.

Investors in general also spend time and resources simply in the search for the best investment talent.

Sanjay Tikku, senior adviser to a major university endowment, argues that, rightly or wrongly, talent simply gravitates towards hedge funds.

"We can debate whether or not hedge funds are the most useful format for investors, but you can't deny that the flow of talent has moved in this direction," said Tikku. "There's a very good reason why talent will gravitate to set up hedge funds – because it's a fantastic opportunity for the individuals in terms of the asymmetry of the pay-offs for them personally. Rightly or wrongly, it means the talent gravitates to this space – and investors want access to that talent."

Finding the best talent may be key, but long-term investors such as pension funds, endowments and family offices have a variety of reasons to add hedge funds to their portfolio.

Ian Prideaux, chief investment officer at The Grosvenor Estate family office, explained: "I've got five main reasons for investing in hedge funds: smoothing of returns; downside protection; absolute return; access to top investing talent; and low correlation to other

asset classes. However, not all those objectives have been met."

The problem for the investor is, of course, finding the best funds to invest in from a large universe of possibilities. "I think at the moment there's something like 9,000 investable hedge funds and our analysis shows that you only really make any money if you're in the best 300 of those, so the selection of talent is very important," said Prideaux. "Really, only the best ones have an edge. If you're invested in the average hedge fund, after fees, over time, you'll probably be disappointed. The skill comes in selecting the best ones."

In addition to the skill of the manager is the flexibility of the mandate. The degrees of freedom available to hedge fund managers has historically given them much of their edge. However, as the industry has become more institutionalised – particularly following the influx of pension fund money – this has increasingly homogenised the risk management processes across hedge funds. And that in turn has led some to fear that the flexibility hedge funds enjoy is not being utilised as it was before – leading to constraints on performance and increasing correlation to traditional asset classes like equities.

Mattia Nocera is CEO and CIO of Belgrave Capital Management, the London-based research and investment management arm of Swiss private bank Banca del Ceresio, which, in addition to its own hedge fund investment programs, is also a partner in the two oldest funds of funds in the industry – Leveraged Capital Holdings NV and Haussmann Holdings NV. He described the change in the industry thus: "Unfortunately, the institutionalisation of this industry has brought a lot of drawbacks in the sense that more money flowing to managers brings higher fees, lower liquidity and a lot of risk management – which, fundamentally, turns out to mean more disappointment and less fascinating results than what we experienced during the '70s, '80s and '90s."

Tikku also felt that a bigger problem currently is not spotting talent, but getting talented managers to take risk like they used to.

The institutionalisation of the hedge fund industry is of course inevitable when large-scale pension fund assets start pouring in. And their governance requirements, structures and fiduciary duty also forces more regulation to be put in place. Across Europe, but perhaps most particularly in the UK, investment consultants are typically used as advisers to the investor boards, often consisting of lay members, who take on an individual risk.

One criticism investment consultants have been facing is that they tend to recommend only the larger, more long-established hedge funds rather than take any chances recommending smaller, newer but potentially more interesting funds that may deliver better returns.

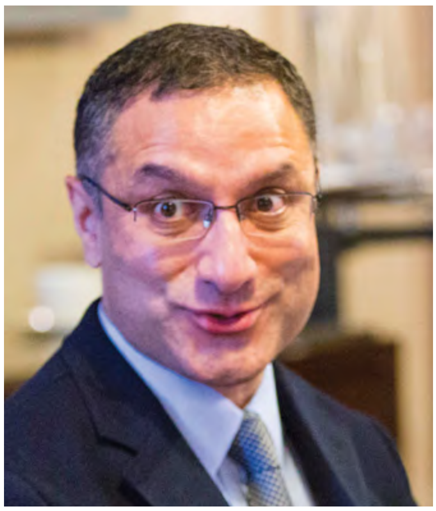
In response, Chris Jones, head of public markets and liquid alternatives at the consultant bfinance, noted that there are some hedge funds that put size to good use, but generally there's a sweet spot for performance that is typically way lower than the largest hedge funds trading today.

Jones also warned that, although the barriers of entry may now be higher than pre-crisis, they are still much lower compared perhaps to other investment areas. "Consultants I think need to make sure that they're picking the people with the best alpha generating capability rather than the people with the best marketing presentations," he added.

Despite the past decade of increasing

"Rightly or wrongly, it means the talent gravitates to this space – and we want access to that talent.

Sanjay Tikku



Sanjay Tikku

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Ian Prideaux

Unfortunately the institutionalisation of this industry has brought a lot of drawbacks in the sense that more money brings higher fees, lower liquidity and a lot of risk management, which turns out to mean more disappointment and less fascinating results.

Mattia Nocera

pension assets being invested in hedge funds, some still argue that perhaps this may not be the best way forward for all types of investors – or all types of pension funds.

Karen Shackleton, who is a senior adviser at AllenbridgeEpic and the independent investment adviser to three UK local authority pension funds, said she has yet to be wowed by hedge funds. "That's not necessarily saying that I don't want my clients to invest in them, because I think they do have a role – and perhaps we haven't yet had the market scenarios where they will really come into their own."

Shackleton is often brought in to work alongside the regular investment consultant of a local authority pension fund, and she argues that complexity often makes it difficult to set the correct expectations. "I'm advising local authority pension funds where the decision makers are councillors who are very often new to pensions, new to the committee. They can potentially change every three years every time there's an election, so there's a steep learning curve," said Shackleton.

"The biggest hurdle for them is complexity. They find it hard to understand what is going on when they lift up the bonnet and look inside – and it doesn't matter really how much education you go through, because these funds are employing complex strategies, using long/short positions, going into esoteric areas, into over-the-counter instruments and so on. How can you set expectations as a hedge fund manager if your client doesn't really understand what you're doing?"

Robert Howie, a principal in the Alternatives Boutique unit within the big consultant Mercer Investments, said one of the problems trustees have is not just understanding the concepts but accepting them given the general perception of hedge funds, partly because of their treatment in the popular press.

Said Howie: "I think you can make a very strong case for hedge funds, but lots of boards still fail to be convinced by those arguments. They're sceptical – and even those boards that kind of get the theoretical arguments remain what I would call reluctant investors in hedge funds."

Part of the problem remains a lingering negative perception in the wider media and in the public mind, Howie suggested. "I've never seen a good story about hedge funds in the popular press and the feeling is that they're all a bit too rich perhaps and make too much money – and that there's not much left behind for investors," he said.

One of the effects of this is that a significant amount of further investment money which could be going into hedge funds is still going elsewhere, Howie argued. "Some of the winners from hedge funds being seen as expensive and complicated have been some of the more simple and cheaper diversified growth funds and the multi-asset funds, which investors look at and see as 'hedge fund lite' options which are cheaper and easier to understand, and liquid as well."

Contrary to what many investors have been doing, Howie actually believes many should be considering hedge funds more actively. "We believe that now is a good time to consider (or reconsider) hedge fund investing" he said.

"The strategic case remains valid and many current factors are positive for hedge funds. Hedge funds can provide both long term growth and diversification from other asset classes; and can generate these returns with less volatility than public equity markets."

Over shorter periods a well-designed portfolio of hedge funds is likely to "come in second place" relative to equities and bonds, Howie argued – lagging in strong bull equity markets and eclipsed by treasuries in times of crisis, even if they can protect capital better than equities do. However, always coming second can mean that the longer term return profile can be very attractive and potentially result in outperformance over the long term (especially with robust portfolio construction and good manager selection).

Howie concluded: "Investor portfolios are often dominated by equity risk – and to a lesser extent credit risk. Hedge funds can contribute by offering access to non-traditional return drivers such as bi-directional security selection and timely variability in beta exposure."

Kevin Gundle, CEO of Aurum Funds Ltd, which has now been running funds of funds and other investments in hedge funds for over 20 years, pointed out that part of the problem is that many of the newer investors such as pension funds have not really invested enough of their portfolios in hedge funds to reap the benefits of them.

Apart from the negative perceptions of hedge funds among the general public and pension fund trustees, another issue is that the very concept of 'hedge funds' itself still remains misleading to many – because hedge funds are not really a clearly defined asset class like equities or bonds, but rather encompass a broad range of investment strategies in multiple asset classes. Bundling them all into the same category remains part of the problem, according to Gundle. "I think there are the broader issues and perceptions that surround hedge funds which unfortunately are very difficult to dispel," he said.

Gundle also pointed out that the experience of earlier investors such as family offices vary from more recent ones such as pension funds – partly due to barriers of entry now being higher, leading for instance to talented traders joining existing hedge funds rather than setting up on their own.

In addition, partly because of the change in investor composition, new regulations have been introduced – which have not been helpful. "I think AIFMD, apart from the fact that it's an absolutely hare-brained concept, has actually reduced choice dramatically for institutions in Europe," said Gundle. "I think regulation has actually done a major disservice to institutional investors because it has reduced choice."

The recent proliferation of more hedge fund-like strategies available in onshore structures such as UCITS funds (see section below), was also potentially a very mixed blessing, argued Gundle. "A lot of the newer hedge fund type strategies, such as alternative UCITS, I think just add additional 'static' and make the finding the needles in the haystacks more difficult – because they're building a lot more haystacks but they aren't putting needles in. Maybe we need a fire to find out where the needles are, because needles don't burn."

> **There's a steep learning curve…and it doesn't matter really how much education you go through. How can you set expectations as a hedge fund manager if your client doesn't really understand what you're doing?**
>
> **Karen Shackleton**

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>
> **Kevin Gundle**

Chapter 2

How to go about investing

SUMMARY POINTS

- Determining objectives
- Where to go for advice – who is up to the task?
- Consultants – specialists and generalists
- Funds of funds, tailored solutions, and going direct

“

I think talent in investment management is there, as it is in sports and music. The difficulty is how do you spot it and how do you use it? That’s really the problem, how do you put together your team of managers?

Mattia Nocera

For investors who have decided that they do want to allocate to hedge funds, there are various ways to go about it, but most seem to agree that they need to start by defining objectives and targets. The participants in the debate agreed that the best way to start looking at investing in hedge funds is not to have too many preconceived ideas and focus first on what you want to achieve and which hedge fund(s) would be the best fit for a specific portfolio and purpose.

Karen Shackleton pointed out that the risk return profile and objectives of different types of investors do of course vary. Endowments and family offices are typically more focused simply on returns, for instance, than local authority pension funds which are more focused on risk – often steering the latter toward more tailored solutions: “For Sanjay and Ian… what hedge funds are doing in their portfolio is actually quite different to what a hedge fund is doing in a local authority pension fund or even a corporate pension fund which is a closed scheme. They all will have slightly different objectives – which is why I think the tailored solution is better.”

Shackleton went on: “There’s definitely been a change from just ‘let’s invest in a fund of funds’ to a much more tailored solution. The advisory piece of that decision has also in some instances been separated from the decision to invest in the funds themselves, and some of the consultants are getting into the advisory space of selecting specific hedge funds. My personal view is that a specialist is the best route – specialist consultants or fund of fund managers, whoever they might be – but people who are most in touch with the space and most likely to be able to add value.”

There were varying views on the role of the consultant as the primary adviser for the investor. Howie of Mercer said: “Don’t be blinkered as to what sort of organisation that fund manager should sit in. It doesn’t automatically have to be a boutique. We find great talent within some of the biggest fund managers in the world that have small teams that run money in a very intelligent way.”

Robert Howie

Mattia Nocera

The benefits of dealing with the bigger consultant were summed up by Howie as follows: "One of the key things to think about is: What you are going to get and who's going to do it for you – what is the resource behind it? How many people does this firm have that are doing the research, risk management, operational back office due diligence *et cetera*, and what experience do those people have? I think those are the key questions."

For Chris Jones of bfinance, the proper role for a consultant and/or fund of funds depends most critically on what the investor is trying to achieve. "If you're looking to invest in a broad way in a large number of hedge funds, then there are some great funds of funds out there that can do that. But some investors would rather be more focused on a small number of managers," he added.

"There could be a fund of funds that would do that in more of a consultancy role or there could be skilled consultants as well. But I'd be deeply questioning if all the managers who get recommended are household names, because the question isn't: 'What's the best hedge fund out there?' It's: 'What are the best hedge funds out there that fit my portfolio the best?'"

Jones had two other key points on this topic, firstly: "I think you've got to invest in an impactful size as a proportion of your portfolio – otherwise you're going to get a headache without any tangible benefit in your portfolio."

And secondly: "There are far too many people who've sought to invest in hedge funds for portfolio diversification and have ended up invested with things that are uncorrelated on the upside and correlated on the downside – which is exactly not what you want. What most people want I think is something that has a fighting chance of going up when risk assets are selling off – so that's a starting point."

Of critical importance is of course ensuring that the investor finds appropriate advisers and consultants with the requisite skills for the task, including follow-up advice and ongoing monitoring of allocations.

As Sanjay Tikku put it: "I don't have a strong view on the choice between consultants and funds of funds, but I do think that many investors need someone – they need some intermediary – to help them invest in this space. Among endowments and pensions in the US the trend has been for people to do it themselves. But I think it's very difficult for small institutions to have the kind of institutional knowledge they need to do it well, because they simply don't have the critical mass."

Tikku continued: "The second point I think, in favour of both consultants and fund of funds, is that just by virtue of where they are and what they do, they are obliged to keep looking at a wide range hedge funds – old and new. So they have a much better relative perspective on how things are evolving in each [strategy] space."

Ian Prideaux said Grosvenor does indeed use a consultant (Cambridge Associates) to help it achieve diversification and smoothing of returns by including hedge funds in the portfolio mix, and that it was generally satisfied with the results. "It's important that your consultant is an expert – we simply couldn't invest in this asset space without their advice," Prideaux said.

For Grosvenor, its target has been the three-month T-bill rate plus 4%, and it has comfortably beaten that over time, though not in a straight line – by about 150 basis points a year – over the last eight years. "We could also have been allocated to much worse managers or indeed better ones with hindsight, but it's unlikely you're going to hit the top, like you're unlikely to hit the bottom. You're looking for a selection that matches your expectation or your target," he said.

As the institutionalisation of the hedge fund industry has grown, the question of alignment

"Don't be blinkered as to what sort of organisation that fund manager should sit in. It doesn't automatically have to be a boutique. We find great talent within some of the biggest fund managers in the world that have small teams that run money in a very intelligent way.

Robert Howie

There are far too many people who've sought to invest in hedge funds for portfolio diversification and have ended up invested with things that are uncorrelated on the upside and correlated on the downside – exactly not what you want.

Chris Jones

Why or when do you need to change adviser? I think at the end of the day, it's all down to whether the manager ultimately delivered what they said they were going to deliver. If they have, then there's not a problem. If they haven't, then ultimately they will be terminated.

Karen Shackleton

of interest between managers and investors has also come more into focus. Managers argue that if you have 'skin in the game' or your own wealth in the fund that ought to make investors feel more comfortable. Likewise, fund of fund managers argue that because their records are public and visible it is easy to see how they are performing – much more so than with the consultants.

Mattia Nocera of Belgrave said that, although the investor base may have changed, the central task of selecting hedge funds successfully has not. "I think talent in investment management is there, as it is in sports and music. The difficulty is how do you spot it and how do you use it? That's really the problem: how do you put together your team of managers?"

"People see how we have done through time because we have a very public and visible track record," Nocera added, explaining how the portfolios evolve through the addition of new managers gradually through a 'farm team' approach, essential to identify new talent. But the approach is difficult to implement with bigger end-investors who require more bespoke portfolios and often create conflicts that are difficult to manage for a fund of funds group in the current regulatory environment.

A major problem for some of the newer institutional investors in hedge funds is that they have not really gone about the right way, argued Kevin Gundle. Calpers, the huge California pension fund which recently made a high profile decision to withdraw from hedge funds entirely, was a classic example, he suggested. "Number one: they didn't do a great job. And number two: they had too little invested. Some institutional investors have been investing in hedge funds in somewhat of a half pregnant way – and that has resulted in very sub-par outcomes."

Gundle said that, in response to investor demand, Aurum has been constructing more customised portfolios – rather than sticking simply to traditional co-mingled fund-of-fund solutions. "We have been able to put together different sorts of portfolios but the clients are not going to come to us for bread and butter equity long/short," he explained, adding that many institutional investors in particular are viewing hedge funds as more of a volatility dampening and diversifier rather than as a source of returns alone.

But Gundle added: "Even for the clients that want a bespoke portfolio, they understand what

Karen Shackleton

> Each fund of funds may look the same, but step a little bit closer and you can see whether the work is being done. It's about the proximity that the principals have to the risk. It's really about how it's managed – the philosophy, the culture, where our own money is.
>
> **Kevin Gundle**

it is that we'll put together for them, and the differences are somewhat marginal."

From a distance, he suggested, each fund of funds provider may look similar, but when you look more closely you can see important differences: "It's about the proximity that the principals have to the risk... It's really about how it's managed – the philosophy, the culture, where our own money is."

Participants from the asset management firms in the discussion then commented on how the changes in the market, particularly since the financial crisis of 2008 – with more end-investors tending to go direct with advice from consultants, or more through bespoke fund of fund vehicles – had been affecting them, and how they had been responding.

Donald Pepper, managing director of alternatives at Old Mutual Global Investors, noted how this was resulting in the creation of more onshore hedge fund product – such as the proliferation of funds in a UCITS onshore European wrapper (see next section below).

Benedicte Rabier, a senior product specialist at Amundi Asset Management focusing on alternative investments, noted how her firm had engaged in a structural transformation by streamlining its business to offer a more secure, regulated and simplified range of investment solutions since the crisis. Prior to 2008, Amundi AI had been managing an extensive commingled fund of hedge fund product range, covering all types FoHFs, but this activity has been completely streamlined due a general lack of confidence in the traditional fund of hedge funds model, and today represents only about 3% of the firm's total assets.

When Amundi AI obtained its AIFM authorisation from the French regulatory authority in December 2013, the firm saw that as the culmination of its commitment to a transparent and regulated hedge fund industry. Rabier explained: "It's because of the demand we've had and because, as Kevin said, we're listening to our clients' demands that we have switched to the AIFMD format and UCITS format on all the underlying hedge fund investments that we propose to our clients. It's because we thought it was a necessary step to investing in hedge funds and because there was such a prime demand for a governance framework coming from institutional investors."

Also echoing Gundle's comments, Rabier argued that the investors who had cut out funds of funds in the post-crisis period and gone direct had not always achieved what they were seeking. "A number of the large institutional clients that invested in alternatives via commingled funds of funds that got burnt in 2008, then decided to get exposure to hedge funds through direct investments in single hedge funds," she said.

"Unfortunately they were not resourced enough to manage their exposures in the most efficient way – so they got burnt again. And that in turn has been a major reason why many of the institutional investors have now chosen investments through segregated and therefore bespoke mandates instead. Today, 60% of our total assets is represented by customised hedge fund solutions for institutional investors. This has been Amundi AI's main focus over the years and is considered as the best practice model for investing in hedge funds."

> We've beaten our target over the last eight years now by about 150 basis points a year, so hedge funds have delivered what we expected of them – not in a straight line, but of course we don't expect that. To that extent we've got what we were looking for.
>
> **Ian Prideaux**

Chapter 3

What are the best structures to invest through?

SUMMARY POINTS

- Offshore and onshore funds
- UCITS and AIFMD, SIFs and QIFs
- 'Liquid alternatives'
- Managed accounts

> We've seen US managers contacting us and wanting us to run their fund under an AIFMD format, because they want to reach out to those investors that have that constraint – of having to invest in European domiciled format.
>
> **Benedicte Rabier**

Offshore structures still dominate the hedge fund industry, with the vast majority of assets still managed in hedge funds domiciled in locations such as the Cayman Islands. Historically, there have been various reasons for that – not least the ability for managers of those offshore vehicles to engage in unconstrained investment strategies.

However, as the institutionalisation of the industry has gathered pace in the past decade, the interest in onshore versions of hedge fund strategies has grown rapidly. This has also been for various reasons, not least the fact that many institutional investors face investment constraints which can prohibit them from investing offshore; and due to new regulations, particularly since the financial crisis of 2008.

One major development in Europe has been the EU's Alternative Investment Fund Managers Directive (AIFMD), which has brought in a myriad of registration and reporting requirements targeted at managers of offshore funds – which have been far from universally welcomed, as Aurum's Gundle had already noted earlier in the discussion.

Another major, related development has been increasing demand for hedge fund-like strategies wrapped in onshore Units of Collective Investment in Transferable Securities (UCITS) funds in Europe, or in so-called 1940 Act onshore funds in the US. To many investors, hedge fund-type products in these sorts of onshore structures are being marketed as 'liquid alternatives' – because they typically require a high level of liquidity, with subscriptions and redemptions possible on a daily basis, like with mutual funds.

Managed accounts, which had been very popular in the past as a way to invest in certain strategies such as managed futures, have also made something of a comeback since the crisis, with investors attracted by the notion that – theoretically at least – they offer more transparency and control.

The increasing popularity of UCITS in particular has sparked a rising debate within

the hedge fund world, though the reasons for its growth seem clear enough.

As Benedicte Rabier of Amundi explained: "Cayman and more generally offshore fund structures still account for the majority of the AuM in the hedge fund industry. However, they have had a limited growth in the last couple of years, especially compared to onshore, regulated vehicles such as UCITS or '40 Act products that have grown at annualised rates close to 40% over the last couple of years. The growth in liquid, regulated alternatives has been supported by investors (and their boards or end-clients) looking for regulated and/or liquid hedge fund-style products, and by managers looking to access to new clients and markets. A new addition to this arena is the AIFMD-compliant products. We are seeing increasing demand as awareness and knowledge of these structures increase."

Rabier said demand for liquidity is one of the key drivers for onshore structures in domiciles like Ireland and Luxembourg: "We think, as asset managers, that they provide a better framework in terms of operations and in terms of governance. If you are thinking of accessing hedge funds directly and you don't choose to have an intermediary who handles some of the risk, you might as well go into onshore structures which have a better framework around governance than offshore structures," she argued.

Rabier added: "The debate between offshore and onshore structure needs a bit of context. Since 2008, we have observed two parallel trends that have benefited to onshore structures: First, the institutionalisation of the hedge fund investor landscape. Institutions now account for 61% of industry AuM [versus 33% in 2005, according to Barclays data]. While institutions may not necessarily be interested in the enhanced liquidity of regulated alternatives such as UCITS and '40 Act funds, onshore structures such as AIFMD-compliant QIFs and SIFs allow for a stronger governance framework that may appeal to those institutions' boards and trustees (manager registration, independent directors at the fund's board, 'central' custodian with a clear responsibility on the oversight of the fund's assets). Second, there has been a shift in private clients' hedge fund investments from traditional offshore funds to liquid alternatives that happen to be available mostly in UCITS and '40 Act fund structures,

"I think it's very important that fund managers don't try to put a square peg in a round hole and offer daily liquidity when the underlying securities don't really warrant that, because it could then end up hurting us all.

Donald Pepper

The market has a great habit of testing the products.

Kevin Gundle

Kevin Gundle

also through managed account platform and AIFMD products as they become increasingly available."

She concluded: "Looking at the various structures available – UCITS, '40 Act, AIFMD-compliant SIF/QIF – it all depends on the client's needs and manager's strategy. UCITS and '40 Act were initially designed for retail investors – respectively in Europe and in the US. Because they are distributed to private investors (and even if they may also be bought by institutions), these products have strong constraints on eligible assets, liquidity, or leverage that limit the scope of available strategies. AIFMD-compliant SIFs and QIFs have, on the other hand, been designed for sophisticated, professional investors. They therefore allow for much more investment flexibility."

One potential problem with the growth of hedge funds in a UCITS format is the worry that not all hedge fund strategies really fit within the greater liquidity requirements. As Donald Pepper of Old Mutual put it: "If people want UCITS, so long as the underlying investments are liquid enough – such as in five of the six strategies we offer – then UCITS are fine. That's actually where we've seen the bulk of our growth in the last year, so we're very happy providing that."

However, unlike with offshore hedge funds, which typically work on the basis of monthly or even quarterly liquidity – and often with a notice period – UCITS require daily liquidity. That may work perfectly well for hedge fund strategies that focus on liquid securities such as large-cap equities. But UCITS are not really appropriate, many believe, for strategies that are less liquid such as those focusing on small cap stocks, distressed securities or many credit instruments.

As Pepper put it: "I think it's very important that fund managers don't try to put a square peg in a round hole – and offer daily liquidity when the underlying securities don't really warrant that, because it could then end up hurting us all."

Ian Prideaux of Grosvenor recorded his concerns about this as follows: "I think there is an unwarranted sort of 'seal of approval' that becomes an expectation, namely: If it's UCITS then it's safer – not that you can't lose money, but somehow you're better protected if it's UCITS because it's got a tick in the box from the EU."

Certainly, the UCITS seal or 'stamp of approval' seems to have played a large role in attracting a stream of new assets to flow into these structures. But many argue that simply the stamp of approval itself does not protect capital – and should not be where due diligence ends but rather where it should start.

All other things being equal, a more liquid version of a strategy would obviously appeal, said Prideaux, but still might not be the right option. "So far as we're concerned, if we could have exactly the same fund in a UCITS format as in a Cayman format, we'd go for the UCITS format every time because we can put it into an onshore structure and we get better tax treatment that way. But that's really the tail wagging the dog. We'd all like better tax treatment, but it shouldn't drive the decision ahead of commercial considerations."

There was a further worry discussed too – namely that, by constraining some strategies within a UCITS format, it can also emasculate their ability to deliver such good performance.

Mattia Nocera of Belgrave put it like this: "I think we're trying to wrap too many strategies within the UCITS structure these days. To me, it's a little bit like what I saw in Italy when Italy was the first country to do onshore hedge fund regulations: There was this big push on the product concept and they distributed and raised €20 billion – only to end up disappointing everybody."

Nocera concluded: "The wrapper really doesn't generate the results. And I'm concerned about having too much money in hedge funds with daily liquidity – because then we'll probably have yet another 'disappointment' from hedge funds that journalists can write about!"

Nocera had further worries too about UCITS funds with a performance fee in Luxembourg in particular, as in that domicile there is not a proper facility for 'equalisation' – to take account of investors subscribing and redeeming at different times and different relative prices. "This means that if you subscribe to a fund after it has performed well and later in the same year you have a drawdown, the accrued performance is amortised back on all shares outstanding at that time – so somebody who has come

I think we're trying to wrap too many things inside a UCITS these days. The wrapper doesn't really make the results.

Mattia Nocera

in late benefits from the amortisation of the other shareholders and vice versa. From my perspective, this creates an issue of alignment, of unequal treatment among investors that is not really being addressed," he said.

Kevin Gundle of Aurum said: "What I'm concerned with is increasing systemic risk by creating these 'liquid alternative' products with a mismatch in assets and liabilities. You probably remember the 130-30 funds – some of those funds turned into UCITS, but a lot of them just got wiped out by 2008. The market has a great habit of testing the products."

Participants agreed that daily liquidity is not a necessity for most long-term investors such as endowments or family offices. As Sanjay Tikku said: "For most long-term investors, there's really no need for daily liquidity or weekly liquidity, even in fact for monthly liquidity."

Where this can become problematic, however, is where a manager creates multiple versions of a strategy, but with varying degrees of liquidity. As Tikku put it: "I don't want to be in a situation where other people have daily liquidity and I have a long lock. That doesn't make sense."

Like Gundle, Ian Prideaux also reflected the irritation of many investors about being dictated to and told what's best for them by the regulators. "I really don't need a regulator sitting in Brussels or Strasbourg or wherever else to come and tell me what's good for me and who I can and can't talk to, or who can and can't talk to me," said Prideaux. "I am a big boy, I am prepared to make my own decisions."

Robert Howie of Mercer said it was important to remember the varying needs of different investors. "I think there are lots of hedge funds that are really good and if you push them into UCITS they're less good," he said. "But it doesn't mean that they're bad investments for certain investors. If you think about members of DC pension plans, with the need to have benefits paid when they are due; and if you think about private investors who are saving for all sorts of things and need liquidity because their life events come when they're not expecting – they have to be able to get their money out."

Chris Jones of bfinance said it all came down to cost, as all markets are liquid – at some cost. He said being in a fund that offers high liquidity could be dangerous, unless you are really going to use the liquidity: "Otherwise you might find all your co-investors using the liquidity while you're staying there – and you're also paying for part of their liquidation costs."

On the issue of managed accounts, Gundle

Ian Prideaux

– who had in previous years been sceptical – said there were various reasons why they may be becoming more attractive now. "A lot more managers today are more sympathetic to the idea of setting up managed accounts. It is more efficient because of the advances in technology," he said. That said, there were still some not insignificant extra operational risks – and costs – to take into account in opting for that route, he added.

Despite all the various concerns about the growth of hedge funds onshore, there seems no likelihood that the trend will abate any time soon.

From the perspective of a big asset management firm running multiple single hedge fund strategies, Pepper said: "I agree 100% with what Kevin and Ian and others have said – that, alongside what's good, there are a lot of other strategies that absolutely shouldn't be sold on daily liquidity that are being sold and in big size. It is a potential disaster waiting to happen."

But Pepper added: "There is a subset of alternative UCITS which is in equity long/short and big large cap liquid strategies. That's what we run and I'm very happy running. And I feel what we do is good for people. We're not selling cigarettes. We're selling great alternatives for democratising in some ways the hedge fund industry – so it's not only for the foundations and the rich, it's also for averagely wealthy people who can now get access."

From an Amundi perspective, Rabier noted: "We've seen more and more US managers contacting us and wanting us to run their fund under an AIFMD format, because they want to reach out to those investors that have that constraint of having to invest in a European domiciled format – which is what we are able to offer through the first AIFMD-compliant managed account platform that we have in Ireland."

> I really don't need a regulator sitting in Brussels or Strasbourg or wherever else it is to come and tell me what's good for me and who I can and can't talk to, or who can and can't talk to me. I am a big boy, I am prepared to make my own decisions.
>
> **Ian Prideaux**

> The main difficulty I have is that I don't want to be in a fund where other people have daily liquidity and I have a long lock. That doesn't make sense.
>
> **Sanjay Tikku**

Chapter 4

How much should you pay? What is a fair price?

SUMMARY POINTS

- Investors are willing to pay for talent
- But fees are too high
- Widespread demand for fees over longer time frames, and for hurdle rates

"Investors don't have a problem per se with paying for talent. I think there is a recognition that if you perform well, then you deserve to be properly remunerated. But a 2% ongoing management fee to keep you going? It's just not sustainable in my view.

Karen Shackleton

There is undoubtedly a widespread feeling among investors that hedge fund fees – certainly for management and also to some extent for performance – have become way too high in the past decade and need to be falling. On the positive side, it is generally agreed that fees have been falling in more recent years, but there is pressure for fees to fall much further – and also for some new standard or set of standards on fees to emerge.

The issue of hedge fund fees has been debated much more vigorously ever since the global financial crisis when many investors felt disappointed with hedge fund performance, if not conned by the line that 'you get what you pay for'. However, most investors still say they are willing to pay for talent, but the proof must be in the pudding – through demonstrated additional value in the portfolio, within agreed parameters.

Investors who have been putting money into hedge funds for a long time, such as Mattia Nocera at Belgrave, remember a pre new millennium era when fees were much lower – sometimes as low as 1% for management and 10% for performance, and very often 1.5% and 15%.

Nocera argued that it was the arrival of cap intro teams at the big investment banks in the early 2000s that changed the game. When you look at historical performance you need to take the lower fees of the past into account, he said. "Some people have looked at the statistical returns of hedge funds in the '90s and got excited, but those numbers were from guys who very often charged only a 15% performance fee for most of the track record."

Later, of course, it became what Nocera described as more of "a 2 and 20 world" – but always one where he tries to negotiate to get the best terms, and argues for managers to bring the management fee down as their assets grow above a certain threshold.

Investors that are newer to the industry, such as pension funds, find it even more difficult to stomach the fees – not least as they look so much more expensive than for other investments.

Karen Shackleton outlined her feelings about this follows: "If there is a message to the hedge fund industry that needs to be heard, it is that fees need to come down if hedge funds are going to be embraced by institutional investors."

It is not that pension fund investors have a problem with the concept of paying for talent per se, said Shackleton. "I think there is a recognition that if you perform well, then you deserve to be properly remunerated for that talent. But a 2% ongoing management fee to keep you going – when you've got other strategies such as diversified growth funds who are charging an all-in fee of something like 0.6% to 0.65% – it's just not sustainable in my view in the long term."

There were suggestions from various participants that it would make more sense to spread fees over several years in order to avoid scenarios where the managers get paid hugely for taking massive risks in the short term and then deliver losses to investors in the longer term. Participants also called for the general adoption of hurdle rates, as in the private equity industry.

Chris Jones of bfinance said: "I think that people don't mind paying if it's for something that delivers a demonstrable benefit to a portfolio. I think there is an issue though when people have been paying alpha prices and getting beta for that – and not just beta to equities but also other risk factors that can be easily replicated."

Jones added: "A thing that worries me as much as the level of fees is the asymmetry of performance fees. It encourages managers to take a risk of ruin that is higher than they should be comfortable for. The manager might blow up within five years, but then he can sail away into the sunset with his booked performance fee on his yacht. This is an enormous problem that still hasn't been redressed."

Robert Howie of Mercer also put the emphasis strongly on long-term performance and reasonable hurdle rates. "Net of fee results is the key thing to focus on, but it is very difficult to not look at headline fees."

Howie explained: "I think one of the image problems hedge funds have is the enrichment of some of their principals and founders. Back in the original days of hedge funds, the investors in hedge funds had yachts. Then the hedge fund managers had yachts too. Now it's only the managers that have yachts because the investors are pension funds. And pension fund members read the papers and see that it's the managers who have yachts."

Ian Prideaux of Grosvenor said it was probably common ground that "if you pay peanuts you get monkeys" and that if somebody performs well they deserve rewarding. "The trouble is that we've got a disconnect between the ex post and the ex ante. You know what the fee level is going to be, but you do not know what the performance will be."

Prideaux said he agreed with Howie and Nocera that if assets got much bigger then management fees should be cut. "If you're running a $500 million fund and charging 2%, you've got $10 million to run the firm with. If it's a $10 billion fund does it really take $200 million to run the firm? Probably not."

Prideaux said he felt fee calculation would be more appropriate on a three-year view and that he was strongly in favour of hurdle rates – noting that the private equity industry typically uses 8%. "What I don't want to do is get a 4% gross return, have them take 2% off as a management fee and then say I'll take 20% of the remainder. That is not what an incentive fee is for in my book. An incentive fee is to be paid for excellent performance – for outsize performance. It should not be paid on any positive performance, however small."

Sanjay Tikku said that investors had to take demand and supply into account, "One has to

Chris Jones

Karen Shackleton

A thing that worries me as much as the level of fees is the asymmetry of performance fees. This is an enormous problem that still hasn't been redressed.

Chris Jones

Back in the original days of hedge funds, the investors in hedge funds had yachts. Now it's only the hedge fund managers that have yachts.

Robert Howie

An incentive fee is to be paid for excellent performance, for outsize performance. It should not be paid on any positive performance, however small.

Ian Prideaux

If you can't deal with the fees, don't invest. As Warren Buffett said once: The price is what you pay, value is what you get. And if you look at the value and you're getting more value or a satisfactory amount of value for the price you're paying, you're getting a good deal.

Kevin Gundle

be pragmatic – negotiate as best one can, for instance, there should be a quid pro quo for size. Sometimes one pays higher fees for higher quality returns – and that's OK. Ultimately the price is set by supply and demand."

However, Tikku also felt that fees were very high in general. "I can see why, for instance, the head of a research foundation might think that hedge fund managers are paid too much. His organisation might be funding researchers working in critical areas, areas that have impact on the lives of millions of people, for example in generating clean water or in creating disease resistant crops. These researchers are very smart, very hard-working, very motivated – as much as any hedge fund manager – and they are making important contributions to society, yet they get paid a tiny, tiny fraction of what fund managers get. Looking at it in this context, you can see why someone might think hedge managers are paid too much."

Tikku also noted that it is worth looking at the internal fee structure within the hedge fund firm – into how they think about compensation, how they actually implement their partnership agreements and so on. That was often an interesting factor in conducting due diligence, he suggested (see more below).

Kevin Gundle of Aurum said fees had already been coming down steadily – with the 2% "sort of gone" and the 20% dropping.

"I hate paying hedge fund fees, period. I always have, always will. Do we negotiate fees with hedge funds? Yes." But, Gundle added: "I am going to be a bit more controversial and say: If you can't deal with the fees, don't invest, because our primary objective is to get good risk adjusted rates of return and risk adjusted rates of return are always calculated net of fees."

Gundle summed up the Aurum approach as follows: "As Warren Buffett said once: The price is what you pay, value is what you get. And if you look at the value and you're getting more value or a satisfactory amount of value for the price you're paying, you're getting a good deal."

In response to what investors were asking, Donald Pepper said Old Mutual had already adjusted its approach – with management fees now mostly in a range from 75-85 basis points, and only higher at 1.5% for special cases like its small cap vehicle – which is capacity-constrained.

Old Mutual also applies hurdle rates on its funds. "We're trying to get ahead of the curve as well," Pepper explained. "It's not purely altruistic – we've seen good inflows partially as a consequence of that. So I think investors should push harder on having at least a cash hurdle, because it doesn't cost the managers much to give it away now."

Benedicte Rabier of Amundi said her firm considers fees as the negative alpha. "We won't pay a fee to a beta generator and will pay a fee for an alpha generator. We strongly negotiate fees – and I guess this enables us to allow our clients to benefit from our increased negotiating power due to our large size and our very longstanding relationships with many of the leading hedge fund managers."

Like Tikku, Rabier also noted that the alignment of interests and the remuneration structure of a single hedge fund is crucial – and a key part of the due diligence job is to review and verify the way it is handled. Rabier noted: "Obviously, due diligence is key prior to investing, and Amundi is putting a strong emphasis on the operational due diligence (ODD) analysis prior to investing."

Chapter 5

How to pick managers successfully

SUMMARY POINTS

- Operational due diligence (ODD) and investment due diligence (IDD)
- Manager selection – where to start?
- Delegation or hands on?
- Seeding or backing new managers
- Picking the best strategies going forward

Due diligence by investors, of both investment process and of operations, has of course always been key to selecting hedge funds successfully. It always came heavily into focus whenever there were any high-profile hedge fund blow-ups, as there were from to time, but came more acutely to the fore after the financial crisis of 2008.

The focus before the crisis was often more on the front office – on investment due diligence (IDD) which focuses primarily on the investment process of the portfolio manager. But these days, operational due diligence (ODD), which focuses more broadly on how a firm runs a fund and operates as a business, is now on a par.

Managers are increasingly not selected because they do not pass the ODD criteria – and can also be terminated because they fall foul of ongoing ODD.

Benedicte Rabier of Amundi said: "It is vital for clients that our ODD team is separate from the IDD team and that the ODD team has a veto right during the selection process to ensure good practice. ODD's concerns are usually raised well ahead of the committees to ensure full transparency of the decision making process."

Rabier described the evolution of the market as follows: "What is interesting to see historically is that the due diligence scope has changed since I started to work in the industry in early 2000. Back then we would mainly emphasise the investment due diligence (IDD) and there was lower interest in the operational due diligence process where the approach was mainly to tick boxes out of an ODD questionnaire – and that has now changed a lot. Since then, the approach across the industry is now to have two distinct teams covering ODD and IDD, both of them being very independent from each other, although they work hand in hand."

She elaborated: "There is now equal industry recognition for the ODD function as well as for the IDD function which is comforting, because if a fund doesn't pass ODD, furthermore if an ODD team doesn't have a veto right, you should not really look at the hedge fund manager or that fund of fund business. The ODD function is crucial during any hedge fund analysis. This is an industry best practice and is a benefit to our clients."

Kevin Gundle of Aurum concurred about the rising importance of ODD. He said: "Our ODD team spend most of their time, as do the investment due diligence team, monitoring existing managers – because that's where the risk is. You can't lose or make money from managers that you don't have money with. So spend most of your time on those managers. And monitoring is something that we are completely obsessive about."

Gundle added that you can never make money from operational risk but you can certainly lose money on it. "It is not a risk, it is a cost," he said, adding that an investment drawdown you can recover from – but an operational drawdown has implications for your reputation as a firm, which

> **The approach across the industry is now to have two distinct teams covering ODD and IDD, both of them being very independent from each other, although they work hand in hand. There is equal industry recognition for the ODD function – which is comforting, because the ODD function is crucial during any hedge fund analysis.**
>
> **Benedicte Rabier**

> We will not invest in a fund if they don't have a dedicated COO and CFO function, because unless you've got properly paid people in those roles, the lunatics are running the asylum.
>
> **Kevin Gundle**

> If you identify a potential problem, maybe it's a risk management framework that is being overruled. Maybe it's the manager's lack of consistency... Maybe the overall performance results are telling you he's not doing what he says he's doing. If you look at the frauds, it really is always the top guy.
>
> **Mattia Nocera**

may be impossible to recover from.

Gundle continued: "We hate the concept of group think. I always want to know the negatives – and I'm head of risk. I can take a completely dispassionate approach to managers. And we change our analysts that monitor the managers from time to time as well – so there's no sort of cosy relationship."

Mattia Nocera was one speaker, however, who queried whether you could really draw a clear distinction between the operational and investment due diligence process. "I always have a difficulty separating the two aspects," he said. "Because if I look historically at the disasters that occurred in hedge funds, and some situations that we avoided, they were all identified during investment due diligence and you could almost call it 'IODD'."

Nocera explained further: "If you identify a potential problem, maybe it's a risk management framework that is being overruled. Maybe it's the manager's lack of consistency between his views and the portfolio construction. Maybe it's the overall performance results that are telling you he's not doing what he says he's doing. If you look at the frauds, it really is always the top guy."

Most investors outsource their ODD functions but there can be benefits to keeping it in-house, according to Sanjay Tikku – because getting as many viewpoints as possible on a firm gives a deeper and more detailed picture. He said he would also rather have the ODD function integrated with the investment process rather than as a separate step – though he did admit that there are benefits of scale from outsourcing.

Throughout the discussion the participants pointed to the key importance of spotting talent and investing with the right managers at the right time – conceding that luck on timing could sometimes play a part. Some investors start on a 'top-down' basis – deciding what strategy areas they want and they go looking for the best managers available in them. Others begin on a 'bottom-up' basis – seeking the best managers available in whatever strategy areas they may be. Many deploy or adapt a blend of the two approaches.

Kevin Gundle said Aurum's philosophy is primarily bottom-up on a day-to-day, week-to-week, month-to-month basis. But, he added: "Every now and again top-down absolutely swings the bat. In August 2007, it was our 'canary in the coalmine' moment – so as things had changed we dramatically changed our portfolios. And because of that we got through 2008 without any problems, and the consequence of the top-down change was a bottom-up reconfiguration of our portfolio."

Many investors have advisers that they use to bring in new manager ideas, though sometimes ideas travel both ways.

Ian Prideaux of Grosvenor said a key priority was to keep a proper balance in the portfolio: "We always try to keep a number of managers on the substitutes bench, so that we always test ourselves to say: Well, we quite like hedge fund A that's in the portfolio but are there better alternatives? They may be *quite* good but is there somebody we think is *very* good sitting on the subs bench?"

Most investors also seem to agree that manager selection is as much, if not more, art as well as science. Sanjay Tikku, who also starts from a bottom-up approach to manager selection, said: "One of the rules I have for myself is that you've got to be aware of your own prejudices – the type of people you tend to like and the type of people you tend not to like, and to try not to let these biases distort your portfolio."

Robert Howie of Mercer described the firm's manager selection strategy starting with having a list of highly rated strategies in each category. "We have a list of highly rated strategies in each category – long/short equity, event driven *et cetera* – so it's a menu that an adviser can use as a palette to create portfolios."

Howie said the firm's hedge fund team has over 20 people, but in addition to that Mercer has over 100 researchers looking at a broad range of global asset classes. This, he argued, substantially deepens the research capability – to the extent that some of the best ideas that come through are not just those from the hedge fund team.

Unlike Mercer, bfinance does not operate with an approved list – because what works for one client may not work for the next. Chris Jones said that 70% of the bfinance manager selection process may fit very neatly on a PowerPoint slide, but the other 30% does not – adding that he felt the 30% is probably just as important as the 70%.

"First of all, you can't delegate this out to analysts," Jones said. "This is like if you lived in a not very nice area and needing to check under your car for bombs – you've got to do it yourself to protect your family rather than get some kid to do it. You need to have the people with the skill, the context and the experience of doing the work," he said.

Seeing a lot of managers is the starting point and after wading through the marketing spiel and interpreting what they are doing, and how, and backing that up with evidence, bfinance then looks at what could go wrong. "For the other 30 %, you've got to trust your experience. You can't be afraid to say if something doesn't smell right, or something's wrong here," said Jones. "Asking the same question to several different people in the hedge fund in a context where they have no chance to collude with one another is a very, very strong thing to do. Asking around is a very, very strong thing to do."

As more end-investors have been going direct – with advice from investment consultants rather than via funds of funds – there has been an increasing trend for assets to consolidate within the bigger managers, making it ever more difficult for new and smaller managers to survive. And hence a growing fear that could limit investor choice – and hit the returns possible from hedge funds overall.

According to Robert Howie of Mercer, the governance structure and fiduciary duty of trustees often simply does not allow institutional investors to invest in new funds – which is one reason they end up with the bigger more established names. But that is not necessarily a bad thing, he argued. "Some of these big funds are big because they're good and therefore you shouldn't think that they're bad. The reason they've got big is not because they're great at marketing or distribution, but just because they're very good investors. And therefore some of those big funds are still good investments."

End-investors rarely seed or take stakes in managers or invest in brand new funds, and although firms operating managed account platforms such as Amundi may be more flexible, they also seldom back a newcomer because of the headline risk and the lack of an institutionalised business model at an early stage.

Benedicte Rabier of Amundi noted: "Having said that, obviously we stay open minded – and if there is a manager who is launching a new fund and has a strong and credible track record, from his previous shop, that can be taken into account; or if he has some back-up money from a decent investor, then that's an interesting manager and it may be considered, as long as it complies with our internal risk guidelines."

Kevin Gundle of Aurum said raising capital for smaller hedge fund managers is much more difficult primarily because the cost of actually staying in business is now much higher. "Unless they grasp the nettle of regulation and distribution, they could stay in that very arid place – and I just think it's the law of the jungle. Money goes where it's treated best for performance and if you are a good performer, your performance will start to show up in the various databases, you'll start getting track and it's really just a matter of time."

Aspirant new managers can of course decide instead to join established asset management companies like Old Mutual.

Donald Pepper said he agreed that firms like Old Mutual had benefited from such a trend. "It's something that for certain people is very compelling. Clearly, if you join a firm like ours, you don't have your own name on the door. And if you think over time you can run the five billion fund by yourself, why would you give up the upside? But there are a lot of first class managers who we are now able to attract who without doubt in 2006/07 would have tried to set up on their own."

Some argue that investors have more choice in the US – given the huge number of managers trading there. But Nocera did not really agree that US funds have lower barriers to entry and argued there are significant capacity issues with existing well-known managers there too. "If anything I'm taking money out of the guys that are closed as they're getting bigger and I am using that cash flow to try to feed new names into the portfolio," he said.

"We're not against giving money very early on," Nocera added. "Generally these are people that have very strong referrals, either from existing firms we know very well, or from professionals or family offices we know well based in a specific region, such as Asia which is mostly a frontier type of market. If you allocate early a small amount of money, the risk is limited and you have time to get to know the manager before building a larger position."

On the question of where the best ideas are today and going forward investors had varied views.

Ian Prideaux highlighted certain established managers like Viking and Litespeed as well as the South African manager Visio, but his experience with CTAs and macro had not been uniformly positive.

Sanjay Tikku was not as down as some others on the CTAs, but argued that there ought to be major opportunities ahead for discretionary macro managers, especially in emerging markets – given "the likely diversity of outcomes in different emerging markets" going forward.

Mattia Nocera also noted the emerging markets – and Asia particularly, because "there is lot more inefficiency and you have a country like China which has four times the population of the US, with a fairly developed equity market although partially closed to us, with new talented managers."

Robert Howie of Mercer said that fundamentals are being more rewarded, which will help long/short equity and long/short fixed income. "There are still global imbalances but I think policymaking is more predictable, which means that macro might start working again. In the current environment there are a lot of positives and we've been long-term believers in CTAs and that belief has remained so."

Among the broad range of strategies that Old Mutual runs, Donald Pepper pointed out that an area which is currently fairly uncrowded is quantitative equity market neutral. "Back in 2007 there were a lot of people doing the same thing. What they demonstrated then was being market neutral is not the same as being uncorrelated – they were all risk-on prone and when the markets became risk-off they suffered significant drawdowns. Our global equity market team learned from that. They significantly re-engineered the investment process, and their correlation over five years is now 0.03."

Benedicte Rabier of Amundi said: "It's really interesting to look at the funds which are activist and which have a seeding power or an origination power across any strategies. It can be a bank loan refinancing, event driven, emerging market Asia – but you have to look at the managers who have a strong network and who have past experience in certain specific areas."

Kevin Gundle of Aurum said: "We had some exposure to CTAs in 2008 which was helpful, but we haven't invested since then. We are very nervous about credit. It's a crowded trade. We don't like activists, I think activists is a one-way bet – maybe you're right, maybe you're wrong." But Aurum did like quant equity market neutral – and had generated good performance in recent times from that strategy.

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Sanjay Tikku

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Robert Howie

What investors want from hedge funds

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