Manager selection

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Introduction

The past few years have seen significant proliferation of hedge funds and funds of funds. Demand from all investor segments is on the rise as hedge funds gain greater acceptance as an asset class with attractive risk/return characteristics. Supply is expanding due to low barriers to entry, and the increased participation of investment banks and asset management institutions.

As of mid-2002 the working numbers for the hedge fund and fund of funds universe were approximately 6,000 and 450 respectively. The asset base of hedge funds was estimated at US$600 billion, including US$150 billion in funds of funds. In addition to becoming larger, the universe has become more global, with the acceleration in new manager offerings from Europe and Asia, and more complex in terms of the number of strategies available.

With so much fragmentation and diversity in hedge funds, there is a very large dispersion in returns. The quality of managers has not necessarily kept up with the increased quantity. Good manager selection is therefore critical in hedge fund investing. Funds of funds pride themselves on their ability to provide guidance in manager selection, but investors also now need guidance on how to select fund of funds managers. This chapter examines the topic of manager selection at two levels:

1. how funds of funds select individual hedge fund managers; and
2. how investors should select fund of funds managers.

Individual hedge funds

Exhibit 6.1 illustrates the steps in the selection process from idea sourcing to investment decision. These steps are generic to most fund of funds practitioners; the differences tend to arise in the areas of emphasis, resource commitments and implementation.

Idea sourcing

We estimate that approximately 1,500 new hedge funds of varying styles and strategies are created each year. They typically come to the attention of funds of funds from three main sources: direct approaches; industry contacts; and database searches.

- *Direct approaches*. Many new hedge funds automatically come to funds of funds seeking seed investment. Their participation and stamp of approval are very valuable to these

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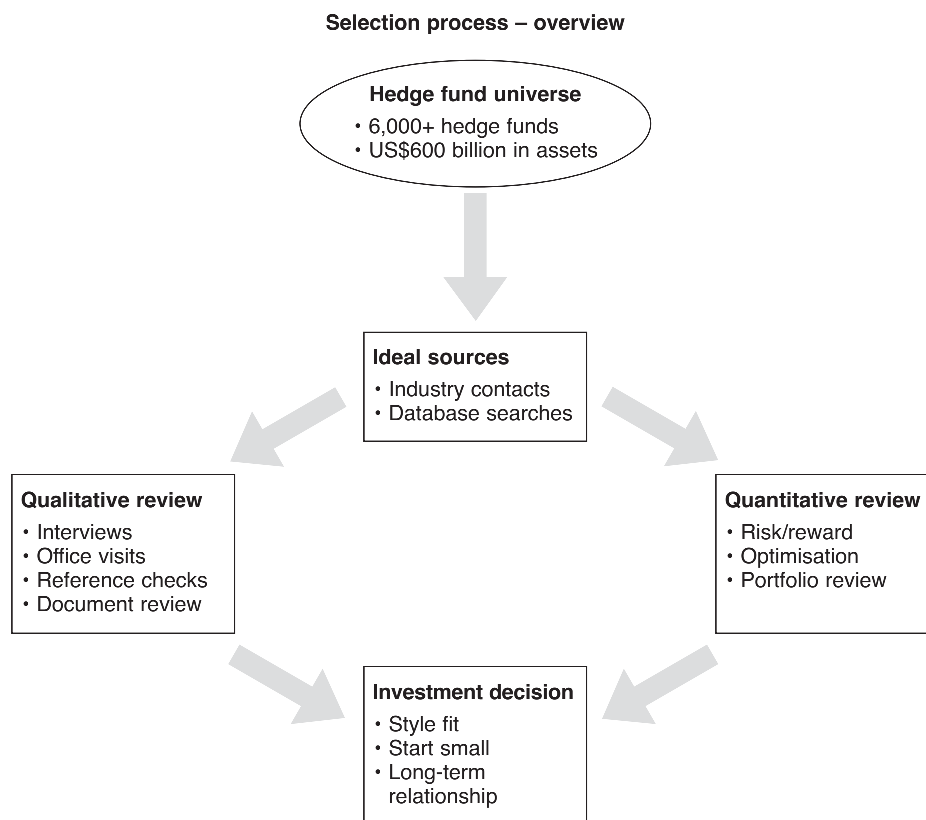
Exhibit 6.1
Selecting individual hedge fund managers



Source: Permal Group.

firms. Some funds of funds have a reputation for being long-term investors, who act gradually and rationally, enhancing access and building trust with the top managers.

- *Industry contacts*. Some fund of funds groups have been major investors in hedge funds for decades. As such, their investment teams have extensive experience in selecting such funds and have built a strong reputation and network of global contacts. The diasporas of the large hedge fund groups such as Quantum and Tiger can be a good source of talent because a great deal of experience and quality may have been built up in these organisations. Some firms have been particularly successful in nurturing younger managers as an important source of future talent. In turn, some of these managers have spawned a large range of hedge fund management companies, which can provide a broad network of industry intelligence. Similarly, prime brokers, bankers and other hedge fund investors all provide investment ideas and information on emerging talent.
- *Database searches and other electronic media*. Most major funds of funds have extensive proprietary databases and also utilise third-party databases, such as Altvest and Asset Sight, as means of gathering information about new product launches. Certain investment banks send monthly information by e-mail on new management groups. Media sources such as trade and non-trade journals generate manager ideas as well. The advantages of

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this increased data flow centre on the provision of different and rapid channels of new ideas and verified data.

Using these various channels, a fund of funds can ensure that it captures as much of the investable universe as possible in terms of available products and managers. Of the 1,500 annual product launches, many are usually dismissed after only cursory review. These preliminary rejections arise for the following reasons:

- *definition*. A number of 'hedge funds' are in fact long-only funds that are branded as hedge funds in an attempt to justify their fee structure;
- *size*. Many new managers have difficulty raising more than US$10–20 million in assets under management and so are unsuitable targets for investment because of the minimum amount of capital that could be deployed in them by institutional investors;
- *inconsistencies*. It is often quickly apparent that the purported strategies or records of the managers are inconsistent with what is known to have occurred in the market; and
- *strategy*. Certain hedge fund strategies may not be appealing to the fund of funds manager as a matter of philosophy or general lack of appetite at the time.

After sourcing the manager, the next step in the process entails an initial meeting, the purpose of which is to review the manager's strategy, portfolio construction methodology and market outlook.

As a result of this preliminary review the fund of funds selects a sub-set of the universe for interview and further due diligence. This process should be dynamic and forward-looking, taking into account both qualitative and quantitative factors.

Qualitative due diligence

The guiding principle is to identify managers who are experienced and have performed well during good and bad periods, possess an understandable edge (ie, a competitive advantage), have a stable, well-staffed organisation, and, perhaps most importantly, invest their own net worth in their funds. The qualitative due diligence process encompasses a number of stages, starting with an examination of the precise investment methodology of the manager and identifying what, if any, analysable competitive advantage the manager might have.

Secondly there are office visits. These visits are important in order to determine the adequacy and depth of the underlying organisation that supports the manager's investment activity. The goal of this process is to make sure that the manager is focusing his or her efforts on managing money and not on managing an organisation. Areas that are reviewed include ensuring that appropriate systems are in place, for example, to monitor risk, and to ensure compliance with relevant regulations and investment restrictions, and that the manager's staff demonstrates appropriate levels of morale and commitment.

Thirdly, there are reference checks. Despite the expansion of the hedge fund industry, it is still a relatively small and tightly knit community, and checking references with colleagues in the industry is invaluable. Funds of funds use their broad network of industry contacts, as appropriate, to derive a firm opinion as to the integrity and trustworthiness of the prospective manager and his or her team. Contact is made with the manager's prime brokers and other funds of funds that are currently investing with them to obtain references. It is also worth-

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while to check for criminal records, law suits and other legal actions. In some instances, private investigators have been used.

Manager integrity is not a given. We once met a manager who told us that he had a PhD from a well-respected university. His offering documents stated that he had a Master's degree and had additionally taken some doctoral-level courses. In spite of the fact that a trade publication featured the manager as having the best Sharpe ratio in his style, we did not hire him. Although they were probably unrelated to his academic credentials, the manager suffered massive trading losses about a year after our visit and went out of business.

The final stage in qualitative due diligence is document review. Offering documentation is reviewed in order to:

- ensure the legal structure is consistent with what has been described and presented, for example, in areas such as redemption procedures;
- ensure that the remuneration structure does not contain any 'hidden fees' that might adversely impact upon performance; and
- review the biographies of the management team and fund directors.

Funds of funds should review the financial statements to ensure that strategy is consistent with the manager's description. An accounting background can be very useful for this aspect of due diligence.

Qualitative due diligence is best done at the manager's office and involves more than one representative from the fund of funds. Sound practice is to have at least two meetings before deciding to invest.

Fees should be part of the assessment criteria and some funds of funds are occasionally successful in negotiating more attractive pricing with managers. However, it may be unwise to reject a manager based solely on fee considerations, or, conversely, to hire a manager because he or she gave you a fee rebate. There is often a need to pay more for unusual talent.

In the long-short area, one of the unique challenges is assessing a manager's short selling skills, especially when they are coming from a long-only environment. In some instances, long-only managers do have some short selling experience, whether it is in their mutual fund portfolios or in their personal trading accounts. It is useful to examine these records as part of the assessment. In most instances, however, this experience is limited and can only be gauged as part of the qualitative assessment.

In this assessment fund of fund managers should look at the manager's approach to stock selection. Is it a bottom-up, fundamental approach that can be applied to the short side as well as the long side, versus a top-down approach where a manager is looking for a short to hedge a long in a specific sector? Secondly, what type of long-only strategy has the manager run? Was it an index-conscious, buy-and-hold strategy, or was it a truly actively managed portfolio? Lastly, a manager's experience in the markets should be considered. Is he or she a long-only manager with a couple of years' experience seeking higher fees, or someone with a long track record managing significant assets? Managers who shift from multi-billion dollar long-only portfolios to a much smaller hedge fund asset base can be very good at getting in and out of positions, whether it is on the long or short side. A good example of this is Jeff Vinik, former manager of the Fidelity Magellan Fund, who made a very successful transition to the hedge fund world.

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Quantitative due diligence

Quantitative due diligence begins with the analysis of monthly return patterns, standard deviations and correlation matrices relative to other managers, and the appropriate benchmarks and style indices. Other statistical information to consider includes length and size of drawdowns, downside deviation and performance during periods of stress. This review should provide an indication of a manager's ability to perform in up and down markets.

When analysing historic information it is important to focus on indirect factors that impact this performance, including the size of assets managed, leverage employed, market environment and portfolio construction: that is, did the gains (or losses) come from only one good (or bad) trade, and is the strategy model-driven or discretionary? Reviewing the manager's portfolio to ensure its contents are consistent with the manager's stated strategy is an important part of this exercise.

For us, quantitative factors such as historic performance account for roughly one-third of the evaluation decision. Manager selections, like most investment decisions, are made on the margin. Virtually all the managers marketing their hedge funds have good statistical records. The final decision becomes a qualitative one.

No strategy is riskless. One needs to understand what risks were taken to generate the numbers and determine if the performance is sustainable. There are many arbitrage strategies, for example, that have very compelling risk/reward properties until the frame of reference changes. Recently a European merger arbitrage manager who was generating around a 1 per cent return per month consistently for 12 months suffered a -10 per cent drawdown in one month. As more 'fat tail' events occur, there is a growing list of hedge fund managers whose Sharpe ratios drop sharply from three to zero.

Capacity is an issue as well: more investors migrating to the strategies with the best backward-looking returns will destroy the alpha for which they are searching. The likely outcome is very mediocre returns that, on an after-fee basis, may be inferior to those on bonds.

Investment decision

If a new manager passes the due diligence process and their strategy fits within the fund of funds portfolio, our approach is to start small: that is, to limit exposure to 1 per cent of the portfolio. This is the ultimate risk management tool, as there is an above-average fallout of managers in their first year. After a period of 12–18 months, we typically reassess our investment and either increase it to a more meaningful position or replace it with another manager. These tend to become long-term relationships. Knowing our managers well helps us to know how and when to use them best.

For each manager we establish an 'expected value' or standards of risk and return based on their peer group. Deviations from expected values are usually a trigger for reducing exposure to a manager or removing them outright. Other reasons for changes in manager allocations are: (a) substituting managers who are in a trial phase; (b) realising some profits after a manager has had an outstanding period of outperformance; or (c) changing the style tilt of the portfolio based on our market view.

Monitoring

All of the managers with whom we invest are closely monitored. Performance is reviewed

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constantly and any deviations from our 'expected values' will prompt a closer examination. We have in-person reviews with the managers twice a year and maintain frequent contact with them via other channels.

The concept of 'expected values' from managers is important both for manager evaluation and for risk control. For example, let us consider three long-short managers in our Japan programme. Manager A returned 230 per cent in 1999 and declined 6 per cent in 2000, manager B returned 152 per cent in 1999 and declined 49 per cent in 2000, and manager C returned 20 per cent in 1999 and was up 35 per cent in 2000. After 1999 the temptation would have been to fire manager C and add more money to managers A and B. However, because our 'expected value' for manager C is that he is very risk-averse and very good at shorting, we were not disappointed with his 1999 performance. It was fortunate that we retained him, as he was one of our best managers in 2000. Meanwhile, we were satisfied with manager A, because he played good defence after a very strong up-year, and we decided to terminate manager B because he was clearly a disappointment on the short side.

The best way to reduce risk in our portfolios is through diversification among managers, strategies and styles. At the manager level, our in-depth understanding of their strategy helps us to assess embedded risks in their portfolios (market, credit, liquidity, leverage) and their overall weighting in our portfolio. We have a high degree of transparency in our investments, either through separate accounts with managers or because we have a level of trust with them that affords us access to the information. Transparency typically depends on the manager, but our approach has always been to communicate with our managers informally and frequently, and to know their portfolios, and how they will react in different markets and situations. We rely on a monthly letter from the manager that details the manager's positions, as well as our informal but frequent telephone conversations with him or her. Regular contact with all the managers is also maintained through formal in-person meetings twice a year, frequent office visits, telephone and video-conferencing as well as e-mail and web-based communications.

For each of the managers with whom we invest, performance is monitored semi-monthly and the manager is contacted if there are any meaningful deviations in performance (positive or negative) relative to our expectations for that manager's style and strategy. On a monthly basis analysis of each portfolio's overall exposure is prepared, including country and sector weightings, and, where applicable, credit exposures.

As part of the ongoing due diligence process, managers are visited in their offices, including meeting and reviewing their back office personnel and operations. In addition to talking to the managers frequently, we are in constant contact with a manager's back office, their administrator and, at times, their prime broker and auditors. Issues such as employee turnover, lateness/abnormalities in reporting performance, newsletters and/or portfolios, and negative feedback from the service providers are always supervised.

Removal

The main triggers for reduction/removal are style drift, discrepancies between statements and actions, and personnel changes (particularly incentive fee-based personnel) that would suggest organisational strife. There are early warning signs such as high turnover, lateness in reporting and discrepancies in performance as indicated by a prime broker versus the manager. A manager who claims that he or she has closed his fund to new investment and yet is actively marketing is also suspect. A dramatic increase in assets managed may be a red flag

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that the strategy cannot handle so much capacity; a dramatic decrease may signal a loss of investor confidence.

If outperformance has been generated by excessive levels of risk or leverage, this is cause for termination as well. Exceptional performance, good or bad, is cause for alarm. As fund documents such as offering circulars and annual reports are updated, unpleasant surprises sometimes emerge.

Managers who stray from their area of expertise or their mandate, or show lack lustre performance after being given a chance to perform, are typically terminated. For newer managers whom we decide to terminate, the implementation is usually rapid because it is a small allocation (under 1 per cent of the portfolio). For more established managers, where we have a larger allocation, the termination process is usually more gradual. This is to avoid disruption and maintain good relations to facilitate reallocation in the future.

Fund of funds managers

Funds of funds provide a number of services to investors, from manager selection to asset allocation to risk management. Arguably, the most valuable of these is manager access and selection – valuable, because, if done well, the services that follow become easier to perform.

The first section of this chapter described how funds of funds apply screening criteria to bring the hedge fund manager universe down to a more manageable number. This section touches briefly on various aspects of the value added by funds of funds and then proposes a set of qualities to look for when selecting a fund of funds manager.

Value-added factors

Manager access

In the hedge fund world, being 'closed' for new investment is a relative concept. Capacity of the managers with whom a fund of funds invests varies by manager and strategy. Nevertheless, funds of funds should be broadly diversified and not overly dependent on individual managers reaching capacity limits. Large funds of funds that are experienced investors in this market-place should have preferential access to the most sought-after managers. As their managers grow and encounter capacity constraints, they sometimes close the fund of funds to new subscriptions. In principle, this is an illustration of the quest for quality over quantity.

The main recipe for the success of a fund of funds is to find the best managers and find them early. Building a relationship early in the careers of talented managers, before they become well-known, is crucial. Fund of funds managers should constantly keep their portfolios refreshed with new manager talent, thereby enhancing capacity at the fund of funds level.

For established managers, access to further capacity is based on building long-term relationships. For many hedge funds, a fund of funds organisation may represent 10 per cent or more of their business and is therefore an important client. For others, funds of funds are considered 'institutional' investors that are beneficial to the stability of their asset base. They are often the first port of call for the top managers when shares in their funds are becoming available. Additionally, they are often put on a shortlist of potential investors when new managers are going out to raise capital.

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Asset allocation

Asset allocation is the art and science of mixing managers and hedge fund styles to meet the fund of funds' specified risk/return objectives. Traditional portfolio construction techniques, such as mean-variance analysis or the use of correlation matrices, are helpful to some degree, but the most important input is a thorough understanding of the managers' strategies and how they are likely to perform going forward.

Dynamic rebalancing among managers and strategies is also required, not only because different investment styles fall in and out of favour but also because the managers themselves are by no means static. This may involve reducing exposure to a manager whom the fund has invested with for a long time, and emotion should not come into play. Particularly during periods of high market volatility and stress, a well-timed rebalancing strategy based on a combination of clear facts and manager psychology is crucial to the success of a fund of funds.

Risk management

'Hedge funds are risky' is one of the most frequently cited reasons for steering clear of the asset class. While investor attitudes are changing and many of the newer funds appearing on the market seem to be less risky, there is no question that a rigorous approach to risk management is required. For a fund of funds, the starting point is a clear understanding and broad diversification of managers and strategies. The ongoing monitoring effort should cover the major exposures of the underlying funds (ie, sector bets, net long positions), manager's adherence to stated investment strategy as well as leverage and liquidity levels. This in turn needs to be consolidated at the portfolio level.

Fees

Are these services worth the extra layer of fees? This depends on how much value the fund of funds is adding. Manager research and selection are specialist activities that are not cheap to replicate. Portfolio construction and risk monitoring also require a different set of expertise from traditional fund management. Funds of funds offer flexibility and often enhanced transparency for investors whose exposure to hedge funds is relatively small. For investors who are new to the category, funds of funds offer a means to ramp up on the learning curve.

Fund of funds selection criteria

Experience

A recent study shows that 63 per cent of fund managers in the United Kingdom have less than three years' experience managing their fund. This is an alarming statistic. In hedge funds the comparable percentage is undoubtedly even higher because so much of the growth is new. A 'safe pair of hands' is one that has navigated through bear markets, bull markets and various economic scenarios, not to mention stress points in the financial system such as the LTCM debacle.

Many firms are launching funds of funds for the first time; track records are usually less than two years or are based on back-tests. The real world is invariably different, especially as the market environment shifts and strategies that depended on one frame of reference do not perform well when this framework changes. Experienced fund of funds managers are those who have actively invested in different hedge fund managers and strategies through different economic and market cycles. This helps in recognising investment patterns.

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Size

Being small can be good for the hedge fund manager because it means one can be nimble; but at a fund of funds level, size provides capacity to managers who are difficult to access, affords a greater research infrastructure and provides comfort to large investors that their mandates can be more easily invested. Size attracts good deal flow. There are not many players with more than US$2 billion in hedge fund investments.

Proven record: a minimum of five years of real returns (not a back-test) should be used to evaluate the fund's risk-adjusted performance. Performance should be compelling in absolute terms, as well as relative to traditional asset classes. Performance should be evaluated on a risk-adjusted basis and over a market cycle.

Product range

Investor preferences vary, either due to the individual geographical and risk/return requirements or to changing market conditions. A globally diverse product line of consistent quality is needed to accommodate this.

Client service

Investing in hedge funds does not have to be user-unfriendly. Clients should feel comfortable with liquidity, investment minimums, reporting and access to information during times of market uncertainty. Timeliness, quality of reports, availability and responsiveness of senior personnel are attractive to investors.

Final thoughts

Investors are advised to be mindful that some aspects of the traditional world do not travel well. Investors should be sensitive to the following:

- *beware of terminology!* For example, the term 'market-neutral' can very easily be misunderstood. Many investors consider market-neutral to be a separate, risk averse asset class. This asset class seems to have all the properties that are on investors' wish lists today. There is a view among new entrants into this arena that market-neutral is going to solve all the problems in their investment portfolios. The reality is that all investment strategies are directional, betas and correlations are not stable over time, and frames of reference change;
- *excessive reliance on quantitative inputs can be detrimental*. It is relatively easy to construct funds of funds with superb Sharpe ratios on a back-tested basis for a given period, but when rolled forward by six months the mix may perform very poorly. Additionally, some of the funds that the optimiser picks may not be investable either because the fund is closed or because the strategy does not have capacity; and
- *the hedge fund industry is a business of artisans*. Hedge funds do not always fit neatly into risk and return buckets or apply institutional-style investment processes. The same is true for funds of funds.

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